

## Reverse charging to prevent VAT fraud

<sup>1</sup>The United Kingdom, on 26 January 2006, made a request to the European Commission to allow the application of reverse charging to a limited range of high technology products.<sup>1</sup> Austria and Germany have also made reverse charging requests in October 2005 and April 2006 respectively, though these were much wider in scope.

<sup>2</sup>Under the provisions of the Sixth VAT Directive of the European Union,<sup>2</sup> individual Member States may apply special VAT measures, if specifically authorised to do so by a unanimous decision of the Council of Ministers, acting upon the recommendation of the Commission.

### What is reverse charging?

<sup>3</sup>Reverse charging involves a significant shift away from the “fractioned payment” principle of VAT. Under the current regime, a seller charges VAT on his sales, termed output VAT, and pays the VAT thus collected to Her Majesty’s Revenue and Customs (HMRC). Each VAT-registered buyer is entitled to claim a refund from HMRC on the VAT he pays the seller, termed input VAT. This results in HMRC receiving a fraction of the total VAT at each stage of the supply chain.

<sup>4</sup>Under reverse charging, the seller does not charge VAT on any sales made to VAT-registered businesses. The business in the supply chain that supplies the end-user, who is not VAT-registered, is responsible for collecting VAT on the final value of the product from the unregistered buyer and then remitting the amount collected to HMRC along with its VAT return.

### The anatomy of a fraud

<sup>5</sup>VAT fraud is a problem for many EU Member States, including the United Kingdom.<sup>3</sup> The present move to introduce reverse charging is aimed at reducing this fraud. To see how this might work, it is helpful to consider the mechanics of the main types of VAT fraud. There are currently two main recognised categories of fraud.

<sup>6</sup>The first is what might be called black market fraud. Businesses operating in the black market do not file VAT returns, and those that do, understate the value of their sales or overstate their input VAT claims.

<sup>7</sup>The second type is called the Missing Trader Intra-Community (MTIC) fraud. According to the provisions of the Sixth VAT Directive, transactions between EU Member States do not attract VAT. A UK-based importer does not get charged VAT on goods imported from within the EU, but has to pay to HMRC any VAT collected by it when it sells those imported goods onwards to a domestic buyer.

<sup>8</sup>This creates an opportunity for fraud. A trader can import goods from another Member State without having paid VAT, sell it onwards to a domestic customer including VAT, and then go missing without paying the VAT collected to HMRC. This type of MTIC fraud is called “acquisition” fraud.

<sup>9</sup>A more complex version of the MTIC fraud involves at least two VAT-registered fraudsters located in the UK and one in another Member State, for example, France, working together to defraud HMRC. In this version, the trader, after importing goods from France, sells them onwards to a UK-based accomplice, issuing a VAT invoice. These goods are then exported to the accomplice located in France, who exports them back to the trader in the UK. The UK-based importer does not pay VAT to HMRC, while the UK-based exporter collects a refund of its input VAT from HMRC.

<sup>10</sup>This cycle is repeated many times before the importer goes missing and the fraud is detected. Each time the goods are exported from the UK, the exporter submits an input VAT claim for VAT supposedly paid by it to the importer, while the importer never pays the HMRC. This type of fraud is called “carousel” fraud because the goods go around the participants many times.

<sup>11</sup>Carousel fraud involves repeated transportation of these goods, perhaps also storage, and as a result, fraudsters typically use products that have a high value in relation to size such as mobile phones, computer parts, digital music players and cameras.

<sup>12</sup>HMRC tried to stop payment to exporters in the case where it knew that upstream links in that chain were affected by fraud. However, the European Court of Justice judgment, dated 12 January 2006, in the Optigen case, declared that EC law prevented HMRC from withholding payments from exporters who are not directly involved in fraud and have no reasonable means of knowing of fraud occurring in upstream transactions.<sup>4</sup>

### The scale of fraud

<sup>13</sup>HMRC publishes annual estimates of MTIC fraud in the UK. The latest publication in this series estimates MTIC fraud in the UK to be between £1.1 billion and £1.9 billion in 2004/2005.<sup>5</sup> According to the same publication, MTIC fraud in 2004/2005 was down from its peak in 2001/2002 of between £1.7 billion and £2.5 billion.

<sup>14</sup>In HMRC’s estimation method, the upper estimate of MTIC fraud is based on the difference between recorded exports by other EU countries to the UK and the UK-

<sup>1</sup> HMRC press release available from <http://go.reckon.co.uk/2izj>

<sup>2</sup> Council Directive 77/388/EC

<sup>3</sup> See, for example, European Commission, COM (2004) 260

<sup>4</sup> Cases 354, 355 and 484/03 Optigen Ltd, Fulcrum Electronics Ltd and Bond House Systems Ltd v. Commissioners of Customs and Excise

<sup>5</sup> HMRC (2005) Measuring Indirect Tax Losses

recorded imports from these countries.<sup>6</sup> The lower estimate is based on a subset of the data used to estimate the upper limit; the data used to estimate the lower limit are considered by HMRC to include only fraud, but not all fraud.

