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**European Tax Law Essay**

Assume you are an adviser to a newly elected “euro sceptic” government of a member state and you have been asked to write a report on whether the level of value added tax fraud is a problem which requires further harmonisation of the transitional system of value added tax and/or improved legal and administrative cooperation between Member States.

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## **1. Introduction**

The emancipation of goods and services crossing jurisdictional boundaries is integral to the realisation of the European Union's main project, creating the Single Market. This is a protracted process of evolution whereby the various barriers to free trade are removed and new systems of governance evolve to cope with the burgeoning single market. In the field of indirect tax the development of a system that is complementary to this unified market has proved politically difficult to achieve through wholesale reform and so a compromise system was introduced in 1993 as the forerunner to a more suitable "definitive" system. This "transitional" system tackled one of the most patently obvious obstacles to free movement by abolishing border checks, essential to enforcing taxation obligations, and introducing a more discreet monitoring system based on invoicing.<sup>1</sup> The retention of the destination principle complicated the monitoring process by requiring a high level of cooperation between States, both in collating the respective invoice details of the supplier/acquirer to ensure they are consistent and in taking action where discrepancies emerge. Yet in practice the level and quality of cooperation has improved little since 1993. The detection and enforcement have essentially remained demarcated by national boundaries and given criminals the opportunity to exploit weaknesses in the systems characteristics to defraud both Member States and the European Union of much needed revenue. This paper seeks to identify viable strategies to correct this failure.

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<sup>1</sup> The transitional system was established by Council Dir 91/680/EEC OJ L 376.

Although a move to the definitive system would arguably improve control, this paper will only seek to identify potential improvements to the transitional system. It will become clear that neither greater administrative and legal cooperation nor harmonisation (or at least improvements) to legal provisions will of itself solve the problem; rather, we must achieve a combination of the two in order to truly improve control. Whilst suggesting those changes that would optimise the current regime, consideration will be given to measures already promulgated by the Community. Before so doing, a review of the transitional system and its weaknesses will be useful.

## **2. Transitional System of VAT**

### **2.1 Theory of the Transitional System**

The transitional system is a complex regime reflecting the compromises required to ensure its adoption.<sup>2</sup> It both retains the destination principle while partly introducing an origin-based system; the former applying in business to business (“B2B”) intra-community supplies; the latter to final consumer purchases. At its adoption 95% of all intra-community supplies were B2B,<sup>3</sup> with further derogations from the origin regime provided through special schemes designed to prevent rate shopping by consumers through car purchases<sup>4</sup> and distance sales.<sup>5</sup> Small and Medium Sized Enterprises also

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<sup>2</sup> VAT being subject to the requirement of unanimity.

<sup>3</sup> Easson, H.J., *Taxation in the European Community*, 1993, p.140.

<sup>4</sup> The high value of car purchases and ease of transport would encourage cross-border shopping excursions. This scheme covers both cars and other new means of transport, which includes Aircraft and Yachts.

<sup>5</sup> This requires a vendor making taxable supplies to another State in excess of a stipulated value to account for VAT in the place of destination. This prevents a consumer from rate shopping without the necessity to

benefit from a special scheme.<sup>6</sup> The complexity provided by such schemes provides opportunities for fraud, mainly due to the authorities reluctance to dedicate adequate resources to monitoring them.<sup>7</sup>

A further defining characteristic of the regime, whose complexity inhibits the monitoring process, is the discretion left to Member States. They have freedom to determine the place of taxation of services,<sup>8</sup> as well as the power to apply reduced rates to specific goods or services.<sup>9</sup> Yet despite the consequences associated with such characteristics, the quintessence of the fraud problem is actually found in the exemption scheme for intra-community supplies. This requires closer consideration.

The exemption scheme<sup>10</sup> applies to intra-community supplies which still pertain to the destination principle. Its *modus operandi* involves relieving the business making the supply of its normal obligation to account for VAT to the national authorities. This means the goods cross the border untaxed while the supplier claims a refund of his input tax. In theory the foreign business makes an acquisition requiring declaration to its own authorities with VAT being levied and accounted for at the rate applicable in the

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actually visit the Member State of the supplier. On the premise that otherwise a consumer with no effort on his part could purchase from a country, taking advantage of its VAT rate, without actually travelling there. One can imagine this being a particular problem, especially in light of e-commerce.

