The evolving carousel

*In this first instalment of a three-part series on 'carousel fraud', **Carl Watson** of Chantrey Vellacott DFK sets out to explain the fundamentals and workings of the fraud in order to provide the reader with a solid understanding of how this scheme operates. Further instalments will examine the issue in the wider context of the impact of the fraud and the efforts and challenges faced by the authorities in stopping this crime, and will examine some of the key legal cases in recent years.*

What is carousel fraud?

Missing Trader Intra-Community (MTIC) fraud, also commonly known as 'carousel fraud', is a high-value, systematic attack on the Value Added Tax (VAT) system. Although the concept behind the fraud is relatively simple, the systems and operations that are put in place to operate and conceal it, and to deflect and counteract the efforts of the tax authorities in combating it, are complex and highly sophisticated. As such, the organisation of carousel fraud appears to be the preserve of organised crime syndicates with wide involvement in other criminal activities. For such gangs, the attractions of carousel fraud are clear: estimates of annual loss to the fraud across the EU range from €60 – €100 billion.

Why it works – an overview

The basic concept behind MTIC fraud is simple – at its essence is theft of tax monies collected on behalf of the government by VAT-registered 'businesses'. There is, of course, more to it than that, and an appreciation of the basic VAT rules relating to intra-EU trade is required in order to demonstrate how the fraud works. For the benefit of those unfamiliar with the workings of the VAT system, I shall outline these in the most basic manner possible, as I do not intend for the topic to be sidetracked by an examination of the European VAT system. It should be noted that this is not a definitive guide to the applicable VAT rules, but a broad and basic outline of the rules particularly relevant to carousel fraud.

There are a few key concepts to the system of VAT in its present form, and which are exploited by the criminals who perpetrate MTIC fraud. These concepts must be recognised to appreciate how MTIC fraud works. These are (using the UK as an example):

(i) VAT is a tax on goods and services, aimed at the consumer. On most goods and services, VAT is charged at the Standard Rate. This is 17.5% in the UK, but may fall anywhere between 15% and 25% across the EU. Every VAT-registered business is required to collect VAT for, and report it (on regular VAT returns) to, the government.

(ii) While it is a consumer tax, it is charged at all stages in the supply chain. When a UK-based, VAT-registered business purchases goods at the Standard Rate from another UK-based VAT-registered business, and sells them on to its customer at the Standard Rate, it should:

(a) Pay the amount of VAT that it charged its customers (this is called Output Tax) to the tax authorities on its next VAT return; and

(b) Reclaim the amount of VAT that it was charged by its supplier (this is called Input Tax) from HM Revenue & Customs (HMRC) on its next VAT return.

(c) In practice, the business will make or receive a single net payment of VAT to or from the government after taking all of its VAT transactions into account when calculating its return.

(iii) When a UK-based VAT-registered business purchases goods (that would normally be charged in the UK at Standard Rate) from an entity registered for VAT in a different EU member state, however, the supply is effectively VAT-free. VAT is charged at 0% by the vendor. The intention of this was to facilitate intra-EU trade. As no VAT was paid on the purchase, the UK purchaser will not be eligible to claim Input Tax back. [1]

(iv) Similarly, if a UK-based VAT-registered business sells goods (that would normally be taxed at Standard Rate in the UK) to a business registered for VAT in another EU member state, there would effectively be no VAT applicable on the sale, and the business would charge VAT at 0%. If it had purchased these goods at the Standard Rate of VAT from a UK-based VAT-registered business, it would be able to claim this back as Input Tax from HMRC on its VAT return, but would have no Output Tax to pay. Consequently, it would be in a position to expect a net repayment from the tax authorities.

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(v) The zero-rating of supplies made by a UK business to an entity that is registered for VAT in another EU member state is dependent upon certain conditions, including that the UK vendor must collect and retain evidence to show that the goods have been removed from the UK.

It is these rules on zero-rating of VAT for intra-EU business-to-business trade that enables MTIC fraud to work so successfully and on such a large scale. The fraud is organised through a series of contrived transactions between complicit networks of VAT-registered entities across at least two EU member states. The entity bringing goods in from another member state will steal the tax it collects from the onward sale. The ultimate exporter [2] would reclaim the Input Tax that it had paid to its immediate supplier from the authorities, crystallising the tax loss.