<sup>15</sup> HMRC also estimates the VAT “tax gap”, which is the difference between actual VAT receipts and the VAT that should have been received had VAT been paid on all domestic consumption. According to the latest estimates, the total VAT gap in 2004/2005 was £11.3 billion, representing 15% of total VAT receipts of £72.7 billion. Thus, MTIC fraud is estimated to account for between 10 per cent and 17 per cent of the total VAT gap.

### The effects of reverse charging

<sup>16</sup> The UK’s application to the Commission proposes the introduction of reverse charging, subject to a minimum invoice value of £1,000, for products such as mobile phones, handheld communication devices, games consoles and computer chips. The Austrian and German proposals involved the application of reverse charging to all “business-to-business” transactions, subject to a minimum invoice value of €10,000 for Austria and €5,000 for Germany.

<sup>17</sup> Under a reverse charging regime, the importer does not charge VAT on its domestic sales as long as its customer is VAT-registered. The customer, if it decides to export the goods, cannot claim a refund of input VAT, as under the reverse charging regime, it would not have paid any. A reverse charging system therefore removes the ability to commit carousel MTIC fraud.

<sup>18</sup> In the UK, the reverse charging mechanism would only apply to a limited range of products. Therefore, carousel fraudsters might still be able to carry out their activities by trading in other products. Any product that has a sufficiently high invoice value-to-transportation cost ratio is a potential target for fraudsters.

<sup>19</sup> Acquisition fraudsters could no longer charge VAT on sales of imported goods that are covered by reverse charging to legitimate VAT-registered businesses. However, acquisition fraudsters could charge VAT on the sales of imported goods to customers who are not VAT-registered, and then disappear.

<sup>20</sup> Under the present system, each business in the supply chain is responsible for paying output VAT to HMRC. Even if a business in the chain fails to submit a VAT return and the associated output VAT, HMRC retains the input VAT. As a result, the loss to HMRC is only a proportion of the total VAT on the product. Under reverse charging, the only business that pays VAT to HMRC is the one that supplies the unregistered end-user and if that business goes missing, the HMRC stands to lose the entire VAT on the product.

<sup>21</sup> In other words, reverse charging makes MTIC fraud impossible at all stages of the supply chain, except at the retail level. At the retail level, the potential for fraud still exists; the amount of tax that can be defrauded is greater, therefore making fraud at the retail level potentially more lucrative. Whether reverse charging would result in an

increase in the overall amount of VAT fraud, or even just in the amount of acquisition fraud, would depend on the characteristics of the supply chain of specific products to which reverse charging apply.

<sup>22</sup> Reverse charging increases the compliance burden on businesses at all stages, except the last, of the supply chain. Suppliers need to take reasonable steps to ensure that buyers are registered for VAT, and to ensure that the goods will be used for business purposes, before supplying VAT-free goods to them. Businesses will also need to submit regular lists of reverse charged supplies they have made, including the VAT number of the buyers.

### The Commission’s decisions

<sup>23</sup> The Commission objected to the Austrian and German requests, concluding that a broad application of reverse charging would unjustifiably increase the compliance burden on businesses, while at the same time increasing the potential for VAT fraud at the final consumption level.<sup>7</sup>

<sup>24</sup> The Commission took a different view on the UK’s request.<sup>8</sup> The targeted nature of the UK’s proposal, in the Commission’s view, is likely to minimise the additional burden on businesses, while achieving its aim of preventing fraud. The Commission also notes that only some 22,500 businesses out of a total of 1.9 million VAT-registered businesses in the UK are likely to be affected by the proposal.

<sup>25</sup> Consequently, the Commission did not object to the UK’s request, provided the application of reverse charging was only for a limited period, until 31 December 2009. The request has not, as yet, received the necessary approval from the Council of Finance Ministers. HMRC is currently awaiting the Council’s decision and has begun preparing for the potential change.<sup>9</sup>

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<sup>6</sup> HMCE (2001) Measuring Indirect Tax Fraud, and HMCE (2003) Measuring and Tackling Indirect Tax Losses

<sup>7</sup> European Commission, COM (2006) 404. See section 6, pages 6 & 7

<sup>8</sup> European Commission, COM (2006) 555

<sup>9</sup> HMRC Business Brief 14/06, available from <http://go.reckon.co.uk/5tqr>