



JÖNKÖPING INTERNATIONAL BUSINESS SCHOOL
Jönköping University

Value Added Tax

The Right to Deduct in Case of Carousel Fraud

Master's thesis within Value Added Tax Law

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Mervärdesskatt

Avdragsrätt vid karusellhandel

Magisteruppsats inom Mervärdesskatt

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Abstract

Taxable persons' right to deduct input VAT is an integral part of the VAT system and may in principle not be limited. Carousel schemes deprive the Member States a great deal of tax revenue, investigations show that up to EUR 100 billion disappear every year. In order to stop these trading arrangements and reduce the big amount of tax revenue which disappears every year, some Member States would like to deny traders involved in carousel frauds the right to deduct the input VAT.

It exist different opinions regarding taxable persons' ability to deduct input VAT when involved in carousel frauds. The ECJ has given judgements in three interesting cases dealing with the right to deduct in case of carousel fraud. In the Optigen case, it was established that taxable persons who do not know or have any reason to believe that they are involved in a carousel fraud cannot be denied the right to deduct the input VAT. In the FTI case, it was concluded that taxable persons involved in carousel frauds can be jointly and severally liable to pay the VAT together with the person, actually liable to pay the VAT. A precondition for making a taxable person jointly and severally liable is that the taxable person has to be aware or should have been aware that the transaction made, was involved in such a scheme. If the taxable person did not know or had no reason to suspect this, he cannot be made jointly and severally liable. The ruling in the Kittel case confirms the Optigen judgement as well as concludes that when a taxable person is aware or should have been aware that he is involved in a carousel scheme, he is not entitled to deduct the input VAT. If this is the case, it is possible for the tax authorities in the different Member States to deny taxable persons this right as well as claim a refund.

These judgements clarify when the national tax authorities can deny a taxable person the right to deduct input VAT when the transactions are made in a chain of fraud. However, another problem occurred, it is up to the national courts to decide when a taxable person should be aware that he is involved in a carousel fraud. This decision shall be based upon objective factors, no guidelines or any other help as to what these objective factors should consist of have been published. This creates an interpretation gap for the national courts followed by the risk of having an outcome with different interpretations from the courts in the Member States.

Magisteruppsats inom Mervärdesskatt

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Författare:	Helen Andersson Karolina Franzén
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Sammanfattning

Den avdragsrätt som beskattningsbara personer besitter utgör en oskiljaktig del av mervärdesskattesystemet och kan därför i princip inte inskränkas. Karusellhandel berövar medlemsstaterna på stora mängder skatteinkomster. Olika undersökningar visar att upp till 100 miljarder euro försvinner varje år till följd av karusellbedrägerier. Vissa medlemsstater vill kunna neka avdragsrätt för beskattningsbara personer som är inblandade i olika typer av karusellhandel som ett försök att stoppa dessa arrangemang och för att minska de skatteintäkter som årligen förloras.

Det finns olika åsikter om möjligheten att neka avdragsrätt för beskattningsbara personer involverade i karusellhandel. EG-domstolen har avkunnat domar i tre intressanta mål som rör avdragsrätten vid karusellhandel. I Optigen målet fastställdes att beskattningsbara personer som inte vet eller har någon anledning att misstänka att de är inblandade i en karusellhandel inte kan bli nekade att dra av den ingående mervärdesskatten. I FTI målet drogs slutsatsen att beskattningsbara personer involverade i karusellhandel kan bli solidariskt betalningsansvariga för säljarens mervärdesskatteskuld. Förutsättningen för att sådant ansvar skall kunna åläggas är att den beskattningsbara personen visste eller hade skälig anledning att misstänka att han var involverad i ett karusellbedrägeri. Däremot kan en beskattningsbar person som inte visste eller hade skälig anledning att misstänka att han var inblandad i ett karusellbedrägeri inte åläggas solidariskt betalningsansvar. Domen i Kittel målet bekräftar Optigen domen samtidigt som den fastställer att beskattningsbara personer som medvetet eller som haft skälig anledning att misstänka att han är inblandad i ett karusellbedrägeri kan förlora avdragsrätten. Om så är fallet kan följaktligen de nationella skattemyndigheterna neka avdragsrätt för en beskattningsbar person samt kräva en återbetalning av redan utbetalad mervärdesskatt.

Dessa domar klarlägger när de nationella skattemyndigheterna kan neka en beskattningsbar person avdragsrätten när en transaktion är genomförd i samband med ett karusellbedrägeri. Ett annat problem uppstod dock eftersom det är upp till de nationella domstolarna att bestämma när en beskattningsbar person skall ha skälig anledning att misstänka att han är involverad i ett karusellbedrägeri. Detta beslut ska baseras på objektiva faktorer, det finns emellertid inga riktlinjer eller annan hjälp att ta till för att bestämma vad dessa objektiva faktorer skall vara. Detta skapar ett tolkningsproblem för de nationella domstolarna, vilket kan resultera i olika tolkningar mellan medlemsstaterna.

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Abbreviations and Glossary

AG	Advocate General
COM	Communication
Commission	European Commission
Commissioners	Commissioners of Customs and Excise
Council	Council of the European Union
CPU	Computer Processing Units
BEF	Belgian Franc
EC	European Community
EC-Treaty	Consolidated version of the Treaty Establishing the European Community
EEC	European Economic Community
ECJ	European Court of Justice
ECR	European Court Report
EG-domstolen	Europeiska gemenskapernas domstol
EU	European Union
EUR	Euro
First VAT Directive	Council Directive 67/227/EEC
FTI	Federation of Technological Industries
GBP	Great Britain Pound
HMRC	Her Majesty's Revenue and Customs
IFS Green Budget	The Institute for Fiscal Studies annual Green Budget, which sets the scene for the Chancellor of the Exchequer's Budget
IMF	International Monetary Fund
Missing trader	The Council defines a missing trader as follows: "Missing trader shall mean a trader registered as a taxable person for VAT purposes who, potentially with a fraudulent intent, acquires or purports to acquire goods or services without payment of VAT and supplies these goods or services with VAT, but does not remit VAT due to the appropriate national authority."
MS	Member State
MTIC	Missing Trader Intra Community
p.	page

Abbreviations and Glossary

para.	paragraph
RSV	Riksskatteverket
Sixth VAT Directive	Council Directive 77/388/EEC
SOU	Statens Offentliga Utredningar
UK	United Kingdom
v	versus
VAT	Value Added Tax
VAT Directive	Council Directive 2006/112/EC
VIES	VAT Information Exchange System

1 Introduction

1.1 Background

VAT is a general tax of consumption and the Member States of the EU have ever since they adopted the First VAT Directive¹ in 1967 worked towards a harmonized common system of VAT.² From a Community point of view, VAT is important when it comes to the funding of the EEC budget. Since 1970 the budget has been financed from the Community's own resources, including payments based on a proportion of the Member States' VAT.³ It was therefore important that the tax bases in the Member States were specified in a uniform way.⁴ In order for the Member States to contribute with the right amount, it is essential that the correct sums of VAT are registered. This amount of VAT can be distorted due to a number of issues, one of those being VAT frauds. An exposure to several VAT frauds in a Member State would lead to a national loss of tax revenue, which would mean that the VAT data would become incorrect and the sum to be paid too small.

Since the adoption of the Sixth VAT Directive⁵, the Member States have had a common tax base even though the harmonization of the tax rates and the exemptions are not completed. Despite that a full harmonization of rates and exemptions are not accomplished, the common system of VAT should still result in neutrality in competition. Similar goods and services should bear the same tax burden in each Member State.⁶

As a consequence of the various VAT rates in the Member States, some states are more accessible to carousel frauds. If a Member State has a high tax rate, there is consequently more money to derive from a fraud. Carousel frauds deprive the Member States a considerable amount of tax revenue every year. Different investigations show that between EUR 50-100 billion disappears every year.⁷ In order to prevent these types of trading arrangements, some Member States would like to be able to deny the traders involved in carousel frauds their right to deduct VAT related to the fraudulent trading.⁸

When it comes to the right to deduct, VAT shall be chargeable after deduction of the amount of VAT borne directly from the various cost components on each transaction.⁹ It

¹ Council Directive 67/227/EEC.

² European Parliament Fact Sheets, section 3.4.5 Value added tax (VAT).

³ European Parliament Fact Sheets, section 3.4.5 Value added tax (VAT).

⁴ SOU 2005:57, p. 112.

⁵ Council Directive 77/388/EEC.

⁶ Preamble (7) of the VAT Directive.

⁷ Depending on which source you take part of, see Magnusson, Dan, Olika typer av momsbrott i samband med gränsöverskridande handel inom EU, p.130 and Johansson, Sara, 1 miljard försvinner i karusellhandel, Realtid.se.

⁸ See, joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 10 and joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 29.

⁹ Article 1(2) of the VAT Directive.

is settled case law that the right to deduct provided for in the directive is an integral part of the VAT system and may in principle, not be limited.¹⁰

1.2 Purpose

VAT fraud in various forms deprives Member States in the EU a great deal of tax revenue every year. Carousel fraud is a common way through which traders deceive the Member States. This results in great losses for the Member States. In order to stop these types of trading arrangements, some Member States would like to be able to deny the traders involved in the carousel fraud from the right to deduct VAT related to the fraudulent trading.¹¹ However, in many cases of carousel fraud, numerous companies deny their participation in the fraudulent behaviour; they claim not to be aware that they are involved in a carousel scheme.

The purpose of this thesis is to analyze the right to deduct VAT in different carousel fraud situations within the EU and further to investigate under which circumstances a taxable person has the right to deduct input VAT when involved in a carousel fraud.

1.3 Method and Materials

This thesis will analyze the right to deduct input VAT from a Community law point of view. The reason for this is that all the Member States' VAT legislation is almost fully harmonized through Community law and Community law is superior to national law.¹² The main source of Community law is the primary legislation, in particular the latest VAT Directive.¹³ In order to establish *de lege lata*, interpretations of the VAT Directive will be done. The preamble of the VAT Directive may be considered since it serves as guidance for the purpose of the legislation.

The ECJ is the interpreter of Community law; therefore case law from the ECJ is very important.¹⁴ The ECJ has given judgements in three interesting cases, related to the right to deduct in case of carousel fraud. The cases used in this thesis are chosen for their principle value to the analysis. The AG's opinions do not have the same legal value as the judgement from the ECJ. However, they are still of importance since they provide a full legal investigation as well as improves the understanding of the judgement.

General principles of Community law relevant to this subject are considered since they are an important complement to other sources of law. Relevant Swedish and foreign literature on the subject will also be considered. Secondary sources will only be used if the primary source is not attainable or not available in neither English nor Swedish. If a secondary source is used, this will be explicitly stated.

¹⁰ Case C-62/93, *BP Soupergaz*, ECR [1995], p. I-1883, para. 18 and joined cases C-110/98 to C-147/98, *Gabfrisa*, ECR [2000], p. I-1577, para. 43.

¹¹ See, joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 10 and joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 29.

¹² Case 6/64 *Flamino Costa v. E.N.E.L.*, ECR [1965], p. 585.

¹³ Council Directive 2006/112/EC.

¹⁴ Article 234 EC.

1.4 Language

There are many different types of VAT frauds. The focus in this thesis is on carousel frauds involving intermediate links, meaning traders who do not know or at least claim not to be aware of the fact that they are involved in a carousel fraud. When referring to a trader or a company, this presumes that there is an economic activity going on and that the activity is not exempted from VAT. All transactions are taxable transactions and all traders are taxable persons. Furthermore, it is assumed that an intra Community acquisition is involved. When mentioning the right to deduct VAT this presumes the right to deduct input VAT, even though this is not always explicitly written. The EU is sometimes only referred to as the Union. When referring to the VAT Directive, it refers to the latest VAT Directive, Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax.

1.5 Delimitations

This thesis will analyze the right to deduct input VAT in relation to the sale of goods. The problem will mainly be tackled from a Community point of view. However some Member States have incorporated ways to prevent certain businesses from the possibility to abuse the VAT system, by using a carousel fraud. Therefore some national legislation will be considered. Different concepts, such as taxable person, economic activity, and taxable transactions will be described briefly, even though a thorough analysis of these concepts will not be conducted.

1.6 Outline

After the introduction chapter, the second chapter will explain certain important terms and relevant principles, found in the EC-Treaty, the VAT Directive or developed by the ECJ through case law. Since case law from the ECJ is an essential part of the Community legislation, it is important to understand these basic expressions and principles in order to comprehend our following analyze.

The third chapter deals with the right to deduct, when it is possible to deduct and under which criteria a trader can deduct input VAT. The next chapter will describe how carousel fraud is committed and explain the background of the cases, which will be scrutinised in the following chapter. In the fifth chapter the right to deduct will be put in relation to carousel fraud and an examination will be made of when a trader is allowed to deduct input VAT when involved in a fraudulent chain. In the sixth chapter, a final conclusion of the thesis is presented.

2 Value Added Tax Law within the European Union

2.1 Application of the Value Added Tax Directive

2.1.1 Introduction

In order to complete the goal of a common market, it is of great importance to harmonize the Member States' legal systems dealing with turnover taxes. If the legislation within this area of law would stay disharmonized, it could lead to distortion of competition and this could jeopardize the freedom of goods and services.¹⁵ A great step towards the harmonization of turnover taxes has been taken through the implementation of the VAT Directive.

The purpose of the VAT Directive is to establish a common VAT system.¹⁶ A general tax on consumption is applied on goods and services and shall be charged after the deduction of the amount of VAT connected to the input VAT on the cost components of the goods and services.¹⁷ This implies that VAT is not to be a cost for the companies; the VAT system is of a neutral character. The final tax burden in relation to VAT is on the last person in the transaction, the consumer.¹⁸

Below a brief overview of the conditions economic activity, taxable transaction and taxable person will be done. This overview will however not be exhaustive, since a full explanation of these conditions would fall outside the scope of this thesis. It is however important to recognize these conditions in order to continue exploring the purpose of this thesis. If these conditions are not fulfilled the transactions would not be subject to VAT in the first place.¹⁹

2.1.2 Economic Activity

An economic activity includes any activity preformed by producers, traders or persons supplying services.²⁰

*“The exploitation of tangible or intangible property for the purposes of obtaining income therefrom on a continuing basis shall in particular be regarded as an economic activity.”*²¹

In order for an activity to be of economic character, it has to be carried out independently.²² These conditions rules out employees and other persons bound to an employer through a contract or by any other mean. In addition the conditions also excludes, situa-

¹⁵ Preamble of the EC-Treaty.

¹⁶ Article 1(1) of the VAT Directive.

¹⁷ Article 1(2) of the VAT Directive.

¹⁸ Article 1(2) and 2(1)(a) of the VAT Directive.

¹⁹ Article 2 of the VAT Directive.

²⁰ Article 9(1) para. 2 of the VAT Directive.

²¹ Article 9(1) para. 2 of the VAT Directive.

²² Article 9(1) of the VAT Directive.

tions creating a legal tie between a person and an employer, such as work conditions and employer's liability.²³

The term economic activity has a wide concept, including any form of activity preformed by producers and traders. The ECJ has confirmed the wide scope of economic activity in its case law. In the *Enkler*²⁴ case, the ECJ pointed out some of the grounds indicating if an activity is carried out for the purpose of obtaining income on a continuing basis. If a property is suitable for an economic exploitation, this indicates that it is an economic activity. However, if the property is suitable for both economic and private purposes all circumstances surrounding its usage must be examined, in order to determine if there is in fact an economic activity.²⁵ It is also possible to compare how the taxable person concerned uses the property with how an equivalent economic activity usually is carried out.²⁶ Criteria based solely on the purpose or results of the activity cannot determine if an activity constitutes an economic activity. Consideration must be taken to the number of customers, the amount of income and other circumstances in the particular case.²⁷

2.1.3 Taxable Person

*“Taxable person shall mean any person who, independently, carries out in any place any economic activity, whatever the purpose or result of that activity.”*²⁸

States, regional and local government authorities and other bodies governed by public law is not to be seen as taxable persons when making transactions or activities, which they engage in as public authorities.²⁹ This concludes that any person, physical or legal can be a taxable person as long as they fulfil the other conditions.³⁰

2.1.4 Taxable Transaction

Taxable transactions contains of the supply of goods, intra Community acquisition of goods and supply of services. Supply of goods is the transfer of ownership in the dispose of tangible property.³¹ Tangible property also includes electricity, gas, heat and similar.³² Any transaction which is not a supply of goods, is deemed to be a supply of service.³³

²³ Article 10 of the VAT Directive.

