Tackling VAT Fraud

VAT fraud is a global phenomenon that can involve vast sums of money. Some of the measures aimed at combating VAT fraud undermine the fundamental design features of the tax, whereas others do not. In this article, the author gives an overview of various anti-fraud measures and supports the adoption of specific measures and recommends abandoning others.

1. Introduction

All taxes suffer from the problem of criminal non-remit-tance and can be undermined by criminal activities, but VAT has attracted a great deal of attention on account of the scale of fraud experienced. Fortunately for tax administrators and the societies that must bear the cost of such fraud, there are anti-fraud measures available. Some of the measures aimed at combating VAT fraud undermine the fundamental design features of VAT as a tax on final consumption, whereas others do not.

The term “VAT fraud” can cover a multitude of activities that result in the public purse being deprived of revenue that it should rightfully collect. Unlike other taxes, VAT has two separate areas at which fraudsters can direct their fraudulent activities: not only can they manipulate their own liability to remit VAT, they can also abuse the mechanism of recovery of input VAT as a means of embezzling public funds. The former category of fraud includes failure of businesses to register, suppression of their sales, mis-classification of their supplies to the effect of applying a reduced rate or other concessions (an exemption or the zero rate for exports) in relation to taxable domestic supplies, failure to account for VAT on transactions that are subject to the reverse charge mechanism and on taxable self-supplies, and smuggling goods into the country. Unique to VAT is claiming input VAT in relation to exempt or non-taxable transactions, or on the basis of fake purchase invoices.

VAT fraud in the form of underreporting sales is likely to also result in underpayment of other taxes, such as income tax and social security contributions.

2. Scale and Incidence of VAT Fraud

VAT fraud is a global phenomenon that can involve vast sums of money. Australia is no exception in this respect. For example, the Australian Taxation Office (ATO) recently announced that it is investigating members of the gold bullion industry in connection with a fraud involving AUD 65 million.1 The scale of VAT fraud in some other jurisdictions is even greater. It is estimated that the European Union had a “VAT gap” in 2011 of EUR 193 billion, a large part of which was caused by fraud. In the European Union, so-called “missing-trader fraud” or “carousel fraud” is estimated to involve an amount of up to EUR 100 billion a year. Others estimate that VAT fraud costs EU Member States (in 2011) EUR 127 million a day.2 In the case of missing-trader fraud, fraudulent suppliers collect large amounts of VAT from their customers and disappear before remitting the tax to the tax authorities. If the fraud involves repeated transactions between the same parties involving the same goods, this type of fraud is referred to as “carousel fraud”. Missing-trader fraud becomes financially very attractive for unscrupulous suppliers and more difficult to detect by the tax authorities where the fraudulent suppliers are able to avoid the burden of VAT on the related inputs. They can avoid that burden where the liability to account for VAT on the inputs is in their own hands, for example under the reverse charge or a similar mechanism. The damage from this type of fraud for the tax authorities is that they must allow the customer to recover the input VAT because the purchase invoice is a valid VAT invoice. The large sums involved and the complexity and scale of some of these sophisticated structures would tend to suggest that organized crime is involved. Indeed, an EU study3 reported that, in the period 2004 to 2010, 21 cases of EU VAT fraud did involve organized crime and that the proceeds were used to finance other types of crime, such as drug trafficking, trafficking in human beings, identity fraud, alcohol smuggling, counterfeiting and terrorist activities.4

It can be concluded from these points that the problem of VAT fraud is real, widespread and extremely harmful to society and the revenues of national governments. Options available for controlling such crimes are considered next.

1. ATO Media Release 2013/13 “The ATO is investigating companies in the gold bullion industry suspected of GST fraud totalling more than AUD 65 million. The ATO, Australian Federal Police and Australian Crime Commission yesterday executed search warrants on premises associated with the companies operating in the gold bullion and precious metals industries. The investigation forms part of the work undertaken by the joint-agency Criminal Asset Confiscation Taskforce (CACT). It is alleged that the companies fraudulently claimed GST and failed to report GST correctly. They formed syndicates to conceal the true nature of their activities and to avoid detection. As a result of the investigation, the ATO has issued garnishee notices and GST amended assessments with liabilities of more than AUD 130 million.”


