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## Multinationals and VAT Compliance in the UK

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# Multinationals and VAT Compliance in the UK

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Several recent developments should cause multinationals to review their VAT compliance obligations in the UK. These developments include the imposition of additional compliance requirements that should be observed by multinationals to avoid being penalised for unknowing participation in “carousel fraud”. Those conceiving this type of fraud may exploit the credibility of multinationals to give effect to the fraud. This article discusses carousel fraud in the context of: (i) two recent European Court of Justice (the “ECJ”) cases, (ii) the changes to UK law (and certain ECJ challenges to UK law), and (iii) the current practice of HM Revenue & Customs (the “UK tax authority”). The article then summarises VAT-related compliance obligations for multinationals operating within the UK.

## I. Carousel Fraud

In its simplest form a carousel fraud involves three businesses in two EC Member States:

Company A in one Member State (say Belgium) sells taxable goods to Company B in another Member State (say the UK). Company A does not charge VAT on that supply if Company B is a taxable person in another EC jurisdiction and has supplied Company A with its VAT registration number.<sup>1</sup> Company B must account for VAT to the UK tax authority, but Company B is also entitled to claim credit for the tax simultaneously and therefore does not have to pay any amount when it acquires the goods.<sup>2</sup> Company B then sells the goods to Company C (in the same jurisdiction), charging VAT at a rate of 17.5 percent, the rate for a standard rated supply in the UK. Company B must account for the VAT it has received from Company C, but Company B “goes missing” without doing so. Company C then sells the taxable goods to Company A (*i.e.* the original seller based in Belgium). Company C has no obligation to charge VAT on the same basis as the supply from Company A to Company B—the goods would then circulate around the same group again (which is why this type of fraud is known as “carousel fraud”). Company C then claims credit for VAT it has paid to Company B.<sup>3</sup> The UK tax authority loses out because it pays or owes Company C a credit, but it never receives any VAT from Company B.

In practice, this type of fraud typically involves longer and complex chains which, more often than not, involve trade in mobile phones and computer processing units. These chains may include the export of goods from one EC Member State and the import of the goods into another to thwart the EC tax authorities’ information-sharing drive. Innocent parties are interposed in the middle of these chains to conceal the fraud<sup>4</sup>

and give the transactions superficial credibility. This is what poses the greatest risk to multinationals.

## II. Recent ECJ Cases

Two recent ECJ cases involving carousel fraud provide insight into current law and practice with respect to VAT.

*Optigen Limited v Commissioners of Customs and Excise, Fulcrum Electronics Ltd v Commissioners of Customs and Excise and Bond House Systems Limited v Commissioners of Customs and Excise* (Joined Cases C-354/03, C-355/03 and C-484/03) (“*Optigen Limited*”), involved buying computer processing units from businesses in the UK and then selling them to purchasers in another EC Member State. The UK tax authority had refused VAT refund claims by these companies, asserting that their purchases were part of a chain of transactions involving a trader not discharging its VAT liability or using a “hijacked” VAT number belonging to someone else.

*Optigen Limited* involved innocent third parties whose claims for credit for VAT were denied by the UK tax authority on the basis that the transactions were part of a supply chain where another transaction was fraudulent. The UK tax authority determined that such transactions were devoid of economic activity (and thus the amounts paid were technically not “VAT”) and therefore contended that these claims should be denied credit for “VAT” paid, even though the tax authority recognised that the claimants were neither involved in the fraud nor were aware of it. The ECJ, however, disagreed with the UK authority and held that each transaction in the chain had to be analysed independently. If such a transaction satisfied the usual objective criteria for a taxable supply ((i) it is a supply of goods or a supply services; (ii) it is effected for consideration; (iii) it is made by a taxable person in the course of its business; (iv) it is made within the territory in which the person is registered; and (v) it is not an exempt supply), it would still be within the scope of VAT “regardless of the intention of a trader other than the taxable person concerned ... and/or the possible fraudulent nature of another transaction in the chain ... of which that taxable person had no knowledge or no means of knowledge”.<sup>5</sup> The Court also held that the right to claim credit for the VAT incurred could not be affected by the fact that, without knowledge of the taxable person, there was fraud in the chain of supply.<sup>6</sup>