How MTIC fraud works in practice

Conceptually, carousel fraud requires a relatively simple setup of three VAT-registered entities based in two different EU member states in order to work. For a fraudulent attack on the UK VAT system, two of the entities would be based in the UK, and the other in another member state. Figure 1 displays the basic minimum structure for the fraud to work in theory.

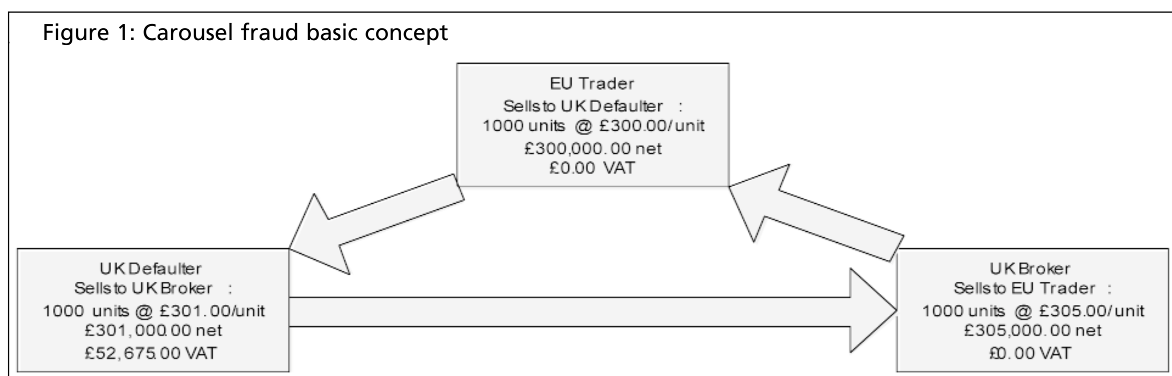
In this structure, a batch of goods is sold by a trader based in another EU member state (EU Trader) to the first UK-based entity (UK Defaulter). As it is an intra-EU business-to-business transaction, no VAT is paid by the UK Defaulter on the purchase, which is effectively VAT-free. The UK Defaulter then sells the goods immediately on to the second UK VAT-registered entity (UK Broker), charging VAT at the Standard Rate. The UK Broker pays the purchase price and the VAT to the UK Defaulter, which has no intention of paying the Output Tax collected to the authorities. The UK Broker then sells the goods back to the EU Trader, and does not charge VAT on the sale as it is another intra-EU transaction. The UK Broker is then entitled to reclaim as Input Tax the amount of VAT that it paid to the UK Defaulter on the purchase of the goods.

This cycle can be repeated many times (hence the term 'carousel') within a single VAT accounting period, accumulating vast sums of tax for the Defaulter to misappropriate. In most such frauds, the goods never reach an end user.

In practice, the structure in Figure 1 would be far too easy for the authorities to stop, as it would be a simple task to link the UK Broker and the UK Defaulter together, and deny the claims made by the UK Broker for repayment of Input Tax.

In order to avoid this, a common and successful tactic employed was the use of intermediaries – or Buffers – to place distance between the Defaulter and Broker, and make it harder for the authorities to deny the Broker's repayment claims. The intermediaries would simply buy and sell the goods in the UK, applying a very small margin, and would account for VAT properly on their parts in the transaction, making the onward deals appear legitimate to the taxman. In the transaction displayed in Figure 2, for example, the First-Line Buffer – the buffer entity that purchases directly from the defaulting trader – makes a gross profit of £500.00 on the deal (for simply raising an invoice and some supporting paperwork). On its VAT return it declares Output Tax of £52,762.50, but can reclaim the sum of £52,675.00 that it paid to the defaulter, so it ends up by paying over only £87.50 to HMRC as the balance. Buffers 2 and 3 also make marginal net payments to HMRC. The defaulter will still renege on its duty to pay over the £52,675.00 that it collected on the deal, and the broker will reclaim £52,860.94 from the government's coffers.