3. Strategies To Detect and Address VAT Fraud

Some of the features of VAT systems create an incentive or opportunity to engage in fraudulent activities and removing them may reduce the risk of fraud. Such anti-fraud strategies may take the form of structural amendments to the legal system or specific procedures, aimed at limiting fraud. However, the strategies can also be aimed at rewarding compliant businesses or at gathering information to check their VAT compliance. In cross-border scenarios, exchanging information between tax authorities is a rapidly increasing phenomenon.

3.1. Delaying refunds of VAT

The system of refunding excess input VAT is an obvious temptation for the criminally inclined because they receive money from the tax authorities. Since VAT is based on the invoice system, registered businesses can recover VAT on purchases of goods and services even before they actually make any taxed supplies. In the case of capital goods, the resulting refunds – which should be made rapidly to avoid the VAT itself becoming a burden on businesses – can be very substantial. However, for legitimate businesses making large investments in the start-up phase and for regular exporters, the refund mechanism is an essential aspect of a properly run VAT. Delaying refunds pending the results of a tax audit is a source of tension between the tax authorities and businesses. Australia has no exception in this respect.6

In Multiflex, the company of the same name had purchased mobile phones and other electronic equipment in Australia and exported them to an associated entity resident in Singapore. Multiflex claimed a GST refund of slightly under AUD 932,000 through its returns in the first half of 2011. As the tax authorities suspected fraud, the Commissioner withheld the refunds pending an audit. In light of the adverse cash flow implications for Multiflex, the matter was afforded an expeditious hearing and the Federal Court ordered the Commissioner to pay the GST refunds to Multiflex “forthwith.” Two weeks later, the Full Federal Court upheld this decision and the High Court dismissed the Commissioner’s application for leave to appeal. In considering the matter, the courts stressed, inter alia, that cascading of GST is to be avoided and that declining the request for a mandamus against the Commissioner “would be antagonistic to the terms, object or purposes of … the GST Act.”7

3.2. Zero rating exports

Zero rating exports of goods is a risky feature of the VAT system, especially where the customer is responsible for removing the goods from the territory of the supplier’s country. Removal of the zero rate for exports removes the opportunity for suppliers to declare taxed domestic transactions as being zero-rated exports. The problem with removing the zero rating of exports is that it undermines the very fundamentals of VAT, which is intended to apply on a destination basis.8 The destination principle is also the underlying rationale of the OECD’s International VAT/GST Guidelines.9 The competitive disadvantage for exporters can be limited if the exporting country has an effective procedure for refunding VAT to the non-resident purchaser.

3.3. Reverse charge mechanism

Making structural changes to the VAT system can be effective in some cases. In order to deal with missing-trader or carousel fraud, EU Member States increasingly introduce the reverse charge mechanism in relation to domestic supplies of specific goods and tradable services. The reverse charge mechanism prevents fraudulent suppliers from receiving large sums of VAT from their customers and going missing before remitting the tax to the tax authorities.10 For the same reason, EU Member States apply the reverse charge mechanism to domestic supplies in specific economic sectors plagued by a low tax morale.11 Application of the reverse charge mechanism in specific sectors will have the effect that fraudsters move to other sectors, and large-scale application of the reverse charge mechanism has the effect of reducing the VAT system to a single-stage retail sales tax, which may give rise to other types of

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5. Excess input VAT means that, for the tax period, the amount of deductible input VAT is larger than the amount of output VAT payable.

6. See M. Walpole, Light in the tunnel of GST refunds in GST in Australia: Looking forward from the first decade, pp. 409-423 (C. Peacock ed., Thomson Reuters 2011). The author refers to the findings of the Inspector General of Tax which were that too much emphasis was being placed on withholding large refunds and too little on the actual risk associated with the claimants. See also Review of Tax Office administration of GST refunds resulting from the lodgement of credit BAS’s – A report to the Minister for Revenue (Jan. 2005).


9. Mandamus is a judicial remedy in the form of an order from a superior court addressed to any government subordinate court, corporation or public authority to do something which that body is legally obliged to do.

