

VAT Reverse Charge Procedure on Electronic Items Carousel fraud and input VAT recovery

The Government has made an application to the European Commission for a derogation from the EC 6th VAT Directive to enable it introduce a 'reverse charge' procedure for transactions between VAT-registered businesses in certain electronic goods that are commonly used in missing trader intra-Community (MITC) fraud (sometimes referred to as 'carousel fraud'). The goods concerned are mobile telephones, computer chips and some other electronic items of a similar nature.

MITC VAT fraud involves businesses that register for VAT in the UK, purchase goods free of VAT from businesses elsewhere in the EU Member States, and charge VAT on their onward sale, but then disappear without having accounted to HM Revenue & Customs (HMRC) for the output tax due. Often the same goods circulate repeatedly through chains of transactions (hence 'carousel fraud'). Losses of VAT from such fraud are estimated by the Government to be between £1.12 billion and £1.90 billion for 2004/05.

In the joined cases of *Optigen Ltd (C-354/03)*, *Fulcrum Electronics Ltd (C-355/03)* and *Bond House Systems Ltd (C-484/03)* (see previous Updates) HMRC argued that where goods move in a circle of transactions through the same chain of companies for the purpose of stealing VAT, there is no 'economic activity' as defined in EU VAT legislation, and therefore no VAT is payable or reclaimable on any of the transactions. In January the European Court of Justice (ECJ) found against the Government, concluding that the right of a taxable person to deduct input VAT cannot be affected by the fact that a prior or subsequent transaction in the chain of supply is tainted by VAT fraud, without that taxable person knowing or having any means of knowing that to be the case.

An earlier initiative to deal with this type of fraud was the implementation of joint and several liability legislation for supplies of phones, computers and accessories (s77A VATA 1994). This holds a taxpayer liable for output VAT that goes astray where the taxpayer knew, or had reasonable grounds to suspect, that VAT would go unpaid elsewhere within the supply chain. However, there is a question mark over the way in which the UK has implemented this legislation. Under s77A a person can be held jointly liable if the price paid for goods elsewhere within a supply chain is less than the open-market value or the price paid by that person, as this is taken to give a presumption of reasonable grounds for suspicion of fraud. The UK legislation would in this respect seem to be contrary to the established principles of European Community law, which require that a taxpayer should be able to determine the nature of a transaction for the purposes of VAT at the time the transaction takes place. It may be practically impossible for a trader to find out at the time a transaction takes place whether a lower price has been paid at any other point in the supply chain. This legislation has been challenged in the ECJ in a case brought by the Federation of Technological Industries (FTI), a trade body representing traders in the mobile phone and computer industries. This case has not yet been concluded, but the Advocate General (whose opinion is given to assist the judges, but is not binding on them) supported the view of HMRC that the powers to impose joint and several liability were wide-ranging and could apply to persons wholly unconnected with the supplier.

The application for a derogation so that a reverse charge procedure can be employed thus represents a third initiative in the fight against this type of fraud. Under a reverse charge procedure suppliers of goods do not account for VAT on sales made to other VAT-registered businesses. Instead the purchaser must account for the VAT (but can recover it as input tax, as appropriate, in the normal way). In this way HMRC is never put in the position where it is making repayments of input VAT to a purchaser while the seller has not accounted for VAT. Clearly, such measures would apply to all traders dealing in the affected goods, and not simply to those suspected of fraud.

The granting of a derogation in response to this request is by no means a foregone conclusion. The Government has stated that it 'will bring forward domestic legislation to ensure that [it is] able to implement the change as soon as possible' (HMRC press release of 26 January 2006). This suggests that legislation may be put in place in advance of the derogation being granted, but not implemented until the EU measure takes effect.