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VALUE ADDED TAX FRAUD

Marius-Cristian Frunza

Value Added Tax Fraud

Serving as an introduction to one of the 'hottest' topics in financial crime, the Value Added Tax (VAT) fraud, this new and original book aims to analyze and decrypt the fraud and explore multidisciplinary avenues, thereby exposing nuances and shades that remain concealed by traditional taxation-oriented researches. Quantifying the impact of the fraud on the real economy underlines the structural damages propagated by this crime in the European Union. The 'fraudsters' benefit when policy changes are inflicted in an economic space without a fully fledged legal framework. Geopolitical events like the creation of the Eurasian Union and 'Brexit' are analyzed from the perspective of the VAT fraud, thereby underlining the foreseeable risks of such historical turnrounds. In addition, this book provides a unique collection of case studies that depict the main characteristics of VAT fraud.

Introduction to VAT Fraud will be of interest to students at an advanced level, academics and reflective practitioners. It addresses the topics with regards to banking and finance law, international law, criminal law, taxation, accounting and financial crime. It will be of value to researchers, academics, professionals and students in the fields of law, financial crime, technology, accounting and taxation.

Marius-Cristian Frunza is a Director with Schwarzthal Kapital, United Kingdom, and an Associate Researcher with the Laboratory of Excellence for Financial Regulation (LABEX ReFI) in Paris, France.

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This book is dedicated in memoriam of Ignacio Echeverría Miralles de Imperial, a Spanish financial crime expert, cowardly killed on 3 June 2017, during the London Bridge terrorist attacks.

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1 Introduction to the mechanisms of VAT fraud

VAT: a European concept

> VAT rules are a quarter of a century old and no longer fit for purpose. Fraud today is not something citizens can accept any more, particularly when it finances organised crime and terrorists.
>
> Pierre Moscovici, European Union Commissioner, 2017[1]

Tax can be defined as a financial liability established and collected by a government or an equivalent agency. The government of a country can apply tax levies to income, capital, resources, labour, goods and services. Tax concerns all physical and moral persons encompassed by the jurisdiction of a government.

Taxes are the main source of revenue for the national budget of a country or region. They are classified as direct taxes and indirect taxes. Direct taxes are charged directly on the income or wealth of the person, while indirect taxes are imposed on the price of goods and services. The computation of tax levy has, in general, two main components:

- the tax levy base, representing the nominal value upon which the assessment of tax liability is made, and
- the tax rate, which is presented generally as a percentage.

Value Added Tax (VAT) is an indirect consumption tax, charged on most trades of goods and services. The base of the VAT is the *value added* by the economic agent. For example an industrial company purchasing raw materials for 100 euros and transforming them into a finite product sold for 130 euros has a VAT liability on the 30 euros of value added in the production process.

A wholesaler buying clothes for 1,000 euros and selling them to retailers for 1,500 euros is liable on the 500 euros of commercial value added. VAT is charged to registered businesses and final non-business customers. Final clients do not pay the VAT directly to the government but to B-to-C (business to client) companies.

1 www.ft.com/content/a6cdc2d4-a8bc-11e7-ab55-27219df83c97.

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B-to-C companies registered for VAT pay their liability periodically (generally quarterly) to the tax office of the country where the product is consumed. B-2-B (business to business) companies are also liable for VAT, depending on the difference between VAT charged to clients and the VAT paid for purchases. If the balance is negative the company can claim a refund from the tax office. If the balance is positive the business is required to pay the tax levy to the concerned national treasury.

The concept of VAT was fathered in the 1950s by Maurice Lauré (Laure, 1955). He was the head of the French Tax Authority. VAT was introduced in France through a law on 10 April 1954.

VAT (TVA, *Taxe sur la valeur ajoutée*) was first tested in Ivory Coast (Côte d'Ivoire), a French colony, in 1954. After the Ivorian experiment, VAT was extended to the entire French territory in 1958. Rapidly, the concept of VAT spread to other European countries.

After the collapse of the former communist bloc and the dismantlement of the Soviet Union in August 1991, major policy reforms were immediately implemented in the former Eastern Bloc, aiming to regulate the exponentially rising economic activities.

VAT (НДС, налог на добавленную) was introduced in Russia in 1992. It is administered by the Federal Tax Service, with a rate of 18% for most goods and services. In 1993, VAT was also introduced in Romania (TVA, Taxa pe Valoare Adaugata), while Bulgaria adopted VAT (ДДС, Данък върху добавената стойност) in 1994. China started to implement VAT gradually between 1984 and 1993, when the State Council promulgated a dedicated policy. The United Arab Emirates and Saudi Arabia adopted VAT as of 2018, with a small rate of 5% that is supposed to increase over time.

Goods and Services Tax (GST) is an equivalent of the VAT implemented in countries like India, Canada, Australia and New Zealand. By the early 2000s, VAT had become the key component of the indirect taxation systems in more than 120 countries, with tax rates varying from 5% to 27%.

Interestingly, the VAT failed to find acceptance in the United States, despite numerous attempts by various politicians to bring momentum around the introduction of the VAT as a Federal tax. Michigan adopted a modified VAT, named a Business Activities Tax, and used the system for 14 years. The United States is, along with a few financial paradises (i.e., the British Virgin Islands, the Cayman Islands, Gibraltar and Guernsey), amongst the only states in the world without a VAT system.

Tax fraud

The separation line between tax compliance and tax fraud is very murky. When a company or an individual looks for leeways from the normal avenue of being fully compliant with all tax liabilities, few legal options are available.

1 Tax optimization consists of adjusting the various financial metrics comprising a base for tax levies in order to minimize the total tax liability. A simple example is using debt in corporate as a means to reduce the corporate tax bill.