10. Supra n. 7, per Jessup J at para. 34.

11. It is sometimes said that taxing exports can cause competitive disadvantage if a country’s exports are inflated by the amount of tax imposed by the exporting country. It is accepted, however, that the exchange rate adjustment removes this competitive disadvantage within a short cycle.


14. Under art. 199 VAT Directive, EU Member States may apply the reverse charge mechanism to domestic supplies of construction work, including repair, cleaning, maintenance, alteration and demolition services in relation to immovable property and supplies of staff working in the construction sector, supplies of immovable property under the option for taxation, supplies of used materials, scrap, industrial and non-industrial waste, recyclable waste, partly processed waste and certain related goods and services, supplies of goods provided as security by one taxable person to another in execution of that security, supplies of goods following the cession of a reservation of ownership to an assignee and the exercising of this right by the assignee, and supplies of immovable property sold by a judgment debtor in a compulsory sale procedure.

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fraud in view of the fact that the standard VAT rates in the European Union vary between 15% and 27%.

3.4. Rate structure and registration

Removing reduced VAT rates may end the possible abuse of such rates but is contrary to the policy objectives of ensuring that final consumption of specific categories of goods and services should be subject to a reduced burden of VAT. Replacing reduced rates by exemptions would give rise to an undesirable increase of tax avoidance schemes because such schemes are mainly in the interest of businesses and government bodies that cannot recover input tax.

Reducing the standard VAT would definitely reduce the profitability of fraud but would also have the effect that VAT loses its position as an important, or sometimes the most important, source of tax revenues.

Increasing the registration threshold will hardly be effective in keeping fraudsters outside the VAT system. Fraudulent suppliers may easily achieve an extremely high turnover and, if they do not, they will not hesitate to falsify their business records. Besides, it is a myth that large businesses are by definition not involved in fraud although, if they are heavily reliant on their reputation, large businesses are less likely to be tempted to engage in fraud (see section 3.5.).

3.5. “Gold card” schemes

An approach that supports the smooth running of the VAT system and secures a normal flow of refunds for honest suppliers is one that recognizes that the risk of fraud on the part of some suppliers is low and that there is little need to impede the flow of refunds or to otherwise subject transactions to excessive scrutiny, because such businesses have a clean record of VAT compliance and a good system of keeping business records, which suggests that their compliance is soundly managed and they thus demonstrate a low risk of non-compliance. In the case of such businesses, the tax authorities can accept that it is more likely than not that the reported transactions are legitimate and that the reporting is complete.

Singapore is an example of a jurisdiction that runs a “gold card” scheme under the heading “GST Assisted Compliance Assurance Program” (ACAP), which has been running since 2011. The incentive for businesses to participate in the scheme is an enhanced relationship with the Singapore Inland Revenue. This means that qualifying businesses should experience (for three years or five years, depending on their status under the ACAP) a reduction of GST auditing activities by the tax authorities; quicker GST refunds; a customer relations manager to handle their GST rulings and resolve their GST issues; expedited rulings and resolution of issues; and automatic renewal of applicable GST schemes.

Anecdotal reports to the author suggest that the scheme works well in Singapore. Australia has arrangements for large businesses similar to those employed in Singapore via, inter alia, its Annual Compliance Arrangements process.

An extreme form of the gold card scheme is found in the Netherlands, where the tax authorities enter into covenants with businesses in the framework of what they call “horizontal supervision”. Under the covenant, businesses promise to be compliant and to discuss any tax issues with the tax authorities in advance, and to voluntarily and proactively disclose all material tax risks and potential discussion points. In return, the tax authorities undertake to respond quickly to the businesses’ requests.

3.6. Chain liability

Another way for the tax authorities to ensure that the appropriate amount of VAT is collected from a chain of transactions, and to reduce collusion between businesses with the purpose of defrauding the system, is to hold parties within a chain of supplies jointly and severally liable for VAT that has not been remitted by other parties in the sequence of supplies. Chain liability exists in many Member States of the European Union, including the United Kingdom. The UK tax authorities (Her Majesty’s Revenue and Customs, HMRC) apply this arrangement in the case of supplies of specific electronic goods that are particularly prone to missing-trader fraud if the customer “knew” or “had reasonable grounds to suspect” that the VAT payable on the supply, or on a preceding or a subsequent supply, would be unpaid.

