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Cross-border VAT frauds and measures to tackle them

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Cross-border VAT frauds and measures to tackle them

1. Introduction

The VAT currently continues to spread in the countries worldwide taxing transactions in goods and services. This leads in turn to the growing risks of both tax avoidance and tax evasion, and also of double taxation in the absence of appropriate international VAT coordination. Consequently, the administering of VAT becomes more complicated when cross-border transactions occur and more than one jurisdiction could apply its own VAT rules.

The low level of VAT administering, particularly, could cause the VAT frauds in the cross-border trade.

So, the main purpose of this paper is to analyze both current problems, related to the cross-border VAT fraud and measures to tackle them. To do this we structured paper as follows. Section 2 reviews recent theoretical and empirical research on the VAT frauds in cross-border trade in goods. Section 3 provides brief theoretical analysis of VAT in international trade. Section 4 examines current problems in the cross-border VAT fraud and main strategies to tackle them. Finally, Section 6 presents some concluding remarks.

2. Literature review

Keen and Smith (2007) described the main forms of noncompliance distinctive to a VAT and considered how they can be addressed, and assesses evidence on their extent in high-income countries. Fedeli & Forte (2009) examined VAT frauds at the EU States' borders by modeling some different collusive characters of these frauds in order to explore their effects on the international trade and the domestic market.

Mesdom (2011) estimated fair destination-based VAT. He concluded that border adjustments are easier to administer for tangible goods than for services and to achieve fair results, some proxies for services will be necessary. Magnusson (2009) analyzed the VAT fraud in cross-border trade from the point of view of institutional theory, notably, by involving routines and norms. The author explained the VAT fraud by applying three causal variables – motivated offenders, the crime opportunity structure and the absence of effective guardians of law and order, or in other words, effective control structure, where the crime opportunity structure and control activities – as well as norms, values and attitudes affect the motive formation of the individuals in a social psychological process. He concluded that information and endeavors to influence the attitudes and motive formation of the people who are committing the VAT fraud in cross-border trade.

Bukhsh and Weigand (2014) discussed VAT frauds scenarios in the cross-border trade and possible prevention approaches. Walpole (2014) analyzed various anti-fraud measures and he concluded that those that encourage VAT compliance and reduce the VAT burden on compliant businesses could be regarded as preferred options. Gradeva (2014) estimated empirically the VAT evasion in cross-border trade in the context of intra-EU trade flows from the EU-15 to seven of the new Eastern European EU member states, notably, the responsiveness of the trade gap to changes in the VAT rate for the time period of 2004-2009 at the six-digit

product level. She found that the trade gap is positively correlated with the VAT rate in three of the seven Eastern European countries.

3. Theoretical background

According to OECD (2015), the destination vs. origin principle is one of the fundamental issues of trade policy in relation to the international application of the VAT.

Under the destination principle, VAT is levied only on the final consumption occurred within the taxing jurisdiction. Under the origin principle, the tax is levied in the various jurisdictions where the value was added. The key economic difference between the two principles is that the destination principle places all firms competing in a given jurisdiction on an even footing whereas the origin principle places consumers in different jurisdictions on an even footing.

Moreover, the application of the destination principle in VAT achieves neutrality in international trade, since exports are not subject to tax with refund of input taxes (that is, “free of VAT” or “zero-rated”) and imports are taxed on the same basis and at the same rates as domestic supplies.

By contrast, under the origin principle each jurisdiction would tax the value created within its own borders and exporting jurisdictions would tax exports on the same basis and at the same rate as domestic supplies, while importing jurisdictions would give a credit against their own VAT for the hypothetical tax that would have been paid at the importing jurisdiction’s own rate.

This would run counter to the core features of a VAT: as a consumption tax. And the origin principle could distort the economic or geographical structure of the value chain and violate neutrality in international trade. For these reasons, there is widespread consensus that the destination principle is preferable to the origin principle from both a theoretical and practical standpoint. This is the international norm and is sanctioned by WTO rules.

