THE LAW ALONE CAN GIVE US FREEDOM – GULAGGING IN VAT LAW

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Introduction

When Goethe was a young man he rebelled against the strictures of the laws of drama. This rebellious phase was called "Sturm und Drang". Its basic aim was to create theatre plays unfettered by the traditional laws of unity, which had governed the genre since the ancient Greeks. At least one play written during this period – Götz von Berlichingen – was unstageable. Once he matured, Goethe abandoned the rebellion and came to the view that a certain discipline, which he called "Beschränkung" (restriction), was necessary and that the law alone can give us freedom[3]. This maxim applies not only to the theatre but, it seems to us, to all walks of life and contains, therefore, a universal truth. In passing it should not be forgotten that among all his many callings, Goethe was also a lawyer.

Transposed to the field of law, what the maxim means is that there is no freedom outwith the rule of law and, hence, that the rule of law must be protected. What in turn this means is that it is necessary to defend any legal system against threat or attack from within the system itself, otherwise the rule of law is endangered. This seems self-evident. If, in order to defend the system, its basic principles are abandoned or suspended, or the system itself is suspended, then the attack or the threat has been successful, because the system has been weakened. Thus, if challenges to the established system, be they by terrorism or less violent means, provoke the suspension of fundamental rights, including defence rights for instance, then the reaction is self-defeating.

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3 "das Gesetz nur kann uns Freiheit geben" – Natur und Kunst, last verse, last line - Johann Wolfgang Goethe - Gedichte, Reclam, Universal-Biblothek Nr.6782-84, Stuttgart, 1969, p. 132-133.

This applies in regard to the law of nations as much as it applies to the domestic system of any state or to any constitutional order of states such as NATO, the UN or the EU. We believe, however, that this seemingly incontrovertible principle has of late been honoured more in the breach than in the observance.

Whether or not the military interventions in the Balkans, Afghanistan and Iraq were legal and commensurate with the rule of law, may be left undecided for now. There are currently so many instances of flagrant disrespect for basic rights or for the judicial process, that it is wholly legitimate to fear for the rule of law. A few examples will suffice.

The trials being prepared by the USA of suspected Al-Quaeda adherents captured in Afghanistan is a good place to start. If these persons are prisoners of war, they should not be tried at all, but sent home. If they are not prisoners of war, then presumably they are suspect criminals. If so they are not going to be tried in the criminal courts as all other suspect criminals with the full panoply of defence rights. On the contrary, they are going to be tried by military court and are not to be allowed to see, far less to disprove or even comment on, much of the prosecution evidence. They are not to be allowed to appoint their own defence lawyers, but will have to accept those appointed by the Pentagon. These lawyers will not even be experienced practitioners in private practice but US military lawyers. What we are witnessing does not seem different than the show trials in the USSR under Stalin. The resemblance holds, right up to the severity of possible sentence – death.

The presumption underlying all this is, of course, that the accused are terrorists. This presumption cannot, however, be made without reversing the presumption of innocence. The special courts are being set up because it has been ruled by uncontestable decision that the accused are terrorists. Once the presumption of innocence has gone, then the rule of law is in terminal decline. Indeed, this is the weakness of all specific so-called anti-terrorism laws by whomsoever they may be adopted.

An example is the Anti-Terrorism, Crime and Security Act 2001 in the United Kingdom, which has been strongly criticised by civil liberty groups. Arguably the most worrying feature of this law is the power it gives the state to certify people as suspected international terrorists and to detain these people without trial indefinitely. Thus on a mere certification *of suspicion* one of the fundamental principles of the Magna Carta (and the equivalent, but different, Scottish rules) may be set aside, and on the same grounds a derogation is made to Article 5(3) of the ECHR. According to Article 15 of the ECHR no such derogation is permissible in the absence of war or public emergency "*threatening the life of the nation*". The United Kingdom was not at war at the time nor was there any

other emergency threatening the extinction of the British people. The government merely said there was[4].

Similar criticism can be made of the government of the USA. Based solely on intelligence and on no standard of legal proof whatsoever, the administration issued an order in September 2001 freezing the assets of 27 different bodies that, according to it, supported terrorist activities[5]. The order also granted the Treasury Secretary the authority to seize the US assets of any foreign bank refusing to cooperate with the US, a practice meeting the definition of extortion[6]. There is then the US Patriot Act 2001[7]. This act allows the detention without trial of persons for up to six months on a renewable basis, if the Attorney-General certifies that national security is at stake.

The danger is not so much in the framing and adoption of such laws as in the attitude of the authorities. Specific anti-terrorism laws, suspending or denying defence rights, may be repealed once their purpose has been met. If the attitude remains, however, they may be re-enacted. Indeed the adoption of repressive laws seems to be a reflex reaction of not a few Western states to so-called threats to national security. If the attitude remains then basic rights can be suspended, not only in regard to terrorism, but in respect of crime in general or specific types of criminal behaviour in particular. In other words a habit or mind-set forms and this manifests itself in other fields or may do so. There is then a contagion effect, and bit by bit the law turns in favour of the state and the rule of law is eroded.

One example of this is the Proceeds of Crime Act 2002 in the UK. Under this act, the courts are empowered to freeze the assets of anyone accused of certain crimes, with the effect that in principle none of these assets are available for the accused's defence. As an exception funds may be released from the frozen assets, usually up to a stated amount for *"legal advice and representation"* but the

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4 Parliament was informed of this state of affairs on Monday 12 November 2001. Nor was this the first time the UK had invoked Article 15; a derogation was entered in 1988 against the background of terrorist offences in Northern Ireland.

5 The Executive Order 13224 blocking Terrorist Property. See also the Terrorist Sanctions Regulations (Title 31 Part 595 of the US Code of Federal Regulations), Terrorism List Governments Sanctions Regulations (Title 31 Part 596 of the US Code of Federal Regulations), and Foreign Terrorist Organisations Sanctions Regulations (Title 31 Part 597 of the US Code of Federal Regulations).