2 Tax arbitrage profits from the way a given transaction is taxed in different countries or different regions of a country. VAT for example has various rates in different countries. Within the same country a region (i.e., Livigno in Italy) could be exempted of tax.
3 Tax avoidance is the practice that employs legal methods in order to aggressively reduce tax liability by claiming deduction or refunds. Tax avoidance can employ sophisticated structures like offshore holdings and structured financial products, like insurance or derivatives, designed to enhance tax avoidance.

Tax evasion is employing illegal methods to reduce partially or totally the tax liability or to access fraudulently tax reimbursement from the national tax office.

By its very nature, VAT's effectiveness relies on the integrity and loyalty of various intermediaries that collect and pay the tax along the economic chain. On the one hand, economies with 'black markets' involving undeclared trades are not submitted to VAT, thereby reducing its base and constituting a source of tax evasion. On the other hand, defecting intermediaries in distressed financial situations or unfaithful (missing) traders vis-à-vis a tax discipline represent a second source of evasion.

VAT evasion touches all countries having indirect taxation systems, including both VAT and GST. If most often the cases from the European Union (EU) or the United Kingdom are reported, VAT fraud occurs also in Australia or the Russian Federation. Countries from the African continent like South Africa were also touched. In 2018,[2] the South African Revenue Service and crime intelligence officers arrested eight men and a woman in connection with a scam with a potential loss to the taxpayer of more than 90 million rans (5.7 million euros). The gang was also associated with violent crimes.

In January 2018 the United Arabs Emirates and Saudi Arabia introduced VAT in their taxation systems. Despite being a source of structural risk for the global trade, VAT is definitely a stable source of income for the national budget. Dubai is already an international hub for financial crime, and the introduction of VAT will most likely make the Emirates more attractive for crooks.

VAT fraud typologies

Tax fraud appears in many forms and shapes, touching multiple markets and sectors of the economy. As pointed out before the borderline between tax fraud, tax avoidance and tax optimization is not well defined and can swing, depending on the interpretation of national laws and regulations. Therefore, any classification of VAT fraud typologies needs to be apprehended cautiously and might not be consistent in regards to both legislation and economic reasoning. Without loss of generality, one can split the economy of a country into two major silos:

- The *formal economy*, represented by those economic activities governed by the national law and with observable and quantifiable turnover figures.

2 www.enca.com/south-africa/police-bust-large-vat-fraud-syndicate.

Traditionally, the formal economy is established on organized commercial entities registered with the national business registries. The size of the formal economy is measured from compulsory reports required by governments from businesses, including tax fillings, financial annual statements, etc.

- The informal or the *shadow economy*, encompassing all trades of goods and services taking place outside the perimeter of national laws. The volumes and the values of the trades for the shadow economy are in most of the cases not directly observable. The output of the shadow economy is not included in the base of any national tax.

Based on these considerations, the following empirical classification of VAT fraud typologies is proposed:

1 *Shadow economy*-related VAT fraud encompasses the undeclared domestic and cross-border trades of goods and services not submitted to VAT.
2 Dissimulation of trades from formal economy is known as *Missing trader* fraud. The *Missing trader*'s aim of concealing the totality or part of the turnover is to underestimate the base of the VAT and to pay less or not to pay the full value of the liability towards the national treasury. The missing trader 'disappears' after a relatively short period of time by closing, abandoning or bankrupting the business.
3 Misrepresenting the figures from the trading book of an organization by employing *Accounting shenanigans* aim to artificially reduce the amount of VAT liabilities, without altering the rest of the accounting figures. The accounting shenanigans can be used over an extended period of time, without ceasing the business, as in the case of the missing trader.
4 Misrepresenting the type of traded goods or services aims to reduce the VAT liability by applying an inappropriate VAT rate lower than required. *Misrepresentation of goods and services* entails declaring for taxation purposes an item in a category different from the correct one in order to arbitrate the VAT rate percentage.

The shadow economy

The base of the value added taxation is represented by the formal economy. Thus, the shadow economy is inevitably linked to tax fraud and especially to VAT fraud. The trades taking place within the shadow economy are not declared for any tax purpose, thereby the government is not able to tax these trades.

The base of the VAT is directly proportional to the turnover of the formal economy. The observability and the accuracy of the figures reported within the formal economy rely on the robustness of the collection processes of accounting data from the organizations included in the national business registry. If the figures related to the taxation base or to the appropriate tax rate of a given company are not accurate, the amount of the collected tax will not be genuine.

Some traders from the formal economy may choose to dissimulate or to misrepresent trades, thereby including them de facto in the shadow economy. Thus, these trades are not included in the compulsory reporting and the respective tax bases are not accurate.

The shadow economy, known as the black market, refers to economic activities that are invisible to the national statistics. Therefore, these activities are not included in the national Gross Domestic Product (GDP) figure. The informal economy can include activities which are both legal and illegal in nature. Traditionally the shadow economy involves trades of services and goods for which the customer pays in cash.

In recent years, with the increasing scrutiny of the cash transactions and with the zero cash policy of some European countries,[3] the assumption of a cash-only shadow economy needs to be reconsidered. Table 1.1 shows a few relevant statistics for three European countries that have a clear policy to move towards a cashless economy. In countries like Sweden or France, the percentage of transactions using a non-cash method was almost 60% in 2016. Many innovative payment methods proposed by the Fintech companies are as invisible to the tax collector as cash payments.

Therefore, in the current context, the shadow economy encompasses non-cash transactions, including:

- Transactions with digital currencies, including cryptocurrencies. Bitcoin and the altcoins have a very heterogeneous legal status across the world. Most crypto-transactions are not submitted to any form of taxation.
- Barter transactions. Exchange of goods and services for other goods or services is very difficult to tax.
- Shadow banking. With the financial crisis many alternative methods of financing saw the light of day. Non-banking financial institutions have a significant share of the market. Many of those liquidity providers are not monitored by regulators or tax authorities. Therefore, their clients are able to operate outside the formal economy.