<sup>6</sup> Small and Medium Sized Enterprises pay tax at source on their purchases (except for distance sales and transport) whilst intra-community supplies made by them need not be taxed if they are exempt when made domestically.

<sup>7</sup> The difficulties encountered in monitoring the special schemes have provided an opportunity to commit fraud (see COM (1998) 490 final p.3) and it seems that Member States, whilst recognising this, have generally failed to provide the resources necessary to monitor them (See COM (2000) 28 final p.9).

<sup>8</sup> Offermans, R., *A New Strategy to Improve the VAT System Operating within the Internal Market*, 2000 VAT Monitor 152 at p.154.

<sup>9</sup> In 1992 a base rate of 15% was agreed – Dir 92/77/EEC OJ 1992 L 316. However, States are allowed certain special reduced rates for specific goods or services.

destination State. In practice<sup>11</sup> this has been exploited by fraudsters who, without the fear of customs checks, can transport goods across borders tax-free without declaration. They are then diverted to the black market. It is possible for States to retrospectively detect such crime through invoice monitoring, but the cooperation required to ensure proper control has not occurred. Before considering why, a brief review of the opportunities for fraud is required.

## 2.2 The Opportunities for Fraud<sup>12</sup>

Fraudulent abuse of the exemption process commonly occurs through either the manipulation of the deduction rules to claim undue input tax or the suppression of output tax owed to the State.<sup>13</sup> Yet these methods are not mutually exclusive and can be used singularly or in combination through a variety of techniques. The perpetrators range from individual businesses committing minor tax fraud<sup>14</sup> through to international and highly organised criminals.<sup>15</sup> Some examples will be illustrative.

One simple method of abusing deduction rule is to produce a false invoice claiming goods to be traded abroad, deducting input tax, before selling them VAT free (either

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<sup>10</sup> Exemption in this international supply context equates to zero-rating because the intra-community supplier, whilst not levying tax on outbound products, may nevertheless claim a refund of all his input tax.

<sup>11</sup> This has led to an increase in VAT fraud within the EC. COM (1998) 490 final p.3.

<sup>12</sup> A good general guide to this area is provided by Lienemeyer, M., *The New VAT System and Fraud*, 1997 8(6) VAT Monitor 270.

<sup>13</sup> Note that the SCAF Study, reported in COM 1998 490 final, suggests that 57% of their sample study of fraud cases were committed in these most simple of ways.

<sup>14</sup> Examples might include the failure to register for VAT; Application of incorrect VAT Rates; and Abuse of Insolvency laws by limited companies to evade their VAT liability. See COM (1998) 490 final p.4.

<sup>15</sup> The main means being the use of shell companies and the carrying out of carousel fraud.

singularly or in concert<sup>16</sup>).<sup>17</sup> Similar false attainment of input VAT is possible using fictitious goods. Fraud carousels<sup>18</sup> work by creating companies (usually shell companies) in different States through which (fictitious) goods are transacted.<sup>19</sup> These take advantage of the rule that input tax is refundable to the acquirer in a domestic transaction irrespective of whether the supplier actually accounted for VAT. The risk to the supplier is reduced if the goods on which VAT is due were received through an intra-community acquisition. Although such non-payment is traceable, the inefficiency of administrative cooperation and time lag reduce the risks. Furthermore, shell companies are easily sacrificed.

Output tax may be suppressed when the acquirer of an intra-community supply fails to pay VAT on it. Although such discrepancies will eventually be traced under VIES, fraudsters can develop methods of disassociating themselves from the goods. This includes providing the supplier with a fictitious VAT number,<sup>20</sup> or ensuring the supplier (in concert or otherwise) issues the invoice to an independent shell company.<sup>21</sup>

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<sup>16</sup> That party could issue an invoice for the purported goods on to another party (involved or uninvolved) in order to muddy the trail!

<sup>17</sup> It will be seen below that methods exist to detect the inevitable inconsistencies that arise when the purported foreign purchaser does not declare an acquisition. However, this will take a long time with the supplier able to accuse the purported recipient of fraud to delay matters. See Lienemeyer, M, *ibid*, p.272.

