

Editorial

The New VAT General Reverse-Charge Mechanism

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VAT fraud is, by its very nature, difficult to measure, but there is little doubt over its significance. Since 2004, it has often been asserted that fraud accounts for approximately 10% of VAT revenue within the EU¹; and more recent estimates of the VAT gap within the EU place it at over EUR 150 billion, or 12.8% of the revenue collected, of which EUR 50 billion is estimated to be connected to organized fraud, fraud committed in large part by criminal organizations.² Similarly, in the UK, HMRC has estimated the VAT Gap to be at 9.8% of total revenue for 2015–2016, and whilst no estimates are offered for overall VAT fraud, some types of fraud are quantified, with Missing Trader Fraud (MTF) estimated to be 0.5% of total revenue.³ Further estimates from other EU institutions, on specific types of VAT, portray a similar picture: Europol has reported that EU countries lose EUR 100 billion annually to that MTF; a perhaps all too convenient figure but certainly one that symbolizes the significance of the problem.⁴ These are, of course, mere estimates: methodological difficulties are openly acknowledged by tax administrations, and the lack of comparable data regarding VAT fraud across the EU has been identified as a significant limitation⁵; moreover, it is also worth noting that the VAT compliance gap is a measure of non-compliance – to include negligence, avoidance, etc. – rather than just VAT fraud.⁶ Yet it is reasonable to assume that, on the basis of these, the

share of revenue lost within the EU to VAT fraud is quite considerable – and this is something that it is also supported by evidence on the increased scale of fraud, with some individual instances of fraud so massive as to account in isolation for a significant amount of revenue loss.⁷

Concerns over VAT fraud had been a constant within EU countries' tax administrations for many years,⁸ yet it is undoubtedly the case that the economic and financial crisis in 2008/2009 ensured that combatting VAT fraud assumed greater priority within the EU,⁹ not least due to the tax's revenue gathering potential,¹⁰ and its perceived neutrality on economic growth. This renewed attention has manifested itself in various administrative and legislative measures, designed to tackle different types of VAT fraud,¹¹ but arguably no other type of VAT fraud has received as much attention as MTF.

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¹ European Commission, *Report from the Commission to the Council and the European Parliament on the Use of Administrative Cooperation Arrangements in the Fight Against VAT Fraud*, COM(2004) 260 final, 5 (16 Apr. 2004).

² European Commission, *Study and Reports on the VAT Gap in the EU-28 Member States: 2017 Final Report*, TAXUD/2015/CC/131.

³ HMRC, *Measuring Tax Gaps 2017: Tax Gap Estimates for 2015–2016* (26 Oct. 2017).

⁴ Europol, *EU Serious and Organized Crime Threat Assessment*, SOCTA 2013.

⁵ European Court of Auditors, *Tackling Intra-Community VAT Fraud: More Action Needed*, Special Report No. 24 (2015). For a review of the literature on measurements of VAT fraud see L. Barbone et al., *The Costs of VAT: A Review of the Literature*, CASE Network No. 106/2012, at 46 et seq.; see also C. W. Nam et al., *Measurement of Value Added Tax Evasion in Selected EU Countries on the Basis of National Accounts Data* (2001) CESifo Working Papers 431 (Mar. 2001).

⁶ The measurement has also been subject to significant criticisms. See M. Keen & J. Slemrod, *Optimal Tax Administration IMF Working Paper WP/17/8* (2017); N. Gemmel & J. Hasseldine, *Taxpayer's Behavioural Responses and Measures of Tax Compliance 'Gaps': A Critique and a New Measure*, 35 *Fiscal Studies* 275–96 (2014); and K. Yiallourou, *The Limitations of the VAT Gap Measurement*, 28(4) *EC Tax Rev.* (2019).

⁷ In this regard, one of the most infamous cases was the so-called CO2 fraud in 2008 and 2009, see Europol Press Release, *Carbon Credit Fraud Causes More than 5 Billion Euros Damage for European Taxpayer* (9 Dec. 2009); and P. Efstratios, *Halting the Horses: EU Policy on the VAT Carousel Fraud in the EU Emissions Trading System*, 1 *EC Tax Rev.* 39–51 (2012). On other reported instances of massive fraud, see Euro just EU-wide fuel oil and precious metals VAT fraud and money laundering network dismantled, Press Release, 21 Dec. 2016; Europol, *Eight Member States Take Action Against International VAT Fraud*, Press Release, 29 June 2016.