Table 1.1 2016 snapshot of the most cashless countries in Europe

Country	*Sweden*	*The United Kingdom*	*France*
Proportion of cards in issue with contactless functionality	25	41	39
Debit cards per capita	0.98	1.48	0.65
Credit cards per capita	1.04	0.88	0.1
Percentage of transactions using non-cash methods	59	52	59

Source: Telegraph, Forex Bonuses.

3 www.telegraph.co.uk/money/future-of-money/10-cashless-countries-world-does-uk-rank/.

- Hawala-type systems encompass money transfers without money movement. In a Hawala transfer the sender and the receiver of the money cannot be linked. The transfer does not require any physical or electronic transfer of money. Hawala-type transfers bypass the traditional avenues of the banking services.

Evading VAT in the shadow economy can take many forms. Most frequently, the VAT loss is caused by unregistered traders that exert an economic activity, without being registered with the respective tax office. Thus, all the underlying trades of an unregistered trader are liable to VAT.

Another source of VAT loss is the undeclared sales of registered traders. In the retail sector, for instance, a small shopkeeper has a discretionary option to keep some sales undeclared, thereby diminishing the base for the VAT levy. This illegal action would also entail an underestimation of the corporate tax or revenue tax of the trader. In the accounts, these undeclared sales are declared as damaged stocks and are thereby written off.

Missing trader

Missing trader fraud is taking advantage of the VAT rules on cross-border transactions of goods and services. VAT is not applicable on cross-border transactions, especially within the EU. A trader can buy a product from another country VAT-free, sell it domestically with VAT and never pay the VAT liability. Missing trader encompasses a wide panel of VAT fraud typologies, including Missing Trader Extra-Community (MTEC) fraud, carousel fraud, cross-invoicing, contra-trading and barter trading.

Missing Trader Intra-Community

The Missing Trader Intra-Community (MTIC) scam is one of the most frequent and damaging VAT fraud types. Its underlying mechanism is based on the fact that intra-Community trades are not submitted to VAT. The basic form of the MTIC fraud is depicted in Figure 1.1. An item is bought from a different country of the EU without VAT and sold domestically with VAT. The VAT is not paid to the local tax authority.

As shown in the investigation of the Hungarian[4] VAT fraud the bigger the difference between the domestic VAT rate and the VAT rates of neighbouring countries, the stronger the incentive to commit fraud. The wide range of VAT rates across the EU (Barbone, 2013), juxtaposed with the frequent rate changes over time, represents a real incentive for fraud and makes it more difficult to track and investigate.

4 Hungary has the biggest VAT rate in the EU.

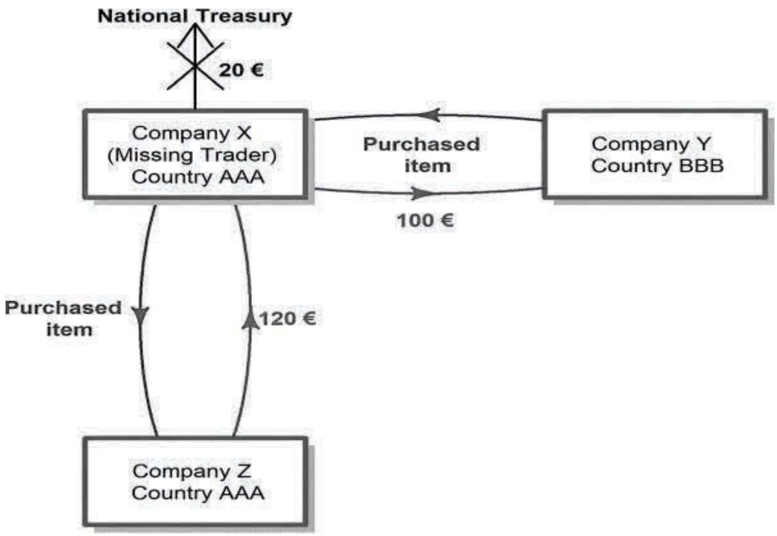

Figure 1.1 Basic mechanism of the VAT fraud. An item is bought from a different country of the EU without VAT and sold domestically with VAT. The VAT is not paid to the local tax authority.

In MTIC fraud's most simple form, a trader collects tax on sales and then fails to remit it to the government, for example, by engineering bankruptcy. It is not a fraud against the Community itself and does not come about because of mismanagement by European institutions but instead is an attack upon the measures that Member States have introduced to promote cross-border trade in the Community. Growth in the fraud is driven by four factors:

a The increase in high-value/low-weight goods, which make it easy and inexpensive to transport valuable consignments.
b The zero rate of taxation on intra-Community cross-border trade, which allows purchasers of goods from other EU countries not to pay VAT on purchases, although they charge VAT on sales normally.
c At the same time, exporters of goods are still able to reclaim VAT that they have paid to other traders, thus crystallizing the loss as the revenue authority refunds a payment for which it had not received a remittance earlier in the transaction chain.
d The abolition of frontier formalities within the EU, which prevents Member States from operating procedures which could impede the free flow of goods within the EU. This means that the verification of the zero-rated goods imported could only be based on an audit of the traders' transaction records – a process which at present is normally only undertaken when VAT receipts are remitted, sometimes after the transactions.

Carousel fraud

The most complex and damaging form of MTIC fraud, the VAT carousel is depicted in Figure 1.2. The same item circulates many times through a chain of companies situated in at least two countries. One of the companies (the Missing Trader) fails to pay the VAT liability to its local tax authority. The amount of the pocketed tax is proportional to the number of times the goods turn in the carousel. For this form of fraud the items with low physical volume and high value are preferred in order to reduce the cost of storage and transportation. Precious metals, mobile phones, laptops and clothes are traditionally the preferred targets for the carousel. Nevertheless, the investigators observed in many cases that the items never got out of the country, and forged paper and invoices were used.