<sup>18</sup> Fraud carousels have developed apace since 1993 and are currently one of the greatest perpetrators of VAT fraud. Indeed most shell companies set up for fraud purposes have been created since 1993.

<sup>19</sup> It requires two fictitious companies in each country. The first company (A1) makes a domestic supply (though omitting to pay VAT) to the second (A2) who is entitled to reclaim his input tax when he makes an exempt intra-community supply. The acquirer of these fictitious goods (B1) fails to declare and remit tax when he sells to another domestic company (B2), but this second company is still entitled to a refund of the input tax he supposedly paid should he make an intra-community supply on to a third country (C1).

<sup>20</sup> To be effective, the VAT number of a business in the acquirers state would have to be used, as VAT numbers must identify the operators location. If it were a genuine VAT number (but not the acquirers) then this would buy time as suspicions would not arise so quickly.

Although there are no statistics definitively determining either the most common methods of fraud or the total revenue loss,<sup>22</sup> estimates suggest that the Member States jointly lose £70 billion annually.<sup>23</sup> The preceding review has sought to highlight both the opportunities that gave rise to this level of fraud and the highly organised methods used to exploit them. The next section will enunciate the systems introduced to tackle these problems and explain the deficiencies that have allowed fraud to become so substantial.

### 2.3 The Current Control Procedures

European law does not impose strict requirements on Member States with regard the administration of VAT. Indeed, the discretion afforded them has typically resulted in VAT being implemented through pre-existing structures designed for other taxes.<sup>24</sup> States are required to nominate a Central Liaison Office (CLO) through which all exchanges of information or other cooperation should be channelled,<sup>25</sup> but there are no strict requirements as to the constitution of CLO's. Given that the Community does not have a central agency responsible for coordinating cooperation between States (though note OLAF, discussed below), inconsistencies between the organisations responsible for cooperation can be detrimental to the monitoring function. One particular criticism is that some States CLO's are completely separate from their highly important anti-fraud

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<sup>21</sup> Which has no connection with the trader and which may be sacrificed. Lienemeyer, M, *ibid*, discusses this at pp. 270-271

<sup>22</sup> One commentator has been heavily critical of the problems encountered in trying to find accurate quantitative information on the problem. Van Duyne, P.C., *VAT Fraud and the Policy of Global Ignorance*, 1999 European Journal of Law Reform, 1(4) at p.425 at p.426.

<sup>23</sup> European Court of Auditors Special Report 6/98, [1998] O.J. C-241.

<sup>24</sup> David, C, *Taxpayers and Tax Administrations: A Satisfactory Balance?*, 2000 VAT Monitor 144, p.145.



divisions.<sup>26</sup> Problems have also arisen through States questioning the legal basis on which the Commission might undertake the strategically important task of relaying information between different CLO's.<sup>27</sup> Indeed there is a danger that CLO's have become a bottleneck to cooperation, with controllers having no automatic right to communicate directly with their counterparts in other States.<sup>28</sup> The problem of inconsistency has also manifested itself within the penalties system. In some States VAT penalties are incorporated in criminal law, in some they are purely administrative.<sup>29</sup> The level of penalties varies between States and prosecution of fraud can encounter definitional and other difficulties.<sup>30</sup>

One of the CLO's main functions is to maintain the VAT Information Exchange System (VIES), the primary monitoring tool for inter-community VAT established by Regulation 218/92.<sup>31</sup> This requires States to build and maintain a database<sup>32</sup> from the details submitted by traders on the mandatory quarterly recapitulative statement.<sup>33</sup> The VAT Directive imposes some mandatory informational requirements such as the VAT registration of the supplier and acquirer, plus the total value of supplies made to that

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<sup>25</sup> The CLO is supposed to be the single point of contact for VAT cooperation under Guidelines concluded between the Member States and the Commission in 1993. See COM (2000) 28 final p.23. There are indications that this creates a "bottleneck" for cooperation. See also footnote 29 below.

<sup>26</sup> COM (2000) 28 final.

<sup>27</sup> Latter point made in COM (2000) 28 final p.27. This could be important regarding the role of OLAF. The Commission is arguing for amendments to put this function beyond doubt.