The second ECJ judgement is the joined cases of *Kittel v Belgium* and *Belgium v Recolta Recycling SPRL* (Joined Cases C-439/04 and C440/04). The former involved Ang Computime Belgium (“Computime”), which bought and re-sold computer components—the claimant was Computimes Receiver. The Belgian tax authority decided that Computime had knowingly participated in carousel fraud and that supplies made to Computime were fictitious. It therefore refused to allow

Computime to deduct VAT paid on those supplies. The latter case involved Recolta Recycling SPRL (“Recolta”), which bought and sold luxury cars. Recolta paid VAT on the purchase of the cars, but the seller did not account for the VAT it had received. Recolta resold the cars free of VAT because the cars were exported. An investigation showed that Recolta’s seller, and the person that subsequently bought them, had set up a VAT fraud in which Recolta was the intermediary. The ECJ was, in summary, asked: (i) whether a taxable person who in good faith entered into a contract rendered void by fraud lost the right to deduct the VAT it had paid; and (ii) whether the answer would be different if the factor that made the contract void was the fraudulent evasion of VAT itself or the fraudulent evasion of VAT that was known to the entity claiming credit for VAT paid. Similar to the judgement in *Optigen Limited*, the Court held that, where a taxable person who did not know or could not have known that the transaction involved fraud committed by the seller, national law should not deny a taxable person credit for VAT paid.<sup>7</sup> However, where the supply was to a taxable person who knew or should have known that he or she was participating in a fraudulent transaction, the national court could refuse to allow a credit for VAT paid.<sup>8</sup>

### III. UK Legislation

The UK responded to carousel fraud by enacting two measures in the Finance Act of 2003. The first allowed the UK tax authority to require a taxable person to provide security for the VAT due from any other person in the chain of the transaction where necessary for the protection of the revenue.<sup>9</sup> The second permitted the UK tax authority to serve a notice on a taxable person rendering him jointly and severally liable for the items most commonly used in carousel fraud where that person knew or had reasonable grounds to suspect that VAT would go unpaid.<sup>10</sup> This legislation also set out presumptions for suspecting that VAT would not be paid—the price payable by the taxable person for the goods in question was either less than the lowest price that might be reasonably be expected to be payable in the open market or was less than the price payable on any previous supply of those goods. The legislation included the power to amend, by Treasury order, the type of goods to which this measure would apply so as to enable the UK to react speedily to carousel fraud using other types of goods.<sup>11</sup>

These measures were very controversial and became the subject of another 2006 ECJ case. *Customs and Excise Commissioners and another v Federation of Technological Industries and others* (Case C-384/04) involved a referral to the ECJ of the question of whether the Member States were prevented from adopting such measures. The ECJ held that the measure relating to joint and several liability could be permissible.<sup>12</sup> Any such measure should, however, go no further than necessary for the protection of the revenue. The ECJ held that a Member State was permitted to make a person jointly and severally liable for VAT if, at the time of the supply, that person knew or had reasonable grounds to suspect that VAT payable would go unpaid. In making this determination, the UK tax authority could rely on presumptions. However, the presumptions could not be formulated so as to make it practically impossible or excessively difficult for a taxable person to rebut them.<sup>13</sup> Traders who took every reasonable precaution to ensure that their transactions were not part of a chain involving fraud could rely on the legality of those

transactions without the risk of joint and several liability to pay VAT due from another.<sup>14</sup> As far as the provisions relating to security were concerned, the ECJ held that the Member States could not require a person who was neither liable for the VAT nor jointly or severally liable to provide security for the VAT due from a third party.<sup>15</sup> This did not, however, prevent the Member State from legislating provisions for security where a person is jointly and severally liable.<sup>16</sup>

In the 2007 Budget delivered on March 21, 2007, the Chancellor of the Exchequer announced that the list of goods to which the joint and several liability provisions relate would be extended, effective May 1, 2007, to include satellite navigation systems and electronic equipment used for leisure, amusement or entertainment.<sup>17</sup> This 2007 Budget announcement also proposed changes in legislation to permit the rebuttable presumption for the imposition of joint and several liability to be made by Treasury order.<sup>18</sup>

The ECJ’s curbing of the two measures enacted in the Finance Act 2003 resulted in the UK tax authority applying for a derogation to change the normal rules that otherwise apply to the purchase of goods and instead apply “reverse charging” (the purchaser, rather than the seller, must account for VAT on goods). The derogation was approved at the E.U. Council’s meeting on April 16, 2007 and the Treasury order giving it effect is now in force.<sup>19</sup> As a result, buyers of mobile phones and integrated circuit devices such as microprocessors and central processing units must account for VAT on their purchases.