²⁴ Case C-230/94 *Enkler*, ECR [1996], p. I-4517.

²⁵ Case C-230/94 *Enkler*, ECR [1996], p. I-4517, para. 27.

²⁶ Case C-230/94 *Enkler*, ECR [1996], p. I-4517, para. 28.

²⁷ Case C-230/94 *Enkler*, ECR [1996], p. I-4517, para. 29.

²⁸ Article 9(1) of the VAT Directive.

²⁹ Article 13 para. 1 of the VAT Directive.

³⁰ Alhager, Eleonor, Kleerup, Jan, Melz, Peter och Öberg, Jesper, *Mervärdesskatt i teori och praktik*, p. 34.

³¹ Article 14(1) of the VAT Directive.

³² Article 15(1) of the VAT Directive.

³³ Article 24 of the VAT Directive.

Intra Community acquisition of goods is the acquisition of the right to dispose movable tangible property as an owner, if the goods are dispatched or transported to the taxable person by the seller or the person acquiring the goods, in a Member State other than where the dispatch or transportation began.³⁴ Intra Community acquisition of goods for consideration within the territory of a Member State shall be subject to VAT.³⁵ It is the Member State in which the dispatch or transport of the goods ends that shall exercise the power of taxation, irrespective of the VAT treatment applied to the transaction in the Member State in which the dispatch or transport began.³⁶ The zero-rated intra Community acquisition is a prerequisite for committing a carousel fraud. It is possible for the seller to make a VAT exempted supply if the buyer is situated as well as registered for VAT in another Member State.³⁷ It is the buyer's obligation to pay the VAT levied on the goods to the tax authorities in his Member State.³⁸ If the buyer goes missing or fails to pay the VAT due, his Member State loses the VAT income on the supply.

The condition, taxable transaction also has a wide scope; goods are anything from a mobile phone to heat while a service is everything which does not constitute a supply of goods. When the ownership of goods is transferred to another person, it is a taxable transaction. The supply must however be a supply for consideration.³⁹

2.1.5 Conclusion

There are several delimitations problems of whether a transaction is to be seen as a supply of goods or a supply of service, if an economic activity even exists and if the person making the transaction is a taxable person. A further analysis of these problems does however fall outside the scope of this thesis. For this thesis, it is relevant to remember that in order for a company to deduct VAT from a transaction, the transaction has to be subject to VAT in the first place. In order to be subject to VAT the transaction has to be a supply of goods for consideration, within the territory of a Member State, made by a taxable person and the taxable person has to make the transaction within an economic activity.⁴⁰

³⁴ Article 20 of the VAT Directive.

³⁵ Article 2(1)(b) of the VAT Directive.

³⁶ Regulation 1777/2005, article 21.

³⁷ Article 138 of the VAT Directive.

³⁸ Article 2(1)(b) of the VAT Directive.

³⁹ Article 2(1)(a) of the VAT Directive.

⁴⁰ Article 2(1)(a) of the VAT Directive.

2.2 General Principles

2.2.1 The VAT Directive

When it comes to VAT law, two principles can be derived from the VAT Directive; the principle of the taxation of the added value⁴¹ and the principle of reciprocity.⁴² The principle of the taxation of the added value means that only the value added shall be taxed. This principle is upheld by taxable persons' right to deduct input VAT. The principle of reciprocity is closely connected with the principle of the taxation of the added value and means that the output VAT for the seller shall be equal to the input VAT for the purchaser.⁴³ The reciprocity principle also states that the right to deduct arises when the deductible tax becomes chargeable.⁴⁴

2.2.2 Case Law

According to the principle of legal certainty, legislation imposing obligations on a taxpayer must be clear and precise so that the taxpayer knows, without ambiguity, his rights and obligation and may act accordingly.⁴⁵ The principle of legal certainty also entails that a taxable person's rights and obligations cannot depend on facts, circumstances and events which occurred after the tax authority made a decision in respect of those rights and obligations.⁴⁶ In the end a taxable person must always be able to rely on the accuracy of the legislation and shall not be punished if he acts accordingly. The principle of legal certainty is not regulated in the EC-Treaty nevertheless it is a very general principle of substantial importance in the case law from the ECJ.⁴⁷

The principle of equality is a fundamental principle which requires that similar situations shall be treated in the same way, unless differentiation is objectively justified.⁴⁸ There are also two neutrality principles: the principle of fiscal neutrality and the principle of neutrality.⁴⁹ The principle of neutrality is a fundamental principle for the VAT system. According to this principle, all similar goods shall bear the same tax burden in each Member State, no matter how long the production or distribution chains are.⁵⁰ The principle of fiscal neutrality means that all economic activities shall be taxed in a completely neutral way. Similar goods, competing with each other shall for VAT purposes be treated in the same way.⁵¹

⁴¹ Article 1 of the VAT Directive.

⁴² Articles 1(2), 167 and 168(a) of the VAT Directive.

⁴³ Articles 1(2) and 168(a) of the VAT Directive.

⁴⁴ Article 167 of the VAT Directive.

⁴⁵ Case 169/80 *Gondrand*, ECR [1981], p.1931, para. 17.

⁴⁶ Case C- 110/94, *INZO v Belgian State*, ECR [1996], p. I-857, para. 21.

⁴⁷ Usher, John A., *General Principles of EC Law*, p. 65.

⁴⁸ Case 215/85, *BALM v Raiffeisen Hauptgenossenschaft*, ECR [1987], p.1279, para. 23.

⁴⁹ See cases 89/81, *Hong-Kong Trade*, ECR [1982], p.1277, C-481/98, *Commission v France*, ECR [2001], p. I-3369 and C-216/97, *Gregg*, ECR [1999], p. I-4947.

⁵⁰ Case 89/81, *Hong-Kong Trade*, ECR [1982], p.1277, para. 6.

⁵¹ Case C-481/98, *Commission v France*, ECR [2001], p. I-3369, para. 22.

Economic traders providing similar goods shall be treated in the same way, as far as the levying of the tax is concerned.⁵² To conclude: tax factors shall never affect the economic decision.

The principle of proportionality is important for the interpretation of the case law. The principle signifies that actions taken by the Member State shall not go beyond what is necessary in order to achieve the desired goal.⁵³

⁵² Case C-216/97, *Gregg*, ECR [1999], p. I-4947, para. 20.

⁵³ Article 5.3 EC.

3 The Right to Deduct

3.1 Deduction in General

The right to deduct input VAT is what makes the consumption tax a value added tax. Output VAT for the taxable seller becomes deductible input VAT for the taxable purchaser in the next step of the sales chain, until the good reaches the final consumer. If input VAT could not be deducted, it would burden the taxable seller as a selling cost instead of being a burden for the final consumer.⁵⁴ A thorough examination of the right to deduct will take place since a full understanding is necessary for a further analyze of the purpose.

3.2 The Origin and Scope of the Right to Deduct

3.2.1 Deduction or Refund

The VAT Directive mentions both the right to deduct VAT and the entitlement to obtain a refund.⁵⁵ In reality, they are the same, since both of them relate to the possibility to retrieve input VAT.⁵⁶ A refund is possible to obtain, if the input VAT exceeds the output VAT or if the taxable person is situated in another Member State or outside the EU. Therefore, it will de facto become a refund since the output VAT does not exist or does not exceed the input VAT.⁵⁷

3.2.2 General Conditions for the Right to Deduct

The right to deduct arises when the deductible tax becomes chargeable.⁵⁸ In order to deduct input VAT the taxable person has to comply with certain conditions. The taxable person is entitled to deduct input VAT related to supplies of goods and services, intra Community acquisitions of goods and importation of goods to the Member State where the transactions are carried out, if the goods are used for taxable transactions.⁵⁹ The supplies can take place in the same Member State as where the taxable person performs his taxable transactions, from another Member State in the form of an intra Community acquisition or through importation into the Member State from a third country.⁶⁰ The input VAT shall relate to acquisitions and import used for the purpose of the taxable person's taxed transactions.⁶¹

⁵⁴ Alhager, Eleonor, Kleerup, Jan, Melz, Peter och Öberg, Jesper, *Mervärdesskatt i teori och praktik*, p. 61.

⁵⁵ Articles 168-172 of the VAT Directive.

⁵⁶ Articles 168-172 of the VAT Directive.

⁵⁷ Alhager, Eleonor, Kleerup, Jan, Melz, Peter och Öberg, Jesper, *Mervärdesskatt i teori och praktik*, p. 62-63.

⁵⁸ Article 167 of the VAT Directive.

⁵⁹ Article 168 of the VAT Directive.

⁶⁰ Article 168 of the VAT Directive.

⁶¹ Article 168 of the VAT Directive.

Regarding a taxable person's right to deduct, the ECJ has declared that in order for the taxable person to be entitled to deduct input VAT and in order to determine the extent of such a right, a direct and immediate link between a particular input transaction and a particular output transaction has to exist.⁶² If such a link does not exist, the taxable person cannot deduct the input VAT. When it comes to the burden of proof for the right to deduct, the taxable person has to show his status as a taxable person and that the conditions for deduction are fulfilled.⁶³ Otherwise, there is no entitlement for deduction.

3.2.3 Restrictions on the Right of Deduction

If a taxable person uses goods both in transactions where the VAT is deductible and in transactions where the VAT is not deductible, only the VAT belonging to the former transactions is deductible.⁶⁴

The Council acting unanimously on a proposal from the Commission, shall decide for which expenditures VAT shall not be deductible.⁶⁵ Expenses that are not strictly expenses of business character such as luxuries, amusements and entertainment shall not be deductible under any circumstances.⁶⁶ Nevertheless, Member States may retain their exclusions provided for under national law until the above-mentioned rule enters into force.⁶⁷ It is also possible for Member States to exclude some goods from the system of deduction for cyclical economical reasons. However, in order to do so, the Member State must consult the VAT committee.⁶⁸ These time-limited measures are provided so that the Member State can handle temporary situations in their economy.⁶⁹

Member States may have certain derogations until the adoption of definitive arrangements.⁷⁰ There are different rules depending on whether the Member State acceded to the EU before or after 1978.⁷¹ However, these derogations are all outside the scope of this thesis and therefore will not be further discussed.

⁶² Case C-98/98, *Midland Bank*, ECR [2000], p. I-04177, para. 24 & Case C-408/98, *Abbey National*, ECR [2001], p. I-01361, para. 26.

⁶³ Case C-268/83, *Rompelman*, ECR [1985], p. 655, para. 24.

⁶⁴ Article 173 of the VAT Directive.

⁶⁵ Article 176 of the VAT Directive.

⁶⁶ Article 176 para. 1 of the VAT Directive.

⁶⁷ Article 176 para. 2 of the VAT Directive.

⁶⁸ Article 177 para. 1 of the VAT Directive.

⁶⁹ Case C-409/99, *Metropol and Stadler*, ECR [2002], p. I-00081, para. 67.

⁷⁰ Articles 370-396 of the VAT Directive.

⁷¹ See for example articles 370-393 of the VAT Directive.

According to case law from the ECJ⁷², limitations on the right to deduct affect the level of the burden of tax and must be applied in the same way in the different Member States. Derogations are therefore only allowed, if expressly provide for in the VAT Directive.⁷³

3.2.4 Rules Governing the Right of Deduction

In order for a taxable person to exercise the right of deduction, he must fulfil certain criteria. Normally, an invoice drawn up in accordance with the VAT Directive shall verify the right to deduct.⁷⁴ Regarding intra Community acquisitions, the taxable person must state all the information needed for the calculation of the VAT on the acquisition in a VAT return and hold an invoice in accordance with the VAT Directive.⁷⁵ The taxable person shall make the deduction by subtracting the amount of VAT in respect of which the right to deduct had arisen for a given period from the total amount of VAT due for the same period.⁷⁶ However, in order to deduct VAT within a certain tax period, two conditions have to be fulfilled. Firstly, the delivery of the goods should have occurred and secondly, the taxable person should hold an invoice or a document which the Member State considers equal to an invoice.⁷⁷

If a taxable person's deduction exceeds the amount of VAT due for a specific tax period, the Member State may either make a refund or carry the excess forward to the next period.⁷⁸ If the amount is insignificant the Member State can refuse a refund or a carry forward.⁷⁹

3.2.5 The Principle of Neutrality

The principle of neutrality is a central part of the VAT system. Therefore, the right to deduct shall ensure that the taxable person's business do not carry the burden of VAT.⁸⁰ The ECJ has defined the principle of neutrality in the *Rompelman*⁸¹ case in the following way:

“..[T]he deduction system is meant to relieve the trader entirely of the burden of the VAT payable or paid in the course of all his economic activities. The common system of value-added tax therefore ensures that all economic activi-

⁷² Case C-409/99, *Metropol and Stadler*, ECR [2002], p. I-00081 & Case C-204/03, *Commission v Spain*, ECR [2005], p. I-08389.

⁷³ Case C-409/99, *Metropol and Stadler*, ECR [2002], p. I-00081, para. 42 & Case C-204/03, *Commission v Spain*, ECR [2005], p. I-08389, para 23.

⁷⁴ Article 178(a) of the VAT Directive.

⁷⁵ Article 178(c) of the VAT Directive.

⁷⁶ Article 179 of the VAT Directive.

⁷⁷ Case C-152/02, *Terra Baubedarf-Handel*, ECR [2004], p. I-05583, para. 34 and 38.

⁷⁸ Article 183 of the VAT Directive.

⁷⁹ Article 183 of the VAT Directive.

⁸⁰ See joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 48, case C-408/98 *Abbey National*, para. 24 and case C-25/03 *HE* [2005], ECR I-3123, para. 70.

⁸¹ Case 268/83, *Rompelman*, ECR [1985], p. 655.

*ties, whatever their purpose or results, provided that they are themselves subject to VAT, are taxed in a wholly neutral way.”*⁸²

According to this definition, the right to deduct is limited to economic activities subject to VAT and as a result, input VAT related to businesses exempted from VAT are not deductible.⁸³

3.3 The Origin Principle and the Destination Principle

3.3.1 In General

There are two different principles when it comes to where the taxation of supplies of goods should take place, the origin principle and the destination principle. For the further investigation, it is important to understand both the differences between the two principles and how and when they are to be applied.

3.3.2 The Origin Principle

The origin principle signifies that VAT shall be chargeable in the Member State from where the goods are exported and no taxation measures shall be taken in the Member State of import.⁸⁴ According to the origin principle the VAT is levied where the goods are supplied, regardless of where they are consumed. There is no need for border controls if the origin principle is used and export would not be tax-free.⁸⁵ Therefore, the intention for committing VAT fraud would be smaller. The origin principle makes it possible for the VAT system to discriminate between domestically produced goods and goods from other Member States. A full implementation of the origin principle would also change the distribution of VAT revenues amongst the Member States.⁸⁶

3.3.3 The Destination Principle

According to the destination principle, the VAT is levied where the products are consumed. This principle guarantees that the products are not discriminated since the VAT is the same for foreign and domestic producers and the export is exempted from domestic taxation. However, in order to make the destination principle effective, an efficient control of the flow of cross-border trade and administrative co-operation is required.⁸⁷ The destination principle is a presumption for committing carousel frauds⁸⁸ since this principle makes it possible for a taxable person in one Member State to sell goods to a taxable person in

⁸² Case 268/83, *Rompelman*, ECR [1985], p. 655, para. 19.