<sup>28</sup> This is possible under Art. 12(1) of the Regulation or Art. 9(2) of the Directive by which a competent authority might be authorised to conduct such exchanges (authorisation being necessary in order that information exchanged is usable against the fraudster). However, the Commission has recommended reform to make clear this possibility (p.29 COM (2000) 28 final.) of using this and to strengthen the CLO's role to ensure it is aware of all such communications.

<sup>29</sup> White, *VAT Revenue and Organised Crime: Time for Action?*, (1999) 24 *European Law Review*, 433 at 448.

<sup>30</sup> See p.18 below.

<sup>31</sup> Regulation 218/92 on Administrative Cooperation in the Field of Indirect Taxation, OJ 1992 L24/1.

acquirer.<sup>34</sup> States may also require businesses to submit details of their acquisitions.<sup>35</sup> Additional information requirements may be made if necessary to properly monitor VAT, so long as they are non-discriminatory.<sup>36</sup> This has created inconsistency in the information available to tax authorities. Nevertheless once mandatory information is collected, this information is logged and allows the VIES to communicate the VAT registrations of all the traders in State B who are receiving supplies from State A, the registration of the trader in State A and the value of the supply. The information is transmitted automatically at the end of each quarter. Although legally possible for States to provide direct access to this information, in practice they have not done so.<sup>37</sup> It would clearly help prevent fraud if both direct, immediate, access and spontaneous exchanges were made.<sup>38</sup>

If a State requires more information in order to monitor fraudulent activity, it is entitled to receive the registration number of operators in the requested State and the value of supplies to operators in the requesting State.<sup>39</sup> If this proves insufficient, the requested State must *at least* disclose invoice numbers, dates, and the value of individual

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<sup>32</sup> The exact requirements are found in Art. 4(1). Once built, this database should be kept up to date, complete and accurate for at least the period of five years previous to the current date.

<sup>33</sup> Art. 22(6)(b) of Directive 77/388 EEC.

<sup>34</sup> There are additional informational requirements under Art. 22(6)(b).

<sup>35</sup> Art. 22(6)(e). This is at monthly or less frequent intervals.

<sup>36</sup> Art. 22(8) and Cases 123 & 334/87, *Jeunehomme and Others v Belgian State* [1988] ECR 4517.

<sup>37</sup> Indeed the Commission has on many occasions, through the Anti-Fraud Sub-Committee, proposed that facilities for the verification of VAT identification numbers should be available both to other Member States and Traders immediately through the Internet. The Member States have always refused. See COM (2000) 28 final p.12.

<sup>38</sup> It seems that many States believe there is no legal basis under the current Regulation that permits such spontaneous exchange, although the Commission disagrees. See COM (2000) 28 final p.26. Under the original proposal for the Regulation there was provisions for the automatic exchange of information and spontaneous assistance, but these were omitted by the final draft. See Terra, *Removal of Fiscal Frontiers – Administrative Cooperation in the Field of Indirect Taxation (VAT)*, 1992 VAT Monitor June 2.

transactions. The Regulation demands this take place immediately without delay, with a maximum time limit of three months.<sup>40</sup> Clearly this imposes only *minimum* standards whilst being permissive to greater cooperation. The patent failure to embrace such opportunities has been blamed on the States recalcitrance,<sup>41</sup> yet the Regulation itself contains requirements that clearly reduce the effectiveness of, and therefore act as a deterrent to, greater cooperation. There is a limit on the volume of requests permissible (ensuring cooperation does not impose a disproportionate burden), the requesting State must be able and willing to reciprocate, and any request must be preceded by the exhaustion of other normal investigative channels.<sup>42</sup> Once these hurdles have been vaulted, certain limiting requirements are placed on the exchange. This includes disclosure being limited to those directly involved in the assessment,<sup>43</sup> plus notification to the potentially fraudulent operator when required by the requested State's law (unless the "prejudice to investigation" clause is invoked).<sup>44</sup> Difficulties also arise where the information requested derives from judicial proceedings as the judiciary must sanction the exchange.<sup>45</sup> If one considers that this cooperation instrument applies neither to

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<sup>39</sup> Art.5(2). David, C., *ibid*, suggests at p.149 that they may also receive the date of issue and or suspension of such VAT numbers and the name and address of the person entitled to it.