6 Extortion is the act of obtaining money or any other advantage by threats (see G.H. Gordon, The Criminal Law of Scotland, W. Green & Son Ltd, Edinburgh, 1967, Chapter 21, Page 645).

7 Signed into law on 26 October 2001.

prosecutor must be notified first, and any variation of the spending limits requires his written agreement[8]. Where the Act applies, then, the prosecution has a perceptible influence on and a certain control of the conduct of the defence. In the UK the severity of this Act is mitigated to some extent by the availability of legal aid, but in the USA, where a similar law obtains[9], not even this mitigation is possible, there being no legal aid available. In the US, then, the accused is thrown upon the Office of the Public Defender if he cannot obtain the release of funds and his defence becomes something of a lottery.

The point of this, for present purposes, is that freezing orders result from a presumption that the assets have been accumulated illegally in whole or in part and should, consequently, not be made available for defence purposes. That presumption is a wholesale negation of the presumption of innocence. The Proceeds of Crime Act in the UK derives from the same mind-set as suspends fundamental human rights, including basic defence rights for suspected terrorists.

Nor can it be said that this pernicious erosion of the rule of law is restricted to criminal law. In both the UK and Germany it is taking place in the field of indirect taxation. This is the focus of this paper. Before turning to this in detail, however, two other pieces of contextual background seem relevant. First, as will be seen shortly, the VAT rules and their application in both these Member States are not consistent with the common VAT system of the EU. At some stage the Council of Ministers may have to become involved, VAT being the ultimate responsibility of the Council. The fact that the current President of the Council of Ministers is opposed to the rule of law, as witness his frank admission before the European Parliament on 2nd July 2003 that 1% of the laws adopted since his government came to power have been for his personal benefit, does not strengthen one's faith that the Council of Ministers will be able to respond adequately should it be called upon to restore the rule of law[10]. Secondly, it helps to bear the corrupting influence of power in mind. It is an inherent trait of government to expand power, and the progression is towards absolute power. This is why democratic states have systems of checks and balances, which include the protection of the individual through the judicial process and adherence to the rule of law. In certain circumstances, however, the case is advanced that a given threat cannot be dealt with adequately unless the normal rules, including

8 See Proceeds of Crime Act 2002, ss. 40-47, and, on restraint orders generally, RSC Order 115 and its Practice Direction.

9 Collectively known as the civil forfeiture rules, there are in fact over a hundred forfeiture statutes, the most often-cited being the Civil Asset Forfeiture Reform Act, 2000, and, again, the Patriot Act.

10 See European Parliament, Verbatim report of proceedings ("Rainbow"), Sitting of Wednesday 2nd July 2003.

the checks and balances, are set aside. This is what happens when terrorism poses or seems to pose a threat. It is also happening in the field of VAT enforcement, and, in this latter respect, the development is arguably more disturbing because, unlike anti-terrorist laws, it passes virtually unobserved.

The Essential Features of the Common System

To appreciate the danger of current attitudes towards VAT law enforcement in Germany and the United Kingdom, it is necessary to understand the essential features of the common VAT system.

Most businesses or undertakings in the EU are registered for VAT, have a VAT number and make regular VAT returns to their Member State of domicile. They are thus "taxable persons" as defined in Article 4 of the Sixth VAT Directive (the 6th Directive)[11]. Running VAT accounts, making VAT returns and other such administrative work may be burdensome to business, but taxable persons do not pay VAT as such. They bear no VAT burden of a fiscal nature. Taxable persons do pay VAT on their purchases[12] and this is known as "input VAT". However, they also collect VAT on their sales[13], and this is known as "output VAT". So they are spenders and collectors. If they spend more than they collect, then the state refunds the difference. If output tax is zero, then the firm is entitled to a refund of all its input tax, for instance. If they collect more than they spend, then what they remit to the state is again the difference, i.e. the output VAT ***less*** the input VAT. Either way the VAT burden of the taxable person is zero. If the taxable person collects exactly the same amount by way of output VAT as he spends by way of input VAT, then he remits no money to the state at all. A hypothetical situation, but one which neatly summarises the way the system works.[14]

11 6th Council Directive of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of Value Added Tax: uniform basis of assessment (77/388, OJ 1977 L145/1).

12 *Ibid.,* Article 2(1).

13 *Ibid.*

14 The deductions system is described at Title XI of the 6th Directive.

The person who bears the VAT burden is the final consumer, who, by definition, is not a taxable person for VAT purposes[15]. The supply chain from producer or service provider to the consumer may be long or it may be short. However, the length of the supply chain does not affect the ratio between the tax ultimately paid by the final consumer and the value of the thing supplied[16]. The final consumer pays VAT only on the last transaction in the chain, i.e. the sale by the last *taxable* person in the chain to the first *non-taxable* person. This is so because each transaction is a complete unit in itself, subject to refunds or deductions as the case may be. In other words, each taxable person is "clean" at the end of each transaction. He incurs no tax burden and consequently he has no tax burden to pass on to the next taxable person in the chain. VAT is thus a non-cumulative tax. As such all that the length of the chain affects is the ex-tax price on which final VAT is calculated (i.e. the tax base or *assiette*). This means that VAT is a much fairer tax than the turn-over taxes it replaced in many Member States, under which the tax paid at each stage was passed on to the successive stage, thereby creating tax burdens of hundreds of per cent, creating disproportionate ratios between the final tax and the value of the item traded and operating as an inducement to evasion practices.