In some detail, implementation of the destination principle with respect to international trade in goods is relatively straightforward in theory and generally effective in practice, due in large part to the existence of border controls or fiscal frontiers. The VAT on imports is generally collected at the same time as customs duties, although in some jurisdictions collection is postponed until declared on the importer’s next VAT return. Allowing deduction of the VAT incurred at importation in the same way as input tax deduction on a domestic supply ensures neutrality and limits distortions in relation to international trade [9, pp. 12-13]. According to the Mesdom (2011), choice between destination and origin principle has a significant impact on the avoidance of double taxation and the equal treatment of imports compared with locally produced goods [13, p.192].

There are different approaches to classify the VAT fraud in cross-border trade. According to the International VAT association report (2007), main sources of VAT fraud are the following:

- the black economy;
- insolvencies;
- missing trader fraud – including “carousel” type fraud;
- other types of fraud, notably:

invalid deductions of input tax – false input tax invoices, or goods obtained for non-business use, and non-payment of output tax, including sales at lower than normal values [3, p.6,9].

Frauds that can arise under VAT, according to Keen & Smith (2013), are:
under-reported sales;
failure to register;
misclassification of commodities;
tax collected but not remitted;
imported goods not brought into tax [10, p.7-9].

According to Bukhsh & Weigand (2014), VAT frauds can be divided into the following categories.

1. Acquisition fraud, which is the simplest missing trader fraud where a fraudster imports some goods, assuming that these are zero-rated in the country of origin, and VAT is due in the country where they have been imported. Then the fraudster charges basic price and VAT and later fraudster become missing trader and does not pay VAT.

2. Carousel fraud, which is another version of VAT fraud where missing trader purchases goods from a supplier located in another EU state. Then he sells the goods to a business and charges VAT and later the missing trader disappears without paying the VAT, which in turn starts a chain process where the buying business sells the goods to a second business and charges VAT, paying the excess VAT received from the second business to the budget. The last business in the chain sells the goods to a broker. After exporting goods in EU, broker reclaims the VAT on next purchase. At this time fraud is revealed that VAT is not being paid by the missing trader.

3. Contra-trading fraud, under which the trader does not claim for reimbursement. The first broker does not submit a claim to obtain a refund of the VAT charged to it. Instead, he imports goods from another EU state, without paying VAT. This VAT charge and import goods chain continues until one broker or another participant of the supply chain submits a claim for a refund of input tax [2, p.2].

4. Current problems related to VAT fraud and measures to tackle them

The report of the European Court of Auditors stated that the current EU system for fighting cross-border VAT fraud is not effective enough and is hampered by a lack of comparable data and indicators. The main problems in this area are the following:

absence of effective cross-checks between customs and tax data in most of the Member States;

problems with the accuracy, completeness and timeliness of data despite the VAT information is shared between Member States' tax authorities;

a lack of cooperation and an overlap of powers between administrative, judicial and law enforcement authorities [7, p.1; 15, p.9].

There are some main features related to the cross-border VAT fraud: organized crime, smuggling, money laundering and estimation problems.

Let's consider them briefly.

Organized crime. VAT fraud is often linked with organized crime. According to Europol, €40-60 billion of the annual VAT revenue losses of Member States are caused by organized crime groups and that 2 % of those groups are behind 80 % of the VAT fraud [15, p.36].

Money laundering. According to the Report of FATF (2007), there are close links between the laundering of VAT carousel fraud and the laundering of funds from other serious organized crime. Due to the nature of the offence and the substantial scale of the profits available, VAT carousel fraud poses a serious risk of being a favored option to invest money from, and invest money in, other crimes, p.18

In order to tackle these challenges the following measures should be done:

providing Suspicious Transaction Reports;

ensuring cooperation and information sharing, notably, ensuring more cooperation between the financial sector and public authorities to develop, distribute and offer feedback on indicators and profiles;

sharing of trends and profiles internationally;

more use of mutual assistance to help identify the money flows [11, pp.12-13; 18].

