Stopping the Carousel?

In the first two instalments of this series of articles on MTIC (Missing Trader Intra-Community) or 'carousel' fraud, ***Carl Watson*** *of Chantrey Vellacott DFK explored how the fraud functions and how the corporate entities employed as vehicles for its perpetration interact. Furthermore, he examined how the fraud has developed in sophistication to confound efforts to fight it and how the organised criminal gangs that mastermind it have taken advantage of favourable circumstances to bring the conduct to such a scale that it harvests tens of billions of euros (or sterling) per year in profit for those in control. In this final instalment, he looks at how matters presently stand and the path to ultimately stopping the fraud in the light of previous strategies and key case law.*

The state of play

Since the inception of carousel fraud in its present guise approximately eleven years ago, things have gone remarkably well for the fraudsters who perpetrate it, and the masterminds behind the complex schemes. The fraud came from virtually nowhere, rising from the ashes of the collapsed VAT gold fraud schemes, and quickly became established as a major and seemingly limitless source of funds for the criminal enterprises that embraced it.

As it currently stands, the situation remains relatively comfortable for them, albeit with a few caveats – not least the recent stance of the UK government in subjecting all substantial VAT repayment claims suspected of being linked to the fraud to close scrutiny prior to repayment: a position that has led to thousands of repayment claims being held up for months or years, and a situation that other EU member states have watched closely. Such matters aside, the fraudsters remain in a relatively strong position from which to continue to perpetrate and profit from the fraud for some time to come.

They benefit from the strong and hugely flexible networks that have been created for perpetration of the fraud and which operate across the EU and beyond. The component parts of the fraudulent transaction chains are readily interchangeable and replaceable, ensuring that they have access to a virtually limitless variety of 'supply' chains through which they can channel fraudulent transactions and disguise the source and ultimate beneficiaries of the crimes. The cell-like structure of the scheme means that if the authorities disrupt the activities of one of the entities within a transaction chain numerous other shell companies are readily available to take its place, ensuring steady continuity in the operations. The flexibility of the orchestrated supply chains is complemented and matched by the flexibility of the choice of goods that can be used to implement the fraud; with no end-consumers to limit the scope or the characteristics of the purported transactions, the fraudsters are theoretically able to report trade in effectively limitless quantities of any type of product. For a fraud that is committed by means of purported business transactions, the criminals remain free of the constraints that bind legitimate businesses: not needing to pay heed to the specifics of goods, market limitations, legitimate pricing, supply and demand, competition or legal considerations. From a certain perspective, it is an enviable position to occupy.

As a low-risk, high return activity, MTIC fraud remains a highly attractive activity for organised criminals – a ready source of funds that boost profits from their other activities, and which has been linked to funding other ventures, including drug smuggling and the financing of terrorism [1]. The high-speed, complex, and high-value transactions in goods also provide the perfect conduit for laundering the proceeds of other crimes. Monies channelled and filtered through and between the accounts of thousands of small corporate entities across the world, in transactions worth tens of billions every year prove an ideal mechanism to disguise the source of cash gained through other criminal activity. The funds are kept secure and out of the reach of the authorities by being transferred between the traders' offshore bank accounts. In many cases, each of the traders in the long transaction chains would use the same offshore financial institution, and the funds would be swapped from account to account within a very short time-frame.

While the supply of corporate entities and shell companies that are created and used to commit the frauds seems virtually limitless, the networks are supported by a similarly diverse range of supporting organisations, which are equally important in perpetrating or disguising the frauds, protecting the perpetrators and laundering the proceeds. These include freight agents, banks and financial institutions, as well as the solicitors and accountants who act to add an air of legitimacy to the fraudulent transactions.