Figure 1: Carousel fraud basic concept



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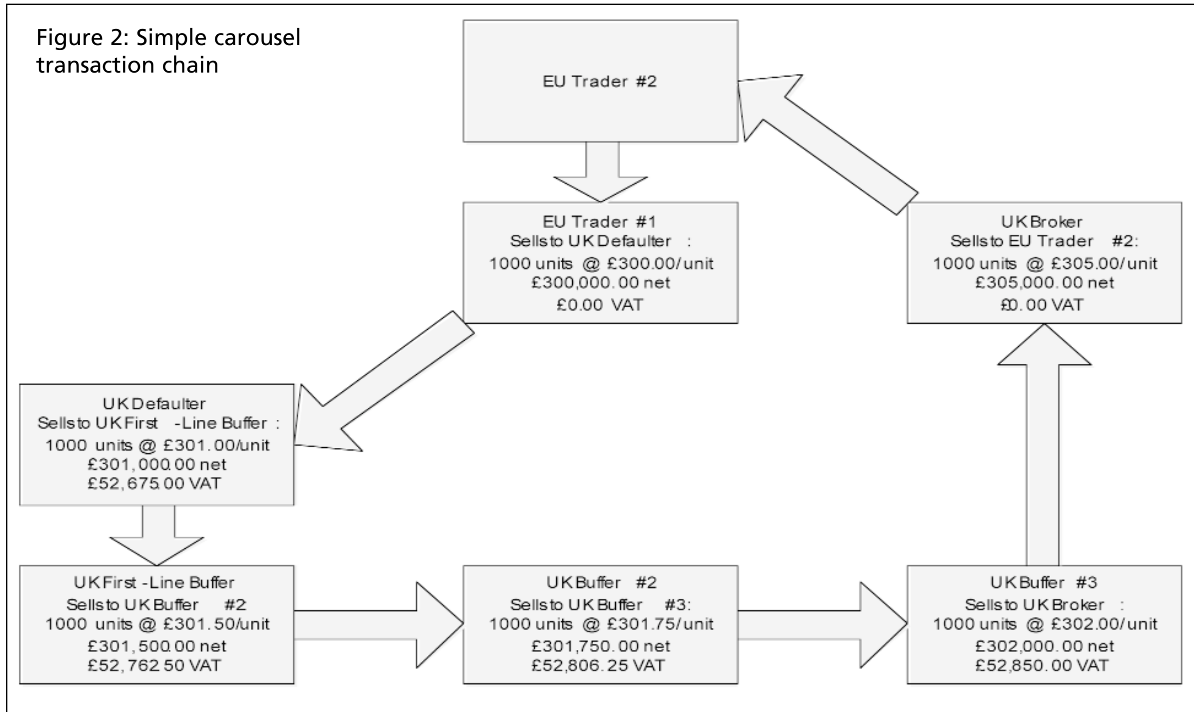