Since each transaction is complete in itself, no taxable person is responsible for the errors committed by any taxable person at previous or subsequent stages in the chain. It follows that VAT authorities must also operate on a transaction by transaction basis. This means that, if a taxable person has met any relevant conditions and has completed the necessary returns correctly and/or in good faith, then his rights under the common system must be respected. Errors, shortcomings, failures and such like committed elsewhere thus fall to be treated in their immediate, hermetic context and may not in any way be imputed to others in the supply chain.

Under such a system it is impossible for a taxable person to acquire goods and services free of VAT when trading entirely within his Member State of domicile.

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15 The Court has had to pronounce several times on whether an individual claiming to be a supplier was *in fact* the final consumer. Equipped with a VAT number, anyone can claim a deduction of input VAT on the grounds that they were acting in the course of their business, and it can sometimes be very difficult to show who in fact was the final recipient of the good or service. The same good (to take a simple example, a pen) might have a business and a personal application. See, inter alia, Case C-230/94 *Renate Enkler v Finanzamt Homburg* [1996] ECR I-4517, and Case C-23/98 *Staatssecretaris van Financiën v J. Heerma* [2000] ECR I-419.

16 See Article 2 of the 1st Council Directive of 11th April 1967 on the harmonisation of legislation of Member States concerning turnover taxes (67/227, OJ 1967, English Spec. Ed., 14).

The same applies in respect of goods or services imported into the Community from third countries, since such imports are subject to VAT at the rate of the Member State of importation[17]. It should also obtain in respect of supplies between taxable persons from one Member State to another – so-called "intra-Community supplies" – but it does not. Such supplies do not attract any VAT[18]. To be precise, such supplies are recorded for VAT purposes, and are thus within the system and not exempt from it. But they may not be taxed by the Member State of supply (or origin), nor may they be taxed by the Member State of delivery (or destination). They are in fact zero-rated and this is the term that most accurately describes their status. In Community languages other than English, however, such supplies are often described as exempt supplies, and the term "intra-Community supply exemption" is in current use, even in English. The intra-Community supply exemption is an essential feature of the common VAT system.

When a taxable person, the supplier, makes a supply of goods or services to a taxable person, the acquiror, in another Member State, then the supplier, may charge no VAT on the dispatch of the consignment and the acquiror may be charged no VAT on delivery. There are some specific conditions. They are essentially that the goods or services in question must move physically from the Member State of supply to the Member State of acquisition; that the supplier's invoices state the VAT identification of the supplier and of the acquiror; that the invoice itself must be validly drawn up. These specific conditions and the intra-Community exemption itself only apply, of course, if the transaction is a transaction within the meaning of the 6th Directive. Thus:

- the supply of goods or services must be effected for consideration[19];
- the supply must be effected by a taxable person, namely any person who independently (i.e. otherwise than in a situation of employment) carries out in any place any economic activity, whatever the purpose or results of that activity[20];

17 Regrettably, the system in respect of goods coming from outside the Community is not dealt with separately in the 6th Directive. The rules for these goods must therefore be pieced together from various different provisions, notably Articles 2(2), 7(1)(b), 8(2), 11(B)(1), 12(5), 21(2) and 23.

18 Article 28c of the 6th Directive.

19 Article 2(1) of the 6th Directive.

20 *Ibid.,* read in conjunction with Article 4(1).

- the taxable person must be acting as such, i.e. for the purpose of his business[21];

- the supply must be completed; in the case of goods this means the transfer of the right to dispose of tangible property[22]; a supply of services is defined as any transaction which does not constitute a supply of goods[23].

If there is a taxable transaction and the conditions for the intra-Community supply exemption are met, then the exemption or zero-rating is mandatory. Traders are not only entitled to rely on it, but they are obliged to rely on it.

Four points may be made to complete the picture. First, what the intra-Community supply exemption means is that on a supply there is no output VAT. Consequently input VAT is recoverable in full[24]. Secondly, on an acquisition there is no input VAT. Consequently, output VAT on a re-sale is payable in full[25]. Thirdly, intra-Community supply constitutes a change of fiscal jurisdiction, the jurisdiction of the Member State of origin ending and the jurisdiction of the Member State of destination beginning at the time of the supply. Thus the supply chain ends in the former with zero tax and begins again in the latter with zero tax. Fourthly, provided the conditions for the intra-Community supply exemption are met, neither Member State is entitled to question the history of the goods before or after jurisdiction passes. The documentation required for the intra-Community supply exemption is, thus, probative.

These, then, are the essential features of the common VAT system in the form in which it has been applicable to commercial transactions between taxable persons since 1st January 1992. It is perhaps still necessary to add that this common system is a vital feature of the trading system in the EU. It is designed to facilitate the free movement of goods and services throughout the Community. It is absolutely essential, therefore, that the system be predictable in its application; i.e. a given action will produce a given and certain fiscal consequence. In the fiscal domain this is precisely what the principle of legal certainty demands. The common VAT system is governed by this higher ranking norm from start to finish.

21 Article 2(1) of the 6th Directive.

22 Article 5(1) of the 6th Directive.

23 Article 6(1) of the 6th Directive.

24 Article 28f(1) of the 6th Directive.

25 Implicit in *ibid.*

The Phenomenon of Carousel Fraud

This phenomenon is well documented[26] and comprises three basic elements:

- the acquisition of goods free of VAT and thus without incurring any input VAT;
- the selling of these goods to consumers with the appropriate VAT;
- failing to pay the VAT to the state.

This kind of fraud only works if the goods are acquired VAT free. To achieve this goods are supplied to other Member States, so benefiting from the intra-Community supply and acquisition exemptions and giving rise to a refund of input tax. The goods may be sold to the final consumer at that point or moved to another Member State or States so as to lay as difficult a trail as possible. Ultimately, though, there is always a retail sale and embezzlement of the state's money. It is not necessary for every trader in the supply chain to be aware of any illegal intent. Indeed it is in the interests of the "ringleader" that as few traders as possible know of any conspiracy to defraud. Thus many traders may handle goods without having the slightest inkling of the illegal intentions of others elsewhere in the chain. The fraud is dubbed "carousel" because of the circular movement often used to achieve VAT free supplies and lay a false trail. Those taxable persons who make the final sale and collect the state's money disappear, with the money, the profit being the embezzled tax. This frustrates the tax authorities.