<sup>40</sup> Art.5 (1) Regulation 218/92. This states that "the requested authority shall provide the information as quickly as possible and in any event no more than three months after receipt of the request." Clearly three months is a very long time in the life of an organised VAT fraudster!

<sup>41</sup> COM (2000) 28 final.

<sup>42</sup> Art. 7(1) Regulation 218/92.

<sup>43</sup> Art. 9(1) Regulation 218/92. The requirement of professional secrecy. Such information when exchanged may only be used by the authorities for the administrative control of tax and judicial proceedings directly related to this.

<sup>44</sup> Art. 8 Regulation 218/92. Clearly a party involved in organised crime would appreciate the opportunity to flea. Furthermore, it makes initial investigations (when it is unclear whether anything untoward is ongoing or not) difficult.

<sup>45</sup> Art. 3(2) Regulation 218/92.

services nor to help with domestic fraud investigations, its lack of use is certainly explainable.<sup>46</sup>

One of the major problems encountered when using the Regulation is the slow response time to informational requests.<sup>47</sup> The development of organised fraud whose perpetrators are highly mobile requires up to date information which the current system cannot provide. It is indeed common for the three-month time limit on requests to be exceeded. The combination of restrictions and slow response means that many States prefer the Directive on Mutual Assistance,<sup>48</sup> designed for direct taxation, as the legal basis for exchanges. Its ambit is wider than intra-community supplies of goods and provides opportunities for developing bilateral arrangements for spontaneous exchange.<sup>49</sup> Yet the use of a separate provision, which in some States is administered by different institutions, can lead to confusion with fragmentation of control.<sup>50</sup> Given the clear problems associated with both provisions, reform is clearly necessary. Possibilities are set out below.

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<sup>46</sup> COM (2000) 28 final. This report highlights many of the problems noted above as explaining the very low use of the system.

<sup>47</sup> The Commission have suggested that one major reason for the low use of such procedures is that the slow response time means that even if the information is provided it will be of no use by the time it is received. COM (2000) 28 final p.22

<sup>48</sup> Directive 77/799/EEC [1977] OJ L 336/15; amended by Directive 92/77 EEC OJ 1992 L316.

<sup>49</sup> The Commission has noted that a number of Member States have recently taken the opportunity to do this, though they are still used relatively little. COM (2000) 28 final pp. 27-28.

### 3. Reform Options

This complex intra-community VAT system permits no easy solution to combating fraud because its governance occurs through 15 autonomous and uncoordinated authorities. Given that the exemption of supplies provides the main opportunity for fraud, attempts to “harmonise” aspects of the system without tackling this will at best achieve a limited simplification for administering VAT. It is therefore better to concentrate on improving the facilities and instruments that allow national authorities to cooperate to detect and punish fraud. Such an approach also recognises the Member States predominant interest in VAT revenue,<sup>51</sup> which ensures that no reform that reduces their sovereignty would be accepted. Thus in accordance with these requirements, it is submitted that the following proposals would improve the administration of VAT:

- 1) **National Prioritisation:** Member States must actively participate in fighting international fraud, through providing resources and developing a coordinated strategy;
  
- 2) **Detection:** Member States must have the legal and administrative tools necessary to cooperate effectively with other States. Firstly, a supranational institution must be available to act as both an intelligence agency and a centre for coordinating pan-European cooperation. Secondly, information exchange and mutual assistance provisions require improvement. Thirdly, knowledge

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<sup>50</sup> It is suggested, at p.17 below, that these instruments will likely be merged into one.

systems must be developed that record information on fraudulent trading patterns and actors for use in risk analyses and proactive detection.

- 3) **Punishment:** The penalty system must deter fraud by ensuring proportional and consistent penalties are available and applied by Member States.

Whilst developing these submissions, analyses will be provided of recent Commission proposals under the “Strategy to Improve the VAT System,”<sup>52</sup> and its “Overall Strategic Approach” to tackling more general Community fraud.<sup>53</sup> It will be concluded that although beneficial, the proposals are narrower than the submissions above and may be rejected by Member States. This latter problem is considered first.