The growth of the cyber-based economy moved the carousel fraud to a new dimension. Immaterial items, like cloud memory, software, Voice over Internet Protocol (VoIP) and some financial instruments (carbon emissions allowances), amplified the damaging effects of the carousel fraud. For these items there is no storage and virtually no cost of transfer. The items can change ownership across countries almost instantly, and a carousel tour can be executed in terms of minutes.

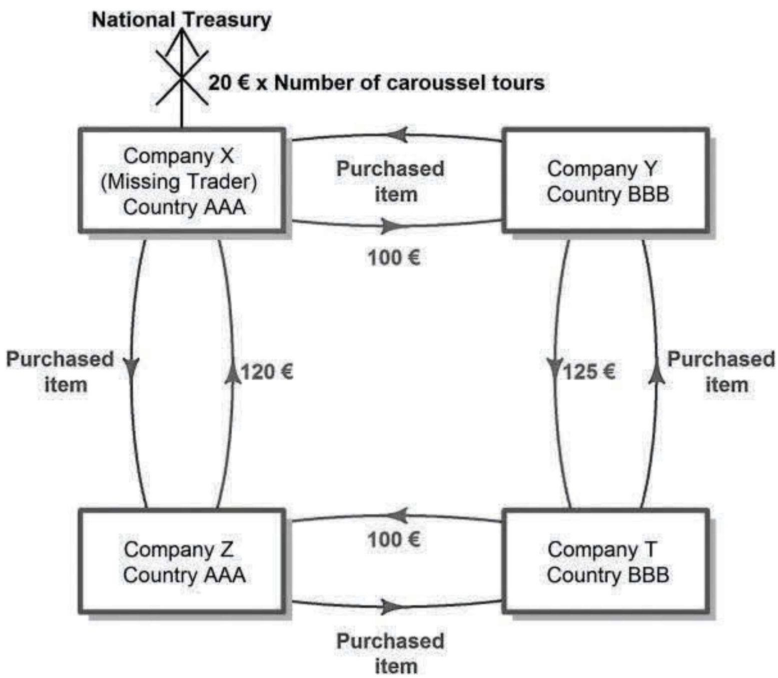

Figure 1.2 Carousel version of the MTIC fraud. The same item circulates many times through a chain of companies situated in at least two countries. One of the companies (the Missing Trader) fails to pay the VAT liability to its local tax authority. The amount of the pocketed tax is proportional to the number of times the goods go through the carousel.

Cross invoicing

One of the main issues with classic MTIC fraud depicted in Figure 1.1 is the fact that the lifespan of the Missing trader is short. In fact the fraudulent company would not be able to justify unpaid VAT liability and thereby is exposed to the risk of being detected by a control of the tax authority. A solution to this issue is to obtain invoices from different legal entities that would match the trades entailing the VAT fraud.

Cross-invoicing is a mechanism aiming to enhance the MTIC and to hinder a potential audit by providing with face invoices that would give the impression that the missing trader is a VAT complaint. A simple control would not be able to discover the reality behind the scam, and the missing trader could continue to steal tax for a longer period. As depicted in Figure 1.3, the missing trader (Company X) buys a good or a service from Company T, based in another country, and resells it domestically to Company Y with VAT. At the same time, Company X engages in bogus trades with two companies, one domestic and another from overseas. These bogus trades are backed by invoices that will match the two other trades, thereby implying in theory a zero VAT liability for Company.

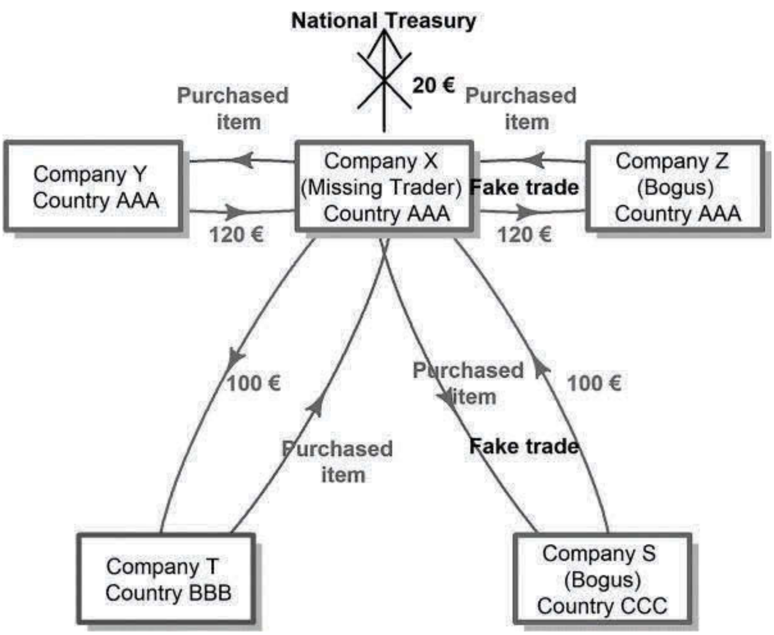

Figure 1.3 Cross-invoicing is an enhanced version of the MTIC. The missing trader (Company X) buys a good or a service from Company T, based in another country, and resells it domestically to Company Y with VAT. At the same time Company X engages in bogus trades with two companies, one domestic and another from overseas. This bogus trades have invoices that will match the two other trades, thereby implying, in theory, a zero VAT liability for Company X.

Double carousel – contra-trading

Another solution that could hamper the detection of MTIC fraud is the use of 'contra-trading'. A 'contra-trader' is a registered company engaged in two different streams of transactions at the same time. The VAT charges of two streams cancel each other out, thereby generating a null total liability for the contra-trader.