⁸³ Alhager, Eleonor, Kleerup, Jan, Melz, Peter och Öberg, Jesper, *Mervärdesskatt i teori och praktik*, p. 62.

⁸⁴ SOU 2002:47, p. 363.

⁸⁵ *Reforming the VAT in EU*, Economy Watch.

⁸⁶ *Reforming the VAT in EU*, Economy Watch.

⁸⁷ *Reforming the VAT in EU*, Economy Watch.

⁸⁸ Magnusson, Dan and Sigbladh, Roland, *Ekonomisk brottslighet – så skyddar du din verksamhet*, p. 210.

another Member State without charging VAT.⁸⁹ In order to sell the goods at a zero-rating, the seller must show that the goods have been supplied to a VAT-registered person in another Member State.⁹⁰ The buyer has to pay VAT for the acquisition in his own Member State and in addition, report all intra Community acquisitions in a VAT statement.⁹¹

3.3.4 The Origin Principle or the Destination Principle

Since January 1993, all frontier control on the sales of goods between Member States has been abolished.⁹² The Commission suggested in 1987, that all taxation related to intra Community acquisitions should be taxed according to the principle of origin. However, the Member States have not been able to reach an agreement in accordance with the Commission's suggestion.⁹³ Instead, special transitional arrangements were established. The Council decided in 1991 that the transitional arrangements should be valid from 1993.⁹⁴ The idea is to replace the transitional arrangements by definitive arrangements based on the taxation in the Member State of origin of the supply of goods.⁹⁵ The transitional arrangements are based on the destination principle. Therefore, for the time being, the destination principle is the main rule. On the other hand, the destination principle is not used on all intra Community transactions. In some cases, the origin principle is used instead, for example, when it comes to distance sales.⁹⁶ However, since these subjects fall outside the scope of this thesis, there will be no further analysis of the matter.

3.4 The VAT Information Exchange System

3.4.1 Background

Member States shall take all appropriate measures to ensure the fulfilment of the obligations arising from the EC-Treaty.⁹⁷ A directive shall be binding, as to the result to be achieved, but it is up to the national authorities to choose form and method.⁹⁸ This concludes that the Member States shall take all appropriate measures to ensure the fulfilment of the VAT Directive. In order for the national authorities to control if traders comply with the provisions in the VAT Directive, some sorts of control systems have to exist.

⁸⁹ Article 138 of the VAT Directive.

⁹⁰ Article 138 of the VAT Directive.

⁹¹ SOU 2002:47, p. 364.

⁹² Preamble of Council Directive 91/680/EEC.

⁹³ SOU 2002:47, p. 364.

⁹⁴ SOU 2002:47, p. 364.

⁹⁵ Article 402 of the VAT Directive.

⁹⁶ Articles 33-34 of the VAT Directive.

⁹⁷ Article 10 EC.

⁹⁸ Article 249 EC.

3.4.2 VAT Information Exchange System - VIES

According to the destination principle, goods sold from one Member State to another shall be taxed in the later. This means that a flow of zero-rated goods is transported over the borders of the Member States.⁹⁹ In order for the Member States to control this flow in an easy and effective way, some sort of control system was needed. That is how VIES was created.¹⁰⁰

VIES is important from three aspects. Firstly, it provides the Member States with a device to control the validity of zero-rating claims, secondly it helps the Member States to detect intra Community supplies, which has been unreported and thirdly the system can confirm the validity of VAT registration numbers.¹⁰¹ If a trader is uncertain of the validity of a customer's VAT number, he can always control the VAT number through VIES. The control system requires every Member State to collect certain information from all its exporters about their trade with other Member States. This means that all traders registered for VAT, who makes zero-rated transactions of goods to a VAT registered trader in another Member State, must present a VIES statement including the value of the sale. The statements shall be handed in to the Member State's tax authority, with detailed information about the trader's intra Community supplies.¹⁰² The VIES statements shall be reported quarterly.¹⁰³ However, small businesses have the possibility to leave a statement once a year and larger businesses can leave a statement every month if they find it more convenient.¹⁰⁴ One big disadvantage with the VIES system is that it has a delay of several months, which makes it harder for the Member States to control the different transactions.¹⁰⁵

In intra Community trading, the VAT number is very important. The trader has to rely on the validity of his customer's VAT number in order to decide if he can make a VAT exempted supply or not. Therefore, it is essential that the VAT number register is up-to-date and accurate.¹⁰⁶ Today, traders run the risk of tax authorities trying to recover VAT from them if they have been misinformed of the VAT status of their trading partners.¹⁰⁷ As a result, the Member States should be liable for the information in their registers and take full responsibility for the consequences of incorrect and outdated information.¹⁰⁸ Today, taxable persons who no longer runs an economic activity and companies identified as missing traders remain in the VIES database too long.¹⁰⁹ Deleting inactive VAT numbers and up-

⁹⁹ SOU 2002:47, p. 365.

¹⁰⁰ SOU 2002:47, p. 367.

¹⁰¹ VIES and Intrastat Traders Manual, The Irish Revenue Commissioners: Taxation and Duty Information.

¹⁰² Article 262 of the VAT Directive.

¹⁰³ Article 263 of the VAT Directive.

¹⁰⁴ VIES and Intrastat Traders Manual, The Irish Revenue Commissioners: Taxation and Duty Information.

¹⁰⁵ Magnusson, Dan and Sigbladh, Roland, Ekonomisk brottslighet – så skyddar du din verksamhet, p. 211.

¹⁰⁶ COM(2007) 758, p. 9.

¹⁰⁷ COM(2007) 758, p. 9-10.

¹⁰⁸ COM(2007) 758, p. 10.

¹⁰⁹ COM(2007) 758, p. 10.

dating the register is important for the traders who have to rely on the register in order to decide whether it is possible to make a zero-rated supply or not.

The Commission considers an amendment of the VIES system, into a VIES II system, which would help the Member States to strengthen their control.¹¹⁰ VIES is a successful tool for the control of information on the vast majority of intra Community transactions. However, the system is not effective enough and there have been few noteworthy improvements since the system was put to use.¹¹¹ There is at least three months between when a transaction is made and when the information becomes available for the Member States, therefore the VIES is an inadequately system for combating carousel fraud. Three months is more time than needed, for a missing trader to disappear.¹¹² A further issue is the failure to hand in complete information to VIES. The whole system is dependent on the correct information submitted by the taxable persons and the sanctions for non-compliance have been scarce.¹¹³ Therefore, the Commission considers that it would be better to replace the present VIES with a more modern and flexible system which could provide the vital information more quickly, more precisely and to a lower cost for the taxable persons.¹¹⁴

¹¹⁰ COM(2004) 260, p. 9.

¹¹¹ COM(2004) 260, p. 9.

¹¹² COM(2004) 260, p. 9.

¹¹³ COM(2004) 260, p. 9.

¹¹⁴ COM(2004) 260, p. 10.

4 Carousel Fraud in General

4.1 History

One of the fundamental goals of the EU is to complete the common market. Custom duties and quantitative restrictions on the import and export of goods between Member States in the Union shall be prohibited.¹¹⁵ In order to reach the goal of an internal market, obstacles to the free movement of goods, persons, services and capital shall be abolished.¹¹⁶ The prohibition of custom duties and the abolishment of obstacles to the four freedoms lead to possibilities of fraudulent behaviour. The removal of import VAT created a new type of tax fraud known as carousel fraud.

The different Member States pay a great deal of money every year to companies whose business it is to deceive the governments. The idea behind a carousel fraud is to use the existing weaknesses in the VAT system when importing and exporting goods within the EU. These types of trading arrangements create great losses for the Member States in form of lost revenue. There have been numerous investigations within the Community, which shows that tax revenues of up to EUR 100 billion disappear every year.¹¹⁷

4.2 Carousel Fraud in Practise

One definition of carousel fraud is frequent buy and sale of goods between connected companies, where at least one of the companies in the chain is situated in another Member State. Generally, it is often a matter of goods with high value in relation to its weight, such as mobile phones and computer components.¹¹⁸

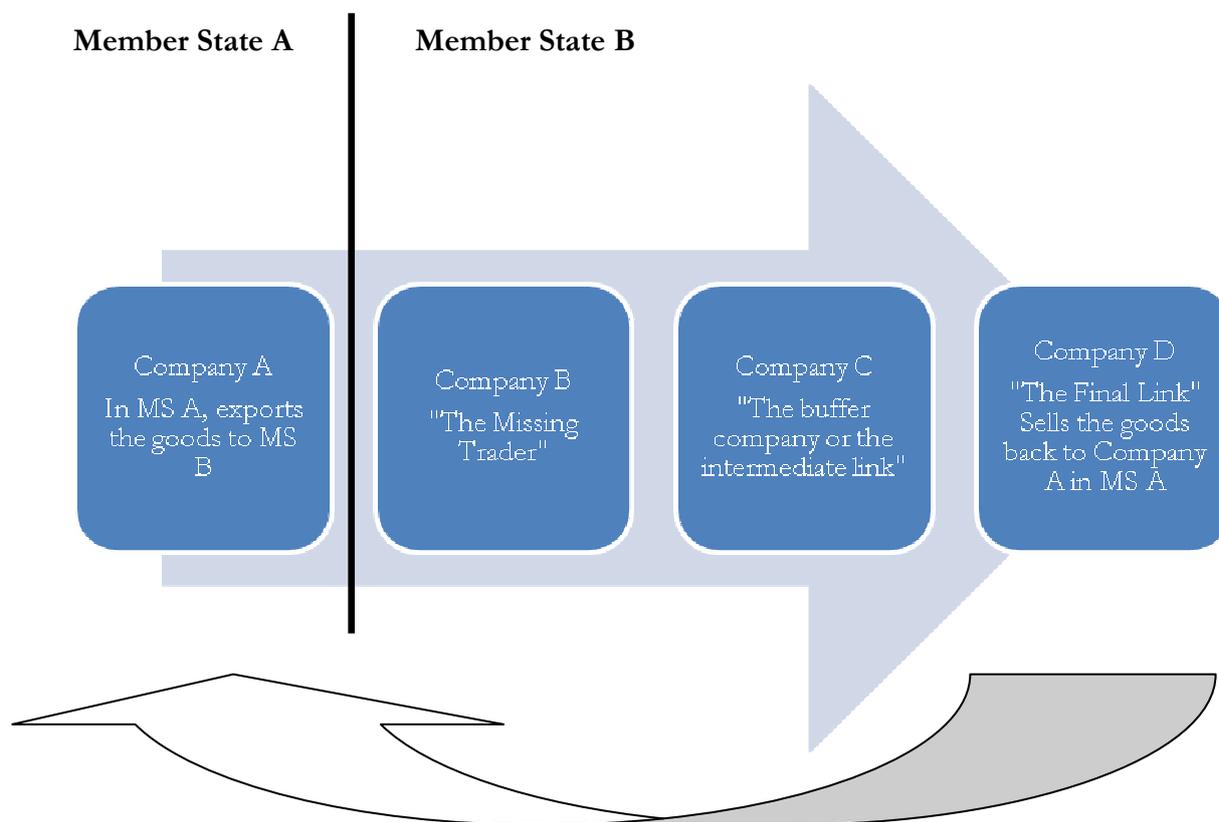
Company B, known as the missing trader, imports the goods to Member State B from the selling company, Company A, in Member State A. When Company B goes missing it is often replaced with a new import company and the carousel fraud can continue.

¹¹⁵ Article 3(a) EC.

¹¹⁶ Article 3(c) EC.

¹¹⁷ Depending on which source you take part of, see Magnusson, Dan, Olika typer av momsbrott i samband med gränsöverskridande handel inom EU, p. 130 and Johansson, Sara, 1 miljard försvinner i karusellhandel, Realtid.se.

¹¹⁸ RSV rapport 2000:8, p. 2-3.



4.3 Case Law

4.3.1 Background

Several different types of carousel schemes exist. In order to get a better picture of how these frauds operate, a thorough analysis of three cases from the ECJ will be made. These cases include a number of different carousel fraud set-ups. The following line-up is not exhaustive; it is merely a presentation of possible set-ups, taken from real situations, made in order to give a comprehension of how carousel frauds operate.

4.3.2 The Optigen Case¹¹⁹

4.3.2.1 Background

This case was a joint case between Optigen, Fulcrum Electronics and Bond House Systems, which started proceedings against the Commissioners. The case concerned the Commissioners' rejection to repay VAT related to the companies' purchase of CPUs in the UK, which were later exported to another Member State.¹²⁰ The cases were joint for the purposes of the written procedure, the oral procedure and the judgement.¹²¹

¹¹⁹ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483.

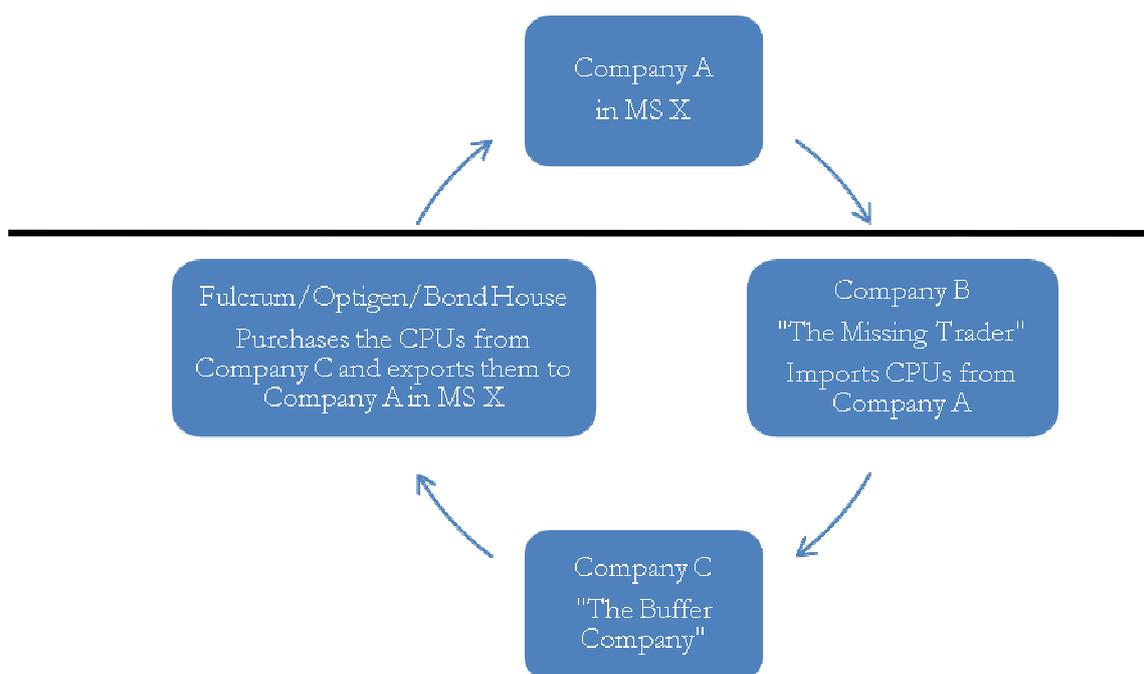
¹²⁰ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 2.

¹²¹ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 27.

