COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 22.2.2008
COM(2008) 109 final

COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

on measures to change the VAT system to fight fraud

{SEC(2008) 249}

TABLE OF CONTENTS

COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

on measures to change the VAT system to fight fraud

1. BACKGROUND

The ECOFIN Council of 5 June 2007 requested the Commission to examine two more "far-reaching" measures to tackle VAT fraud:

- the taxation of intra-Community transactions, and
- the introduction of the option of applying a blanket reversal of tax liability (a general reverse-charge system).

In addition, the Council specifically asked the Commission to analyse the possibility of running a generalised reverse-charge pilot project for a limited period of time in an interested Member State.

At its meeting of 4 December 2007, the Council urged the Commission to present its findings on the work on such more far-reaching measures so that these could be debated during the first quarter of 2008. This Communication is presented by the Commission in reply to that request from the Council.

As regards the taxation of intra-Community transactions, the Council asked that the Commission first explore the possibility of taxing these transactions in the Member State of departure, and that it focus on the following aspects:

- the general effects of a clearing procedure on the budgets of Member States and specifically on principally "importing" Member States and on principally "exporting" Member States;
- a rough estimate of the additional costs for taxpayers and tax administrations caused by introducing the taxation of intra-Community supplies;
- the risk of new forms of fraud and efficiency in eliminating existing fraudulent activities;
- the allocation of responsibilities and risks between the Member State of departure, where tax is paid, and the Member State of arrival, where tax is deducted;
- competitive aspects of taxing intra-Community supplies in relation to domestic tax rules and in comparison with the current scheme.

As far as the concept of a generalised reverse charge is concerned, the Council asked the Commission to address the following aspects:

- the effects on Member States that do not apply the reverse-charge system, especially the effects on their budgets, including with regard to the competitiveness of their companies;

- the coherence and harmonisation of VAT law in the EU;

- the costs for taxpayers and administrative authorities of implementing a reverse-charge system;

- the migration of fraud cases to those Member States that do not apply a reverse-charge system;

- the risk of new forms of fraud;

- the possibility of running a pilot project for a limited period of time in an interested Member State.

2. THE AIM OF THIS COMMUNICATION

In view of the relatively short time available to the Commission, the results of the analysis are mainly based on some specific studies by a consultant, the value of which remains limited; the replies received to questionnaires sent out to tax administrations; feedback from businesses, and analysis by Commission staff. There are a number of issues that might require further and more in-depth analysis, but the initial results obtained already permit the formulation of a number of basic questions to the Council of Ministers which are necessary in order for the Commission to orientate any further work.

The more-detailed analysis is contained in the attached staff working paper. On the basis of that analysis, this Communication explains the state of play relating to the different options for changing the current VAT system, thereby taking up the points referred to the Commission by the Council, and raises the political questions which the Commission expects the Council to answer. Further work on measures to change the VAT system to fight tax fraud could only be usefully undertaken if clear and concise guidance on these questions is given and further appropriate input is received from tax administrations.

3. TAXATION OF INTRA-COMMUNITY SUPPLIES IN THE MEMBER STATE OF DEPARTURE

Since 1987, the Commission has advocated the origin principle of VAT as being the only way to ensure the creation of a real internal market. The 1987 proposal and that made in 1995 had as a starting point the harmonisation of VAT rates, or at least a very close approximation of those rates, so as to ensure that there would be no distortion in competition. However, Member States were not at that time, and are still not willing to cede their sovereignty as regards setting the level of VAT rates. Therefore, in designing a system of taxation of intra-Community supplies, the Commission has set out a system that does not require such far-reaching harmonisation. Accordingly, the concept of taxation of intra-Community supplies is

based on the principle that domestic VAT rates will continue to apply exactly as hitherto, and the only change would be to replace the exemption for intra-Community supplies by taxation at the rate of 15%. Where the Member State of arrival of the goods applies a rate of more than 15%, that additional VAT will accrue to that Member State; where the Member State of arrival of the goods applies a rate lower than 15% because of the application of one or more reduced VAT rates or the zero rate in certain Member States, the Member State of the purchaser will allow a credit to the taxable person making the intra-Community acquisition. In the same vein, the Member State of arrival will be able to collect VAT that results from any limitation applicable to the acquirer's right to deduct input VAT. In this way, distortions of competition which might otherwise arise from different national levels of VAT rates are avoided.