The two streams of transactions are depicted in Figure 1.4:[5]

- The first stream entails a VAT credit for the contra-trader (Company T). Company T buys a product domestically from Company Z (which is the missing trader) with VAT, sells it abroad to Company X without VAT. It benefits from a VAT credit of 20 euros.
- The second stream generates a VAT liability to Company T. The contra-trader buys a product (it can be different from the product of the first stream) from abroad (Company Q) without VAT and resells it domestically to Company S at a price, including 21 euros of VAT. Company S will export the products abroad to Company Y without VAT.

Thus, the contra-trader is liable for 1 euro of VAT because the input tax offsets the output tax liability. In this scheme, the counter-trader has a very small liability towards the national tax office. The missing trader will not pay the VAT

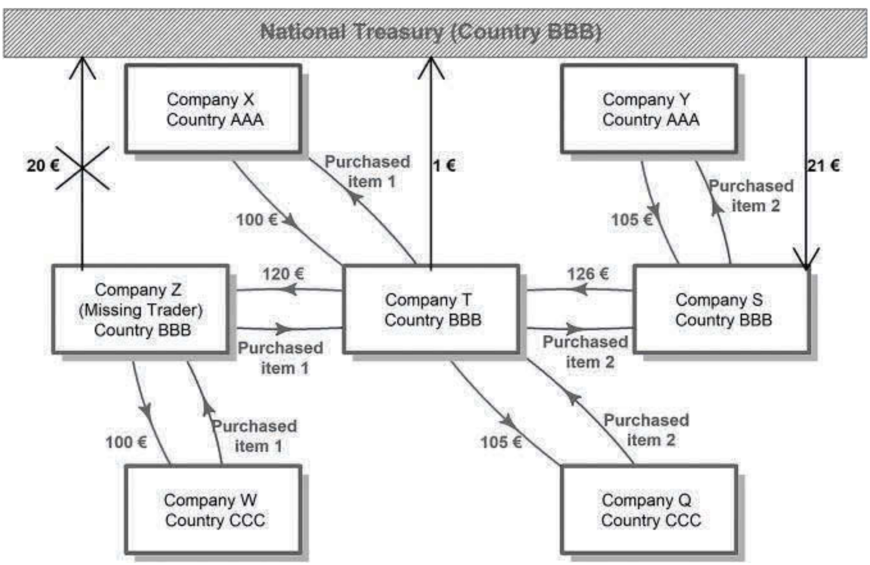

Figure 1.4 Contra-trading aims to hinder the detection of MTIC fraud. It consists of two streams of MTIC frauds or two carousel.

5 www.gov.uk/hmrc-internal-manuals/vat-fraud/vatf23550.

liability, while Company S will be refunded for its VAT credit. The contra-trader benefits from a refund act on a legal basis. Therefore, an audit from the customs department will not reveal any abnormality. In general between the missing trader and the contra-trader there are a few buffers involved that would make the detection even more complex.

In Great Britain, contra-trading was signalled by Her Majesty's Revenue and Customs (HMRC) in VAT fraud cases with mobile phones and computer components.

Countertrade (barter) fraud

The transfer of funds in an MTIC fraud is generally done through the banking system. This represents a big source of risk for the fraudster as bank transactions are an audit trail in the eventuality of an investigation. Bypassing totally or partially the banking system would confer a big advantage to MTIC scammers. One way of achieving this is by using countertrades. Countertrade or barter is a form of international trade in which goods or services are exchanged for other goods or services without involving any transfer of currency or cash settlement. The products exchanged should therefore have the same value.

Figure 1.5 shows the mechanism of MTIC based on countertrades. Two MTIC companies import different products from other countries without VAT. Instead of selling the products domestically Companies Z and S swap the products and resell them in their respective countries with VAT. The collected VAT is never

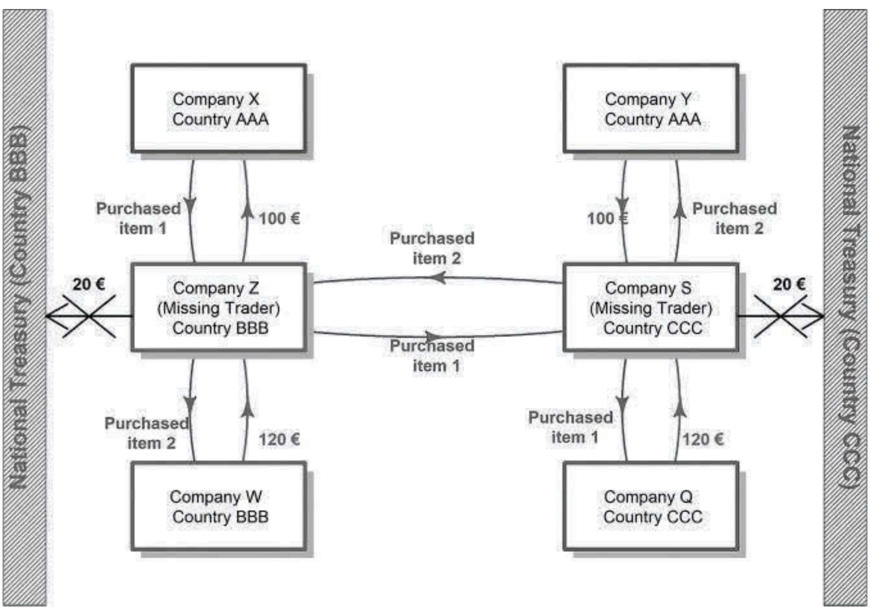

Figure 1.5 VAT fraud with countertrades or barter trades.

paid to their national tax office. The advantage of barter transactions is that between the Companies Z and S there is no fund transfer. The missing traders are not defrauding VAT on the products Company Y bought with currency from other countries but on other products. For example Company Z could import mobile phones, while Company S could import computer components and swap the products afterwards. This type of fraud would raise less suspicion, thereby being less likely to be detected.