These well funded and tightly organised networks, and the organisations that support and aid in the facilitation of the fraud, are, accordingly, well placed to continue their systematic attacks on the indirect tax regimes of EU member states. The sometimes ill-advised, often

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weak and inconsistent responses of the EU governments, and the taxation and customs authorities within them, have aided the gangs in reaching such a position of strength. Concerted and decisive early action could have disrupted and quashed the schemes at the outset but instead governments have responded by taking a softly-softly approach, limiting resources and powers available to investigators and, in some cases, ignoring the problem altogether. It is only relatively recently that some EU governments admitted that they had a problem with MTIC fraud at all. Recent tougher approaches, although still focussed primarily on civil action, taken by the UK government have changed the scene in the past couple of years, although new opportunities have also opened up to the gangs, with the expansion of the EU allowing the economies of the accession states to be attacked with well-practised sophistication.

Against such a background, an ultimate solution to the problem will not come easily.

A matter of principle

While the authorities have pursued some of the fraudsters criminally, conducting a number of high-profile raids and prosecutions over recent years, the emphasis has overwhelmingly been placed on tackling the crime using civil powers. In the UK, a number of key approaches have been taken over the years, meeting with varying short and long term success, and it is useful to consider some of the key arguments that were used as the background against which the search for a solution is set.

Joint and several liability

In 2003, the UK government provided by amendment to the *VAT Act 1994* that where MTIC fraud was committed and monies stolen by a missing trader, other taxable parties within the supply chain could be held jointly and severally liable for the stolen VAT. The measure was designed to be applied where it could be shown that at the time of the supply the parties knew or had reasonable grounds to suspect that some or all of the VAT attributable to the supply of the same goods (at any stage in the supply chain) would go unpaid. This sanction could only be imposed where MTIC fraud was suspected, and was limited to certain specified goods – initially mobile phones and computer equipment, which at the time were the prime goods used in the fraud. In 2007, further legislative amendment expanded the range of goods to which the provision applied, to include electronic consumer goods and items compatible with computers and electronic equipment.

While the measure was potentially draconian in concept, and was certainly greeted with dismay and legal challenges [2] by many entities operating in those sectors most affected by the fraud, it proved difficult to apply successfully. To the author's knowledge, there has been only one successful application of the measure to date that has been upheld at tribunal.

Non-economic activity

Another key concept applied in the fight against MTIC fraud was the non-economic activity principle. In essence, the argument held that where the sole or prime motivation behind a transaction was to defraud the exchequer, the activity would not qualify as an economic activity for taxation purposes and, accordingly, that there would be no right to deduct input tax. Therefore, a VAT-registered entity that purchased goods from (and paid input tax to) a supplier in a transaction in which the underlying motivation was the intent to steal VAT from the government would not be eligible to reclaim the input tax from the revenue authorities.

The UK government applied this principle to a large number of claims for VAT repayments from entities they suspected of being involved in MTIC fraud transaction chains. Decisions were made to deny numerous such claims and, predictably, the issue soon came before the VAT and Duties Tribunal. The key cases were those of *Optigen Ltd*, *Fulcrum Electronics Ltd* and *Bond House Systems Ltd*. HM Revenue & Customs (HMRC) won the key points at tribunal, alleging that the transactions to which the VAT repayment claims applied were motivated by VAT fraud, although HMRC did not allege direct knowledge or involvement of the appellants in the fraud. The tribunals upheld that the transactions under appeal fell outside of the VAT system. The three losing parties appealed to the High Court, and the High Court referred the joined cases to the European Court of Justice (ECJ). Numerous other appeals against decisions made by HMRC to deny reclaims of tens of millions in input tax were held up pending the outcome of the ECJ hearing.

Ultimately, the UK government lost at the ECJ. Broadly, following the opinion given by the Advocate General prior to the hearing, the ECJ found in favour of the three appellants. The court observed that "the principle of fiscal neutrality prevents there being any general distinction as between lawful and unlawful transactions. Consequently, the mere fact that conduct amounts to an offence is not sufficient to justify exemption from VAT." Further to this, it found that "the right to deduct input VAT of a taxable person who

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carries out such transactions cannot be affected by the fact that in the chain of supply of which those transactions form part another prior or subsequent transaction is vitiated by VAT fraud, without that taxable person knowing or having any means of knowing." [3]

The UK government had not argued that *Bond House*, *Optigen* or *Fulcrum* were knowledgeable or complicit in the MTIC frauds that had occurred in the transaction chains in which they had been involved and this caused the argument to fail. As a consequence, the government was forced to make repayments to numerous traders whose appeals were held behind the *Bond House* case.