3.1. Results of Commission analysis

Taxation of intra-Community supplies appears to provide an adequate solution to the problems caused by Missing Trader Intra-Community (MTIC) fraud. It would however by no means solve **other types of fraud**. In fact, bringing intra-Community supplies within the scope of taxation could add opportunities for other existing fraud patterns to be used in respect of such transactions. It is, however, impossible at this stage to measure the overall expected result of a change to taxation of intra-Community supplies in the Member State of departure. Furthermore, **competitive aspects** have to be taken fully into account. While there is little reason to believe that tax differentials between a common rate of 15% and the rates currently operated by Member States would have any major impact, the potential cash-flow impacts raise some concerns. In fact, given that intra-Community supplies currently amount to €2 400 billion per annum, the amount of VAT which would have to be financed by businesses would be in the order of €360 billion, which could have various cash-flow effects that are extremely difficult to evaluate as they depend on factual circumstances, such as the relationship between supplying and acquiring businesses and the relationship between taxable persons and their tax administrations. It is impossible to generalise such individual circumstances, and they would require detailed modelling to arrive at a reliable conclusion. What is clear, however, is that taxation of intra-Community supplies would be likely to further disadvantage SMEs. This is because SMEs are already in a disadvantageous position on the domestic market when it comes to matters of pre-financing.

Other **costs for taxpayers** are dependent largely on the reporting obligations that are considered to be necessary both for the taxation of intra-Community supplies and for the essential clearing system. The Commission considers that monthly recapitulative statements both from the supplier and the acquirer should be sufficient in that respect. In this regard, the costs involved are basically that of the typical one-off cost of the change and are minor in the longer term. The change regarding the shortening of the time period covered by recapitulative statements is anyway envisaged under the current system — the Commission is in the course of presenting the relevant proposals in response to the invitation formulated by ECOFIN in June 2007 — and the extension of the reporting obligations to taxable persons acquiring goods is likely to result only in limited costs.

Costs for tax administrations appear to be quite difficult to estimate with any accuracy. The replies from Member States to the questionnaire did not offer much guidance in this respect.

For Member States, the most important issue to be considered would be likely to be the way in which the **clearing system** would function. Contrary to the position taken in 1996, the Commission would prefer microeconomic bilateral clearing based on recapitulative statements. This would give Member States room for manoeuvre to define, within common guidelines still to be drawn up, the precise way they want it to operate. The information on the recapitulative statements, which would also serve the purpose of clearing, would have to be based on invoices issued and received as the current rules regarding the taxable events associated with intra-Community transactions would not be sufficient to ensure that the declaration by the supplier, the payment of the tax, the supplier's recapitulative statement, the purchaser's recapitulative statement and the deduction by the purchaser occurred in the same time period. For consistency, the same rules would have to be applied to domestic transactions.

All Member States would be concerned by the clearing system — they would either have to pay to other Member States or receive from other Member States depending on their relative trade balance. In principle, all Member States would have to both pay and receive. According to the overall balance of trade statistics, 16 Member States would be overall "net receivers' whereas the other 11 Member States would be "net payers". For the 16 Member States, the total amount of excess of acquisitions over supplies in 2006 was of the order of €200 billion. Applying a VAT rate of 15% would mean that these Member States would be expecting to receive tax revenues of **€30 billion** from the other Member States. This should be seen in the perspective that, for the majority of Member States **the value of intra-Community supplies is between 10% and 20% of total supplies**, so Member States would, in any event, still have the guarantee that they could depend on 80% to 90% of their total VAT which would be due from their own taxable persons.