Missing Trader Extra-Community

MTEC fraud is a version of MTIC, whereas the supplier of goods is outside the EU. This fraud works well for services and digital products. The development of online marketplaces showed that MTEC can also occur for physical goods.

With the increase of global trade, the expansion of MTEC fraud can become a real threat, and understanding its particularities becomes crucial for both investigators and customs services.

Accounting shenanigans

VAT fraud can be achieved in more subtle ways, without involving undeclared trades or missing companies. Accounting shenanigans encompass a set of techniques aimed at manipulating the financial statement and fillings of a company in a way that would present the firm in a different light from its real situation. Accounting shenanigans are often used in financial crime to abuse the confidence of investors in a company.

VAT levy is computed from accounting inputs relative to sales and acquisitions. Thus, by altering the accounting values of purchases and sales, a firm can reduce the VAT base, thereby diminishing the VAT liability. The manipulation can entail:

- an overestimation of purchases and
- an underestimation of sales.

For misestimating the purchases/sales two variables can be manipulated: the volume of purchase/sales and the price of purchases/sales. Theoretically, the volume and price are predetermined and are well described in contract invoices or delivery agreements. That might be true for most products and services, but there are cases when the price is the result of a valuation process or the result of subjective opinion. Acquisition or sale of items for which the fair value is difficult to establish can easily be misrepresented in accounting. Examples can include infrastructure, real estate, forestry, mining, resources, etc.

The energy markets have some specificities in the way that contracts are established. Swing contracts, which are popular in gas and energy markets, do not indicate a fixed volume and price for the transactions. They indicate a minimum and maximum volume and a minimum and maximum price. The valuation of these contracts is relatively complicated. The actual volume and price are difficult to establish, even when the trade is executed. Moreover, what is sold through these contracts is capacity, and checking the actual delivered volume of the trade would be a very complex task. Therefore, energy markets are targeted by fraudsters that would want to use accounting shenanigans to evade VAT.

Misrepresentation of product type

In most countries, the VAT system has different rates for different types of products. Some goods and services benefit from a reduced-rate VAT and even of VAT exception in some cases. Misrepresentation of product type consists in buying a product with a given VAT rate and rebranding the product in such a way that a different VAT rate is applied. From the difference, a profit can be made as no tax liability is entailed in theory by misrepresenting the product. The misrepresentation of product type is often presented by the fraudster as production or transformation process. The fraudulent company claims buying raw materials and transforming them into end-products, which have a different VAT rate. Two cases can arise:

- If the VAT of the mislabelled product is higher than the VAT rate of the original product, the profit is realized immediately when the mislabelled product is sold.
- If the VAT of the mislabelled product is lower than the VAT rate of the original product, the profit is unrealized, and the trader will require a VAT refund from the tax office.

2 Markets and VAT fraud

Overview

> I do not care about revenues.
>
> Jack Ma, Alibaba founder

A first risk assessment of the markets most susceptible to missing trader fraud was proposed by Ainsworth R. (2010). Virtual goods and services like CO_2 emissions and Voice over Internet Protocol (VoIP), along with energy supplies (gas and electricity), were underlined as bearing the biggest risks concerning Value Added Tax (VAT) fraud. These markets follow *the low-volume/high-value* postulate, which states that products requiring low storage space and being sold at big prices are a priority for Missing Trader Intra-Community (MTIC) fraudsters. The postulate was true, especially in the early years of VAT fraud, when the object of the scam were physical products, which needed to be stored and transported several times abroad in order to be able to claim the VAT. Therefore, items with low volume would reduce the cost of the fraud, while high price would increase its profit.

MTIC fraud on services was a game changer because services have virtually no costs of storage and transportation. Experts included these products in the same category of low volume/high value. Nevertheless, there is a big difference between the real and the virtual products. For the former there is an actual demand; thereby at the end of the MTIC chain the product is being sold to real customers. For the virtual products and services, there is no real demand for the artificial supply created by fraudsters. The particular feature of these markets is that the demand can be created artificially through bogus companies.

Markets of high-value products are also concerned by VAT fraud. Such fraud networks work at a lower speed than in the case of items with low volume. These markets encompass luxury goods and industrial equipment. The demand for these products is highly elastic with respect to price.

Another category of items bearing the risk of tax evasion is the market with an inelastic demand, whereas the consumption changes less, depending on the price. This category includes basic products like food, petrol, alcohol, tobacco and technology gadgets.

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Low-volume, high-value products

The basic postulate of the MTIC fraud underscored the fact that tax evaders aim to maximize the profit of the crime while minimizing the execution costs. Therefore, criminals are prioritizing the products with high value that will generate a big loss to tax offices and those with low volume, which will require low cost of storage and transportation. Low physical volume products, including precious metals, electronic devices and clothes, are ideal for carousel-type frauds.

Precious metals and stones

Historically, precious metals were reported in the very first cases of VAT fraud in the 1970s in the United Kingdom. The sale of Krugerrand[1] was exempted from VAT, while gold bullions were not. Therefore, criminals found an ingenious method in which they would buy Krugerrands, melt them, sell the bars with VAT and never pay the tax back. In the 1990s, with the birth of the European Common Market, the VAT fraud with metal and precious stones increased exponentially in the United Kingdom. Gangs specializing in VAT fraud imported gold from Benelux countries VAT-free and resold it in Britain, without clearing their tax liability. That era established the foundation of the criminal networks that grew over time and entered into new markets and areas of crime.

Despite being heavily curtailed by law enforcement, VAT fraud with precious and non-precious metals is a persisting phenomenon in the European Union (EU). In Spain, Operation *Fenix* started in 2006 and revealed a network of 102 individuals and 45 companies based in Andalusia. Between 2002 and 2016 the Spanish gang defrauded more than 150 million euros from the Spanish taxpayers.[2] The main company of the network based in Barcelona imported 24 carat gold VAT-free from Switzerland, which it sold to wholesalers and jewellery manufacturers, most of them residents in Andalusia. The VAT collected through the domestic sale was never reimbursed. The court trial ended in 2017, and the recovery of the tax loss was limited.