Generating the necessary resolve amongst Member States to tackle intra-community fraud is absolutely paramount in both ensuring that States support new legislative proposals (under the unanimity requirement) and make full use of them once adopted. Clearly engendering a change in attitude is not easy, but given that VAT revenue is predominantly received by Member States it is obvious that cooperation could be self-serving. One underlying aim of the Commission’s VAT strategy is to create fresh impetus following scathing reports by ECOSOC<sup>54</sup> and the Commission<sup>55</sup> on the inadequate priority, resources and prevention strategies applied to intra-community fraud. Although the Commission is wrong to blame the Member States wholeheartedly for these failings,

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<sup>52</sup> COM (2000) 348 final

<sup>53</sup> COM (2000) 358 final.

<sup>54</sup> CES 808/2000, Opinion of the Economic and Social Committee, *Combating tax evasion in the single market*, 13<sup>th</sup> July 2000. At pp. 7-8 they launch an interesting attack on the image conscious council.

<sup>55</sup> COM (2000) 28 final at pp. 5-6.

given the flaws in the current monitoring tools,<sup>56</sup> it is essential to reform that national authorities give priority to this and trust other States to reciprocate.<sup>57</sup> It is hoped that by introducing the package of measures suggested below, impetus for and trust in cooperation will be engendered at all levels from individual controllers to national and community strategists.<sup>58</sup>

The introduction of new detection systems is an essential element of this package. The creation of a supranational organisation capable of coordinating detection strategies and assisting in legal responses is cognisant with the cross-jurisdictional nature of organised fraud. Although sovereignty considerations would prevent this organisation from dictating national strategy,<sup>59</sup> it could be essential in collecting and analysing data, alerting authorities to potential fraud risks and coordinating Member States response. Ideally there would be obligations of notification on the national authority, and it would have autonomous powers of investigation,<sup>60</sup> whilst maintaining a degree of independence from the normal cooperation procedures to ensure it did not become a bottleneck to exchanges between CLO's or individual controllers.<sup>61</sup>

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<sup>56</sup> As discussed in Section 2.3 above.

<sup>57</sup> It is perhaps this trust in reciprocity which will prove the most tenacious obstacle to overcome, given that without it one Member State could end up spending valuable control resources simply to help uphold another States revenue.

<sup>58</sup> The Commission has introduced certain other measures that will hopefully stimulate such cooperation, including the Fiscalis programme.

<sup>59</sup> Given their sovereignty over their own resources.

<sup>60</sup> This autonomous power is to be welcomed. If it only had powers to assist in Member States investigations, it would have been constrained by the need to persuade Member States to dedicate control resources to launching an investigation in the first place.

<sup>61</sup> It is accepted that this might require dual notification to both another Member State and this supranational body but, as has been seen through discussion of CLO's, the *necessity* to pass information through a central institution does create the possibility for bottlenecks to occur.

The Community recently created “OLAF,” an organisation corresponding closely with the requirements postulated above, pursuant to its wider aim of tackling *all* fraud against the Community budget.<sup>62</sup> OLAF’s role is to collect and analyse information on fraudulent activity,<sup>63</sup> including the power to launch independent external investigations. It must also provide the Communities support to national authorities,<sup>64</sup> including the judiciary and police, when requested.<sup>65</sup> Unfortunately its founding regulation does not create the clearly defined role with regard VAT that is so desirable. It seems clear that, despite some State’s fallacious arguments which are more disturbing for their uncooperative tones than their validity,<sup>66</sup> OLAF is entitled to intervene in VAT matters given the Communities clear “interest” in this revenue source.<sup>67</sup> Yet its role would be greatly enhanced if clear obligations had been imposed on national authorities to provide information to it and cooperate with it on VAT matters.

Improving detection necessarily requires amendment and extension of the problematic mutual assistance provisions discussed in Section 2.3.<sup>68</sup> Amendments should facilitate and require spontaneous exchange of an expanded array of key information with

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<sup>62</sup> Regulation 1073/99; Regulation 1074/99; Pursuant to Art. 280 of the Treaty of Rome.