According to a Presidency note of the Council of Ministers of 5th April 2000 (Fisc 45 CRIMORG 58)

> *"the most serious fraud in intra-Community international trade is based on organised 'carrousel' fraud ...".*

26 It is mentioned in the Report of the European Court of Auditors for 2001 (OJ C 295, 28.11.2002, p. 1 at pp. 28-29), and the Report of the European Anti Fraud Office for the year ending June 2002 (OJ C 328, 30.12.2002, p. 1 at p. 15), as well as in numerous Council of Ministers' documents, among them a Presidency note of 31st January 2000 (FISC 15 CRIMORG 14), a Presidency note of 13th March 2000 (FISC 37 CRIMORG 47), a Presidency note of 5th April 2000 (FISC 45 CRIMORG 58), and a Presidency note of 27th April 2000 (FISC 53 CRIMORG 68).

This does not seem to be disputed by any government or EU institution. The phenomenon is perceived as a threat to national budgets and is also a fraud on the Community budget, since the latter is made up in part by payments from national VAT receipts.

Carousel fraud does not, however, outweigh the common VAT system in importance.

The UK Approach

A The United Kingdom has recently made a radical change to the VAT Act 1994. The VAT Act is the main vehicle by which the UK implements EU VAT directives. These changes were presented to Parliament by the Finance Minister on 9th April 2003 in the following laconic terms:

> "*Anti-avoidance measures on VAT fraud … are set out in detail by the Inland Revenue today"*[27].

Parliament was subsequently informed in hyberbolic terms by a junior minister (Mr Boateng) that VAT fraud and missing trader fraud *"costs us billions"*[28]. Later in the same debate the Paymaster General (i.e. the Government's cashier) announced that missing trader fraud "*has become a serious problem across Europe*"[29]. So, the existence of a European problem has given rise to UK domestic legislation because the problem causes an unquantified shortfall in UK revenue. The change in question overrides the common VAT system and replaces it, where certain transactions are concerned, with a wholly different and incompatible system. The Government's explanations seem rather inadequate.

The change is brought in by adding a new section to the VAT Act 1994[30]. This is Section 77A. This provision renders a taxable person at any stage of a supply chain (jointly and severally) liable to pay any VAT which any other prior or subsequent taxable person in the same supply chain has not paid. In other words any single taxable person is made liable in law for the embezzlement of state money by another taxable person by virtue of

27 Chancellor of the Exchequer's Budget Statement, 9th April 2003.

28 Vol. No. 404 HC Deb col 545 (6th May 2003) – House of Commons debates record.

29 Vol. No. 404 HC Deb col 629 (6th May 2003) – House of Commons debates record.

30 See Finance Act 2003, s. 18(1).

the fact that the embezzler has handled the same goods at some other point in time. This is reminiscent of chapter eighty of Solzhenitzyn's novel, *The First Circle*, where an offence against the state has been committed by one person out of a possible five persons. The state, not knowing which person actually committed the offence, finds it easier to send all five persons to the Gulag[31].

The gulagging[32] of the taxable person for the defaults of others, is subject to a condition in the United Kingdom. It is, according to S.77A(2), that at the time of the supply

> *"the person knew or had reasonable grounds to suspect that some or all of the VAT payable in respect of that supply, or on any previous or subsequent supply of these goods, would go unpaid".*

So, there must be some guilty knowledge imputable to the trader in question. The amending provision states that if the pricing of the goods is in some way abnormal there will be a presumption of guilty knowledge[33]. This does not give much comfort. Nor does it restrict the scope of the legislation because S.77A(8) makes clear that S.77A(6) does not preclude *"any other way of establishing reasonable grounds for suspicion"*. In the United Kingdom one can, in other words, be gulagged for VAT purposes, on the grounds that the state suspects. It is on exactly the same grounds that one can be detained indefinitely without trial under the Anti-Terrorism and Security Act 2001. At least under the UK VAT legislation the gulagging can be contested in court. However, a successful challenge in Scots, English or Northern Irish law will depend on proving a negative, leaving a decisive and vital advantage with the state.

A complaint has been made to the Commission of the European Communities against this amendment to UK law, on the grounds that it infringes the 6th Directive, impedes intra-Community trade, infringes a number of higher-ranking norms of Community law, has not been notified to the Commission under Article 27 of the 6th Directive and could not be authorised even if it were notified. A challenge to a demand

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31 Fontana/Collins, Nineteenth Impression, November 1974, William Collins & Co. Ltd., Glasgow, Chapter Eighty, page 616.

32 'Gulagging' in this context obtains where the state seeks to make good its losses by seeking money from individuals unconnected with those who were responsible for the loss. The term may be a neologism, but it is used for its expressiveness.

33 Section 77A(6).

for payment under S.77A will be successful for so long as there has been no notification and subsequent clearance of the new law, the constant case law of the ECJ being to the effect that, if Article 27 of the 6th Directive has not been respected, then the domestic legislation may not be enforced[34]. A challenge will also be successful if the ECJ were to uphold argument that the new law infringes Community law on substantive grounds.

For the time being, however, it is evident that the United Kingdom is seeking to fend off what it sees as a threat to the VAT system by acting in a manner wholly outwith and alien to that system. Thus, in seeking to eliminate a problem in the system, the UK would actually negate if not destroy the system itself.