The drawback of the chain liability is that innocent businesses may be unwittingly used by criminals and thus, although they lack deliberate intent, such innocent businesses bear the consequences of the fraud committed by others. Taken to extremes, such an approach may undermine the confidence that businesses have in the tax authorities with a consequent decline in incentives to comply with the rules (on the basis that they perceive themselves to be “damned if we do – damned if we don’t comply”). The threat of such joint liability must, on the other hand, make businesses more circumspect about the businesses they contract with and would encourage them to be alert to warning signs that a particular contract involving supplies subject to VAT is suspect. The approach is very much in the “big stick” category of incentives to encourage compliance and obviously may have rule-of-law implications if the protection of innocent businesses is inadequate.


17. HMRC (2008) Notice 726: joint and several liability for unpaid VAT. The goods affected are listed at para. 1.4 and include telephones and telephone equipment, including parts and accessories; computers and computer equipment, including parts, accessories and software; satellite navigation devices; electronic games and amusement devices – including digital cameras, camcorders, portable electronic devices for playing music and games such as iPods, hand-held/portable DVD players, and PlayStation Portables.

18. Id., at para. 2.1.
3.7. Guarantees
It is also possible to prop up the VAT system and ensure ultimate recovery of amounts underpaid by means of a guarantee given by a third party for the VAT liability of a particular business entity. The system assures the tax authorities of remittance of VAT without the need to unduly delay refunds or engage in overzealous investigations.

The dominant approach in the United States is the use of certified service providers (CSPs). These CSPs are commonly responsible for filing their customers’ tax returns, and they also guarantee and settle their customers’ tax liabilities and provide other compliance services.

Drawbacks of such a system include the increased cost of doing business associated with securing such guarantees and the possibility that an organized criminal group will be as able to establish a fraudulent guarantor or take advantage of a legitimate guarantor as they will be to perpetrate the contemplated fraud.

3.8. VAT accounts
A means of maintaining the normal ebb and flow of VAT refunds and remittances associated with normal business transactions, whilst providing a buffer of security for the tax authorities, is to operate a VAT account system. Under such a system, the VAT paid by the customer is placed in a designated bank account held by the supplier. Suppliers can only use the balance of their blocked VAT account for remitting VAT to the tax authorities or for paying VAT to their suppliers. The tax authorities do not refund VAT to businesses until they have checked the validity of their claim, which means that VAT is only refunded if the tax has been remitted first. It is obvious that this system slows down refunds and can cause some cascading. It is also obvious that large amounts of money are tied up in businesses’ blocked accounts.

3.9. D-VAT certification
The use of certified tax software can limit the risk of specific types of fraud and other irregularities, and it can provide certainty to honest businesses engaged in domestic and cross-border transactions.

Certified software, i.e. software systems developed by third parties or a business’s own tax accounting software, is currently being used on a voluntary basis in the US retail sales tax but it could also make VAT systems more robust.

Under D-VAT certification, the tax authorities will develop a testing regime for the certification of the software. To be certified, the software would need to be comprehensive, and capable of determining the correct VAT rate for every transaction and correctly calculating the VAT due; posting these amounts on the related invoices; linking each input or output to the correct VAT return; completing the VAT return accurately; and remitting the VAT due. Many existing accounting systems already have those features but they are not certified as being “accurate”. In addition, the software will need to verify whether or not the system used by the contract partner is also certified.

The use of certified software in the United States is voluntary. However, in some instances, notably when an enterprise is heavily engaged in transactions deemed inherently prone to missing-trader fraud, a jurisdiction might make certified software a mandatory condition of doing business.

3.10. VAT Locator Numbers
There are two models for the use of VAT Locator Numbers (VLNs): in Brazil, the use of VLN is compulsory in relation to domestic or cross-border supplies of goods or services and, in Chile, the system is optional. Under the VLN system, customers cannot deduct input tax if the VAT is mentioned on an invoice without a valid VLN.