⁸ Due to what has been designated as a quasi-symbiotic connection between the evolution of the EU VAT system and the development of fraud, see C. Tussiot, *La Fraude à la TVA, un Instrument de Modernisation Fiscale*, in *La Fraude à la TVA* 24 (C. Herbain ed., Larcier 2017).

⁹ IMF, *supra* n. 1, at 7.

¹⁰ Whilst VAT accounted for over 18% of total tax revenues of EU Member States, in some Member States, such as Bulgaria and Hungary, consumption taxes amount to as much 50% of total tax revenue, see European Commission, *Taxation Trends in the European Union*, 2017 Edition, 20–21, and 159.

¹¹ For a typology of VAT fraud, see R. de la Feria, *Tax Fraud and the Rule of Law*, Oxford University Centre for Business Taxation Working Papers WP/18/02 (2018).

1 MISSING TRADER FRAUD

The year this Review was launched, 1991, was a crucial year for EU VAT: the year in which the transitional VAT system was approved¹²; it is also the year that intra-Union VAT fraud, in its organized form,¹³ gained prominence. Previous experience in the Benelux countries with the Postpone Accounting System (PAS) – the inspiration for the transitional VAT system that applied from 1993 onwards to intra-Union transactions –¹⁴ had already indicated that the system that was about to be put in place was susceptible to fraud.¹⁵ In particular, research carried out in the late 1980s and early 1990s, seems to have alerted to the possibility that intra-EU VAT fraud was about to establish itself in the form of crime networks. The problem is said to have been brought to the attention of the then Director-General of the European Commission's Internal Market, who reportedly remarked indifferently that this form of organized cross-border crime was not the Commission's problem.¹⁶ Whether this is an accurate account of events or not, it is indeed true that tax administrations had been pointing out that the system was susceptible to fraud since its inception in 1993. According to field experts, the feared flow of mega frauds did not emerge immediately after 1 January 1993; instead criminal activity is said to have started 18 to 24 months later: at first so-called veterans tested the system and how easy it was to cash the VAT by making a few loops across the border; these were then followed by some legitimate traders¹⁷; and finally the 'legitimate' and 'criminal' entrepreneurs started to cooperate.¹⁸

The type of fraud that the transitional EU VAT system has facilitated is what can be broadly designated as VAT collected but not remitted to the Government. Whilst there are various possible methods to commit this type of fraud – such as false accounting, engineering bankruptcy after collecting the tax but before it is remitted, and VAT number hijacking – the most important is undoubtedly the so-called carousel fraud, or MTF. EU legislation (no

longer in force) has previously defined a missing trader as:

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 the VAT due to the appropriate national authority.¹⁹

MTF essentially exploits two key features of the EU VAT system, one which is common to nearly all VAT systems around the world, and another which is specific to the EU VAT system: the destination principle, which requires all exports to be VAT-free, with the tax collected solely on imports (common to all); and the time delay in the remittance of import VAT, coupled with the time gap between the collection of the tax and its remittance on internal supplies (specific to EU VAT). In its simplest form, a trader – the MTF – collects VAT paid to him by a customer without accounting or remitting to the tax authorities, disappearing soon after, and before the authorities realize what has occurred.²⁰ There are numerous variations to this basic model: the same goods may move around different chains continuously, with all the traders in the chain, or its employees, involved, or at least aware that the fraud is occurring (carousel fraud); or different goods are sold by fraudsters to unsuspecting third parties, inserting themselves into legitimate production chains (MTF). A more recent version of the MTF is reportedly the insolvent trader, in which instead of a missing trader, the scheme includes an existing firm, which is stripped of any assets before the tax authorities reach it. Whilst these fraud schemes had traditionally operated within the EU, similar schemes have now developed involving third countries, taking advantage of VAT temporary exemption rules on imports.²¹

2 ADDRESSING MISSING TRADER FRAUD: REVERSE-CHARGE MECHANISM

Whilst evasion has been receiving growing attention over the last few years, in terms of VAT fraud, MTF has been the main focus of EU institutional attention since the late 1990s. This is partially due to the scale and organized nature of the MTF, which often requires EU coordinated action, partly because MTF is to a large extent a direct consequence of arrangements put in place in 1993 for intra-EU trade, and partially because of now well-known

¹² As recently discussed in detail in R. de la Feria, *The Definitive VAT System: Breaking with Transition*, 3 EC Tax Rev. 122–26 (2018).

¹³ On the distinction between organized VAT fraud, and other types of VAT fraud, see de la Feria, *supra* n. 111.