The three companies bought CPUs from companies established in the UK and later resold them to purchasers established in another Member State.¹²² Each of the three companies claimed a net balance of input VAT, of different value.¹²³ The transactions in question were part of a chain of supply involved in carousel fraud. The transactions formed part of a chain in which a defaulting trader¹²⁴ was involved.¹²⁵

According to the order for reference, the plaintiffs were not aware of the fact that their transactions formed part of a carousel fraud.¹²⁶

Member State X



The United Kingdom

4.3.2.2 Optigen and Fulcrum

The main business of the companies Optigen and Fulcrum were to trade with computer chips. These chips were purchased from companies established in the UK, and were later resold by the two companies to buyers in another Member State. With these transactions Optigen and Fulcrum formed part of a carousel scheme, this was however not the intention of the companies, they were not at all aware that they formed part of a carousel fraud. They did not deal with the company, which played the role of the missing trader; neither

¹²² Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 8.

¹²³ For exact values for each company, see, joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 9-11.

¹²⁴ A defaulting trader, is a trader who insures liability to VAT without de facto discharging his liability with the tax authority, instead he goes missing. The trader can also use another company's VAT number. See joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 12.

¹²⁵ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 12.

¹²⁶ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 12.

were they aware of or had any reason to believe that they were involved in such a scheme.¹²⁷ The Commissioners however, declined Optigen and Fulcrum's claim of VAT return, since they claimed that the transactions in question were not made within an economic activity and that they lacked economic substance.¹²⁸ The Commissioners declared that the purchases in question were not supplies used for business purposes and neither were they supposed to be used for such purposes.¹²⁹ Optigen and Fulcrum appealed against the Commissioners refusal of repaying the VAT.¹³⁰

4.3.2.3 Bond House

Bond House was a company incorporated in England and Wales, its business was to deal with computer components. The main business was bulk purchase of CPUs from traders registered for VAT in the UK. Bond House later resold the CPUs to companies registered for VAT in other Member States.¹³¹

In May 2002, Bond House made 51 transactions of CPUs to customers in other Member States. These transactions were approximately 99% of the turnover in May. In each of these 51 transactions, UK suppliers bought the CPUs at a fair market value. Bond House paid the agreed price plus VAT to the suppliers, and later resold the CPUs to customers in other Member States. The customers paid a slightly higher price for the CPUs than Bond House. The supplies were zero-rated, and Bond House made a VAT return for May 2002. The company claimed repayment of the amount of VAT, which it had paid to its purchaser. The Commissioners however, refused repayment of the claimed input VAT for 27 of the 51 purchases.¹³² Bond House appealed against the Commissioners' decision.¹³³

4.3.2.4 A Description of Carousel Fraud

In the judgement from the ECJ, a general description of how a carousel fraud usually takes place can be found.

- Company A, established in Member State A sells taxable goods to Company B, established in another Member State, Member State B
- Company B is the defaulting trader or the company who is using another company's VAT number. Company B sells the goods to another company, Company C at a reduced price. Company C is a buffer company established in Member State B.

¹²⁷ Opinion of AG Poiares Maduro, in joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 11.

¹²⁸ Opinion of AG Poiares Maduro, in joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 11.

¹²⁹ Opinion of AG Poiares Maduro, in joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 11.

¹³⁰ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 15.

¹³¹ Opinion of AG Poiares Maduro, in joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 13.

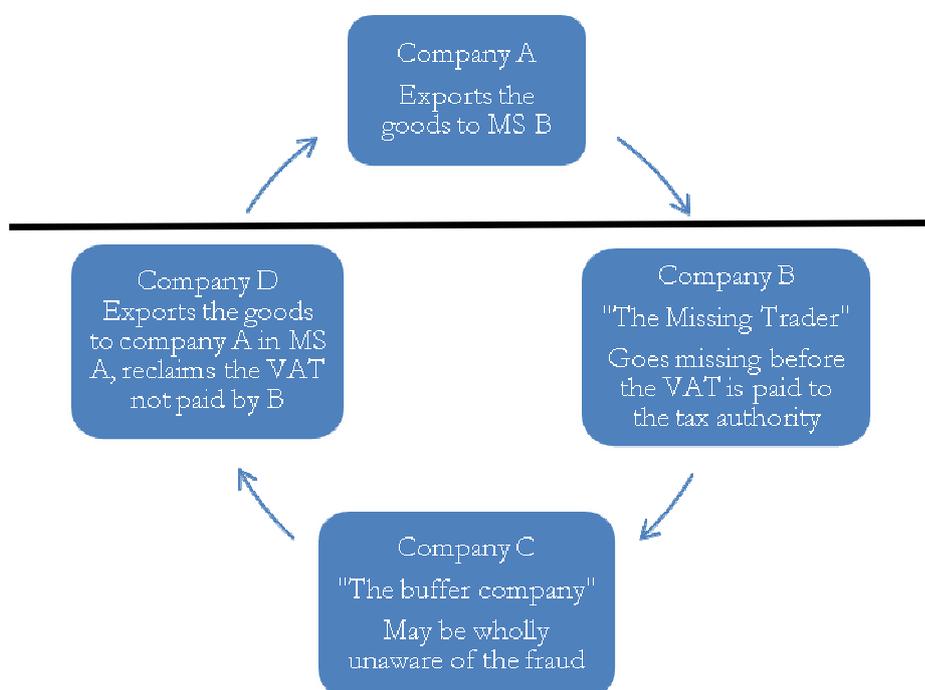
¹³² Opinion of AG Poiares Maduro, in joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 13.

¹³³ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 19.

Thus, further sales can be made at a profit. By this, Company B incurs liability to VAT on the purchase of the goods, but is also entitled to deduct the VAT since it is a taxable transaction. Company B also incur liability for the output VAT, which it has charged to company C, but Company B goes missing before discharging the later liability to the tax authorities.

- Later, Company C sells the goods to Company D, another buffer company, established in Member State B. Company C pays the output VAT charged after deducting the input VAT paid and this scenario continues until a company in Member State B exports the goods to another Member State. The export of the goods is exempted of VAT, but the exporting company is still entitled to claim a refund of the input VAT, which it has paid on the purchase. In order for the scheme to be a true carousel fraud, the purchaser in the last Member State is Company A.¹³⁴

Member State A



Member State B

4.3.3 The FTI Case¹³⁵

4.3.3.1 Background

This case was a proceeding between 53 traders in mobile phone and computer processing units and their trade body, the FTI, against the Commissioners and the Attorney General.¹³⁶ The proceedings concerned whether or not national provisions, with the purpose to

¹³⁴ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 13.

¹³⁵ Case C-384/04, *FTI*, ECR [2006], p. I-4191.

¹³⁶ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 2.

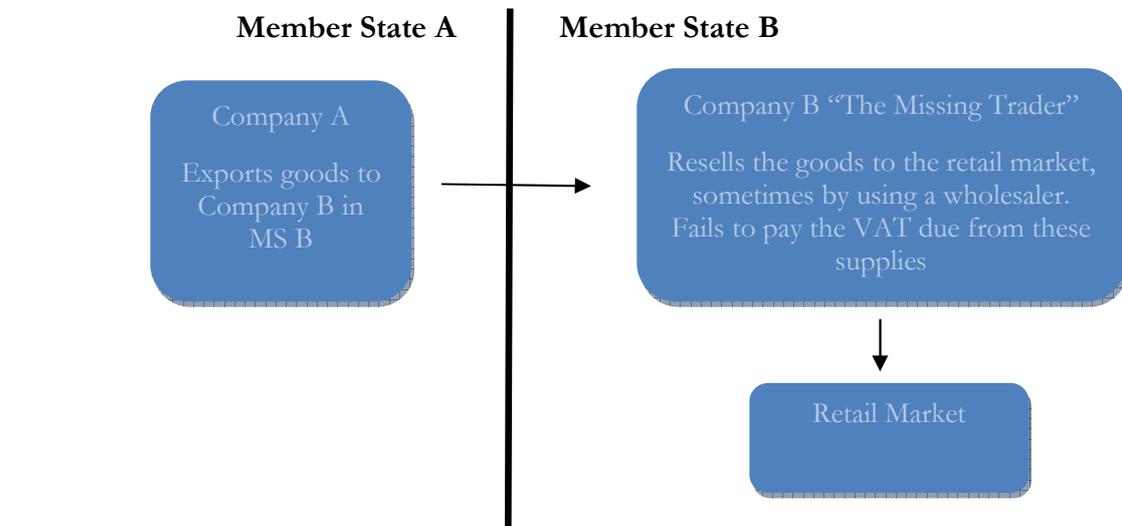
cope with the problems concerning fraudulent abuse of the VAT system, was compatible with Community law.¹³⁷

The national provisions in question were national legislation with the purpose of combating MTIC fraud, including carousel fraud.¹³⁸ The FTI questioned these provisions' compatibility with Community legislation. The national rules meant that the Commissioners had the right to require that the taxable person claiming a refund should undertake such evidence related to the VAT and that the Commissioners may require that a security is to be given in order to make a VAT credit.¹³⁹ They may also require joint and several liability of traders who knew or had reasons to suspect that all or some of the VAT of that supply would go unpaid.¹⁴⁰

According to the Commissioners, the MTIC fraud can be divided into two separate categories, acquisition fraud and carousel fraud.¹⁴¹

4.3.3.2 Acquisition Fraud

By acquisition fraud, the Commissioners essentially mean a scenario with a Company B, registered for VAT in Member State B, which serves as the Missing Trader. Company B imports goods from a supplier in another Member State, Member State A, and later resale the goods. Company B usually resale the goods to the retail market, this occur either directly from Company B or through a wholesaler. After the transactions, Company B fails to pay the VAT due on its onward supplies to the Commissioners.¹⁴² Another situation, which suits under acquisition fraud, is the cases where Company B pretends to be an existing VAT registered business, but in reality, the company has hijacked the VAT number.¹⁴³



¹³⁷ Articles 205 and 273 of the VAT Directive, former articles 21(3) and 22(8) of the Sixth VAT Directive.

¹³⁸ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 7.

¹³⁹ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 5.

¹⁴⁰ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 6.

¹⁴¹ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 10-12.

¹⁴² Case C-384/04, *FTI*, ECR [2006], p. I-4191, para 11.

¹⁴³ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para 11.

4.3.3.3 Carousel Fraud

Carousel fraud is when,

*“the same goods travel within the Union from one Member State to another and back again, without reaching an end-user.”*¹⁴⁴

Company A, established in one Member State, Member State A, export goods to Company B, established in Member State B. Company B, the missing trader, later resale the goods to a buffer company, Company C, but fails to account for VAT.¹⁴⁵ The buffer company may be wholly unaware of the fraud and later resale the goods to another buffer company, at a higher price. This kind of chain of supplies continues until the goods are sold to a company, registered for VAT in another Member State. Sometimes this final sale is made to Company A in Member State A, then it is a true carousel fraud. This final sale is zero-rated due to export, but the seller still has the right to deduct the input VAT. The exporting company tries to recover the input VAT from the tax authority.¹⁴⁶ If the company receives the claim, the tax authority pay the exporting company the VAT charged on the sale by the last buffer company, Company C, but does not receive the sum charged as VAT from Company B.¹⁴⁷ The fraud can then start over again and on each lap around the carousel the VAT paid to Company B, the missing trader, is taken from the public revenue. Company B might use a “hijacked” VAT number or it might register itself for VAT and then disappear before the tax authority takes action.¹⁴⁸ See picture in chapter 4.2.

4.3.3.4 Difference between Acquisition Fraud and Carousel Fraud

The difference between acquisition fraud and carousel fraud is that the company in an acquisition fraud often intends to go missing. However, the company is usually not part of a large organised chain.¹⁴⁹ Regarding carousel fraud, organised criminals are often financing the companies involved in a carousel fraud, normally with the active or passive co-operation of others wanting to make a fast profit.¹⁵⁰ The people organising the carousel frauds typically give young men the promise of quick money if they appear as the front man for a business that after a few months goes missing. The people organising the carousel fraud easily replace the Missing Traders.¹⁵¹

¹⁴⁴ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para 12.

¹⁴⁵ Opinion of AG, Poiares Maduro, in case C-383/04, *FTI*, ECR [2006], p. I-4191, para. 9.

¹⁴⁶ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para 13.

¹⁴⁷ Opinion of AG, Poiares Maduro, in case C-383/04, *FTI*, ECR [2006], p. I-4191, para. 9.

¹⁴⁸ Opinion of AG, Poiares Maduro, in case C-383/04, *FTI*, ECR [2006], p. I-4191, para. 9.

¹⁴⁹ Needham, Andrew, ‘MTIC’ Fraud – What Can Advisers Do To Help Identify It In A Business? – VAT Voice May/June 2006.

¹⁵⁰ Needham, Andrew, ‘MTIC’ Fraud – What Can Advisers Do To Help Identify It In A Business? – VAT Voice May/June 2006.

¹⁵¹ Needham, Andrew, ‘MTIC’ Fraud – What Can Advisers Do To Help Identify It In A Business? – VAT Voice May/June 2006.

4.3.4 The Kittel Case¹⁵²

4.3.4.1 Background

The Kittel case was a joint case between Computime, represented by Mr. Kittel v Belgian State and Belgian State v Recolta Recycling. The case concerned the refusal from the Belgian tax authorities to allow deduction of VAT paid on transactions, since the transactions in question, supposedly, were connected with carousel fraud.¹⁵³ In Case C-439/04 the company is supposedly aware of the fact that it is part of a carousel fraud, while in case C-440/04 the company has made the transaction in good faith, without any knowledge of being part of a carousel fraud.¹⁵⁴

4.3.4.2 Computime

Case C-439/04, concerned a company, Computime, whose business was to buy and resell computer components. The tax authorities claimed that Computime was participating in a carousel fraud in order to recover VAT invoiced by suppliers for the same goods. The tax authorities also claimed that the supplies effected to Computime were of fictional nature. Therefore, the tax authorities refused to allow Computime's demand for deduction of the VAT paid on those supplies.¹⁵⁵

The computer components were purchased in Belgium and later exported to other Member States, Luxembourg in particular.¹⁵⁶ The purchaser in Luxembourg resold the components to a third company, also established in Luxembourg. This third party brought the components to a neighbouring country and finally sent them to the supplier of Computime.¹⁵⁷ The supplier of Computime did not pay the VAT, which was invoiced to Computime, to the tax authorities.¹⁵⁸ Computime supposedly knew about this fraudulent VAT behaviour.¹⁵⁹

¹⁵² Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161.

¹⁵³ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 2.

¹⁵⁴ Opinion of AG Dámaso Ruiz-Jarabo Colomer, in joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para.2.