Smuggling. The Eurojust meeting (2014) highlighted the fact that, in most cases, excise fraud and VAT fraud are linked, and constitute some of the EU's biggest annual losses of revenue from unpaid duties. Consequently, the two main types of challenges were identified:

legal and prosecutorial challenges: in addition to different EU legislation in tax and customs area, different approaches to tackle VAT fraud, excise fraud schemes are complex and continually evolving;

practical challenges, notably, weaknesses in control mechanisms which make the origin of goods, the identity of the traders and the location of the proceeds difficult to determine.

Accordingly, they analyzed such solutions as harmonization of excise tariffs and goods subject to excise, further training for investigatory and judicial authorities, the development of specialized control mechanisms and the improved exchange of information between Member States' authorities. And they identified that the use of the judicial support is the best practice to tackle cross-border excise fraud effectively, which include the exchange of information facilitated through coordination meetings, joint action days and the establishment of joint investigation teams [5, pp.2-3].

According to the EU Report (2016), it is difficult to measure the impact of VAT frauds in the cross-border trade, since the compliance VAT gap is not a reliable estimate of intra-Community VAT fraud, because it includes not only both domestic and cross-border VAT fraud, but also other revenue losses, including those due to legal tax avoidance, traders' insolvency and tax administrations' practices of tolerating tax arrears by companies in difficulties. Moreover, the VAT gap is very sensitive to estimates of the grey economy that are included in GDP data [15, p.20].

The EU experts consider that the common risk analysis and an effective feedback mechanism would allow the network to further enhance its role as a quick reaction from tax administrations against cross-border VAT frauds. For the cross-border exchange of information there are clear legal frameworks established for both tax and customs competent authorities [15, p.53].

VAT fraud particularly affects the plant/machinery sector, motor vehicles, soft drinks but other sectors are also involved [4, p.28].

The analysis of current strategies aiming to reduce the possibilities of fraud and exclude new important fraud risks allowed us to summarize them in the Fig.1.

OECD (2015) has elaborated main guidelines in order to achieve VAT neutrality in the cross-border trade. With respect to the level of taxation, foreign businesses should not be disadvantaged or advantaged compared to domestic businesses in the jurisdiction where the tax may be due or paid, p.16

This means that there should not be any discriminatory application of the rules because foreign businesses should not end up having a tax advantage compared to domestic businesses in terms of their final tax burden. Consequently, the VAT should not distort competition between foreign and domestic businesses.

To ensure foreign businesses do not incur irrecoverable VAT, jurisdictions may choose from a number of approaches, notably, making supplies free of VAT, allowing foreign businesses to obtain a refund through a specific regime, allowing foreign businesses to obtain a refund through local VAT registration, shifting the responsibility to locally registered suppliers/customers, granting purchase exemption certificates, etc.

In the area of administration and compliance, where specific administrative requirements for foreign businesses are deemed necessary, they should not create a disproportionate or inappropriate compliance burden for the businesses. Domestic businesses and foreign businesses are in different situations in relation to the tax administration. The former will generally has a fixed place of business from which the business is operated, local employees, a local bank, local links to the tax authorities and various forms of identification/registration through bodies, while foreign businesses are less likely to have a legal presence, local staff or links within the local community. And this lack of presence and history in a jurisdiction could be regarded as an element of risk for tax administrations, for which appropriate measures may need to be taken to protect against evasion and avoidance [9, pp. 17-26].

Concerning the law aspects, according to the VAT expert group legal certainty is important for business and tax administrations alike particularly in cross-border scenarios in order to determine the correct place of taxation, i.e. to eliminate double taxation or non-taxation, to avoid VAT costs arising due to assessments and penalties, and to ensure the proper functioning of the single market and provide a level playing field [14, p.1].