VAT fraud with gold is not anymore a European or British phenomenon. It expanded to the other regions of the world that apply indirect taxes in one form or another. In early 2015, Australian prosecutors[3] realized that since 2012 the Australian gold industry had been heavily hit by tax fraud, representing more than 350 million euros of loss for the taxpayers. When a trader buys investment-grade gold bullion that has been stamped into bars and coins, he does not pay the Goods and Services Tax (GST).[4] When the same trader sells 'scrap' gold, which can be anything from cheap jewellery to fragments of pure

1 South African gold coin, first sold in 1967.

2 www.europapress.es/andalucia/noticia-juicio-cordoba-102-acusados-fiscal-caso-fenix-fraude-joyeria-20170323140106.html.

3 www.smh.com.au/business/gold-fraud-550m-tax-scam-hits-gold-industry-20160707-gq0s5f.html.

4 Goods and Services Tax, similar to VAT.

gold, a 10% GST does apply. A trader can collect potentially between 1,000 and 1,500 euros of tax for each kilogram of gold. Moreover, no licence is required in Australia to trade in gold bullion. The scam is thus simple and is similar to that from the 'Hatton Garden' days in the 1970s. As a result, the demand for gold in Australia became so intense that traders started to use fake transaction paperwork for gold trades that never happened.

The Australian Crime Commission cracked down on multiple GST fraud groups through Operation *Nosean*, which started in 2012. One of the indicted, Brisbane precious metals trader Robert Bourke, involved with a GST fraud syndicate, was a known figure in the criminal world. Despite his criminal record Bourke was still able to act as a gold buyer on behalf of self-managed super funds. His business generated a loss in tax of 15 million euros.

Gold is not the only target of tax fraudsters. Other metals, like silver, copper, or aluminium, and even rare metals like palladium and rhodium attract tax evaders. In 2017, British investigators discovered a criminal enterprise organized by Tony Bond, a scrap metal dealer[5] who has been accused of evading 17.5 million pounds in VAT. The fraud took place between 2008 and 2017 through a set of companies, including Bullion Bond, Eco Logic Solutions, Precious Waste Recovery, Dentalloy and Stewart Nicol Solutions Ltd.

In 2012, the Dutch authorities became aware of VAT fraud in the trade of copper cathodes.[6] The fraud was reported to be connected to the United Kingdom and Germany.

VAT fraud with aluminium resale was reported in Italy in 2004. Enzo Cibaldi, a businessman from Brescia, was a leader of a 23-strong group involved in fraud, accounting for 12 million euros in unpaid VAT.[7] Raw metal was bought from abroad and sold in Italy as semi-finished products, with VAT through two companies, Deral Spa and Acciaieria Riva, the latter being the missing trader.

Technology products

During the 1990s, VAT fraud was under the sign of the precious metals and stones. With the development of consumer electronic gadgets, including mobile phones, laptops, memory discs, TV screens and smartphones, tax evaders embraced new opportunities. Trading electronic gadgets was less suspicious than precious metals and at least as profitable. Examples showed in Table 2.1 are not the biggest cases of VAT fraud with electronic devices, but they aim to mark the timeline of the evolution of this scam from the late 1990s throughout the 2000s.

5 www.dailymail.co.uk/news/article-4802972/Scrap-metal-dealer-accused-17-5million-VAT-fraud.html.

6 www.tax-news.com/news/Netherlands_Tackles_VAT_Carousel_Fraud_In_Metal_Industry____58281.html.

7 www.siderweb.com/articoli/industry/686026-frode-sui-metalli-12-mln-di-euro-truffati-all-iva.

Table 2.1 Example of VAT fraud cases with trades of technology products

Fraud/operation	*Country*	*Year*	*Amount of VAT fraud*
Memory units	France	1996	10 million euros
Badajoz case	Spain-Portugal	1997–2002	36 million euros
Carré & Ribeiro	Portugal	2005	34 million euros
Operation *Medina*	Spain	2006	400 million euros
Forli group	Italy	2017	60 million euros
Operation *Sith*	Spain-Portugal	2017	25 million euros

The emergence of tax evasion in the electronic supplies business was reported as early as 1996, when David Haccoun, co-chairman of Dane Elec,[8] a French memory discs trading company, incriminated multinationals for evading VAT on memory units sale and hampering the competition. VAT loss from this fraud was estimated to be 10 million euros.

A case of VAT fraud of 36 million euros in computer equipment that occurred between 1997 and 2002[9] was investigated in 2008 in Badajoz, Spain. Companies involved in the fraud were based in Portugal and Spain.

Operation *Medina*[10] was one of the biggest busts from the 2000s in the VAT fraud groups. A total of 45 people have been arrested and charged for defrauding over 400 million euros between 2003 and 2006 on transactions of computer equipment and mobile phones. Few major retailers of electronic products were caught by the indictment. Thus, Bernabé Noya, the owner of the telecommunications business group Meflur, one of the most important companies in Northern Spain, was investigated for VAT evasion. Another company, Infinity System, a computer manufacturer with a turnover of 500 million, was also raided by prosecutors.

A massive case of VAT evasion in the resale of electronics was revealed in Portugal in 2005. The famous case of 'Carre & Ribeiro',[11] a company which generated a loss of 34 million euros to the Portuguese taxpayers, underlined the complexity of prosecuting and recovering stolen taxes in VAT fraud cases.