### IV. UK Cases

Three recent UK cases demonstrate the UK tax authority’s determination to tackle carousel fraud using remedies not otherwise common in UK tax cases. In the High Court’s decision in *Fresh ‘N’ Clean (Wales) Ltd v Miah and others* 2006 EWHC 903 (Ch), the UK tax authority had appointed provisional liquidators (on the basis of unsatisfied VAT liability stemming from carousel fraud) to wind-up Fresh ‘N’ Clean (Wales) Limited. The liquidators commenced action against the director and the principal trading partner of the company. Finding that the director had breached his duties to the company, and the trading partner and its director had dishonestly assisted the director, the Court granted judgement allowing for the recovery of the unsatisfied liability.

In another High Court decision,<sup>20</sup> the UK tax authority obtained court orders restraining the director of the company—asserted to be the missing trader in a carousel fraud—and two directors of the principal trading partner of that company from dealing with any of their assets to prevent their dissipation. While this judgement is unusual and is likely to be restricted to its facts, it demonstrates the length to which the UK tax authority is prepared to go when dealing with carousel fraud.

In *Total Networks SL v Customs and Excise Commissioners* 2007 EWCA Civ 39, Total Networks SL (a company incorporated in Spain) was alleged to have been part of a carousel fraud resulting in non-payment of UK VAT. Because Total Networks SL was not trading in the UK, it was not subject to the UK VAT regime, and, therefore, the UK tax authority could not bring a claim against it. Instead, the UK tax authority commenced a tort action against Total Networks SL for conspiracy to cheat the public revenue. On the preliminary question of whether there is such a cause of action, the Court of Appeal sided with the taxpayer, but only because it was

bound by its earlier decision<sup>21</sup> where it had held, *inter alia*, that, in order to permit a suit for conspiracy based on a tort, the conspirator had to be subject to an action for the underlying tort. Because the remaining alleged conspirators were in the UK and subject to the VAT regime, the remedies under that regime displaced tort-based remedies. The Court stated, however, that, in the absence of the earlier decision, the claim could have proceeded if there had been an intention to cause loss to the UK tax authority.<sup>22</sup> We expect the UK tax authority to appeal.

## V. Compliance Consequences

Where a multinational knows or should know that there is, will be, or has been a VAT fraud in the chain of supply, it cannot reclaim VAT it has paid. The courts will ask objective questions to determine connection with the fraud: did the person take the precautions expected of a reasonable businessman? Would a reasonable businessman have known that the relevant transactions were connected to fraud? If so, VAT will not be able to be reclaimed.

What a business has to do to protect itself from an adverse finding depends on the industry. The following are indications of carousel fraud, and failure to have systems in place to spot them may be regarded by the UK tax authority as “means of knowing” that fraud is involved, and credit for the VAT may be denied or notice for joint and several liability may be served:<sup>23</sup>

- the goods acquired cost less than the lowest price that might reasonably be expected to be paid for them;
- the goods were acquired for a price less than the price payable on any previous supply of the goods;
- commercial checks on the creditworthiness and status which are good commercial practice for the sector suggest any reason to doubt the representations made;
- the goods are being supplied by a new company in the market place which undercuts established suppliers;
- the contacts at the supplier have poor knowledge of the market and the goods;
- the goods are acquired after unsolicited approaches from an organisation with little or no history in the market, and the seller offers a guaranteed profit on high-value deals;
- the offer includes repeat deals at the same or a lower price and small or consistent profit irrespective of the quantities purchased;
- the offer is accompanied by an unsecured loan with unrealistic interest rates and/or terms;
- instructions are given to pay less than the full invoice price to the supplier; and
- instructions are given to make significant payments to third parties or to entities based offshore.

In practice, screening for these conditions places an additional burden on businesses, especially those trading with many different lines of goods, because documentary evidence needs to be retained to demonstrate the lowest market prices for each line of goods. Of course, this is in addition to the statutory duty to retain VAT invoices received and copies of VAT invoices issued. Particular attention also should be given to preserving evidence if the price of goods acquired is falling or falls. This is of great concern to businesses where the purchasing function is completely independent of the tax compliance function.