Figure 2: Simple carousel transaction chain

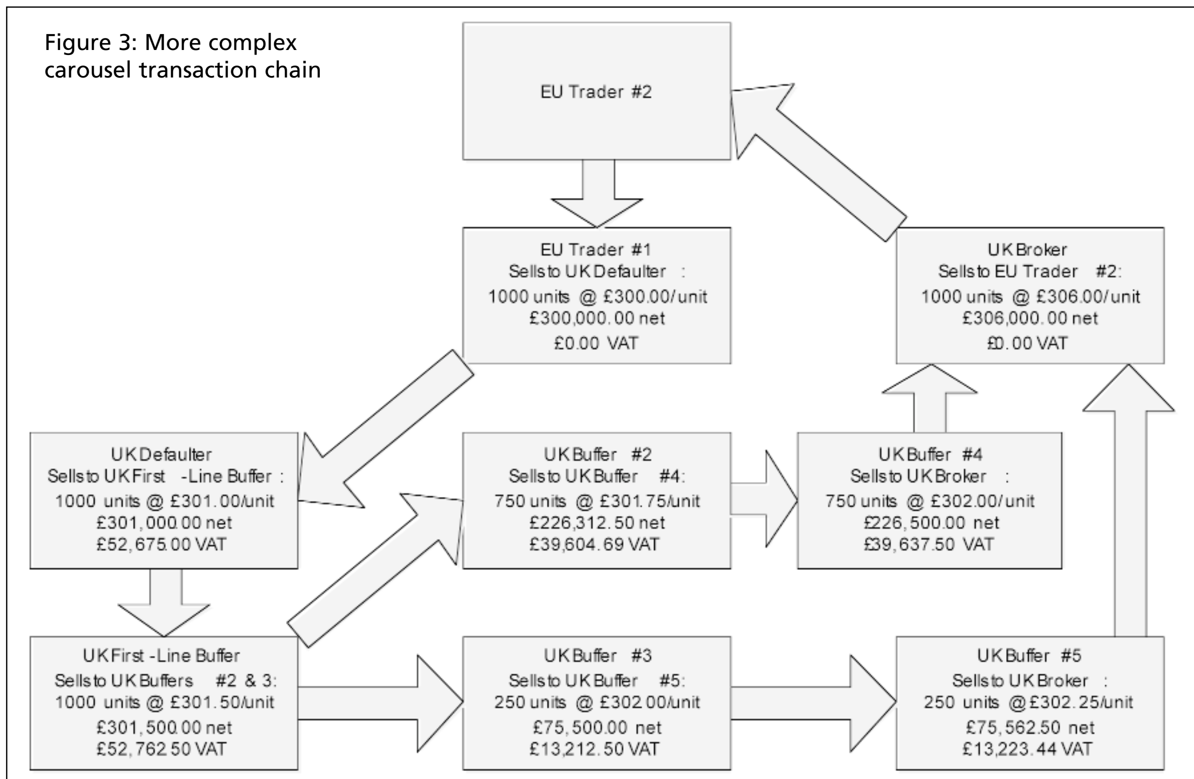

Figure 3: More complex carousel transaction chain

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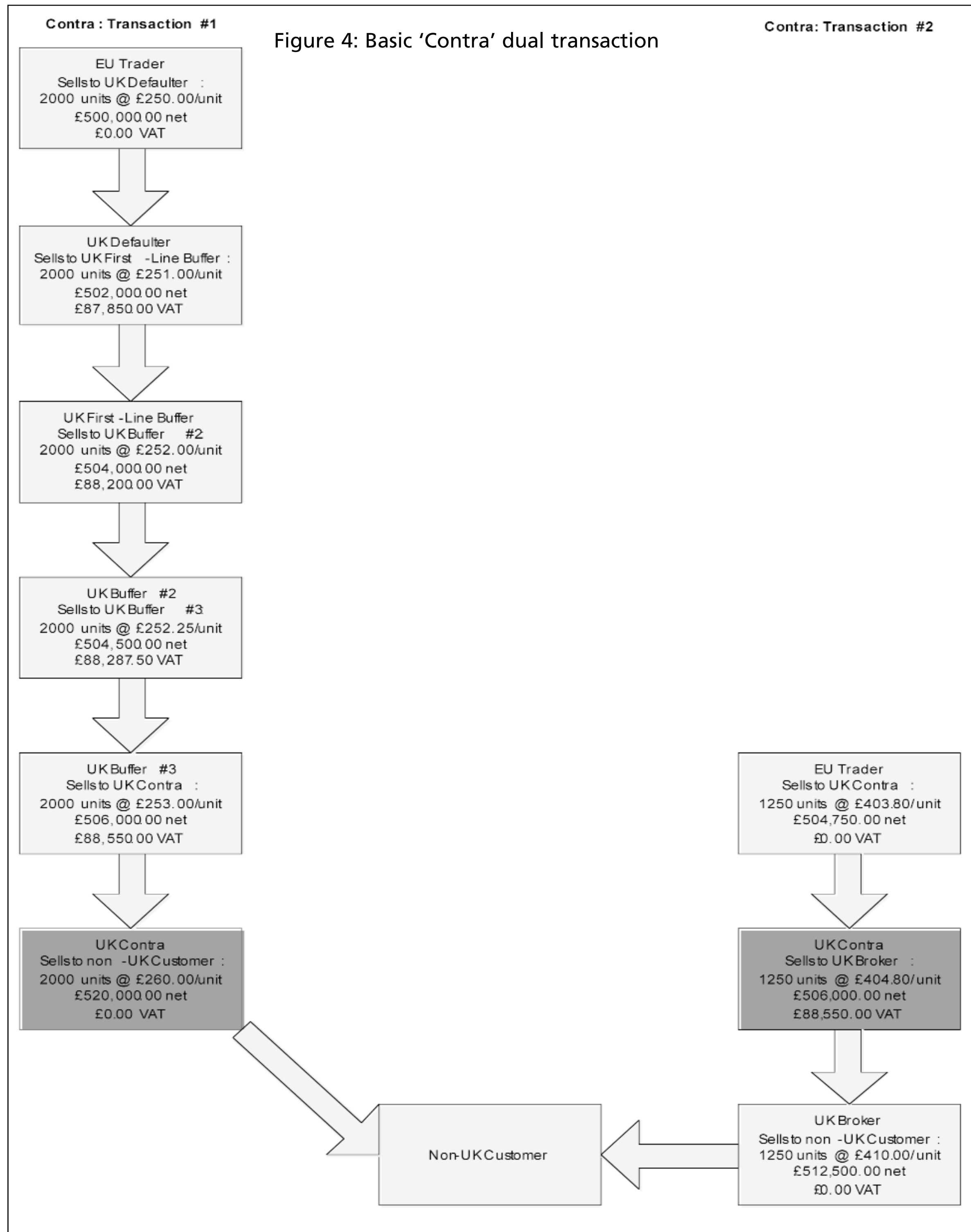

Figure 4: Basic 'Contra' dual transaction

Further complications were also commonly introduced into the transaction chains, such as splitting the consignments (Figure 3), all to make it harder for the authorities to trace the link between Broker and Defaulter.