B It has been pointed out to the British Government that this amendment will catch innocent parties[35]. This seems to be a matter of indifference to the Government, however. It is also apparently a matter of indifference to the courts. In two recent judgments the VAT Tribunals of Manchester and London have handed down rulings that are wholly inconsistent with the common VAT system, and that cause the bankruptcy of companies whom the courts in question accept are wholly innocent. The rulings came shortly after the announcement of the amendments to the VAT Act. In one of the cases the judge freely admits in writing that he expected his decision to go the other way. These rulings may, therefore, be a manifestation (and a confirmation) of the contagion effect.

The later of these two cases was *Optigen Ltd. v the Commissioners of Customs and Excise; Fulcrum Trading Co (UK) Ltd. (in liquidation) v the Commissioners of Customs and Excise*[36] and it was decided on 1st May 2003. The facts in summary form were as follows:

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34 Case 324/82, *Commission v Belgium* [1984] ECR 1861; Case 5/84, *Direct Cosmetics Ltd v Commissioners of Customs and Excise* [1985] ECR 617; Case 50/87, *Commission v France* [1988] ECR 4797; Case C-97/90, *Hansgeorg Lennartz v Finanzamt München III* [1991] ECR I-3795; Case C-62/93, *BP Soupergaz Anonimos Etairia Geniki Emporiki-Viomichaniki kai Antiprossopeion v Greek State* [1995] ECR I-1883.

35 In the debate following the Second Reading of the Finance Bill in the House of Commons, Mr Michael Jack, MP for Fylde, declared that *"unsophisticated small firms without the benefit of complex legal advice on contracts may be caught up innocently"*: Vol. No. 404 HC Deb col 592 (6th May 2003) – House of Commons debates record.

36 Case Reference Numbers LON/02/961-5; Decision Number 18113.

The case concerned the refund of input VAT paid by Optigen on the purchase of computer chips it sold to a company called Fancygrove. Optigen was a taxable person registered in the UK. Fancygrove was a taxable person registered in Ireland. The sale to Fancygrove was zero-rated, being an intra-Community supply. Thus Optigen collected no output VAT on behalf of the state. It had paid the input tax in order to acquire the goods to sell to Fancygrove, expecting this to be refunded as the law requires. The state refused to refund the input VAT and so the matter went to court. Before the goods in question were purchased by Optigen they had moved in a fairly lengthy chain of supply. First they had been sold by a UK company to Fancygrove, by way of a zero-rated intra-Community supply. They were then sold to a company called VW Business in the UK. VW Business sold the goods in the UK to a company called Thornton from whom it collected output VAT. VW Business did not pay over the VAT collected from Thornton and disappeared. Thornton then sold the goods on to SDP, which sold on to Fulcrum which in turn sold to Optigen. From the case report it is apparent that Optigen acted in good faith and had no knowledge of the prior supply chain.

The Tribunal decided that the transactions prior to Optigen's purchase were not economic activities within the scope of VAT and, seeing no way to distinguish Optigen's transaction from those preceding, it also deemed Optigen's transaction to have been non-economic and thus outside the VAT system. On these grounds the refund was refused.

In essence then the Tribunal refused to order the refund of money paid in good faith by Optigen by way of VAT on the grounds that the money paid over was not VAT. Thus it sought to solve what was very clearly an issue of VAT law not by applying VAT law to the problem, but by denying that VAT law was relevant on economic grounds. In this way the state has it both ways. It collects the money on foot of VAT law and refuses repayment on the grounds that VAT law is not applicable. The only party which loses is the claimant, Optigen, whose innocence and good faith is not in doubt. This ruling may be overturned on appeal and there is clearly an instance of unjustified enrichment, but as the case stands now it is impossible to reconcile with the rule of law: the VAT law of the United Kingdom does nothing other than implement or transpose the VAT law of the European Community. The London VAT Tribunal thus disapplied European Community law. It has no power to do so.

The earlier of these two cases was *Bond House Systems Limited v The Commissioners of Customs and Excise*[37]. It was decided by the Manchester VAT Tribunal on 29th April 2003. It was similar to Optigen in as much that Bond House, a taxable person in the UK bought computer chips from another UK taxable person and sold them to a taxable person in another Member State. Bond House thus paid input VAT but collected no output VAT on the subsequent intra-Community transaction. It claimed a refund of the input VAT. Prior to Bond House's acquisition of the goods there had been a supply chain as in the Optigen case. The VAT Tribunal, after going to great lengths to emphasise Bond House's innocence held:

> *"Notwithstanding Bond House's ignorance of that [fraudulent] objective, and its innocence of any wrongdoing, its relevant transactions were devoid of any relevant substance"* (paragraph 169).

Consequently the Tribunal refused to order repayment of the input VAT claimed. The comments made above in respect of Optigen apply equally to Bond House. Why these cases are wrongly decided in economic and in legal terms is indicated below. For the moment it is rather frightening to measure them against the rule of law.

Bond House and Optigen have both in effect been gulagged. What presumably prompted the state's refusal to repay large sums of input VAT to the claimants was the fact that in both cases traders ***other than*** Bond House and Optigen had embezzled the state's money and that the state was out of pocket for that reason. There was, however, no connection between the embezzlers and either Bond House or Optigen, but they have, in effect, been made to pay for the criminal conduct of others. That is precisely what gulagging is. To the extent that a state allows this to happen, it does not defend the rule of law. To the extent that a state actually promotes gulagging through legislation, it intentionally hastens the demise of the rule of law. Section 77A of the VAT Act is legislation that actively hastens the demise of the rule of law. It is on any reasonable view an extremely worrying development.

37 Case Reference Number MAN/02/534; Decision Number 18100. The full report can be downloaded from http://www.courtservice.gov.uk/tribunals/tax_frm.htm

The Substantive Errors of the Courts

A An economist might say that, whatever the reasons in law were which led the tribunals to refuse the refunds, their conclusions are absurd from an economic point of view. Bond House for example was a legitimate trader of long standing. It had bought and sold chips in full cooperation with the tax authorities. Its activities were clearly economic activities adding value to the goods it had purchased and generating income. The question whether the activities of Bond House and Optigen for that matter had economic substance would never have arisen had no fraudulent act taken place at some point in the chain.