Commercial good practices—checking the creditworthiness of suppliers and buyer as well as monitoring for signs of fraud in a sector—may effectively become mandatory on the threat of loss of VAT credit or repayment. Furthermore, new entrants in particular sectors who are prepared to sell their goods at a loss in the initial stages to win market share may face credibility concerns.

For goods subject to the derogation (*i.e.* mobile phones and integrated circuit devices such as microprocessors and central processing units), reverse charging will apply so that a taxable person who acquires those goods will be required to account for the VAT due to the UK tax authority, not the supplier. The effect of these changes is that no VAT would be paid by the purchaser (Company C in the example set out at the outset) to the supplier (Company B), thus eliminating the risk of loss to the UK tax authority as a result of the supplier “going missing”.

## VI. Conclusion

Multinationals must increase their vigilance generally and improve communications between the tax compliance function and other parts of their businesses—credit, purchasing, sales—to reduce the potential exposure to carousel fraud. Reverse charging is a favourable development for multinationals who have had to battle with the UK tax authority for the repayment of VAT on such goods, but it may impose an additional compliance burden, and it is a limited solution benefiting only those who trade in mobile phones and integrated circuit devices. There is a risk that fraud will scatter to other goods not currently subject to reverse charging, ensnaring another set of innocent third parties.<sup>24</sup> And although there may be warnings regarding potential joint and several liability, which requires a Treasury order, denial of credit for VAT paid by a multinational may come out of the blue.

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- 1 Belgian VAT Code Art 39bis, 1&deg;
- 2 Sections 25(2) and 26 of the Value Added Tax Act 1994
- 3 *Ibid.*
- 4 See also the High Court decision in *R (on the application of Just Fabulous (UK) Limited v Revenue and Customs Commissioners* 2007 EWHC 521 (Admin) where contra-trading was adopted as a means of concealing the fraud. Contra-trading involves an interposed loop in the chain—goods are exported but no claim for the repayment for the VAT paid is made—instead other goods are imported and then sold and VAT collected on that sale is offset against the VAT paid in the initial transaction.
- 5 Para 51 of the judgement.
- 6 Para 52 of the judgement.
- 7 Para 52 of the judgement.
- 8 Para 53 of the judgement.
- 9 Section 17 of Finance Act 2003 which amended paragraphs 4(1A) and (2) of Schedule 11 of the Value Added Tax Act 1994.
- 10 Section 18 which introduced Section 77A into the Value Added Tax Act 1994.

- 11 Section 77A(9) of the Value Added Tax Act 1994. See Business Brief 10/06 dated July 20, 2006, which sets out other goods under scrutiny at that point in time, which were: (a) handheld devices for recording or playing of sound and/or images; (b) handheld computers; (c) handheld communication devices other than mobile phones; (d) positional determination devices for GPS systems; (e) games consoles with screens, or of a kind used with a television or computer; and (f) electronic storage media, which may be used in, or in connection with, any of the foregoing or computers.
- 12 Para 28 of the judgement.
- 13 Para 32 of the judgement.
- 14 Para 33 of the judgement.
- 15 Para 44 of the judgement.
- 16 Para 46 of the judgement.
- 17 BN 60 of Budget 2007 and SI 2007/939
- 18 See para 3 of BN 60 of Budget 2007 and section 97 of the Finance Bill 2007
- 19 SI 2007/1417 which came into effect on June 1, 2007
- 20 HM Revenue & Customs v Egleton and others 2006 EWHC 2313 (Ch)
- 21 *Powell v Boldaz* 39 BMLR 35
- 22 Para 67 of the judgement.
- 23 See section 77A(6) of Value Added Tax Act 1994, the leaflet issued to businesses in the mobile phones industry and VAT Information Sheet 06/07. A notice for joint and several liability can only be given to goods that fall within section 77(A)(1) of the Value Added Tax Act 1994.
- 24 The House of Lords European Union Committee, which is one of the U.K. Parliament's Select Committees, warns in its 20<sup>th</sup> Report (published on May 25, 2007) that the measures taken by the U.K. tax authority to tackle carousel fraud, described in this article under the heading U.K Legislation, do not prevent its occurrence and innocent parties still remain exposed.