The first step of the VLN system is that the supplier creates an electronic file in XML24 which contains all necessary contract and tax information for a transaction. The seller signs the file digitally and transmits it electronically to the tax authorities. By doing so, the supplier is requesting authorization for the use of the invoice in this form. After checking the XML file for accuracy and completeness, which is a fully automated process and is completed in a fraction of a second, the tax authorities assign a VLN which the supplier must attach, commonly in the form of a bar code, to the invoice, which the supplier then transmits to the customer. The customer seeks authorization from the tax authorities on the basis of the VLN to deduct the VAT mentioned on the supplier’s invoice. If the information provided by the customer matches the information provided by the supplier, the tax authorities authorize the invoice for deduction purposes. The VLN system, which is based on the same rationale underlying the stamp duty system in other jurisdictions, i.e. a document has no legal enforceability unless it is validly stamped, has resulted in significant revenue gains. Even greater efficacy is achieved in cross-border supplies if both the country of origin and that of destination apply the same system.

A far more sophisticated and secure version of VLN is real-time VAT,25 which, in some respects, is born out of the

20. Bulgaria applied the system of VAT accounts but withdrew it when it acceded to the European Union, on 1 January 2007. The Czech Republic has a deemed guarantee rule under which the payment of VAT in relation to a supply to an unauthorized account of the supplier results in the customer becoming a guarantor for the correct VAT remittance by the supplier. This is effectively the same as joint liability discussed above. See section 3.5. and http://www.kemphoogstad.cz/en/news/guarantee-for-settling-vat-by-supplier-in-real-life.
22. Id.
24. XML stands for eXtensible Markup Language.
same insights as VLN. Whereas VLN digitally tags each supply and penalizes businesses that pay VAT to their suppliers without having a valid VLN, real-time VAT digitally sequesters each payment that includes a VAT component, and automatically eliminates the possibility for suppliers to receive VAT from their customers and for customers to deduct any VAT that has not been remitted. Under real-time VAT, the system shifts the supplier’s VAT liability to the date on which he pays his suppliers through a secure banking system. The banking system is capable of splitting off the VAT element in the customer’s payment and (electronically) remitting the VAT to the tax authorities, which makes it necessary that all transactions are paid by means of electronic funds transfer (EFT) to the effect that the supplier’s liability is automatically collected when the customer pays for the transaction. Under real-time VAT, suppliers only receive the VAT-exclusive price for their supplies. Through EFT, the tax authorities refund the deductible VAT immediately to the customer.\(^{26}\)

### 3.11. Information exchanges and information checking

Rather than changing the incidence of VAT, there are ways of addressing the fraud problem by managing and checking information so as to identify false transactions and other irregularities. To that end the tax authorities of various jurisdictions share information relating to cross-border transactions or transactions carried out abroad.

#### 3.11.1. The Convention on Mutual Administrative Assistance in Tax Matters

The OECD Convention on Mutual Administrative Assistance in Tax Matters has seen considerable impetus in recent times, as nations have adopted a more proactive approach in dealing with VAT fraud and other tax-reducing schemes. The Convention was developed jointly by the OECD and the Council of Europe, and became available for signature by nations in 1988.\(^{27}\) The Convention was amended under a Protocol which entered into force in 2011.\(^{28}\) It is thus in line with modern international standards. It is open for signature by all countries, not only OECD and European countries. Australia became a signatory soon after the amending Protocol entered into effect, on 1 December 2012.\(^{29}\) The Convention is aimed at combating loss of revenues, including VAT revenues, caused by both legal and illegal tax minimization activities by, inter alia, exchanging, on request or spontaneously, information concerning particular persons or transactions; simultaneously investigating the tax affairs of a person within both jurisdictions; and permitting tax officials of one state to be present at the appropriate part of a tax examination in the other state.

It is testament to the power of the Convention that over 70 countries have signed it.

#### 3.11.2. Tax Information Exchange Agreements (OECD Model TIEA)

In addition to the Mutual Convention (see section 3.11.1.), there are other systems for information exchange in place, such as the Tax Information Exchange Agreements (TIEAs) of which there have been a flood in recent years. TIEAs are bilateral international agreements based on the OECD Model TIEA and operate under the principles of international law. Australia has signed 35 TIEAs, which also cover VAT. Unlike the Convention, information under TIEAs can only be exchanged on request and may not be shared with third parties. The requesting state must confirm that it has pursued all available means to obtain the information in its own jurisdiction. The tax authorities of one state may only carry out tax examinations in the other state or be present at tax examinations abroad with written consent of the persons concerned.