Furthermore it is not established that the activities of others in the supply chain were devoid of economic substance. Who says that there is no commercial justification for a consignment to pass from one set of hands to another in the ordinary course of business? Is that for a judge to say?

It is simply wrong to hold that an activity has no economic substance simply because it is illegal[38]. Illegal activities sustain the economic life of many cities, some of them in the EU. They also sustain the economic lives of not a few states around the world. Any legal rule that declares that an activity is devoid of economic substance because it is illegal is based on a misunderstanding of economics. Economics is not law. It is "*the study of mankind in the ordinary business of life*"[39]. Some time later Sir John Hicks, who became a Nobel Prize winner, defined economics in similar terms:

> *"provisionally we may say that the particular aspect of human behaviour which is dealt with by economics is the behaviour of human beings in business*"[40].

38 As the Court puts it in Case C-230/94 *Renate Enkler v Finanzamt Homburg* [1996] ECR I-4517, reiterating Article 4(1) of the 6th Directive, "*the purpose or results of the activity are irrelevant*" (Paragraph 25).

39 Alfred Marshall – *Principles of Economics*, Macmillan, 1890.

40 *The Social Framework*, Oxford, 1942.

More detailed definitions have been made since then. It has been stated that

> "*the subject matter of economics is that part of human behaviour which relates to the production, exchange and use of goods and services*"[41].

According to Samuelson (another Nobel Prize winner),

> *"any society must meet three fundamental economic problems: what commodities shall be produced and in what quantities, how shall such goods be produced, and for whom are goods to be produced?"*

To this he added that

> "*these would not be problems if resources were unlimited*"[42].

It is thus abundantly clear that economic activity includes the processes of buying and selling, or in more common economic terms, the processes of demand and supply. This is exactly what was taking place in the Bond House and Optigen cases. It runs counter to any basic understanding of economic activity to hold that no part of the supply chains in Bond House and Optigen comprised economic activity. The courts misdirected themselves on the facts[43].

B The Bond House and Optigen rulings are also the subject of a complaint to the EC Commission. Their immediate effect is to deter intra-Community trade: if there is no certainty that input tax will be repaid after an intra-community supply of the same goods is made, then traders will sell on the home market, because there they will offset the input tax paid out with the output tax they bring in. Thus, the judgments infringe the free movement provisions of the EC Treaty.

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41 David Begg, Stanley Fischer, Rudiger Dornbusch, Economics, McGraw Hill, 1984.

42 Paul A. Samuelson, *Economics, an introductory analysis*, McGraw Hill, 1955, 3rd Edition.

43 In Case C-230/94 *Renate Enkler v Finanzamt Homburg* [1996] ECR I-4517, the Court declared that "[t]he fact that property is suitable only for economic exploitation will normally be sufficient to find that its owner is exploiting it for the purposes of his economic activities" (Paragraph 27). A computer chip is "suitable only for economic exploitation"; it has no conceivable private purpose. By this reasoning, then, trading in computer chips must be an "economic activity". No other conclusion is possible.

They are legally defective for a related reason: they only work if the taxable person is seeking a refund of VAT paid over to the state. They do not work if the state is claiming VAT from a taxable person, because in these circumstances it does not suit the state to contend that the transactions were outwith the VAT system. Any ruling which holds or implies that transactions have no economic purpose when money is reclaimed from the state, but do have an economic purpose when money is claimed by the state, is rather obviously unsound.

In terms of the rule of law the Bond House and Optigen cases are dangerous. In the first place they discard the principle of legal certainty. In the second they go even further than the change to VAT law brought in by Section 77A. Section 77A operates on the basis of suspicion. The VAT tribunals do not even require suspicion to penalise. In our two cases they penalised, to the point of bankrupting, two trading companies, whom they stressed were wholly innocent of any wrongdoing. As a result the current VAT law in the United Kingdom allows the state to put taxable persons out of business for doing nothing other than performing their business in conformity with the law. In this respect, then, the United Kingdom is not a state based on the rule of law. If these rulings are consistent with the VAT law of the EU, *quod non*, then, notwithstanding dicta of the ECJ[44] and the language of the draft Constitutional Treaty[45] to the contrary, the EU is not based on the rule of law either.

The EU Approach

The British and, as we will see below, the German tax authorities are seeking to protect their respective revenues by means inimical to the common VAT system. The approaches under discussion here have a preponderantly subjective element. EU VAT law, which sets the standard, excludes subjective elements and relies entirely on the meeting of formal requirements. It is formalities based and takes, thus, a wholly objective approach. If it were otherwise the common VAT system would be unworkable, because traders would be unable to operate without knowing the detailed history of the supply chain preceding their purchase of goods, and they would then have to be certain of the intentions of all other traders

44 For example, Case C-314/91, *Beate Weber v European Parliament* [1993] ECR I-1093, para. 8; Case 294/83, *Les Verts v European Parliament* [1986] ECR 1339, para. 23 ; Case C-2/88, *Imm. Zwartfeld and Others* [1990] ECR I-3365, para. 16; *Opinion 1/91* [1991] ECR I-6079, para. 21.

45 See Draft Treaty establishing a Constitution for Europe, Article 2, as well as the Preamble to the Charter of Fundamental Rights of the European Union.

who might handle the goods at subsequent stages in the supply chain. As Hentschel says:

> *"Undertakings in the Community should neither be frightened off trading with other businesses in the Community, nor be turned into detectives. … Undertakings may, therefore, rely on credible details furnished by their customers in the EC as a matter of principle"*[46].