¹⁴ On the connection between PAS and fraud see Y. Fedchyshyn, *Postponed Accounting in the European Union*, 1 Int'l VAT Monitor 11–15 (2014).

¹⁵ R. Wolf, *The Sad History of Carbon Carousels*, 6 Int'l VAT Monitor 403 (2010); C. Amand & K. Boucquez, *A New Defense for Victims of EU Missing-Trader Fraud?*, 4 Int'l VAT Monitor 234, 236 (2011).

¹⁶ See the remarkable account by P. van Duyn, *VAT Fraud and the Policy of Global Ignorance*, 1 Eur. J. L. Reform 425–43, at 434 (1999).

¹⁷ For example, one of the biggest meat trader in the Netherlands, see P. C. van Duyn, *Organized Crime, Corruption and Power*, 26 Crime, L. & Social Change 201–38 (1997).

¹⁸ On the parasitic relationship between legitimate and organized crime traders, and their *modus operandi*, see A. Aronowitz et al., *Value-Added Tax Fraud in the European Union* (Amsterdam: Kugler Publications 1996).

¹⁹ Commission Regulation (EC) No. 1925/2004 of 29 Oct., OJ L 331 13–18 (5 Nov. 2004).

²⁰ Case C-354/03 *Optigen and Others*, ECLI:EU:C:2005:89, para. 8.

²¹ Under what is known as Customs Procedure 42, see European Commission, *Seventh report under Art. 12 of Regulation (EEC, Euratom) n° 1553/89 on VAT collection and control procedures*, Commission Staff Working Document, SWD 38 final, 19 et seq. (2014). See also F. Borselli, *Pragmatic Policies to Tackle VAT Fraud in the European Union*, 5 Int'l VAT Monitor 333–42 (2008).

connection between organized crime and organized tax fraud, and its use as a financing method for illegal activities.²² Whilst initially the response to MTF concentrated on enhancing administrative cooperation, attention soon turned to the expansion of the reverse-charge mechanism (RCM) as a key anti-fraud measure.²³

First introduced in 2006, under what is now Article 199 VAT Directive, the mechanism applied initially to construction work, supply of staff, waste and immovable property.²⁴ Its first extension was approved four years later with the insertion of Article 199a VAT Directive, which extended the application of the RCM to mainly emissions trade – although other industries had also been proposed, such as telecommunications, microprocessors, perfumes and precious materials.²⁵ In 2013, comes the second significant extension to the RCM with the approval of a new Directive, which allowed Member States to apply a RCM on an optional and temporary basis, until 2018, to a wide range of supplies of, including mobile phones, integrated circuit devices, supplies of gas and electricity, telecom services, game consoles, tablet PCs and laptops, cereals and industrial crops, and raw and semi-finished metals. Concurrently, and in addition to these provisions, several Member States are granted authorizations under Article 395 of the VAT Directive to apply the RCM to specific goods and services, as summarized in Table 1. It is also noteworthy that other derogations have been recently requested and rejected by the European Commission²⁶; and that for some expired derogations renewal was also rejected, either on the basis of either the removal of the risk,²⁷ or because they were deemed to have an adverse effect on the EU internal market as a whole.²⁸

²² European Court of Auditors, *supra* n. 5; Europol, *supra* n. 4; and Europol, *Eight Member States Take Action Against International VAT Fraud*, Press Release (29 June 2016).

²³ See K. Lind, *Reverse Charging: The Best Possible Solution for Preventing VAT Fraud*, 2(2) World J. VAT/GST L. 97–115 (2013).

²⁴ Originally inserted into the Sixth VAT Directive as Art. 21(2)(c) by Council Directive 2006/69/EC of 24 July 2006, OJ L221, 9 (12 Aug. 2006).

²⁵ Council Directive 2010/23/EU of 16 Mar. 2010, OJ L72, 1 (20 Mar. 2010). See also *Proposal for a Council Directive amending Directive 2006/112/EC as regards an optional and temporary application of the reverse charge mechanism in relation to supplies of certain goods and services susceptible to fraud*, COM(2009) 511 final (29 Sept. 2009).

²⁶ European Commission, *Communication from the Commission to the Council in accordance with Art. 395 of Council Directive 2006/112/EC*, COM(2013) 105 (28 Feb. 2013), rejecting a request from Romania; and Commission implementing Decision 2013/769/EU of 11 Dec. 2013, OJ L341 68 (18 Dec. 2013), rejecting a request from Hungary.