#### 3.11.3. VAT Information Exchange System – Eurofisc

In the European Union, the VAT Information Exchange System (VIES), on the one hand, enables businesses to check the VAT status of their customers established in another Member State\(^{30}\) and, on the other hand, provides information to the tax authorities of the Member State of destination on the identity of customers who have received supplies of goods and services from suppliers established in another Member State.\(^{31}\)

In addition to the VIES, the tax authorities of the EU Member States have other channels for sharing VAT information on a confidential basis and for obtaining information from customers about businesses that collect and remit VAT. In this context, Eurofisc constitutes a network for the swift exchange, through designated Eurofisc liaison officials, of targeted information in cases of suspected fraud.

26. Real-time VAT has a valuable built-in safety mechanism but requires a compulsory payment procedure for all commercial transactions.
29. The Convention came into force in Australia on 1 December 2012. (See http://www.treasury.gov.au/Policy-Topics/Taxation/Tax-Treaties/HTML/Convention-on-MAA-in-Tax-Matters (accessed Aug. 2014)). Whereas Australia’s Double Tax Agreements (DTAs) have the force of law by reason of having been statutorily adopted for application within Australia under the International Tax Agreements Act 1953 (Cth), the Multilateral Convention and Tax Information Exchange Agreements (see section 3.11.2.) do not. However, the lack of statutory status does not seem to limit the actual ability of the Australian Commissioner of Taxation to gather information in accordance with Australia’s obligations under the Convention.
30. In order to zero rate intra-Community supplies of goods, the supplier must hold evidence that the customer is registered for VAT in the Member State of destination.
31. To that end, businesses making intra-Community supplies of goods and services must file the necessary information through periodic recapitulative statements (EU sales lists), which are processed through the VIES. The information generated by the VIES enables the tax authorities in the Member States of destination to check whether the customers have accounted for VAT on the accompanying intra-Community acquisition of goods or under the reverse charge mechanism in relation to cross-border services.
3.12. Nota Fiscal Paulista lottery system

In 2007, the Brazilian state of Sao Paulo started an incentive scheme, the Nota Fiscal Paulista, designed to encourage customers to collect VAT receipts from their suppliers.\(^{32}\) In the framework of the lottery system, customers provide their social security numbers to their suppliers who record the number on the receipt. Suppliers must provide all receipt information (with or without social security details) to the tax authorities, who create separate accounts for each social security number and reward the customers by way of a tax rebate of 30% and by way of letting them participate in a lottery: for every expenditure of USD 50, consumers receive a lottery ticket to potentially win one of the 1.5 million prizes that are distributed every month. The prizes usually range from USD 5 to USD 25 but the largest prizes are up to USD 500,000.

After deduction of expenses (USD 1.6 billion), the incentive scheme has led to a net increase of tax revenues over four years of USD 400 million.

In Argentina, final consumers who pay their suppliers by means of a debit or credit card receive a 5% VAT refund. This incentive scheme has been applied since 2001 and is apparently successful because the period of application has been extended, every year, by another year since the date of introduction.\(^{33}\)

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33. See VAT News, 25 Intl. VAT Monitor 1, p. 28 (2014), Journals IBFD.

4. Conclusions

Governments around the world have adopted a large variety of measures that are aimed at combating VAT fraud and encouraging VAT compliance. Some of the measures have much less pronounced adverse economic effects than others. Measures that encourage VAT compliance and reduce the burden of VAT on compliant businesses are the preferred options.

It seems clear that we are entering a new era of information exchange and computerization of record keeping, which may lead to more effective enforcement and collection of VAT without the need to impose obligations on businesses that are economically adverse. However, whilst all jurisdictions love to receive information from abroad, having to provide information to the tax authorities of another jurisdiction is a different matter, because it does not lead to tax revenues in the jurisdiction that has to do the work on information gathering. The more stringent the financial targets for tax authorities, the more difficult it will be for them to devote their limited resources to “non-productive” investigative activities.