That the VAT system is formalities based is thus confirmed by a high ranking official in the Crime and Investigation Department of the German Ministry of Finance. In the same article Hentschel goes on to say:

> *"The fact that the customer does not declare subsequent turnover – including of course its own intra-Community acquisition – and that physical persons belonging to the turnover tax evasion camp operate behind the corporate body does not prevent the granting of the intra-Community supply exemption, because all the formal requirements … are met"*[47].

So, if the formalities are met, the law may not be set aside, even if there is suspicion or even certainty that illegal activity has taken place somewhere in the supply chain. This is confirmed in two ways.

A When the current VAT law of the Community was adapted in 1991 as a provisional means of complying with internal market requirements the Council (and implicitly all the Member States) adopted a protocol together with the Commission stating that:

> *" The Council and the Commission declare that the application of the provisions of the transitory regime may under no circumstances result in a refusal of the exemption contemplated by Article 28 A (of the 6th Directive) when it transpires a posteriori that the acquiror has forwarded incorrect details, provided that the taxable person has taken the necessary steps to*

46 See Hentschel, Oberregierungsrat beim Finanzamt für Fahndung und Strafsachen, Berlin, 'Rechtliche Hindernisse bei der Bekämpfung des grenzüberschreitenden Umsatzsteuerbetrugs', Steuerrecht/Praxisforum in 2003 (DStR 4/2003), our translation.

47 Our translation again; note that German law uses the term 'turnover tax' instead of 'value added tax'.

> *avoid an incorrect application of the VAT rules in respect of the supplies effected by his firm"*[48].

This supports Hentschel's view and means that where a supplier has taken all necessary precautions, he benefits from the intra-Community regime, even if it transpires later that the formalities were not complied with in full at the time of the transaction. The same taxable person benefits *a fortiori* from the intra-Community exemption regime if no error in the administrative formalities is made. In these circumstances it is established that the current VAT regime is predicated on the probative nature of correct administrative documentation. It is furthermore established that this is fully accepted by the Council and the Commission on the one hand and by all Member States on the other.

B This has been confirmed by the ECJ as recently as 5th June 2003. In case C-438/01, Design Concept / Flanders Expo[49], Design Concept, a taxable person in Luxembourg, acquired advertising services in Belgium from a taxable person there. Ordinarily, that supply and acquisition would have attracted no VAT in Belgium. The supply exemption was refused by Belgium on the grounds that Design Concept was acquiring the services in question on behalf of a body in Luxembourg, which was not a taxable person. Were it not for the intercession of Design Concept the exemption would not have been available. The ECJ ruled categorically that what happened to the advertising services once in the hands of Design Concept was irrelevant to the granting of the exemption. Thus, Belgium had to assess the intra-Community supply exemption on the sole basis of the supply from the Belgian taxable person to its acquiror or customer, the taxable person in Luxembourg. The further supply to the non-taxable person in Luxembourg was irrelevant and extraneous to the Belgian assessment.

For these reasons national VAT authorities are not permitted to "lift the veil". They must act solely on foot of valid documentation. This is the only way of ensuring objective assessment and uniform implementation of Community VAT law throughout the EU.

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48 Doc. – No. 9763/91 of the Council, Fisc 123, Restreint, available in French only, our translation.

49 Not yet reported.

The German Approach

Germany transposed the above mentioned Protocol into national law by means of § 6a, par. 4 UStG (Turnover Tax Law). By virtue of that provision the state, on request, supplies taxable persons in Germany with confirmation or non-confirmation of the VAT identification numbers and business addresses of taxable persons in other Member States. If a German taxable person, having gone through this process and obtained confirmation of the correctness of these details, effects an intra-Community supply he is deemed by law to have acted in good faith, and is entitled to the intra-Community supply exemption upon effecting supplies to the acquirors in question. He is also deemed to have done everything necessary to avoid an incorrect application of the VAT rules within the meaning of the Protocol.

Since July 2001 Germany's position is that supplies to other Member States made on foot of information confirmed as correct through this process, may result in refusal to grant the intra-Community supply exemption and a demand that VAT be paid in respect of the supplies effected. This puts firms in serious financial difficulty because they have, by operation of law, not been able to collect any output VAT on the supply. In addition, where they have incurred the expense of input VAT in respect of the same goods, they are denied a refund, because the output tax on the supply imputed to them will, in most cases, exceed the input tax collected and paid at the preceding stage. The German approach is, therefore, virtually the same as the UK approach, in that taxable persons may take considerable care to comply with the law, only to discover that they are to be penalised by being put out of business for their trouble. In this respect Germany cannot be said to be a state based on the rule of law.

This practice, based on directions from the 'Oberfinanzdirektion' in Düsseldorf (S 7144 -1- St 432 –K of 10th July 2001) and in practice followed throughout Germany, is also the subject of a complaint to the EC Commission in Brussels on grounds similar to those by which the validity of the British approach is contested, not least that the practice operates as a serious impediment to inter-state trade and is incompatible with the common VAT system in terms of the Design Concept judgment. The disregard for EC law manifested by these directions is disturbing enough. What is arguably even more disturbing is the way in which the perceived interests of the state are made in absolutist terms to prevail over the rights and interests of the individual.

Germany's Gulagging Argument

The German theory, expounded in the directions, is that, if it transpires after the supply transaction has taken place that the customer does not account to the other Member State for the VAT he has collected on a resale of the goods supplied from Germany, then the German supplier failed to furnish the details of the actual customer in the other Member State to the German tax authorities, thereby disqualifying himself from the intra-Commmunity supply exemption. In other words, if the foreign customer becomes a "missing trader" the consequences of an embezzlement by another person in another Member State are to be imputed to the German supplier, despite his acting in good faith and as required by German law, and regardless of the fact that the German supplier has no control over the actions of unconnected undertakings.