The VAT fraud with electronics got out of control in Great Britain, where it was estimated that in 2006, 10% of the country's exports were related to carousel fraud. Electronic products were turning in well-organized carousels up to 30 times, generating tens of millions of pounds in VAT refunds from Her Majesty's Revenue ad Customs (HMRC).[12]

In 2006, the British government asked permission from the European Commission to introduce reverse VAT on electronic products to curtail the fraud. This measure tackled the fraud only temporarily. New cases occurred later, following the same pattern.

8 www.channelweb.co.uk/crn-uk/news/1875763/memory-market-hit-huge-vat-fraud.

9 www.hoy.es/20080926/badajoz/condenado-anos-prision-principal-20080926.html.

10 www.elmundo.es/mundodinero/2006/11/30/economia/1164895173.html.

11 www.dn.pt/arquivo/2005/interior/quatro-empresarios-detidos-por-fraude-em-carrossel-no-iva-631893.html.

12 www.theguardian.com/uk/2006/aug/16/ukcrime.economy.

A 60 million euro[13] VAT fraud in the sector of the sale of electronic products, mobile phones and computers was reported in 2017 in Italy in the province of Forlì. The scam was organized around individuals who controlled 36 companies which imported and resold electronic products. In the same year, in Spain and Portugal the prosecutors dismantled as part of Operation *Sith*[14] a gang of 19 individuals, which had stolen 25 million euros of VAT over three years in trades of electronic products.

Clothes

Clothing business passed through massive mutation over the past two decades. Countries with a strong manufacturing sector in the EU – including France, Italy and Spain – saw the size of the industry shrinking, with factories moving into Eastern Europe, Northern Africa and Asia. The economic downturn put additional pressure on prices, and this made the clothing retail sector vulnerable to VAT fraud. Clothes fall into in the low-volume, high-value category, especially for luxury marks. Wholesalers play a crucial role in this market. They act like brokers between the manufacturers and the retailers. It is after going along the chain of wholesale that the end products see their markup increase compared to factory prices. Thus, in Europe, for clothes the retail price is 2.2 times higher than the factory price, and for shoes the prices are 2.8 times higher. Obviously, if the products come from cheap labour countries, the markups could be even higher. It was the case of an Italian investigation in a port in Agrigento in Southern Italy that found a network of missing traders specialized in importing clothes from China.[15] The fraud accounted for 2.6 million euros.

The mechanism of the VAT fraud in the clothing sector has some specific features entailed by the fact that buyers from outside the EU are entitled to refunds when shopping in Europe. A group of 146 Chinese nationals was busted in Italy as they were claiming illegally VAT refunds when shopping for clothes and shoes. An operation of Italian prosecutors called *Red Channel* showed that the group had stolen almost 1 million euros of VAT.[16]

Artificial demand

Throughout the 2000s, VAT fraud with low-volume/high-value products was massively hindered by the reversed charge introduced by different European governments and by the increased awareness of law enforcement. Thus, defrauding

13 www.ansa.it/emiliaromagna/notizie/2017/07/21/iva-60-mln-evasa-gdf-sequestra-ville_e759ea2a-b1ee-432a-88fc-3d6ae5775b44.html.

14 www.larazon.es/hacienda-desmonta-un-fraude-en-iva-de-25-millones-de-euros-DO15283642.

15 www.lasicilia.it/news/agrigento/154229/porto-empedocle-funzionari-adm-scoprono-frode-iva-per-oltre-2-6-mln.html.

16 www.pupia.tv/2017/07/canali/cronaca/merce-acquistata-italia-passaporti-stranieri-scoperta-frode-iva-denunciati-146-cinesi/391189.

VAT on traditional markets like precious metals, electronic products or clothes became a more complicated and less profitable crime. Moreover, these products need at the end of the trading chain a real demand from customers. The amount of the VAT fraud on low-volume/high-value products is capped by the capacity of the demand to absorb the merchandise.

Tax perpetrators who had gained experience with electronic products explored new fields where they could leverage their expertise with the VAT scam. The perfect scam would require a fast-circulating underlying, with low entry cost, and be sophisticated enough to make it hard to detect. Moreover, if the demand on the underlying could be artificially inflated, the pocketed VAT could reach, in theory, astronomic numbers. Three avenues seemed to be promising prospects for fraudsters: telecom services, CO_2 emissions allowances and energy markets.

Telecom services

With the liberalization of the telecom sector across the EU in the early 2000s a number of telecom retailers started the trading of broadband capacities. The supply of phone call cards was mainly for foreign workers, customers who were making calls to their home countries and were looking for a cheap price per minute. The companies dealing with this market were buying and selling broadband capacity across the continent. In a similar way to the physical items, broadband capacity was bought without VAT and sold with VAT, the tax never being reimbursed to the national treasuries. Detecting this scam is far more complicated as the broadband is not a physical item, and the demand can be artificially manipulated with premium tariff numbers or servers that automatically make calls. The contracts relative to broadband capacity are also complex as they imply various options and kickback fees. A broadband trader could buy, for instance, from a big national telecom company a massive amount of broadband capacity for a specific geographical area at a discount price. The contractual agreement could also include take-or-pay options similar to those in the energy markets (Frunza, 2015).

The complexity of telecom markets was the perfect financial shenanigan for covering potential fraud. Therefore, the number of cases investigated related to VAT fraud on telecom services was limited, the most prominent being the *Phuncards-Broker* operation in Italy.

In 2017, the French government became aware of the issues in the telecom service and decided to inflict a penalty on two main French telecom providers: SFR and Bouygues Telecom.

The practice pointed out by the French government is the misrepresentation of products linked to services such as SFR Presse or LeKiosk (Bouygues), integrated into the telecom subscriptions of SFR[17] or Bouygues Telecom. These services allow customers to read many newspapers in an unlimited way. However,

17 www.lemonde.fr/actualite-medias/article/2017/07/27/tva-le-gouvernement-cible-les-pratiques-de-sfr-et-bouygues-telecom_5165487_3236.html.