In accordance with the wishes of the Council, the Commission has not at this stage gone into intricate details of the workings of the clearing system. Nevertheless, it is clear that in order to avoid budgetary deficits, the first payment would need to be made between Member States very soon after the reference month and a "final" settlement of the balance would need to be established at other appropriate intervals of six and 12 months. What is more important at this stage is the understanding of responsibilities between Member States. A Member State would always be liable to pay the VAT shown on the recapitulative statement of the supplier to the Member State of the purchaser even if the taxable person making the supply did not pay over the tax to his Treasury. The Member State of the customer would control its taxable persons in the normal way to ensure that they had not over-deducted VAT on the intra-Community acquisitions. Applying these principles would ensure that each Member State has the incentive to correctly collect and control the VAT. Nevertheless, were there to remain differences that could not be clarified it is suggested that both Member States equally bear any shortfall so as to ensure that both have the incentive to exercise a proper control function.

3.2. Conclusion on taxation of intra-Community supplies

The analysis which the Commission was in a position to carry out within the timeframe fixed by the Council revealed that a system of taxation of intra-Community supplies has a number of positive elements. It also identified certain concerns, but none of them are of such a nature that the system should be discarded.

However, there is one major issue which in the Commission's view would need to be clarified before investing in further analysis of the system. **Politically, the most difficult issue involved would be that of making individual Member States' tax receipts dependent on transfers made by other Member States.** As its impact may amount to some 10% of the overall VAT receipts, and the overall volume represents some €30 billion at EU level, **the question which logically arises is whether Member States are prepared to enter into such a dependency.**

If the answer were yes, the Commission would be prepared to come forward with more detailed information as to the concrete working of the clearing system, and would also finalise the analyses needed concerning the particular set-up of the taxation scheme. Clearly such work would require further input from tax administrations.

Were the answer to be no, any system involving a clearing mechanism would be ruled out. In that case **only taxation of intra-Community supplies at destination would be an alternative** and the Commission would expect guidance from the Council on whether that alternative should be analysed further or not. The Commission would, however, want to indicate clearly that such an alternative would require the setting-up of a real One-Stop Scheme — which the Council and the European Parliament in any event support — and it would allow for taxation at the appropriate rate in the Member State of acquisition — a common rate of 15% for intra-Community supplies would not be necessary. In addition, there would be lower costs both for taxable persons and for tax administrations.

These are, in the Commission's view, the elements for which further guidance from the Council is necessary to determine whether the taxation of intra-Community supplies remains an option to be considered.

4. REVERSE CHARGE

4.1. Results of Commission analysis

The Commission believes that the introduction of a generalised reverse charge would substantially reduce MTIC fraud as well as other types of deduction fraud. However, it is concerned that reverse charge may end up negatively affecting Member States' revenues due to other new types of fraud.

To combat such new **types of fraud**, principally untaxed consumption and the misuse of VAT identification numbers, the system would need to be accompanied by a number of measures that would complicate the system and create new burdens for businesses and tax administrations.

Firstly, it would appear necessary to apply a **threshold** in order to limit the risk of untaxed final consumption. Such a threshold would appear to be a major complication as it would require distinctions that are not currently operated and that do not correspond to any commercial reality. It also requires a series of new definitions to make it applicable in practice and to cover all various possible situations.

Secondly, since the system would be based on making a distinction between taxable persons qualifying for making purchases under the reverse-charge system and all other persons, **new responsibilities** are imposed on the taxable persons having to operate such identification. Tax administrations would need to develop and offer the necessary tools for businesses to cope with such challenges and to provide them with the legal certainty they need when deciding on application of the normal VAT system or reverse charge. It should not be overlooked that basically all taxable persons are likely to have to apply both systems in parallel, thus provoking a great deal of complication. Moreover, the system would result in an increase in the number of refund claims made by taxable persons who would no longer be able to offset input tax on smaller acquisitions as their output would remain untaxed under reverse charge. As Member States already dedicate a disproportionate amount of their resources to checking repayment claims, it would appear that they would have to increase their human resources to ensure that the current level of control was maintained on taxable persons whose declarations show a liability. This may directly affect the efficiency of VAT as a revenue source for Member States.