Knowledge or means of knowledge

While the *Bond House* case was a key loss for the UK government, requiring a fundamental re-think of strategy, and a pivotal moment after which the level of repayment claims submitted by MTIC broker companies rocketed due to an increase in confidence amongst the fraudsters, there was a silver lining. The ECJ had inferred that the point on which such issues as determining the right to deduct input tax rested was whether the entities had knowledge or the means to know that the underlying motive in the transaction chains was to commit fraud. This principle was underlined further in other key proceedings brought before the ECJ, this time the joint cases of *Axel Kittel against the Belgian State* and *the Belgian State against Recolta Recycling SPRL*. The Belgian government had essentially argued that transactions motivated by carousel fraud were incurably void under domestic law, and that input tax was not deductible. In its deliberations, the ECJ referred to the *Bond House* judgement, and concluded that the right to deduct would be determined on the knowledge and intentions of the taxable person – where they had taken adequate precautions and could not suspect that the transaction formed part of a fraudulent scheme, they would retain the right to reclaim input tax. Conversely, the ECJ concluded that "where it is ascertained, having regard to objective factors, that the supply is to a taxable person who knew or should have known that, by his purchase, he was participating in a transaction connected with fraudulent evasion of VAT, it is for the national court to refuse that taxable person entitlement to the right to deduct." [4]

Consequently, it is the knowledge/means of knowledge argument that has been adopted and applied in the majority of MTIC cases in the UK over the last two years, although these cases have so far met with mixed success. [5]

A solution in sight?

Ultimately, such strategies are short-term issues for dealing with frauds that have already been perpetrated. Additional measures, such as the 'extended verification' procedure of subjecting all large claims suspected of being connected with MTIC fraud to close scrutiny prior to repayment, and the Reverse Charge derogation that the UK government won from the EU to change the way that VAT is accounted for on mobile phones and computer chips, are also short-term tactics. The House of Lords observed that extended verification was only an interim measure, noting that "HMRC's current strategy has succeeded in containing MTIC fraud, but will not eliminate it… HMRC's current strategy is unsustainable." [6] The reverse charge, more limited than the wider-spread derogation sought by Germany and Austria (rejected by the EU), was secured by the UK government but has, as was predicted by most commentators, simply had the effect of changing the habits of the fraudsters in terms of their moving away from trading in mobile phones and CPUs to other goods not covered by the derogation.

The only permanent solution will inevitably involve a change to the VAT system across Europe. Numerous options are available, and detailed commentary on these is available elsewhere. However, at present, moves are being made towards a Flat Rate Origin System. Under this system, intra-community transactions between VAT-registered businesses would no longer attract no VAT, but would incur a flat rate of 15% (the minimum standard rate of VAT that can be charged by EU law). This would remove most of the profit available from such a fraud: if implemented, an MTIC fraud in the UK could only profit by 2.5% of transaction value, the difference between the flat rate and the domestic standard rate of VAT at 17.5%. While the profit motive would still exist to a lesser extent, and especially in those EU member states where VAT is charged at the maximum rate of 25%, allowing 10% profit if the flat rate system is adopted, this still remains the most promising prospect to date. While still in its early stages, the measure was proposed in a recent report of the Committee on Economic and Monetary Affairs to the European Parliament. [7]

Whilst this would be a promising step forward, even if the proposals are adopted and ratified by the European Parliament, implementation will still be several years off, and there remains a need for clear, coordinated interim strategies between member states, and improved cooperation between their agencies. Regrettably,

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experience suggests that this is a big ask, despite the gravity of the situation. The carousel may continue to spin for some time to come.