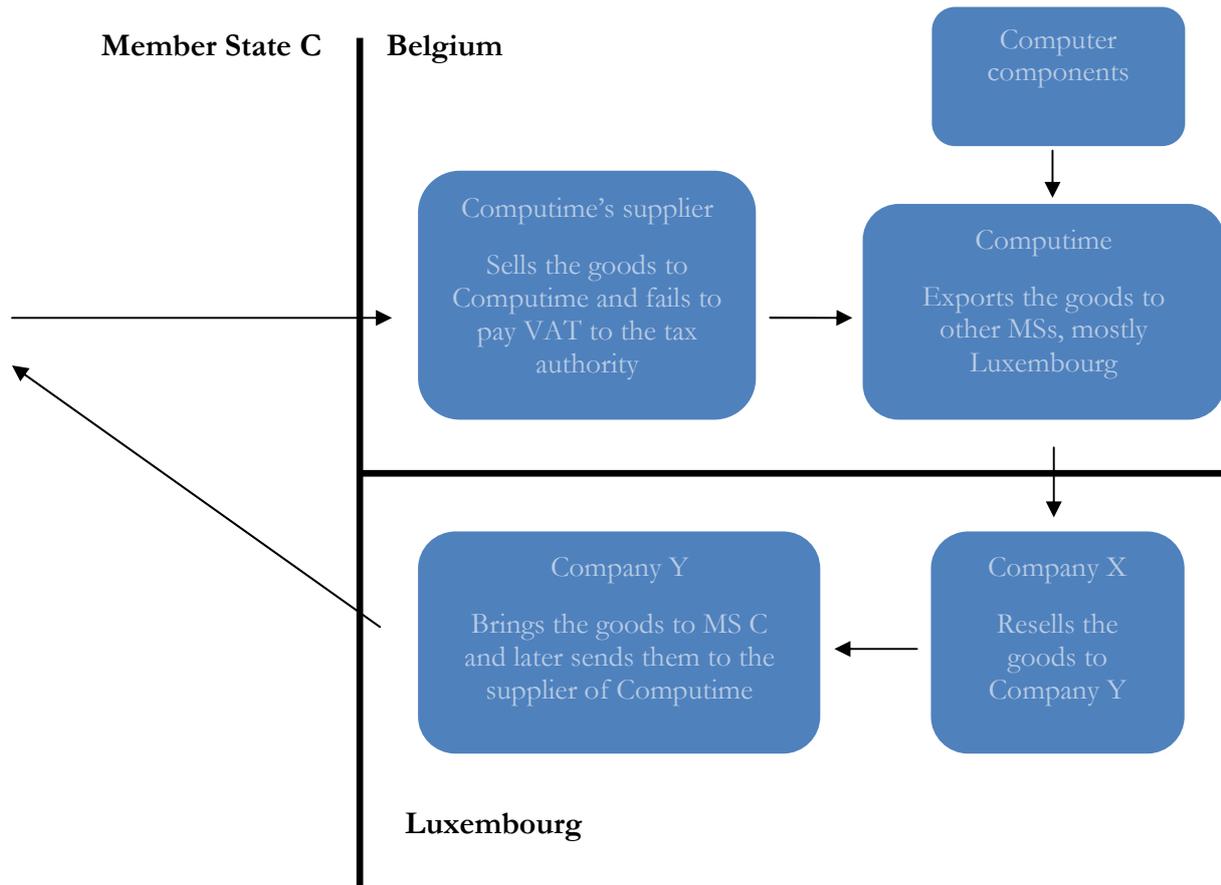
¹⁵⁵ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], I-6161, para. 10.

¹⁵⁶ Opinion of AG Dámaso Ruiz-Jarabo Colomer, in joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 13.

¹⁵⁷ Opinion of AG Dámaso Ruiz-Jarabo Colomer, in joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 14.

¹⁵⁸ Opinion of AG Dámaso Ruiz-Jarabo Colomer, in joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 15.

¹⁵⁹ Opinion of AG Dámaso Ruiz-Jarabo Colomer, in joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 16.



4.3.4.3 Recolta

Case C-440/04, concerned Recolta’s purchase of sixteen luxury vehicles from Mr Ailliaud. Mr Ailliaud purchased the vehicles from a company, Auto-Mail. The purchase from Auto-Mail was not subject to VAT and Mr Ailliaud did not pass the VAT paid by Recolta to the Belgian State. Recolta later sold the vehicles back to Auto-Mail, without VAT, since it was an export sale.¹⁶⁰ The vehicles did never leave Belgium; in fact, they formed part of a special arranged fraud scheme in order to avoid having to pay the invoiced VAT.¹⁶¹

The Special Inspectorate of Taxes carried out an investigation, which concluded that Mr Ailliaud and Auto-Mail had created a scheme for carousel fraud, and the transactions of Recolta formed part of this fraudulent scheme.¹⁶² The VAT collector demanded Recolta to pay taxes and fines of several BEF millions, due to its participations in this scheme. Recolta brought proceedings against this claim before the court of first instance, the Tribunal de première instance de Verviers.¹⁶³ The Court of First Instance found that nothing suggested

¹⁶⁰ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 14.

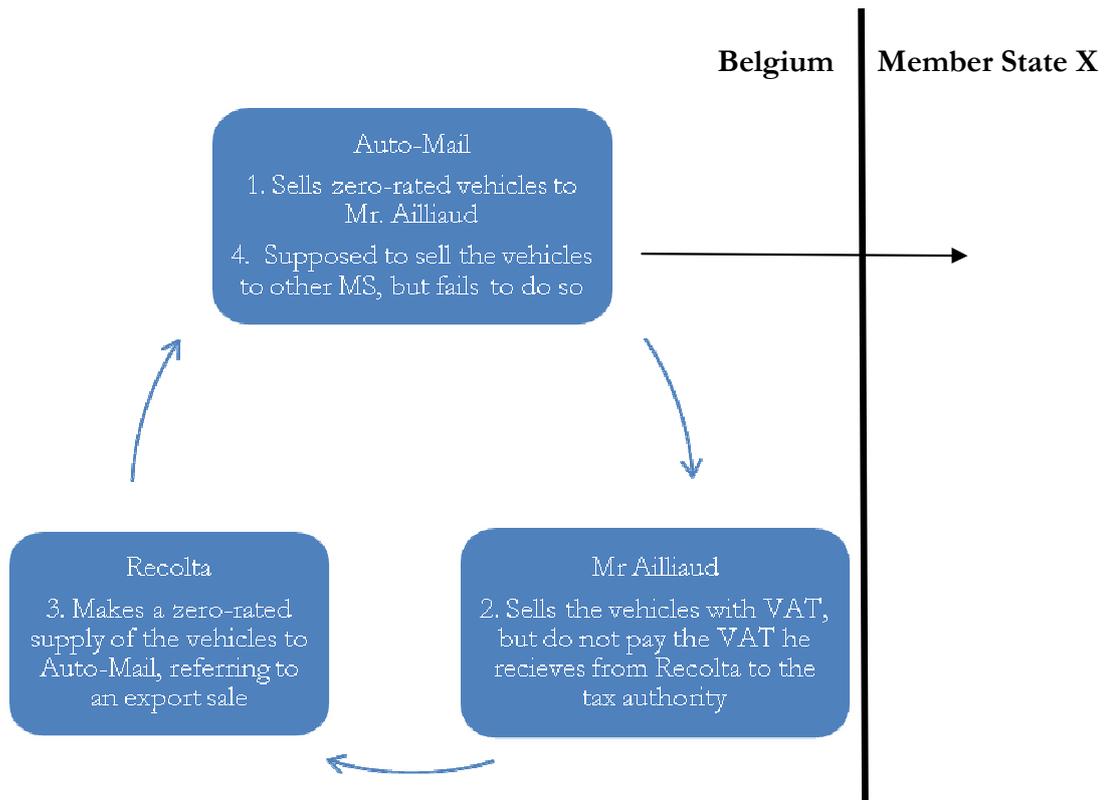
¹⁶¹ Opinion of AG Dámaso Ruiz-Jarabo Colomer, in joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 19.

¹⁶² Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 15.

¹⁶³ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 16-17.

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that Recolta or its directors knew or had any reasons to suspect that they were involved in a major fraud scheme.¹⁶⁴



¹⁶⁴ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 17.

5 The Right to Deduct in Case of Carousel Fraud

5.1 Case Law

The right to deduct when involved in carousel fraud, both knowingly and not, has been interpreted by the ECJ. Analyzes of the relevant case law is to be made below. In the *Optigen* case the ECJ interpret the deduction right for taxable persons when they are unaware or have no reason to suspect that they are involved in a carousel fraud. The *FII* case relates to situations when taxable persons can be jointly and severally liable for the VAT, in situations of carousel fraud. Finally in the *Kittel* case the ECJ explains the right to deduct, when taxable persons are aware or should be aware that they are taking part of a carousel scheme. These three cases give a clearer picture of how to handle the right to deduct for taxable persons, knowingly or not, involved in carousel frauds. The ruling in these cases does however create new interpretation problems regarding how to decide when a company is part of a carousel fraud.

5.2 *Optigen*¹⁶⁵

5.2.1 Background

5.2.1.1 *Optigen* and *Fulcrum*

The companies *Optigen* and *Fulcrum* bought CPUs from companies established in the UK and resold them to companies established in other Member States.¹⁶⁶ *Optigen* claimed a refund of input VAT of GBP 7 million in its VAT return, while *Fulcrum* claimed a refund of nearly GBP 7,2 million in June and GBP 4 million in July.¹⁶⁷ The Commissioners disallowed *Optigen*'s claim for a refund and partially disallowed the refund claim made by *Fulcrum*.¹⁶⁸ The Commissioners based their refusal on the declaration that the companies' purchases lacked economic substance and that they were not part of any economic activity.¹⁶⁹ Both companies appealed against the Commissioners' decision before the VAT and Duties Tribunal in London.¹⁷⁰

Optigen and *Fulcrum* were not involved in the fraud and they did not have any reasons to believe that they were part of the fraud, other than as ordinary buyers. The companies did not trade with the missing trader or the trader using the hijacked VAT number.¹⁷¹

¹⁶⁵ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483.

¹⁶⁶ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 8.

¹⁶⁷ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 9-10.

¹⁶⁸ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 9-10.

¹⁶⁹ Opinion of AG Poiares Maduro, in joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 11.

¹⁷⁰ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 15.

¹⁷¹ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 22.

5.2.1.2 Bond House

Bond House bought CPUs from companies in the UK and resold them to companies in another Member State. The company claimed a refund of GBP 16,3 million for input VAT for these supplies. The Commissioners decided that Bond House was only allowed to reclaim GBP 2,7 million, since the transactions formed part of supply chain which involved a defaulting trader.¹⁷² Bond House appealed against the decision, before the VAT and Duties Tribunal in Manchester.¹⁷³

Bond House was not suspected of any VAT fraud. Bond House had no knowledge of the existing fraud and they did not act irresponsibly nor did they trade with any of the fraudulent traders. All Bond House transactions were legitimate, meaning that the goods and the money were in fact exchanged on every transaction.¹⁷⁴

5.2.2 Community Legislation

The supply of goods for consideration within the Member State by a taxable person acting as such shall be subject to VAT.¹⁷⁵ The definition of a taxable person is any person who independently carries out any economic activity no matter what the purpose or result of that activity is.¹⁷⁶ Furthermore, the supply of goods shall mean the transfer of the right to dispose of tangible property as an owner.¹⁷⁷

5.2.3 The Questions Referred

The national court wanted to know if the transactions in question, constituted a supply of goods effected by a taxable person acting as such and an economic activity within the meaning of the VAT Directive.¹⁷⁸ The transactions were not themselves fraudulent, however they formed part of a supply chain in which a former or subsequent transaction was, but without the trader connected with the honest transaction knew or had any way of knowing that part of the supply chain was involved in a carousel fraud. The national court also wanted to know if the right to deduct VAT might be limited for traders in such a situation.¹⁷⁹

The Optigen case is important in two different ways. Firstly, the ECJ is answering the question if a transaction forming part of a supply chain in which a former or subsequent transaction was fraudulent constitutes a supply of goods effected by a taxable person and an economic activity within the meaning of the VAT Directive. Secondly, the ECJ answers if the right to deduct may be limited in such a situation.

¹⁷² Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para 11-12.

¹⁷³ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 19.

¹⁷⁴ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 23.

¹⁷⁵ Article 2(1)(a) of the VAT Directive.

¹⁷⁶ Article 9(1) para. 1 of the VAT Directive.

¹⁷⁷ Article 14(1) of the VAT Directive.

¹⁷⁸ Articles 2(1)(a), 9(1) and 14(1) of the VAT Directive.

¹⁷⁹ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 29.

Optigen and Fulcrum reckon that the right for a trader to obtain a credit for a VAT payment shall be judged based on the actual transaction and the purpose of that transaction and not on any former or subsequent transaction of which the trader had no knowledge.¹⁸⁰ According to the UK government, the right for a trader to obtain a credit for a VAT payment shall be based on all transactions forming a circular chain of supply. All the transactions within the circular chain of supply, whose aim is to conduct a carousel fraud, shall fall outside the scope of the VAT Directive. The mere fact that innocent traders are involved in some of the transactions does not bring those traders within the scope of the VAT Directive.¹⁸¹ The Commissioners argue that a trader's right to obtain a credit for a VAT payment shall be based on the actual transactions to which the trader was a party. His right to obtain a credit is not affected by any fraudulent actions in the supply chain of which he was unaware. Therefore, it would be contrary to the VAT Directive if a taxable supply would be excluded.¹⁸²

5.2.4 Interpretation of the ECJ

According to the ECJ, an analysis of the concept economic activity shows that the scope of economic activity is very wide. The term economic activity is objective in character, meaning that the activity shall be considered per se, without reference to the purpose or result of the activity.¹⁸³ The definition of supply of goods and taxable persons acting as such are also objective in character and applied without regard to the purpose or result of the transactions in question.¹⁸⁴ As the ECJ previously has held, it is not the duty of the tax authorities to investigate the taxable person's intention with the transaction. It would be contrary to the objectives of the VAT system of ensuring legal certainty and facilitating the application of VAT if the tax authorities had to consider the objective character of the transaction in question.¹⁸⁵ It would also be contrary to the common VAT system and the facilitating of the application of VAT if the tax authority, in order to decide whether a transaction is a supply of goods and an economic activity, had to consider the intention of a trader involved in another possible fraudulent transaction which took place before or after the transaction in question and which the taxable person had no knowledge of.¹⁸⁶ Therefore, each transaction must be considered on its own and the character of the transaction cannot change due to former or later happenings.¹⁸⁷

¹⁸⁰ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 30.

¹⁸¹ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 32.

¹⁸² Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 35.

¹⁸³ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 43, see also Case C-260/98, *Commission v Greece*, ECR [2000], p. I-6537, para. 26.

¹⁸⁴ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 44.

¹⁸⁵ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 45, see also Case C-4/94, *BLP Group*, ECR [1995], p. I-983, para. 24.

¹⁸⁶ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 46.

¹⁸⁷ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 47.

5.2.5 The Judgement

Transactions, which are not themselves fraudulent, constitute supplies of goods effected by a taxable person acting as such and an economic activity within the meaning of the VAT Directive, if they fulfil the objective criteria on which the definition of taxable person acting as such and economic activity are based upon.¹⁸⁸ The intention that a trader, other than the taxable person involved in the same supply chain, had with its transactions does not matter.¹⁸⁹ Taxable persons' right to deduct input VAT cannot be limited because another, former or subsequent, transaction in the supply chain is part of a VAT fraud, if the taxable person had no knowledge of the fraudulent transactions.¹⁹⁰ The ECJ has repeatedly held that the right to deduct provided for in the VAT Directive is a fundamental part of the VAT system and may in principle, not be limited.¹⁹¹ The right to deduct input VAT shall not be affected by the fact that the VAT on an earlier or later sale of the goods has not been paid to the tax authority.¹⁹²

5.2.6 Conclusion

If a taxable person did not know or had any means of knowing that a former or subsequent transaction in the supply chain is fraudulent, his right to deduct input VAT cannot be denied. A trader who has taken every possible precaution which could be required of him in order to ensure that his transactions are not involved in a carousel scheme, must be able to rely on the legality of the transaction without risk losing his right to deduct.¹⁹³ A central part of the VAT system is that VAT shall be chargeable on each transaction in the supply chain, therefore each transaction shall be considered on its own. As a result, the character of a transaction cannot change due to former or subsequent happenings.¹⁹⁴ Each transaction has to be considered on its own due to the neutrality of the VAT system and the principle of legal certainty.¹⁹⁵

The ECJ did only interpret how the right to deduct in case of carousel fraud would be affected for unaware traders, nothing was said about if and how the right to deduct were to be affected if the trader was aware or had reasons to believe that he took part of a carousel fraud, these questions were left unsolved.

¹⁸⁸ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 51.

¹⁸⁹ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 51.

¹⁹⁰ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 52.

¹⁹¹ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 53.

¹⁹² Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 54.

¹⁹³ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 33.

¹⁹⁴ Opinion of AG Poiares Maduro, in joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 27.

