

Recovery of VAT where fraud has occurred in the supply chain

(Optigen Ltd - C-354/03, Fulcrum Electronics Ltd - C-355/03 and Bond House Systems Ltd - C-484/03)

*In a significant development, the European Court of Justice (ECJ) has ruled that **companies unwittingly party to carousel fraud are entitled to reimbursement of input VAT**. Businesses that have had VAT repayments withheld by HMRC as a result of suspected VAT fraud in the supply chain should seek immediate payment of such amounts as a result of this decision. Businesses that have suffered financial hardship as a result of the failure of HMRC to repay VAT may also wish to consider action in order to seek recompense for this situation.*

Background

The case concerns the ability of businesses that are innocent parties in a series of transactions designed to commit VAT fraud (commonly referred to as 'carousel fraud') to recover VAT on purchases.

Example of a carousel

1. X, a business established on Member State A, sells goods to Y, a business established in Member State B. Y provides a VAT registration number in Member State B and therefore X can zero-rate its sale as the goods are dispatched cross border. X can also deduct the VAT charged to it on the initial purchase of the goods sold to Y.
2. Y sells the goods to Z, a business established in the same Member State. Y should account for VAT on the initial acquisition of the goods and account for VAT on the domestic sale to Z, while at the same time deducting the VAT on acquisition because the VAT is incurred in acquiring the goods supplied to Z as a taxable supply.
3. Z then sells the goods back to X and deducts the VAT charged by Y while zero-rating its sale to X because it is a despatch to a business in another Member State.

In carousel fraud, Y simply does not account for the output tax due, resulting in an outright tax loss, because Z will have obtained an input VAT credit but the tax authorities will not have received the output VAT due from Y.

In the instant cases, despite acknowledging that the Appellants were innocent parties and not knowingly involved in fraudulent activities, HMRC refused to make payment of the input VAT due, on the grounds that the transactions on which the VAT had been charged formed part of a carousel fraud.

The Appellants appealed HMRC's decision to the VAT & Duties Tribunal. The Tribunal found in favour of HMRC.

The Appellants made a further appeal to the High Court, which in turn referred the proceedings to the European Court of Justice.

The UK made three main submissions to the ECJ:

- The transactions cannot qualify as economic activities because they are not genuine economic activities since the whole purpose of the transactions was to misappropriate money rather than release goods into the market for consumption;
- The purpose of the transactions must be considered because the transactions would not have taken place but for the intention of one party to commit fraud;
- Previous decisions showed that certain unlawful activities were outside the VAT net - carousel fraud was one of them.

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The Court answered the questions referred as follows:

"Transactions such as those at issue in the main proceedings, which are not themselves vitiated by value added tax fraud, constitute supplies of goods or services effected by a taxable person acting as such and an economic activity within the meaning of Articles 2(1), 4 and 5(1) of Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment, as amended by Council Directive 95/7/EC of 10 April 1995, where they fulfil the objective criteria on which the definitions of those terms are based, regardless of the intention of a trader other than the taxable person concerned involved in the same chain of supply and/or the possible fraudulent nature of another transaction in the chain, prior or subsequent to the transaction carried out by that taxable person, of which that taxable person had no knowledge and no means of knowledge. The right to deduct input value added tax of a taxable person who 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 value added tax fraud, without that taxable person knowing or having any means of knowing."

The ECJ has determined that each transaction in a supply chain should be considered individually and on its own merits when assessing the right of a taxpayer to deduct VAT. As a result, businesses that have acted in good faith should not be deprived of the right to recover VAT as a result of the fraudulent activities of other parties to that supply chain.

Businesses that have had VAT repayments withheld by HMRC as a result of suspected VAT fraud in the supply chain should seek immediate payment of such amounts as a result of this decision. They should also ensure that they take appropriate steps in order to demonstrate that they have no knowledge of, or could not have known about, VAT fraud occurring in a supply chain. Businesses that are unable to demonstrate this may still find that VAT repayments are delayed or withheld by HMRC.

Businesses that have suffered financial hardship as a result of the failure of HMRC to repay VAT may also wish to consider action in order to seek recompense for this situation.

It should also be borne in mind that in a separate case currently before the ECJ (*Commissioners of Customs & Excise, Attorney General v Federation of Technological Industries- C-384/04*) 53 traders in mobile phones and computer processing units and their trade body, the Federation of Technological Industries, are claiming that security measures, including joint and several liability, introduced by the UK in an attempt to counter missing trader fraud are not authorised by Community law and are incompatible with the European Convention on Human Rights. The Advocate General gave his Opinion in this case on 7 December 2005 and suggested that a Member State can introduce joint and several liability but only subject to the principles of Community law and subject to the taxable person knowing or having ought to known that VAT would go missing from the supply chain. If the ECJ when giving judgment follows the Advocate General's Opinion, the provisions contained within paragraph 4 of Schedule 11 VAT Act 1994 concerning HMRC's powers to require security as a condition of making payment of a VAT credit or to require security in certain circumstances, will not be authorised by EU law. For innocent businesses taking reasonable steps to ensure that the supply chains in which they deal are legitimate, the removal of any security obligations should be a significant assistance to their businesses.

The ECJ judgment in the instant case, coupled with the AG's Opinion in the FTI case, may mean that HMRC and the UK government will have to adapt their strategy in dealing with the problem of 'missing trader fraud'.

Further implications of decision

The Optigen judgment may also provide guidance on the forthcoming decision of the European Court of Justice in the Halifax case, which also considers whether a transaction chain should be considered in its entirety or whether each transaction should be considered on its individual merits.

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