²⁷ European Commission, *Communication from the Commission to the Council in accordance with Art. 395 of Council Directive 2006/112/EC*, COM(2013) 283 final (16 May 2013), as regards Germany.

²⁸ European Commission, *Communication from the Commission to the Council in accordance with Art. 395 of Council Directive 2006/112/EC*, COM(2013) 317 (29 May 2013), as regards the UK.

Table 1 Derogations for Introduction of Reverse-Charge Mechanism

Member State	Goods/Services
Austria	Mobile phones/Microprocessors = or > EUR 5,000 (2010–2013)
Germany	Mobile phones/Microprocessors = or > EUR 5,000 (2010–2013)
Hungary	Raw food (2012–2014) Supplies of staff (2018–2020) Insolvency (2018–2021)
Italy	Mobile phones/Microprocessors (2010–2013)
Latvia	Timber (2006–2021) Ferrous and non-ferrous metals (2018) Game consoles (2018)
Lithuania	Timber/Insolvency procedure (2006–2021)
Netherlands	Clothing (1992–2012) Mobile phones/Microprocessors/Laptops and tablets/Game consoles = or > EUR 10,000 (2013) Telecommunication services (2013–2018)
Poland	Hard drives (2017–2020)
Portugal	Doorstep sales (2004–2015)
Romania	Wood/Insolvency procedure (2010–2013) Raw food materials/Wood (2011–2013) Wood (2014–2019)
United Kingdom	Mobile Phones/Microprocessors = or > EUR 5,000 (2010–2013)

The final step towards facilitating the introduction of RCM as a method to combat fraud, came with the approval of the so-called quick anti-fraud mechanism (QRM) in 2013,²⁹ which enables immediate measures to be taken against MTF, and whose purpose is not to replace the existing derogation system, but rather it is limited to massive and sudden fraud situations, in specific economic sectors, in a particular Member States.³⁰ It is against this background that the proposal for a new generalized reverse-charge mechanism started gained momentum.

3 NEW GENERALIZED REVERSE-CHARGE MECHANISM

Supported, and actively advocated, by some Member States for some years, the formal tabling of the legislative proposal for a generalized RCM came in 2016.³¹

²⁹ Council Directive 2010/45/EU of 13 July 2010, OJ L 189 1–8 (22 July 2010). Its application has now been extended to 2020 by Council Directive (EU) 2018/1695 of 6 Nov. 2018, OJ L 282 5–7 (12 Nov. 2018).

³⁰ B. J. M. Terra, *The European Quick Reaction Mechanism Against VAT Fraud*, 1(2) World J. VAT/GST L. 185–90 (2012); and I. Lejeune *et al.*, *Quick Reaction Mechanism Against EU VAT Fraud*, 2 Int'l VAT Monitor 94–98 (2013).

³¹ European Commission, *Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax as regards the temporary application of a generalised reverse charge mechanism in relation to supplies of goods and services above a certain threshold*, COM(2016) 811 final (21 Dec. 2016).

Although the Commission also presented two other legislative proposals at around the same time, aimed at tackling VAT fraud more fundamentally, namely on administrative cooperation, on the definitive VAT system for intra-Union trade,³² the generalized RCM was seen, in essence, as an interim measure, aimed at addressing the urgent concerns of some Member States as regards MTF. Finally approved in late 2018, the most significant (only?) advantage of the new mechanism is the potential eliminating MTF.³³ The disadvantages, however, are numerous. At a more immediate level, it will increase administrative and compliance costs, by requiring increased reporting, introducing distinctions between business to business (B2B) and business to consumer (B2C) transactions, and introducing threshold consideration.³⁴ More fundamentally, however, the main disadvantage is that it effectively transforms the VAT into a de facto Retail Sales Tax (RST).

VAT, like any other type of tax, is vulnerable to fraud. Traditionally the inclusion of consumption taxes in the tax mix is seen as spreading the risk of enforcement, and VAT perceived as less susceptible to fraud than its principal alternative, and economically equivalent, the RST.³⁵ This comparative advantage is attributable to the multi-stage nature of VAT, which requires the tax to be collected on business-to-business transactions, but also allows businesses to credit the VAT paid on their purchases (inputs) against the VAT charged on their sales (outputs). This multi-stage collection process ensures: (1) that buyers of intermediate goods have opposing interests to the sellers, thus reducing the scope for evasion; and, (2) that the risk of evasion is spread across the different elements of the production

chain. The incentive for traders to ensure that suppliers provide them with credit-allowing invoices, what is usually designated as third party reporting, guarantees that VAT is, to some extent, self-enforceable.³⁶ On the contrary, RSTs lack the multi-stage collection feature, which essentially means that (1) all the risk of evasion is concentrated in the last stage of the production chain, namely the sale to the final consumer, which is precisely one of the most vulnerable, and (2) the third-party reporting is limited to that same stage, where the buyer has a similar interest to the seller, and thus there is a significant risk of, at best, disinterest in the tax element, and at worst the scope for collusion.