¹⁹⁵ Opinion of AG Poiares Maduro, in joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 29.

5.3 FTI¹⁹⁶

5.3.1 Background

The UK's public revenue, loses over GBP 1,5 billion per year due to different types of VAT frauds.¹⁹⁷ The UK legislation provides joint and several liability for traders who knew or had reasons to suspect that all or some of the VAT of a supply would go unpaid.¹⁹⁸ This national legislation was adopted with the intention of combating MTIC fraud, including carousel fraud. However, the FTI claimed that the legislation in question were not compatible with the VAT Directive.¹⁹⁹ According to the FTI, the VAT Directive does not authorize the Member States to adopt such legislation.²⁰⁰ The application from the FTI was considered by the Court of Appeal (England and Wales), who decided to stay the proceedings and ask the ECJ for a preliminary ruling.²⁰¹

5.3.2 Community Legislation

A taxable person carrying out taxable supplies of goods shall be liable to pay VAT, except for the cases referred to in articles 194-199.²⁰² When a taxable person, not established in the Member State where the VAT is due, carries out a taxable supply of goods, the Member State may provide that the person to whom the goods are supplied shall be liable for the payment of that VAT.²⁰³ In some cases, if certain conditions are fulfilled, the person to whom the supply of goods is made shall be liable for the payment of VAT.²⁰⁴ However, it is possible for the Member States to make derogation from this provision if a tax representative is appointed as the person liable for payment of the VAT pursuant to article 204 of the VAT Directive.²⁰⁵ VAT shall be payable by any taxable person making a taxable intra Community acquisition of goods.²⁰⁶ Member States may provide that someone, other than the person liable to pay the VAT shall be held jointly and severally liable for the payment of VAT in certain situations.²⁰⁷ The question in the case was if the national rule was in conflict with Community legislation.²⁰⁸

¹⁹⁶ Case C-384/04, *FTI*, ECR [2006], p. I-4191.

¹⁹⁷ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 14.

¹⁹⁸ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 6.

¹⁹⁹ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 7-8.

²⁰⁰ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 16.

²⁰¹ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 17.

²⁰² Article 193 of the VAT Directive.

²⁰³ Article 194 of the VAT Directive.

²⁰⁴ Article 197(1)(a-c) of the VAT Directive.

²⁰⁵ Article 197(2) of the VAT Directive.

²⁰⁶ Article 200 of the VAT Directive.

²⁰⁷ Article 205 of the VAT Directive, referring to articles 193-200 and 202-204 of the VAT Directive.

²⁰⁸ Articles 205 of VAT Directive, former article 21(3) of the sixth VAT Directive.

5.3.3 National Legislation

The UK's legislation in question was sections 17 and 18 of the Finance Act 2003, which were enacted in order to prevent the fraudulent abuse of the VAT system and to combat MTIC fraud, including carousel fraud.²⁰⁹ The following summary of the national legislation is based on information from the ECJ. According to national legislation, the Commissioners may require that the taxable person claiming a refund of input VAT shall undertake such evidence relating to VAT as the Commissioners specify.²¹⁰

The national Finance Act provides joint and several liability for traders in supply chains where tax is unpaid. The joint and several liability applies on certain goods, if the taxable supply has been made to a taxable person and if that taxable person, at the time of the supply, knew or had reasons to suspect that some or all of the VAT related to the supply, or on any previous or following supply of the same goods, would go unpaid.²¹¹ In that case the Commissioners may give him notice specifying the amount of VAT that is payable. The effect of the notice is that the taxable person given the notice and the person who is actually liable for the VAT specified in the notice, are jointly and severally liable.²¹² A taxable person shall be presumed to have reasons to suspect that all or some of the VAT would go unpaid, if the price he pays for the goods was less than the lowest price that might reasonable be expected on the open market or was less than the price on any previous supply of those goods. The taxable person shall not be presumed to have reasons to suspect that VAT would go unpaid if he can show that the low price depended on circumstances that were unconnected with failure to pay VAT.²¹³

5.3.4 The Questions Referred

The Commissioners submit that Community legislation gives Member States the right to enact legislation such as the one in the national Finance Act.²¹⁴ However, the FTI submits that the Community legislation in question does not give Member States the right to adopt national legislation as this one.²¹⁵ Therefore, the Court of Appeal (England and Wales) decided to stay proceedings and ask the ECJ for a preliminary ruling on five different questions. Not all questions are relevant for this thesis, therefore the important parts has been summarised into one question.

1. Does Community legislation allow the Member States to adopt national legislation, which provide that any person can be made jointly and severally liable for the pay-

²⁰⁹ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 2 and 7.

²¹⁰ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 5.

²¹¹ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 6.

²¹² Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 6.

²¹³ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 6.

²¹⁴ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 15.

²¹⁵ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 16.

ment of VAT together with the person who is made so liable²¹⁶, as long as the legislation is compatible with the general principles of Community law?²¹⁷

FTI is important from two aspects. To begin with, the ECJ is answering the question if Community legislation precludes national legislation which provides that any taxable person can be made jointly and severally liable for the payment of VAT together with the person actually liable. Secondly, the ECJ rules that there is a difference between transactions where a trader knew and transactions where a trader was unaware of the fraudulent behavior.

5.3.5 Interpretation of the ECJ

The ECJ stated that according to Community legislation, the Member States are allowed to adopt legislation, which provides that a taxable person other than the person actually liable to pay the VAT is made jointly and severally liable.²¹⁸ Therefore, the Member States are in principle permitted to adopt legislation under which a taxable person is to be jointly and severally liable, if the legislation complies with the general principles of Community law and in particular the principles of legal certainty and proportionality.²¹⁹ According to the principle of proportionality, the Member States may not go further than necessary in order to fulfil the goals.²²⁰ The national legislation provides that a taxable person may be jointly and severally liable if the taxable person knew or had reasons to suspect that all or some of the VAT of that supply, or any previous or subsequent supplies of those goods, would go unpaid. A taxable person is assumed to have reasons to suspect a fraudulent behaviour if the price was less than the price on the open market or less than the lowest price paid on any previous supplies of those goods.²²¹ Legislation based on presumptions like these are allowed.²²² However, the presumptions cannot be formulated in a way, which makes it impossible or excessively difficult for the taxable person to rebut the tax authority with evidence to the opposite. Nonetheless, those presumptions must not de facto bring about a system of strict liability since that would go beyond what is necessary to protect the public exchequer's rights.²²³ Traders taking every available measures, which could reasonably be required, to ensure that their transactions are not part of a fraudulent transaction chain must be able to rely on the legality of those transactions without being made jointly and severally liable to pay VAT due from another taxable person.²²⁴

²¹⁶ Articles 193, 194, 197, 200, 203 and 204 of the VAT Directive.

²¹⁷ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 17.

²¹⁸ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 25.

²¹⁹ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 28-29.

²²⁰ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 30.

²²¹ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 31.

²²² Article 205 of the VAT Directive.

²²³ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 32 and Opinion of AG, Poirares Maduro, in case C-383/04, *FTI*, ECR [2006], p. I-4191, para. 27.

²²⁴ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 33.

5.3.6 The Judgement

Community legislation allows Member States to adopt legislation which provides that a taxable person, to whom a supply of goods has been made and who knew or had reasons to suspect, that all or some of the VAT payable in respect of that supply, or any previous or subsequent supply, would go unpaid, may be made jointly and severally liable, with the person who is actually liable, for payment of that VAT. However, such legislation must, comply with the general principles of Community law and in particular, the principles of legal certainty and proportionality.²²⁵

5.3.7 Conclusion

According to the judgement, Member States are allowed to adopt legislation which requires that a taxable person, to whom a supply of goods has been made, may be jointly and severally liable for the payment of VAT due on these goods together with the person who is actually liable. Such legislation can only be adopted if the taxable person knew or had reasons to suspect that, all or some of the VAT in question would go unpaid. Nonetheless, the requirements must comply with Community legislation such as the principle of proportionality and the principle of legal certainty. The principle of legal certainty requires that measures adopted in accordance with Community law must be clear and that the application of the measures must be predictable for those who are going to rely on them.²²⁶ Pursuant to the principle of proportionality, a Member State cannot go beyond what is necessary in order to achieve the goal while taking action.²²⁷ Therefore, in order to stop the VAT fraud in supply chains and make another person liable for the payment of VAT the Member States has to balance between ensuring legal certainty for legal business and increasing the tax authority's ability to recover huge sums of VAT that has not been collected due to carousel frauds.²²⁸ The outcome of this case left an interpretation problem, regarding what it takes in order for a taxable person to be deemed to have had reasons to suspect that he formed part of a carousel fraud. This is not an easy task for the national courts to decide, especially not without any clear guidelines.

5.4 Kittel²²⁹

5.4.1 Background

5.4.1.1 Computime

The Belgian tax authority had produced a report, which stated that Computime knowingly had participated in a carousel fraud, and due to this, they were refused to deduct the VAT paid on their supplies.²³⁰ Based on the report Computime were demanded to repay taxes

²²⁵ Case C-384/04, *FTI*, ECR [2006], p. I-4191, para. 35.

²²⁶ Opinion of AG, Poiares Maduro, in case C-383/04, *FTI*, ECR [2006], p. I-4191, para. 24.

²²⁷ Article 5.3 EC.

²²⁸ COM(2007) 758, p. 11.

²²⁹ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161.

²³⁰ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 10.

including fines of approximately EUR 18 million.²³¹ Computime wanted this demand of payment set aside and therefore they applied to the Tribunal de première instance de Verviers. This court declared the application unfounded, as did the Cour d'appelle de Liège. Subsequently Computime's receiver, Mr Kittel, acting on behalf of Computime, brought an appeal against this judgement before the Cour de cassation.²³²

5.4.1.2 Recolta

The Special Inspectorate of Taxes had made an investigation, which showed that Mr Ailliand and Auto-Mail had set up a scheme for carousel fraud, and that Recolta formed part of this scheme.²³³ Due to this, Recolta was demanded to pay taxes including fines of approximately EUR 360 000.²³⁴ Recolta appealed to the Tribunal de première instance de Verviers, and was successful. Much of this success depended on the fact that nothing suggested that Recolta or its directors knew or suspected that they were involved in a carousel fraud scheme.²³⁵ The Belgian State appealed against this decision to the Cour d'appell de Liège, but once again Recolta was successful.²³⁶ The Belgian State later appealed to the Cour de cassation.²³⁷

5.4.2 Community Legislation

In order to analyze the Kittel case some relevant Community legislation has to be reviewed. A general tax on consumption shall be applied to goods and services, this tax shall be exactly proportional to the price of the goods and services.²³⁸ Subject to VAT is the supply of goods or services which is effected for consideration. A taxable person, acting as such, shall make the supply and it shall be within the territory of the country.²³⁹ When the right to dispose tangible property is transferred, it is a supply of goods.²⁴⁰ The right to deduct arises when the deductible tax becomes chargeable.²⁴¹

²³¹ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 11.

²³² Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 12-13.

²³³ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 15.

²³⁴ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 16.

²³⁵ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 17.

²³⁶ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 18.

²³⁷ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 19.

²³⁸ Article 1(2) of the VAT Directive.

²³⁹ Article 2(1)(a) of the VAT Directive. For a definition of taxable person and economic activity, see article 9(1) of the VAT Directive.

²⁴⁰ Article 14(1) of the VAT Directive.

²⁴¹ Article 167 of the VAT Directive.

5.4.3 National Legislation

The following summary of the national legislation is based on information from the ECJ. According to Belgian law, unfounded obligations or obligations with false or unlawful basis cannot give rise to any effect.²⁴² Belgian law also provides that, unlawful basis is when the basis is contrary to law, morality or public policy.²⁴³ When the Belgian State appealed to the Cour d'appell de Liège they claimed that the main purpose of the contract between Mr Ailliaud and Recolta was that Mr Ailliaud wanted to effect transactions, which were contrary to the workings of VAT.²⁴⁴ This concluded that the transactions were unlawful and due to the Belgian law, this was actually not a supply of goods and therefore the trader had no right of deduction.²⁴⁵

5.4.4 The Questions Referred

In order to give a judgement in these cases the Cour de cassation referred some questions to the ECJ. Cour de cassation referred two questions, regarding both the Computime case and the Recolta case.

1. *“Where the recipient of a supply of goods is a taxable person who has entered into a contract in good faith without knowledge of a fraud committed by the seller, does the principle of fiscal neutrality in respect of [VAT] mean that the fact that the contract of sale is void – by reason of a rule of domestic civil law which renders the contract incurably void as contrary to public policy for unlawful basis of the contract attributable to the seller – cannot cause that taxable person to lose the right to deduct that tax?”*²⁴⁶
2. *“Is the answer different where the contract is incurably void for fraudulent evasion of [VAT] itself?”*²⁴⁷

The court also referred a third question in the Computime case.

3. *“Is the answer different where the unlawful basis of the contract of sale which renders it incurably void under domestic law is a fraudulent evasion of [VAT] known to both parties to the contract?”*²⁴⁸

This case is important in two different ways. Firstly, the ECJ is answering the question if Community legislation precludes national law, which states that the right to deduct is restricted for taxable persons who do not know or could not know that the transaction they made formed part of a fraud, made by the other taxable person. Secondly, it interprets if the situation is different where taxable persons knew or should have known that by making the transaction they participated in a scheme of fraudulent nature.

²⁴² Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 8.

²⁴³ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 9.

²⁴⁴ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 18.

²⁴⁵ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 18.

²⁴⁶ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 25.

²⁴⁷ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 25.

²⁴⁸ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 25.

5.4.5 Interpretation of the ECJ

The right to deduct forms an integral part of the common VAT system and may in principle, not be limited.²⁴⁹ Traders are not supposed to bare the burden of VAT; this burden shall lie on the last person in the chain, the consumer.²⁵⁰ The deduction rules are a great part of the rules governing VAT since these rules relieve the traders from this burden.²⁵¹ The deduction rules do also ensure the neutrality of taxation between all kinds of economic activity, so that the purpose and result of the economic activity does not matter.²⁵² It is settled case law that a general distinction between lawful and unlawful transactions is prevented by reasons of the principle of fiscal neutrality.²⁵³ This concludes that traders who takes every precaution, reasonable required, ensuring that their trading is not involved with fraud, has to be able to rely on the legality of those transactions, without risk losing the right to deduct the input VAT.²⁵⁴

Regarding the third question, dealing with taxable persons who knowingly participate in a scheme of fraud, the situation is different. In order to deduct VAT the objective criteria has to be fulfilled. The supply has to be a supply of goods, the transaction has to be made by a taxable person, acting as such and it has to be the case of an economic activity.²⁵⁵ If the transaction is made for the reason of evading tax these objective criteria is not met.²⁵⁶ Community legislation recognises and encourages actions taken for the prevention of tax evasion, avoidance and abuse.²⁵⁷ A trader cannot rely on Community legislation for the purpose of fraud or abuse.²⁵⁸ Tax authorities are able to claim a refund of deducted tax retroactively, if they find that this right of deduction has been exercised fraudulently.²⁵⁹ Taxable persons making transaction in order to evade VAT are not able to rely on the right to deduct, therefore neither should taxable persons who knew or should have known that they took part in a transaction connected with fraudulent evasion.²⁶⁰ A taxable person who knew or should have known that he formed part of a scheme of fraud is to be regarded as a

²⁴⁹ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 47.

²⁵⁰ Article 1(2) and 2(1)(a) of the VAT Directive.

²⁵¹ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 48.

²⁵² Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 48.

²⁵³ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 50, see also Case C-455/98, *Salumets*, ECR [2000], p. I-4993, para. 19 and Case C-158/98, *Coffeeshop 'Siberië'*, ECR [1999], p. I-3971, para. 14 and 21.

²⁵⁴ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 51.

²⁵⁵ Article 2(1)(a) in the VAT Directive.