In the directions it is put as follows:

> *"Good Faith under § 6a para. 4 UStG contemplates only incorrect customer information as to the conditions laid down in § 6a para. 4 UStG (namely, that customers act in a business capacity, use the supplied items for their business, the goods physically move to the other Member State). The provision is, however, inapplicable to offences against § 6a para. 3 (accounting records). Put differently, § 6a para. 4 UStG affords no good faith protection for the assumption that the ostensible customer is identical with the actual customer. On this point the supplier must satisfy himself. Should, however, the actual customer not be established, then this fact must be taken as falling into the domain of general business risk. … The risk of the missing identity of the supposed business partner is not transferable to the taxman".*

The directions ignore one of the essential features of VAT. It is that the taxable person bears no fiscal burden, but acts only as the collector of taxes on behalf of the state. The taxable person is thus the agent of the state, albeit by force of law. The risk of an agent's defalcating with the principal's funds is in law and equity borne not by any third party but by the principal himself. Thus the theory on which the directions are based is utterly fallacious. In this case it seems that the arrogance of office has blinded the state to this rather obvious legal reality.

This basic principle of law also finds expression in the 6th Directive. According to the case law on Article 27 thereof, special measures are, unless notified and cleared, unenforceable[50]. The risk of unenforceability as a result of ignoring this safeguard, lies squarely with the state. One of the purposes of Article 27 is to

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50 See *supra n. 30*.

protect the individual against the state. The directions are without doubt a special measure within the meaning of Article 27 of the 6th Directive, being a derogation from its terms, ostensibly to prevent evasion of tax. Since the directions have not been notified and could not be cleared if they were, the entire risk lies with the state, to whom the VAT is due, not with an innocent trader acting in good faith.

Thus, whilst the German attitude is disturbing, the individual taxable person may rely on the protection of EU law, which is exactly why the construction of the Community and its legal system was necessary. In such cases it is, thus, supra-national law that gives us freedom.

Remedy

The EU clearly wishes to put carousel fraud to an end. In our view it must act within the system to do so. Carousel fraud as described herein would not survive the introduction of origin tax, because under an origin tax system it would be impossible to obtain zero-rated supplies[51]. It is also the stated objective of the EU

51 It should be explained that the opposite of an origin tax system is a destination tax system, which is the system currently in place. This system means that all the tax is paid in the Member State of destination. From some points of view, this makes sense since it is the final consumer who should pay the tax, and the Member State of destination is where he is located. However, the destination principle necessitates what might be called a "refund regime", in order to ensure that the good enters said Member State free of tax. The acquiring taxable person pays no input tax, and therefore he does not need to "pay himself back" out of the tax he receives from the final consumer. Thus, the entire quantity can go to the State. In an origin system, on the other hand, tax is paid over to the State *at each stage*. Literally, each buyer pays tax, via the seller, to the Revenue of the Member State *where that transaction originated*. Within one and the same Member State, the origin system works out because the tax on the value added at each stage of the chain ends up in the same pocket. It is *borne*, thanks to the deductions system, by the final consumer only. But it is *collected* incrementally. On the supranational scale, however, such a system would leave the money divided between several Revenues, only one of which (that of the Member State of final consumption) is really entitled to it. The price of moving to the origin principle at the EU level, then, would be some form of "clearing house" system to ensure that the State where the good is consumed is the State which receives *all* the value added tax, that is, the tax on the value added at *every* stage of production, no matter how many countries this took place in. The Revenues in the Member States through which the chain of supply snaked on its way to the final consumer will have to relinquish the money collected eventually. It is not theirs to keep. The choice is whether they do so on a micro level, via refunds, or on a macro level, via a clearing house. Two interesting articles on the subject are Craig A. Hart, "The European Community's Value-Added Tax System: Analysis of the New Transitional Regime and Prospects for Further Harmonization", *International Tax and Business Lawyer,* 1994, and Jane L. Seigendall, "A Framework on Consumption Taxes and their Impact on International Trade", *Dickinson Journal of International Law,* Spring 2000.

to end the current zero-rating of intra-Community supplies between taxable persons and, precisely, to introduce an origin tax system[52]. Advancing to an origin tax system would have a welcome side-effect, therefore. The power to bring an origin tax system about is contained in Article 93EC (ex article 99). It is also open to the Community to introduce origin tax in respect of a limited range of products only. These could be the products normally used in carousel frauds: mobile telephones and computer chips. Limited introduction of origin VAT could be effected by recourse to Article 93EC on a permanent basis. In our view it could also be done on a provisional or trial basis in respect of the offending products by recourse to Article 27 of the 6th Directive. This has also been suggested to the EC Commission and a reaction is awaited. What cannot be tolerated from a legal point of view, however, are attempts to solve the problem by recourse to illegal methods, and this is made worse by the existence of an effective remedy fully compatible with EU law.

Conclusion

What is repulsive to EU law is the gulagging of the individual taxable person. There is no difference in kind between suspending basic rights on the pretext of combating terrorism and imputing the faults or crimes of others to innocent taxable persons on the pretext of combating fiscal fraud and embezzlement. Both negate and will ultimately lead to the destruction of the rule of law. If Member States will not respect this, the Community, and in particular the EC Commission, will have to take strong remedial action. The Member States must be brought into line and corrective legislation is necessary. In our view the Commission, as guardian of the Treaty does not have the luxury of remaining inactive. The defects of the current system may not be laid at the door of innocent parties and the law may not be disdained. Inaction on the part of the Commission would send a signal to the Member States, encouraging them to continue acting illegally.

52 Cockfield Report, European Communities Commission, COM(85)310 final, Part Three. For more recent confirmation that the EU's preferred system is that based on origin, see Commission Press Release IP/03/746 of 26th May 2003 ("VAT: public consultation on how to facilitate compliance"), in which the solution is described as "optimum".