It is true that the self-enforceability of the VAT is somewhat illusory: there is some evidence that 'bad production chains' can form, particularly in developing countries³⁷; and more importantly, self-enforceability does not cover all aspects of the production chain, falling namely in last stage of that chain, where the final consumer has no incentive to ask for the invoice; and after the registered businesses receive the invoice, when there is no incentive to ensure that VAT has actually been remitted. It is precisely at these two moments that fraud tends to occur. Yet, the risk in a RST is much higher, as it completely lacks any self-enforceability elements. In that context, whilst recognizing the vulnerability of VAT at those moments where self-enforceability is absent is crucial to combatting VAT fraud, responding by essentially removing the self-enforceability features of the VAT, and effectively transforming it into a de facto RST, seems ill-advised: rather like throwing out the baby with the bathwater.³⁸ A generalized reverse-charge mechanism may well kill MTF, but in the process it may also give birth to a widespread, more fundamental, VAT compliance problem that will be much harder to either contain, or combat. Let us hope it does, indeed, stay temporary.

³² Both now adopted, see Council Regulation (EU) 2018/1541 of 2 Oct. 2018, OJ L 259 1–11 (16 Oct. 2018); and Council Directive (EU) 2018/1910 of 4 Dec. 2018, OJ L 311 3–7 (7 Dec. 2018).

³³ Council Directive (EU) 2018/2057 of 20 Dec. 2018, OJ L 329 3–7 (27 Dec. 2018). See also B. Wohlfahrt, *The Future of the European VAT System*, 6 Int'l VAT Monitor 387–95, at 392 (2011).

³⁴ M. Lamensch, *Are 'Reverse-Charge' and the 'One-Stop-Scheme' Efficient Ways to Collect VAT on Digital Supplies?*, 1(1) World J. VAT/GST Law 1–20 (2012).

³⁵ In fact the decreased susceptibility of fraud is the main reason for the superiority of VAT over RST, since economically they are identical taxes, see S. Cnossen, *VAT and RST: A Comparison*, 35(3) Can. Tax J. (1987); M. Gillis, P. Mieszkowski & G. Zodrow, *Indirect Consumption Taxes: Common Issues and Differences Among Alternative Approaches*, 51(4) Tax L. Rev. 725–74 (1996); G. R. Zodrow, *The Sales Tax, the VAT, and Taxes in Between—or, Is the Only Good NRST a 'VAT in Drag'?*, 52(3) National Tax J. 429–42 (1999); C. H. E. McLure & W. Hellerstein, *Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals*, 31 State Tax Notes 721–35 (2004); S. Fedeli, *The Effects of the Interaction Between Direct and Indirect Taxation: The Cases of VAT and RST*, 53(3–4) Pub. Fin., 385–418 (2003); J. Slemrod, *Does It Matter Who Writes the Check to the Government? The Economics of Tax Remittance*, LXI(2) National Tax J. 251–75 (2008); R. Bird & P. P. Gendron, *The VAT in Developing and Transitional Economies* 32–33 (CUP 2007); and S. Cnossen, *The Technical Superiority of VAT or RST*, in *Australian Tax Reform in Retrospect and Prospect*, in *Australian Tax Reform in Retrospect and Prospect* 325–59 (C. Evans & R. Krever eds, Thomson Reuters Australia 2009).

³⁶ On the self-enforceability of VAT, see M. Waseem, *Information, Asymmetric Incentives, or Withholding? Understanding the Self-Enforcement of Value-Added Tax*, Oxford University Centre for Business Taxation Working Papers WP 18/08 (2018).

³⁷ Empirical evidence of this phenomenon has been found in Brazil, e.g. see A. de Paula & J. A. Scheinkman, *Value-Added Taxes, Chain Effects and Informality*, 2 American Econ. J.: Macroeconomics 195–221 (2010).

³⁸ See R. M. Bird, *Decentralizing Value Added Taxes in Federations and Common Markets* 12 Bull. for Int'l Tax'n 655–72, at 667 (2013).