<sup>63</sup> Art. 2(5)(b) Commission Decision 99/352/EC.

<sup>64</sup> Art. 2(2), *ibid.*

<sup>65</sup> It seems that Member States have benefited greatly from these two functions to the extent that they have embraced them. See p.46, *Report by the European Anti-Fraud Office (OLAF), First Report on Operational Activities, 1<sup>st</sup> June 1999 – 31<sup>st</sup> May 2000.*

<sup>66</sup> p.46 OLAF Report, *ibid.*

<sup>67</sup> Regulation 1073/99 Art. 2, “The Office shall provide the Member States with assistance from the Commission in organising close and regular cooperation between their competent authorities in order to coordinate their activities for the purpose of protecting the Community’s financial interests against fraud.” It is surely beyond doubt that such an interest exists, with 42.3% of the Community budget deriving from VAT. See Cullen, “Fraud Against the Community Budget: A Common Concern”, *EC Tax Journal*, 1999, 3(2), p. 63

<sup>68</sup> COM (2000) 358 final talks at p.7 of involving OLAF in the design of new legislation. This will hopefully be useful in ensuring measures are adopted that fully reflect the requirements for tackling international fraud.



provisions for direct access and a reduction in the time lag for specific requests.<sup>69</sup> It is desirable that insofar as possible the restrictions on exchange, especially under Art. 7(1),<sup>70</sup> are lifted. Specific provisions should also stipulate that OLAF be allowed to receive and disseminate information from and between Member States without restriction. A proposal was due in December,<sup>71</sup> expected to merge the Regulation and Directive,<sup>72</sup> which will hopefully adopt these recommendations.

The current detection tools would be complimented by the development of knowledge systems that are more proactive at identifying fraudulent activity, especially given the complex strategies detailed in Section 2.2.<sup>73</sup> The necessary data could be accumulated by introducing requirements for the recording and filing of information on uncovered fraud cases.<sup>74</sup> If variables pertaining to known fraudulent activity were recorded, they could be cross-referenced with information on particular operators and used to identify those traders presenting a higher fraud risk. This would compliment the risk analyses tool.<sup>75</sup> Although problems relating to data protection would arise, the Commission has noted that suitable derogations are available and has suggested that specific provisions could be

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<sup>69</sup> COM (2000) 28 final at p.25. They suggest that the slow response time to requests is the greatest problem under these regulations rather than the legal tool itself, due to officials of one Member State giving insufficient priority to a fraud case in another Member State.

<sup>70</sup> Regulation 218/92.

<sup>71</sup> COM (2000) 348 final. At p.7 it states that, as part of Phase 2 of its action programme, proposals will be published on the revision of rules on administrative cooperation and mutual assistance. These were due in December 2000 but have not yet been published.

<sup>72</sup> COM (2000) 28 final p.26.

<sup>73</sup> This is consonant with the Commission's view in their latest strategy document that such systems must be developed, though the exact form is as ever rather vague. See COM (2000) 358 final at p.11-12.

<sup>74</sup> COM (2000) 28 final p.13. The Commission bemoaned the complete inability of Member States to keep detailed records of past cases. They also noted the inability to agree any form of systematic and coherent system of filing.

<sup>75</sup> Advocated strongly by the Commission in COM (1998) 490 final p.19; COM (2000) 28 final p.35 Recommendation 2.

introduced to allow data transfer for fraud prevention purposes.<sup>76</sup> One commentator even suggests the system could be implemented now if a “strictly identical data format and processing programme” were introduced.<sup>77</sup> This could record details of the company or individual “taking advantage of fiscal social security numbers” to hide the subject of these exchanges.<sup>78</sup> Although such optimism is probably misplaced, the development of similar tools is desirable as they might increase detection speed.