**MEASURES TO REDUCE POSSIBILITIES OF VAT FRAUDS
IN THE CROSS-BORDER TRADE IN GOODS**

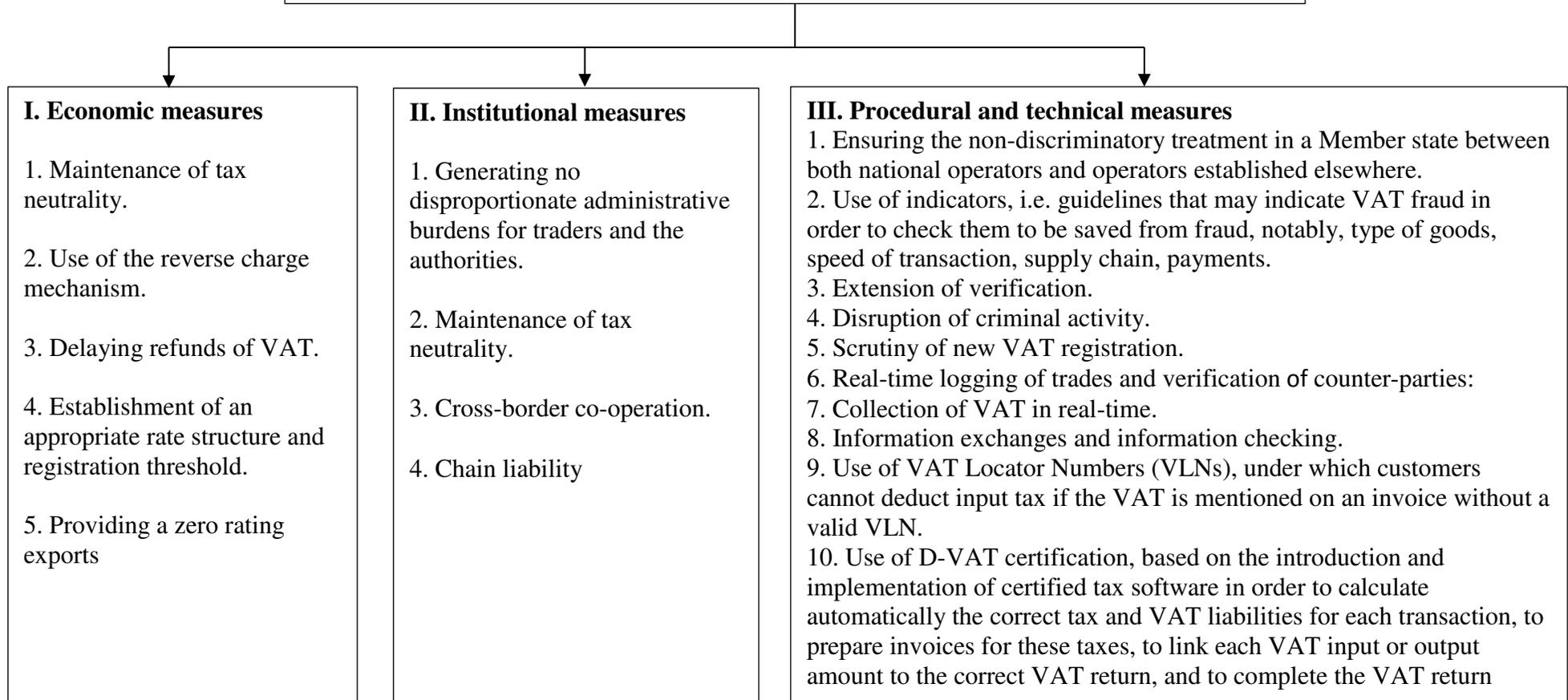


Fig. 1. Measures to tackle VAT frauds in the cross-border trade

Source [1; 2; 3; 16]

5. Conclusion

The analysis of the theoretical background of VAT in cross-border trade in goods allowed us to determine both some main features related to the cross-border VAT fraud (organized crime, smuggling, money laundering and estimation problems) and measures to tackle them.

We defined, based on the evaluation of current strategies aiming to reduce the possibilities of cross-border VAT fraud, the three main groups of such measures, notably, economic measures, institutional measures and procedural and technical measures.

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