Notes

1. Laundering the Proceeds of VAT Carousel Fraud, Financial Action Task Force, February 2007.
2. The Federation of Technological Industries, and 53 others, unsuccessfully challenged the legality of the Joint and Several Liability principle before the European Court of Justice, in case C-384/04.
3. European Court of Justice Joined Cases C-354/03 *Optigen Ltd*, C355/03 *Fulcrum Electronics Ltd* and C484/03 *Bond House Systems Ltd* [2006].
4. European Court of Justice Joined Cases C-439/04 *Axel Kittel* and C-440/04 *Recolta Recycling SPRL* [2006].
5. Where decisions have been made to deny tax using the Means of Knowledge principle, after a lengthy period of enquiry into VAT repayment claims under the contentious 'extended verification' process, a large number of appeals have been lodged with the VAT and Tribunals Service. The first decisions have been released on these cases over the last year, and the results have been mixed for HMRC. They have seen significant wins in cases such as *Mobilx Ltd* (MAN/07/0179, MAN/07/0302 & MAN/07/0356) and the joined appeals of *Calltel Telecom Ltd* and *Opto Telelinks (Europe) Ltd* (MAN/06/0424 & MAN/06/0425).
   The VAT and Duties Tribunal decision in the joined appeals of *Calltel Telecom Ltd* and *Opto Telelinks (Europe) Ltd* appeals was jointly issued. Calltel's appeal was allowed in part, in respect of one transaction whereby the trader won the right to deduct UK£86,187.50, but the tribunal dismissed the appeal in respect of the remaining net claim of UK£7.95 million. Opto Telelinks' appeal for a net claim of UK£10.2 million was dismissed in its entirety.
   HMRC has also suffered significant losses under the new argument, particularly in cases where they have alleged, but been unable to sufficiently demonstrate, the trader's knowledge of underlying fraudulent motive relating to complex contra schemes, as in the cases of *Olympia Technology Ltd* (LON/07/204) and *Livewire Telecom Ltd* (LON/06/1365).
6. Stopping the Carousel: Missing Trader Fraud in the EU, House of Lords European Union Committee, May 2007.
7. Report on a coordinated strategy to improve the fight against fiscal fraud (2008/2033(INI)), Committee on Economic and Monetary Affairs, July 2008.

Carl Watson *is a counter fraud specialist at Chantrey Vellacott DFK. He may be contact on tel: +44 (0) 20 7509 9154; email: cwatson@cvdfk.com*

Play fair

In his book "Bringing Down the House," Ben Mezrich describes how a group of MIT (Massachusetts Institute of Technology) students took Las Vegas for millions in the 1990s, by using a card counting technique. Targeting Blackjack – the only casino game where the gambler sees the cards already played – so therefore can guess at which remain, the team adopted the 'hi-lo' system, which over time indicates how advantageous a game is to a player. Team members, known as 'spotters', counted the cards, discreetly indicating when the game had become statistically advantageous to the player. Another team member would come to the table and bet large sums of money – and stand a good chance of winning. For several years, the MIT Blackjack Team went from casino to casino using the system to make millions; separating the card counter from the player made them difficult to detect. But eventually, the casinos caught on. As card counting is not illegal in the US – only cheating using a device is illegal – all they could do is prevent the students from playing.

The MIT Blackjack team is history – and their exploits the subject of a recent Hollywood blockbuster '21' starring Kevin Spacey. But there are still plenty of professional cheats out there trying to beat the casinos, writes ***Lucy Jones*** *from Dallas, Texas.*

"Some use sleight of hand," says Professor William Thompson, a casino expert at the University of Nevada, Las Vegas. "At roulette, they will try and place a chip, after the number has been closed. They will cough or drop a drink to distract the dealer, and then put a chip on the winning number," he said. "In poker, where amateurs may not be holding their cards closely, players will signal to each other what other people hold."

Cheats have plied slot machines with 'slugs' or false coins and used magnets and lasers to extract money. In one case, a gaming machine inspector re-programmed slot machines before they came out of the plant.

He found out where they were being sent – then employed people to play on the machines and win. He was eventually caught and imprisoned but now works for casinos to prevent similar scams from occurring in future.

Jeff Jonas, who has built surveillance systems for casinos for a decade, says that if a cheat has been uncovered, he or she may try to disguise themselves using a different hairstyle or attire. Some will go as far as cross-dressing or feigning to be wheel-chair ridden.

He has come across cheats who have marked cards

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