Thirdly, to overcome the disappearance of the fractioned payments, **compensatory reporting obligations** would need to be introduced that allowed for basic cross-checking of the information stemming from suppliers and acquirers. Such obligations would need further refining in order to guarantee consistency in reporting with the objective of avoiding mismatches of data.

While the additional costs such a system would create for businesses are not fully known, the reporting obligations alone would represent some significant one-off costs for introduction as well as recurrent costs. It appears that the correct operation of a threshold is by far and away the most costly element of reverse charge for businesses. A recent study for the Vienna Chamber of Commerce by the Austrian Institute for SME Research indicates that the one-off costs for SMEs would vary between €12 750 and €20 000, while the on-going annual costs would amount to between €6 000 and €9 300. An earlier German study estimated the overall costs for German taxable persons at between €1.6 billion and €2 billion in the year of introduction of reverse charge and between €100 million and €200 million in on-going annual costs.

The cost for tax administrations would depend very much on the control measures they would implement. Whereas there would be gains on the one hand — as fraud related to VAT deductions would be largely reduced — there are new areas for which specific control would appear to be unavoidable. In fact under reverse charge, the bulk of the VAT would be payable by the final suppliers in the production chain who in many countries may be smaller and less trustworthy than the small number of large businesses that currently pay a large proportion of the VAT in most Member States. Clearly, the nature of the retail sector makes it more resource-intensive to control, especially with the prospect of all retailers receiving tax-free supplies. New

detailed reporting obligations on all businesses within the economy would equally require **new forms of risk management** in order to manage the new huge flow of information. The identification of taxable persons would be even more crucial than under the current system and would require additional efforts and resources. Finally, general control of all businesses needs to be maintained — not only those paying VAT — in order to avoid diversion of goods and services to the **black economy**. In their replies to the questionnaire, Member States were largely unable to give indications as to the extent of costs administrations would be likely to incur.

In the replies from Member States there was little concrete hint as to the potential effects of applying a reverse-charge system on other Member States. Responses indicate, nevertheless, that it was deemed necessary to operate a very tough control system in order to protect other Member States from adverse effects that the reverse charge could potentially create. Administrative cooperation is judged to need improvement in order to cope with such a new situation.

There is little evidence of fraud migrating to other Member States because of the introduction of specific anti-fraud measures. As such measures were traditionally sector-specific in the past there are, however, concerns that a more general measure such as the reverse charge may have different consequences.

4.2. Coherence with current VAT system

The Commission takes the view that such a fundamental change to the VAT system as a result of introducing a generalised reverse charge on an optional basis would significantly affect the coherence and harmonisation of the EU VAT system and the scope for its future development.

EU legislation is currently drafted and developed with a common framework in mind. A European Community with two fundamentally different VAT systems would necessitate consideration of both systems when drafting and discussing legislation. It would be extremely difficult to add further developments to such a dual system in order to match the evolving internal market. This is particularly important when it comes to two completely different sets of obligations. Such a biased system would put future harmonisation of VAT at major risk as Member States' interests in making improvements would differ depending on the system they apply.

It is thus important to realise that having the reverse charge on an optional basis would represent a step away from the current level of harmonisation which benefits businesses operating on the single market. The additional complications for businesses engendered by an optional reverse charge would appear to fly in the face of Community growth and jobs objectives which depend upon reducing the obligations on businesses. In particular, it would be contrary to the VAT strategy pursued so far, which aims to further simplify the operation of VAT in the single market by reducing burdens and obligations on businesses and providing them with legal certainty.

4.3. Conclusion on reverse charge

A generalised reverse-charge system would clearly be a new concept that could generate both positive and negative consequences. Independent of any final

judgement on the system, there is, however, a major problem with the concept of an optional reverse-charge system. This is because the reverse charge would be a fundamentally different system to the one currently applied. It would necessitate the definition of a second system at EU level and thus have negative consequences on operation of the internal market; it also would undermine harmonisation and possibilities for future improvement of the VAT system.