²⁵⁶ Case C-255/02 *Halifax*, ECR [2006], p. I-1609, para. 59.

²⁵⁷ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 54, see also, Joined cases C-487/01 and C-7/02 *Gemeente Leusden and Holin Groep*, ECR [2004], p. I-5337, para. 76.

²⁵⁸ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 54, see also, case C-373/97, *Diamantis*, ECR [2000], p. I-1705, para. 33 and case C-32/03, *Fini H*, ECR [2005], p. I-1599, para. 32.

²⁵⁹ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 55, see also, case C-268/83, *Rompelman*, ECR [1985], p. 655, para. 24 and case C-110/94 *INZO v Belgian State*, ECR [1996], p. I-857, para. 24.

²⁶⁰ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 56.

participant of this fraud, regardless if he profited by the resale or not.²⁶¹ A taxable person that knowingly takes part in such a scheme, does in fact become accomplice and by participating, aiding the person behind the fraud with the execution of it.²⁶² Treating a taxable person who knowingly trades with another taxable person, who uses the VAT system in a fraudulent way, as an accomplice is also a way to prevent such situations; it makes it more difficult to carry out such fraudulent transactions.²⁶³

5.4.6 The Judgement

The outcome of this case is that the ECJ ruled that if taxable persons did not and could not know that the transaction, of which they took part, was connected with fraud committed by the seller, national law cannot cause taxable persons to lose their right to deduct the VAT.²⁶⁴

On the other hand, when taxable persons knew or should have known that they formed part of a fraudulent evasion by their transaction, they must be regarded as participants in that fraud.²⁶⁵ Due to this, when ascertained that a taxable person in fact knew or should have known that he took part of a fraudulent evasion by his transactions, it is up to the national court to refuse this taxable person the right to deduct the input VAT.²⁶⁶ The ascertainment shall be done with regard to objective factors.²⁶⁷

5.4.7 Conclusion

Regarding the first question the ECJ confirms its judgement in *Optigen*.²⁶⁸ To refuse deduction where a taxable person does not know or should have known that he took part of a scheme of carousel fraud is not possible.²⁶⁹ This would not be compatible with the principle of the common VAT system.²⁷⁰

The third question, when a taxable person is aware that he takes part of a carousel fraud, was however an unsolved issue after the *Optigen* judgement. The judgement in the *Kittel* case does somewhat clarify these situations, but leaves a great interpretation gap. It is up to the national courts to refuse deduction of input VAT if the taxable person, having regarded the objective factors, is supposed to have been aware of his participation in a carousel

²⁶¹ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 56.

²⁶² Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 57.

²⁶³ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 58.

²⁶⁴ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 52.

²⁶⁵ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 56.

²⁶⁶ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 59.

²⁶⁷ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 59.

²⁶⁸ Joined cases C-354/03, C-355/03 and C-484/03, *Optigen*, ECR [2006], p. I-483, para. 55.

²⁶⁹ Opinion of AG Dámaso Ruiz-Jarabo Colomer, in joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 38.

²⁷⁰ Article 1(2) of the VAT Directive.

fraud. The task of deciding if a taxable person clearly knows that he takes part in a carousel fraud, and therefore remove the right of deduction is manageable. To remove the right to deduct for a taxable person who is supposable aware is another issue. In order to do this the national courts have to decide what a taxable person has to have done in order to fall under the category of being supposedly aware that he has taken part of a carousel fraud. The fact that this decision shall be based on objective factors does not make the situation any easier.

5.5 Awareness

5.5.1 Background

Since it is the task of the national courts to give rulings, while regarding the objective factors, of when taxable persons are supposed to have been aware that they were participating in a carousel fraud, possible indicators has to be identified. These indicators could serve as guidelines, for taxable persons, so that they do not risk losing their right to deduct input VAT. Besides the objector factors, another possibility is available when dealing with deduction in cases of carousel fraud. This other possibility is applying the reverse charging system. Reverse charging can be used in certain situations on certain goods. This subchapter consist of an analyze of both the problematic with objective factors and the possibility to use reverse charging

5.5.2 Indications of Carousel Fraud

No specific Community legislation deprives traders, involved in a carousel fraud, from the right to deduct. However, case law has shown that it is possible for the Member States to adopt national legislation, which deprives traders from their right to deduct if a trader knows or should have known that, by his purchase, he was participating in a fraudulent transaction.²⁷¹

When trying to interpret if a taxable person should have known that he was part of a carousel fraud this would probably have to be made on a transaction by transaction basis.²⁷² The HMRC has identified some indicators which are relevant when assessing if a trader should have been aware. These identified indicators includes exceptionally high volumes of trade, rapid increase in trade, regular trading patterns, consistent margins, trading only with a small number of suppliers and consumers, the ability to easily find a ready buyer for any consignment of goods and if the price of the goods is below the market price at the time of the transaction.²⁷³ One thing to keep in mind is that when deciding if a trader was aware, one ought to look at what information the taxable person had access to.²⁷⁴

There are also other factors which can indicate that a trader, who another trader is making business with, is involved in a chain of carousel fraud. If a trader is dealing with a new business ran by young men with no previous trail in the mobile or computer industry he

²⁷¹ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 61.

²⁷² Collins, Jason and Cooper Ben, Non- Economic Activity – RIP, the Tax Journal, 31 July 2006.

²⁷³ Collins, Jason and Cooper Ben, Non- Economic Activity – RIP, the Tax Journal, 31 July 2006.

²⁷⁴ Collins, Jason and Cooper Ben, Non- Economic Activity – RIP, the Tax Journal, 31 July 2006.

should be careful. It is not logical that these men were working in the local liquor shop one week and operating a EUR 50 million turnover computer company the next week.²⁷⁵ If the existing business has changed dramatically over night, for example a wallpaper business starts to sell mobile phones, or if new people have joined the company, and appear to be running it instead of the original owner this can indicate that the business is involved in a carousel fraud.²⁷⁶ Another indicator is if the company's turnover has grown unrealistically fast during the last year. Another question one can ask is if the company has constant profit margins, it is not likely that a company earns EUR 1 per computer chip on the domestic market and EUR 15 per computer chip sold to another Member State.²⁷⁷ If the company is buying from the Netherlands, Spain and France or selling to Dubai or Hong Kong this could indicate carousel fraud since these countries are common starts and finishing points for the chains.²⁷⁸ Another indicator is how the company has been financed. Large loans from family members, such as a rich uncle who lends money to a nephew he only has met once, might indicate that the company is involved in a carousel scheme.²⁷⁹ *'If it seems too good to be true, it normally is!'*²⁸⁰

5.5.3 The Burden of Proof

According to case law, it is the taxable person seeking to deduct VAT who has to show that he is a taxable person and that he fulfills the conditions for deduction.²⁸¹ It is also settled case law that traders cannot rely on Community legislation in order to commit fraudulent or abusive measures.²⁸² However, if the tax authorities ascertain that a taxable person has exercised his right to deduct in a fraudulent or abusive manner, they may be permitted to claim repayment of the deducted VAT retroactively.²⁸³ In the end, it is up to the national courts to refuse deduction of VAT, if it is shown that the right to deduct has been relied upon with fraudulent or abusive purposes. This decision shall be based on objective factors.²⁸⁴ This indicates that the burden of proof for the taxable person only regards whether

²⁷⁵ Needham, Andrew, 'MTIC' Fraud – What Can Advisers Do To Help Identify It In A Business? – VAT Voice May/June 2006.

²⁷⁶ Needham, Andrew, 'MTIC' Fraud – What Can Advisers Do To Help Identify It In A Business? – VAT Voice May/June 2006.

²⁷⁷ Needham, Andrew, 'MTIC' Fraud – What Can Advisers Do To Help Identify It In A Business? – VAT Voice May/June 2006.

²⁷⁸ Needham, Andrew, 'MTIC' Fraud – What Can Advisers Do To Help Identify It In A Business? – VAT Voice May/June 2006.

²⁷⁹ Needham, Andrew, 'MTIC' Fraud – What Can Advisers Do To Help Identify It In A Business? – VAT Voice May/June 2006.

²⁸⁰ Needham, Andrew, 'MTIC' Fraud – What Can Advisers Do To Help Identify It In A Business? – VAT Voice May/June 2006.

²⁸¹ Case C-268/83, *Rompelman*, ECR [1985], p. 655, para. 24 and case C-110/94, *INZO v Belgian State*, ECR [1996], p. I-857, para. 23.

²⁸² Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 54, see also, case C-373/97, *Diamantis*, ECR [2000], p. I-1705, para. 33 and case C-32/03, *Fini H*, ECR [2005], p. I-1599, para. 32.

²⁸³ Case C-32/03, *Fini H*, ECR [2005], p. I-1599, para. 33, Case C-268/83, *Rompelman*, ECR [1985], p. 655, para. 24 and case C-110/94, *INZO v Belgian State*, ECR [1996], p. I-857, para. 24.

²⁸⁴ Case C-32/03, *Fini H*, ECR [2005], p. I-1599, para. 34.

the conditions for deduction is fulfilled, while it is the tax authorities who have to prove that the taxable person has acted fraudulently. If the tax authorities cannot prove the existence of fraudulent or abusive purposes, the conditions for denying deduction of VAT is not satisfied.

5.5.4 Reverse Charging

In a reverse charging system the buyer of the goods is liable to account the VAT on the supply, instead of the seller. The seller of the goods will not charge VAT, but have to specify on his invoice that the supply is subject for a reverse charging. The buyer has to account for the VAT, but remains the right to deduct it.

By applying reverse charging in business-to-business transactions, the responsibility of paying VAT is placed on the buyer instead of the seller. This solution would be rather effective when it comes to carousel fraud, since the VAT due on the sale by the missing trader would become the liability of the buyer of these goods.²⁸⁵ Therefore, the gains of claiming a refund of VAT, which has not been paid yet, would be eliminated.²⁸⁶ It is already possible for the Member State to apply reverse charging on certain types of goods.²⁸⁷ In 2006, the UK proposed for applying reverse charging for mobile phones, compute chips and other goods that are considered vulnerable goods for carousel frauds. The Council authorized the UK to introduce special measures regarding reverse charging for certain goods, if the derogation only applied to supplies of goods for which the taxable amount is equal or higher than GBP 5 000. The decision is only temporary and shall expire on 30 April 2009.²⁸⁸

Some other Member States have also proposed for applying reverse charging in areas not provided for in the VAT Directive. For example Germany has a proposal which suggests that all business-to-business transactions over EUR 5 000 shall be subject to reversed charge. Both parties in the transaction must report the supply to the tax authorities.²⁸⁹ Austria has a similar proposal which recommend that all business-to-business transactions above EUR 10 000 shall be subject to reversed charge.²⁹⁰

The problem with reverse charging is that if it is limited to a list of certain goods, such as computer chips and mobile phones, the frauds might just move on to other goods not included on the list. It is also possible that the elimination of a trader's output VAT liability might increase the claim of refunds and lead to control difficulties and the risk of refund frauds.²⁹¹ There could also arise problems related to the maintenance of the borders between goods that are subject to reverse charging and goods subject to normal zero-rating.²⁹²

²⁸⁵ Article 199 of the VAT Directive.

²⁸⁶ IFS Green Budget January 2007, p. 175.

²⁸⁷ Article 199 of the VAT Directive.

²⁸⁸ Council Decision 2007/250/EC, article 1 and 4.

²⁸⁹ COM(2006) 404, para. 2.2.

²⁹⁰ COM(2006) 404, para. 2.1.

²⁹¹ Keen, Michael and Smith, Stephen, "VAT fraud and evasion: what do we know and what can be done?" IMF Working Paper, p. 24.

²⁹² IFS Green Budget January 2007, p. 175.

On the other hand, a universal reverse charging on goods above a certain size would effectively remove these issues, but would instead turn VAT into some sort of single-stage retail sales tax. The VAT payments would be deferred until the goods are sold to the final consumer.²⁹³ A universal reverse charging would however lead to other problems such as if the goods are sold to the final consumer without being reported, the whole tax revenue would go missing. In the existing VAT system, if goods are unreported, the VAT losses are limited to the difference between the VAT due on the sale to the final consumer and the VAT already paid in earlier stages.²⁹⁴ Reverse charging will prevent the VAT system from being exposed to carousel frauds, however if reverse charging would be applied extensively, it would be the death of VAT.²⁹⁵

5.6 Conclusion

Based on objective factors, the national courts shall decide if taxable persons knew or should have known that they participated in a carousel fraud.²⁹⁶ If the answer is affirmative the courts can deny taxable persons their right to deduct. Since the judgement shall be based on objective factors, such factors need to be identified, otherwise the national courts could interpret identical situations differently, which would lead to disharmonized interpretations. The decisions would have to be based on a transaction by transaction basis, since two situations can never be identical.²⁹⁷ Some relevant factors have been identified; however these indicators are not given by Community authorities so they are merely suggestions. Included in the list of possible factors are if it is an exceptionally high volume of trade, rapid increase in trade, regular trading patterns, consistent margins or if the price of the goods is below the market price.²⁹⁸ These indicators could in addition, serve as guidelines for the taxable person making the transaction. If the business of their trading partner includes some of these indicators, it could be a warning sign that something is not completely legitimate.

The taxable person seeking a deduction shall show that he is a taxable person and that he fulfils the conditions for deduction.²⁹⁹ Ultimately the national courts can refuse a deduction if it is shown that the purpose of the transaction, of which the taxable person seeks deduction, has been fraudulent or abusive.³⁰⁰ The national tax authorities have the burden of proof regarding whether or not a taxable person has made transactions with fraudulent or

²⁹³ IFS Green Budget January 2007, p. 175.

²⁹⁴ IFS Green Budget January 2007, p. 175.

²⁹⁵ Keen, Michael and Smith, Stephen, "VAT fraud and evasion: what do we know and what can be done?" IMF Working Paper, p. 25.

²⁹⁶ Joined cases C-439/04 and C-440/04, *Kittel*, ECR [2006], p. I-6161, para. 59.

²⁹⁷ Collins, Jason and Cooper Ben, Non- Economic Activity – RIP, the Tax Journal, 31 July 2006.

²⁹⁸ Collins, Jason and Cooper Ben, Non- Economic Activity – RIP, the Tax Journal, 31 July 2006.

²⁹⁹ Case C-268/83, *Rompelman*, ECR [1985], p. 655, para. 24 and case C-110/94, *INZO v Belgian State*, ECR [1996], p. I-857, para. 23.

³⁰⁰ Case C-32/03, *Fini H*, ECR [2005], p. I-1599, para. 34.

abusive purposes. If such purposes cannot be established the right to deduct cannot be denied.³⁰¹

When the reverse charging system is used, taxable persons are protected from the possibility to lose their right to deduct. It is also a way to protect the VAT system from being used for the purpose of committing carousel frauds.³⁰² When reversed charging is applied, the responsibility of paying VAT is placed on the buyer instead of the seller.³⁰³ This would be very effective in carousel frauds since the VAT due on the sale of the missing trader would become the liability of the buyer of the goods instead. The system would not have to be applied on all sorts of goods, if it was to be applied on high risk goods such as mobile phones and computer components the effect would be sufficiently noticeable. The result is however uncertain, since the frauds could move ahead to other goods instead, as well as create difficulties related to the maintenance of the borders between goods subject to normal zero-ratings and goods subject to reverse charging.³⁰⁴

The aim is a VAT system which does not impose excessive burdens on the business in general and still is not excessively exposed to fraud.³⁰⁵ As it might be too hard to please everybody and develop a perfect VAT system, the solution might be to tolerate some level of VAT frauds.³⁰⁶

³⁰¹ Case C-32/03, *Fini H*, ECR [2005], p. I-1599, para. 34.

³⁰² IFS Green Budget January 2007, p. 175.

³⁰³ Article 199 of the VAT Directive.