The imposition of proportionate and consistent penalties designed specifically for VAT would be a useful deterrent.<sup>79</sup> In Section 2.3 the current inconsistencies were highlighted, although a basis now exists for the welcomed harmonisation of administrative penalties.<sup>80</sup> In regard to penal provisions, important given that some States classify VAT penalties as penal<sup>81</sup> and all States subject fraud to their penal law, the situation is more complex. Major differences in the substantive definition of fraud cause both inconsistency and problems in cooperation and information exchange.<sup>82</sup> Furthermore many prosecuting authorities limit trials to national fraudulent activity due to the complexity, cost, and difficulty of wider prosecution.<sup>83</sup> Clearly ratification of the Convention<sup>84</sup> which

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<sup>76</sup> COM (2000) 28 final p.30. They suggest that the excuse of many Member States, based on the Data Protection Directives provisions on data flows, does not take account of the derogation under Art. 13 where the financial interest of the Member State are at stake.

<sup>77</sup> Van Duyne, P.C., *VAT Fraud and the Policy of Global Ignorance*, European Journal of Law Reform, 1(4) 425 at 442.

<sup>78</sup> Van Duyne, *ibid*, p.442.

<sup>79</sup> White, S., *VAT Revenue and Organised Crime: Time for Action?*, (1999) 24 *European Law Review*, 433 at pp. 438 - 439, suggests that criminals take uneven penalty structures into account in determining where to focus their activity.

<sup>80</sup> Regulation No. 2988/95, OJ L 312.

<sup>81</sup> White, S. *ibid*, p.438.

<sup>82</sup> COM (2000) 358 final. Highlighted at p.8.

<sup>83</sup> COM (2000) 358 final p.16. It must be hoped that OLAF can have a role in helping to facilitate such trials. The Commission noted that its reports will have the same evidential status in criminal trials as an equivalent report by a national authority.

establishes a common definition of fraud,<sup>85</sup> with a more structured penalty scheme,<sup>86</sup> would be beneficial.<sup>87</sup>

#### 4. Conclusion

The transitional system was an interim measure designed to remove barriers within the tax system to free movement as part of the single market programme. In retrospect it is easy to conclude that the drive to complete this market by 1993 has resulted in inadequate consideration being given to the potential for fraud embodied in the exemption scheme. Yet the main problem is that governance structures expected to evolve through use of the mutual assistance provisions have failed to materialise. The preceding discussion suggests that this is attributable to *both* the State's attitude and the deficiencies in the tools and institutions designed to facilitate control. Thus in assessing whether further harmonisation and/or greater legal and administrative cooperation are required to tackle fraud, both the need to stimulate cooperation by Member States and improvements to the legal basis for cooperation must be addressed.

The inherently fraud susceptible nature of this system derives from an exemption scheme that is not monitored effectively. It was suggested that "harmonisation" of the transitional

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<sup>84</sup> Convention on the Protection of the European Communities Financial Interests, OJ C-316 of 27/11/95 at pp. 48 - 57.

<sup>85</sup> Art. 1(1) comprises a common definition of what constitutes fraud against the Communities financial interests. It includes both intentional acts and omissions in respect of five stipulated scenarios.

<sup>86</sup> Art. 1(2) requires States to introduce criminal penalties to cover acts falling within the definition of fraud. These must be punishable by penalties that are effective, proportional and have the desired deterrent effect. Fraud whose value exceeds 50,000 ECU must be punishable by custodial sentence under Art. 2(1).

<sup>87</sup> Five years on and only a few States have ratified this provision.

system will have little effect on VAT fraud so far as the exemption is retained and therefore the focus of reform must be improvement of legal and administrative cooperation. The proposals detailed previously reflect the need to improve cooperation by coordinating control strategies at a European level, creating more effective information dispersion, improving mutual assistance provisions, and providing tools that are proactive in identifying fraud. Clearly such reforms can only be effective if the apprehension of the Member States is overcome. Yet there is no obvious solution to altering the prioritisation and attitude of 15 national authorities. Unless States embrace the opportunity for reform, those proposals that are adopted are likely to contain limitations which reduce their effectiveness. OLAF exemplifies a development that offers tremendous potential but fails to realise its full potential because an express role (and power) in VAT enforcement has been omitted.<sup>88</sup> It is nevertheless hoped that where such ventures are successful, States will be encouraged to progressively agree to measures whose effectiveness is less circumscribed by limitations. Only then will the governance structures so crucial to fraud prevention truly evolve.

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<sup>88</sup> Indeed it is quite likely that if such a development had been proposed, the Regulation establishing OLAF would not have been adopted!

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