In addition, the optional character of a generalised reverse-charge system has been identified as a cost factor for businesses and as one of the main factors creating risks of new types of fraud within the EU.

The Commission therefore believes that a general reverse-charge system should either be introduced on a mandatory basis throughout the EU or be disregarded as a concept.

5. THE POSSIBILITY OF RUNNING A PILOT PROJECT FOR A LIMITED PERIOD IN AN INTERESTED MEMBER STATE

5.1. Results of Commission analysis

In the light of the above analysis, the Commission is still not convinced about the suitability of the general reverse-charge model as a means of making the VAT system more fraud-proof. It accepts the obvious deterrent effects on MTIC fraud but is concerned about the other effects of such a change. However, it has to stress that the analysis carried out of the reverse charge is mostly a hypothetical exercise since there is no real experience available from which to draw any lessons. The analyses carried out so far would not allow a final decision to be taken, especially because of a lack of empirical evidence — no country in the world currently operates such a system. Since any further analysis would in any event face the same problem because of its hypothetical character, the Commission believes that only a pilot project in a Member State could provide a more substantive reply to the questions raised by the Council.

Nevertheless, it must be underlined that the purpose of the pilot project would be to test the introduction of an **obligatory general reverse charge**, as it could not be envisaged, for internal market reasons and because of the *de facto* abolition of the common VAT system, to permit only a few Member States to introduce such a change to the VAT system.

A pilot would have to be organised in such a way as to offer the best opportunity to increase the knowledge about how a reverse charge works, while at same time not exposing either the Member State volunteering nor any other Member State to major risks.

In this regard it is important that the Member State volunteering is an economy large enough to be representative but not of such overwhelming importance as to impact on intra-Community trade.

A pilot would by definition run over a certain period of time. Such time should be sufficient to obtain the necessary results and not make the costs for taxable persons

of changing to the reverse-charge system and the eventual cost of changing back to the classical VAT system disproportionate. The pilot should as a result demonstrate:

- To what extent the reverse charge really succeeds in limiting and reducing existing fraud — this would need to be appreciated both in terms of the overall reduction of the VAT gap due to fraud and in respect of the types of fraud that are being reduced.

- To what extent new types of fraud are a real danger and what are the most promising measures to counter such risk — there would need to be continuous assessment of the development of different types of fraud and the measures of control implemented to limit it, with it being clearly understood that these should not be measures that already show promise of combating fraud under the current system.

- The costs to businesses and tax administrations of implementing and operating the system and whether these costs would be proportionate to any benefit received by the Treasury.

Clearly, the exercise would need to be accompanied by a monitoring scheme that would make the whole operation transparent and provide for feedback on potential adverse effects on other Member States. In order to achieve a balance of interested parties it is suggested to create a steering group that would consist of the volunteering country, the Commission and at least the neighbouring Member States.

In the Commission's opinion, the pilot should run for at least five years as statistical material to measure its effects would in any event only be available after three years. An even longer period might be considered as fraudsters may be hesitant to develop new fraud patterns knowing that the pilot would only run for a very limited period.

The Commission is prepared to work out, together with all the delegations in Working Party No 1, the necessary details needed to apply a generalised reverse charge for a trial period. Based on such work the Commission could then come forward with the relevant legislative proposal.

5.2. Conclusion on pilot project

Reverse charge is a concept that cannot and should not be ruled out at this stage as it offers a number of undisputed advantages. However, it is a system that is so different to the one operating now that it could never be introduced on an optional basis without harming the objective of the smooth functioning of the internal market. As a decision on its introduction is premature in the absence of any empirical evidence concerning such a system, **the Council is asked to:**

- **consider whether a pilot project should be envisaged to establish whether or not a reverse charge would be an appropriate response to tackle VAT fraud, and**

- **confirm, should such a pilot be envisaged, that the Commission should proceed with the preparatory work to allow a volunteering country to start a pilot project on the basis of the conditions outlined in this Communication.**