In recent years, the level of sophistication has increased further, with the advent of the 'Contra transaction', a simple form of which is depicted in Figure 4.

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The concept of the Contra trader takes the level of sophistication of the fraud one stage further, and appears designed to mitigate the threat of the tax authorities delaying or denying Broker's repayment claims while they investigate the transactions.

Contra transactions work by shifting the point at which the tax loss is crystallised from the defaulting transaction chain to a different chain of apparently legitimate intra-company trading. This is achieved by splitting the operation across dual transactions. The example in Figure 4 illustrates this method. Transaction #1 is, to all intents and purposes, a typical carousel fraud transaction not dissimilar to that illustrated in Figure 2. The goods pass along a regular fraudulent transaction chain to the Contra trader, who acts as a Broker in this part of the transaction, and sells the goods outside of the UK. The Contra will make a reclaim for Input Tax of £88,550.00 paid on the purchase of these goods on its next VAT return.

To prevent the authorities from withholding or refusing repayment of what would be a fraudulent repayment claim submitted by the Contra trader, the second part of the dual transaction is conducted. In Transaction #2, the same Contra trader acts as the Acquirer, purchasing goods from a VAT-registered trader in another EU member state without VAT. It will then sell these goods to a UK-based Broker, charging VAT, and the Broker will sell the goods back outside of the UK without a positive charge to VAT. Instead of defaulting on the Output Tax owed to the authorities on this transaction, the Contra trader can offset it against the Input Tax on the Transaction #1. In this example, both Input Tax and Output Tax total £88,550.00, and so the Contra trader will have nothing to pay to, or reclaim from, HMRC at the end of its VAT accounting period, assuming no further transactions were conducted.

The accomplice Broker in Transaction #2, however, will submit a claim for repayment of Input Tax of £88,550.00 that it paid to the Contra trader. The claim will be difficult for the authorities to refuse to repay, as investigation of the transaction chain will show that it is 'clean', ie, that it does not commence in the UK with an apparent tax loss. There is no need for Buffer entities to be involved in Transaction #2, as it actually benefits the fraudsters for the authorities to be able to trace the 'clean' UK chain quickly and establish that there is no apparent tax loss in it.

The challenge for the authorities in investigating the claim, and trying to establish the fact of fraud, is to find a link between the Broker in Transaction #2 and the Defaulter in Transaction #1, and show that the Broker knew or should have known [3] that the underlying nature of the overall transaction was fraudulent.

Conclusion

Carousel fraud, then, is a serious, sophisticated and constantly evolving attack on the revenues of EU member states, and is one of the most significant fraud threats facing these countries. The next instalment of the series shall examine the fraud in this context.

Notes

1. Technically, goods brought into the UK are subject to Acquisition Tax – VAT paid in the UK by the purchasing company. At the same time, the purchaser is eligible to reclaim the Acquisition Tax as Input Tax on the same VAT return, rendering this purely a paper exercise for most businesses. Such technicalities are essentially irrelevant for the purposes of this article, and will be disregarded.
2. In VAT parlance, where a UK business buys goods from and sells goods to other EU member states, the transactions are not referred to as imports and exports (this is reserved for extra-EU transactions), but rather as Acquisitions and Dispatches. The distinction is largely ignored in this article.
3. The test for the authorities to apply in civil investigations to deny repayment of the claims, rather than pursue the matter criminally, has been established in cases such as that of *Bond House* Systems Ltd (European Court of Justice: Joined Cases C-354/03, C-355/03 and C-484/03 Optigen Ltd, Fulcrum Electronics Ltd and Bond House Systems Ltd v Commissioners of Customs and Excise) and *Axel Kittel* (European Court of Justice: Joined Cases C-439/04 and C-440/04 Axel Kittel v Etat Belge and Etat Belge v Recolta Recycling SPRL) as showing that the Broker had knowledge or should have known that the transactions in which they engaged were fraudulent in nature.

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