³⁰⁴ Keen, Michael and Smith, Stephen, "VAT fraud and evasion: what do we know and what can be done?" IMF Working Paper, p. 24 and IFS Green Budget January 2007, p. 175.

³⁰⁵ IFS Green Budget January 2007, p. 175.

³⁰⁶ IFS Green Budget January 2007, p. 175.

6 Final Conclusion

A general tax on consumption shall be applied on goods and services and is to be charged after the deduction of the VAT connected to the input VAT. This stipulates that the consumer have the final VAT burden, since he is the last person in the chain of transactions. If input VAT could not be deductible, the taxable person would be the carrier of the tax burden and this would contradict the entire VAT system. The right to deduct should in principle, be unlimited. However in order to have the right to deduct VAT, certain conditions have to be fulfilled. It has to be a taxable transaction, which means that it has to be a supply of goods, intra Community acquisition of goods or a supply of services, the transaction has to be made by a taxable person and an economic activity has to exist. Without satisfying these conditions, the transaction is not subject to VAT. National limitations of the right to deduct cannot be made unless such possibility can be found in the VAT Directive. The right to deduct must be applied uniformed in all Member States; otherwise, this would affect the level of the tax burden. A taxable person has both the right to deduct VAT and the entitlement to obtain a refund. In order to be entitled to deduct the input VAT a direct link has to exist between a particular input transaction and a particular output transaction. In mixed transactions only VAT, which fulfils the conditions of being deductible, is deductible.

Two different principles exist when it comes to the taxation of the supplies of goods, the destination principle and the origin principle. Both principles are used, but the destination principle is the most common. According to the origin principle the VAT is charged where the goods are produced, no matter where they are consumed. Using the origin principle would reduce the intention of committing VAT frauds since the export would be subject to VAT. The origin principle could however lead to discrimination between domestically produced goods and goods from other Member States. The destination principle gives that when goods are sold from one Member State to another the goods shall be taxed in the later. This set-up gives a flow of transportation of zero-rated goods between the Member States. The outcome of this set-up is a presumption for committing different types of carousel fraud. The products cannot be discriminated because the VAT is the same for domestic and foreign products and the export is exempted from domestic taxation. Today the destination principle is a transitional arrangement that is supposed to be replaced by definitive arrangements based on the origin principle. However the Member States have not been able to come to an agreement and therefore the destination principle remains the main rule.

Zero-rated intra Community acquisition is a prerequisite for committing carousel fraud. This makes it possible to make VAT exempted supplies, as long as the buyer is situated and registered for VAT in a Member State other than the seller. The buyer is obliged to pay the VAT levied on the goods to the tax authorities in his Member State. The buyer however fails to pay the VAT due and as a result, his Member State loses the VAT income on the supply. In order to sell zero-rated goods to another Member State, the seller has to show that the goods have been supplied to a VAT-registered seller in the other Member State. The buyer has to pay VAT for his acquisition in his own Member State and he shall also report all his intra Community acquisitions in a VAT statement. Simultaneously, he can make deductions for the acquisitions if he fulfils the conditions for making deductions. In order for an effective control of these zero-rated transactions some sort of control system is needed, this is where VIES plays a great role. VIES provides a control devise, so that these types of transactions can be supervised. The system also contributes to the work of detecting unreported intra Community supplies as well as confirming the validity of VAT

numbers. All traders registered for VAT, who carries out zero-rated supplies to a trader registered for VAT in another Member State, must be able to show the value of the sale in a VIES statement. The taxable person shall hand in this statement to the tax authority, including detailed information about the intra Community supply in question. In this way, the Member States collect the information about the exporters' trade with other Member States. If the taxable person submits a VIES statement too late or with incorrect information the sanctions are almost none existing, which creates a non-effective system. The majority probably uses the system in the right way and is honest when handling in these statements. However, it is easy for the dishonest traders, who make transactions for the purpose of fraud, to submit incorrect information without becoming penalized.

VIES gives traders who are uncertain of the validity of their trading partners VAT numbers a possibility to control the validity of these VAT numbers. This does however sound a bit better than reality shows; one big disadvantage does exist. The VIES system have a delay of several months and if a trader has an invalid VAT number, for the purpose of committing a carousel fraud, the missing trader often manages to disappear before the invalid VAT number is discovered. It is therefore essential that the VAT number register is up-to-date and accurate. If not, the tax authority might try to recover VAT from a seller who has misjudged the buyers VAT status. As it is today, persons who no longer run an economic activity as well as identified missing traders remain in the system too long. It should be the responsibility of the Member States to have accurate information in their registers and take the consequences steaming from incorrect and outdated information. The end result appears to be that VIES is not effective enough and that it is not an adequate system in order to combat carousel fraud. The Commission has acknowledged this and considers if a more modern and flexible system could replace the VIES system, in order to provide the information quicker and more precise. The future will show if this becomes reality or not. Today's system is not satisfying and something has to be done in order to make sure that taxable persons do not risk losing their right to deduct, as a result of an ineffective control system. At present, it is the dishonest traders who advantage from the time delay and gets away with this, while taxable persons, with no intention of getting involved in carousel frauds are the ones who risk losing their right to deduct. This is not the purpose of the system nor is it the intention, but somehow it is the outcome.

A common way traders deceive Member States of tax revenue is by committing carousel frauds. These frauds creates great losses for the Member States, it has been shown that up to EUR 100 billion disappear every year in form of lost tax revenues. Connected to this, is the question of whether or not traders involved in carousel frauds should remain their right to deduct. Carousel fraud can be defined as frequent buy and sale of goods between connected companies, where at least one of the companies in the chain is situated in another Member State. The purpose of the transactions between these companies is to make zero-rated supplies. A taxable person can then regain VAT, but the missing trader in the chain fails to pay the VAT due to the tax authority. The company failing to pay the levied VAT goes missing before the payment occurs, and is often replaced with a new company; this makes it possible for the chain of transactions to be repeated. The carousel chains often consist of goods with a high value in relation to its weight, such as mobile phones and computer components. The ECJ has delivered judgements in three important cases related to carousel fraud, and has concluded when a taxable person involved in a carousel fraud, in fact, has the right to deduct VAT.

In the Optigen case, the ECJ concluded that having to consider the objective character of the transaction would be contrary to the objective of the VAT system, having to consider

the intention of traders' transactions would have the same effect. The ECJ further states that as long as a trader fulfils the objective criteria of being a taxable person, acting as such and an economic activity, the right to deduct the input VAT cannot be limited, if the taxable person had no knowledge or any means of knowing of the fraudulent transaction. The right to deduct is not to be affected by the fact that VAT has not been paid on an earlier or later sale of the goods, since a transaction shall be considered on its own according to the neutrality of the VAT system and the principle of legal certainty. A trader must however have taken every possible precaution, which could be required of him, to ensure that he is not forming part of a carousel scheme. If the taxable person has done everything that can be required of him, he has to be able to rely on the legality of the transaction and not risk losing the right to deduct. If a taxable person would lose the right to deduct when he has done everything in his powers to make sure that he is not involved in a carousel fraud, the principle of legal certainty would not be upheld. In the judgement of this case the ECJ clearly ruled that denying a trader his right to deduct, just because he is involved in a carousel scheme in any way is not possible. Such a possibility of denying the right to deduct in general would not be in accordance with the objectives of the VAT system. The ECJ only referred to situations where the traders had no knowledge or any means of knowing that they took part in a carousel fraud. The question of the right to deduct for taxable persons who knowingly participates in a carousel fraud was not wholly clarified.

In the FTI case, the ECJ stated that Member States are allowed to adopt national legislation providing that a person other than the person actually liable to pay the VAT could be made jointly and severally liable. This is the case if a taxable person knew or had reason to suspect that all or some of the VAT payable in a supply or any previous or subsequent supply would go unpaid. Such legislation is in phase with Community law. However, the requirements for the taxable person to show that he did not know or had any reason to suspect that some of the VAT would go unpaid must comply with Community law and especially the principle of proportionality. It shall not be impossible for a trader to prove that he is unaware. The question of when a trader shall be seen as knowing that all or some of the VAT would go unpaid is quite possible to prove. The criteria of having no reasons to suspect is however more complex. The national courts shall give rulings in accordance with Community law and its principles. However, if the national courts were to make these judgements without any guidelines as how to interpret the criteria of having no reason to suspect, one can imagine that the courts in the different Member States would have an unequal interpretation. This would not be in line with the principle of equality, which is of major importance when dealing with Community law. The authorities of the EU should publish some sort of guidelines, which could serve as a help for both the traders and the national courts when having to rule upon this issue.

In the Kittel case, the ECJ expanded its judgement in the Optigen case concerning the situation of taxable persons who does not know or have no reason to suspect that they are involved in a carousel fraud. The right of deduction ensures the neutrality of taxation between all sorts of economic activities; this is why the purpose and result of the economic activity cannot matter. Another important principle to keep in mind is the principle of fiscal neutrality, as a consequence of this principle there cannot be a general distinction between lawful and unlawful transactions. The ECJ also ruled upon the case where a taxable person knowingly participates in a carousel fraud. Having the objective criteria of being a taxable person, acting as such, and economic activity in mind, the conclusion is that if a transaction is made for the purpose of evading tax, these objective criteria is not met. A taxable person is not entitled to rely on Community legislation for making fraudulent or abusive transactions. If a deduction has been granted, and afterward it can be shown that it

has been exercised fraudulent, the tax authorities can claim a retroactive refund of the deducted tax. This outcome does not only concern knowingly taxable persons, this ruling has the same effect on taxable persons who should have known about their involvement in a carousel scheme. It does not matter whether the taxable person who knowingly participates in the carousel scheme gain from the fraud or not. By knowingly taking part of unlawful transactions, he aids the taxable person behind the fraud and is therefore made an accomplice. It is the task of the national courts to deny a taxable person his right to deduct if the taxable person knew or should have known that by his transaction he took part in a fraudulent evasion. This decision of denying deduction has to be made with regard to objective factors.

The judgement in the Kittel case does somewhat clarify when taxable persons who knowingly participates in a carousel fraud have the right to deduct, but it leaves a great interpretation gap regarding how. It is up to the national courts to refuse deduction of input VAT if the taxable person, having regarded the objective factors, is supposed to have been aware of his participation in a carousel fraud. This is not an easy task for the national courts, especially since the right to deduct does not only disappear when a taxable person clearly knew that he took part in a carousel fraud, but also when he is supposed to have known. This second expanded situation does include fairly innocent parties. The issue, which arises from this, is what a taxable person has to have done in order not to fall in under the category of a person, who should have known that he was involved in a carousel fraud. The identification of these possible objective factors plays a great role in transactions made in a carousel fraud. Numerous cases can be expected where national courts stand in front of situations where it is up to them to decide if the traders should have been aware that they formed part of a fraudulent scheme or not.

An interpretation of whether or not a taxable person should have been aware that he was involved in a carousel fraud has to be made on a transaction-by-transaction basis. Some guidelines have to be established, so that taxable persons can have some indications of when they could lose their right to deduct. Indicators, which should serve as a warning to taxable persons could be situations when it is the case of exceptional high volumes of trade, rapid increase in trade, regular trading patterns, consistent margins, if the trading only was with a small number of suppliers and consumers and if the price of the goods is below the market price. If one or more of these indicators matches a taxable person's transaction, he ought to take this as a warning and be aware that he might be involved in a carousel fraud and with that consider if he really should get involved in such a transaction to begin with. If a taxable person gets suspicious, he has to be aware that if getting involved he might end up losing his right to deduct. The trader can also increase the carefulness when dealing with high-risk goods, such as computer components and mobile phones. Another possibility is to be more careful of who you are trading with and look out for warning signs, such as new businesses with no previous trail in the business, if the business has changed dramatically in a short period of time or if the turnover has boosted in a short period of time. If it seems too good to be true, regarding any of these indicators it probably is.

The burden of proof regarding the right to deduct VAT lies on the taxable person. It is the taxable person who has to show that the objective criteria of taxable person and the right to deduct are satisfied. The tax authorities may deny taxable persons the right to deduct or claim repayment of VAT if it can be shown that the taxable person has made the transactions with fraudulent or abusive purposes. It is up to the national tax authorities to prove that a transaction is made with the purpose of fraud or abuse. The national tax authorities

shall make the decision based on objective factors. The level of proof required, in order for the tax authorities to establish that the taxable person has exercised the right to deduct fraudulently or abusively, is probably high. Based on objective factors it is difficult for the tax authorities to prove that the taxable person had reasons to believe that he was involved in a carousel fraud and therefore had fraudulent or abusive purposes. Since the burden of proof is presumably high, the tax authorities will find it hard to deny a taxable person the right to deduct, at least until some guidelines are given.

Another possibility to ensure taxable persons their right to deduct input VAT is by using the reverse charging system. This would take away, in the case of trading with certain goods, the problems of risk losing the right to deduct input VAT stemming from the issue of objective factors. By applying reverse charging the responsibility of paying VAT is placed on the buyer instead of the seller. Regarding carousel fraud this is an effective solution since the VAT due on the sale by the missing trader would become the liability of the buyer of these goods. In this way the claim for a refund of VAT, which has not yet been paid would be eliminated. It already exist a possibility to apply reverse charging on certain types of goods. The UK is allowed to use reverse charging on certain goods for example mobile phones and computer chips. If reverse charging was to be applied on high-risk goods this would significantly decrease the effects of this type of VAT fraud. Nevertheless, carousel frauds would not totally disappear; the taxable persons executing these frauds would most probably find other solutions or other goods to trade with. However, it would be one step in the way of decreasing the risk for innocent parties to lose their deduction right followed by the responsibility to take every precaution of making sure that they are not involved in any fraudulent scheme. Other risks with reverse charging are that it might increase the claim of refunds, lead to control difficulties and risk of refund frauds. Goods subject to reverse charging and goods subject to the normal zero-rating would have to be treated differently at the borders and this could result in maintenance problems. If all business-to-business transactions over a certain size were subject to reverse charging the problems with carousel frauds would decrease, but the VAT would be turned into some kind of single-stage retail sales tax, meaning that the VAT payment would be postponed until the goods are sold to the final consumer. Applying reverse charging on all sales of goods would lead to the death of the VAT system as we know it.

It is established that the right to deduct in principle, is unlimited. However, the ECJ has opened the possibility to deny a trader this right in certain situations. It is possible to deny a trader the right to deduct if the objective factors show that a trader is aware that he is taking part of a carousel fraud as well as if a trader should have been aware of this. When giving these judgements the ECJ solved one problem, the issue of the possibility to deny a fraudulent trader his right to deduct. The judgement however created a new issue, the problem of how to interpret objective factors. No guidelines or other tools have been given to the national courts as a help to how to interpret if a trader is supposedly aware that he is part of a carousel fraud. This interpretation gap creates an uncertain situation both for the national courts who has to give rulings on the matter and the traders who now risk losing their right even though they assume that they have done everything in order to make sure that they only take part in legitimate trading. Without some sort of guidelines the entire VAT system could be in jeopardy. Even though the authorities in the EU might publish some sort of guidelines in the future on how to interpret objective factors some of the uncertainty will still remain, the only possibility is to continue the work of finding solutions on how to combat carousel fraud through different kinds of measures, or at least how to make these arrangements more difficult and less advantageous to get involved with.

Final Conclusion

The authorities of the EU have a difficult task to solve regarding the efficiency of the VAT system. The aim to be achieved is a VAT system that is not exposed to carousel frauds and yet does not impose unnecessary burdens on the taxable persons. As this might be too hard to achieve, Stephen Smith may have had the solution when he said: “[s]ome level of VAT evasion may well have to be tolerated in the wider business interest.”³⁰⁷

³⁰⁷ IFS Green Budget January 2007, p. 175.

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