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TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

VAT Collection and Control Procedures
applied in the Member States

Third Commission Report
[Article 12 of Regulation (EEC, Euratom) No 1553/89]

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1. INTRODUCTION

Article 12(3) of Regulation (EEC) No 1553/89¹ states that "the Commission shall produce a report every three years on the procedures applied in the Member States and on any improvements contemplated".

This report is the third one produced by the Commission: the first was published in 1992 and the second in 1995.²

In recent years, the various authorities which deal with VAT management procedures have focused their attention in particular on the problems connected with the activities of controlling and combating fraud.

The interests at stake are very important: VAT is the main source of revenue for the Community budget, although its relative share is falling steadily. It also represents one of the most important sources of revenue for the Member States. It was already stressed in the second report that a revenue shortfall and, therefore, a shortfall of the VAT resource, had to be offset by an additional call on the GNP resource, thus altering the relative shares of the VAT and the GNP resources. The additional call on the GNP resource is financed by all the Member States. Lack of efficiency in collecting VAT in just one Member State has an impact on the other Member States.

The Member States and the Commission are therefore obliged to pay close attention to the development of fraud, and to promote measures to improve and enhance the prevention of and the fight against tax fraud.

No categorical conclusions can be drawn on tax fraud - in particular in terms of quantity - but the information available does nevertheless give some clue as to the scale and importance of fraud, and indicates certain general principles for combating it.

After a brief survey of the basic features of VAT fraud today, the report summarises the experiences and the basic principles underlying control systems and describes how they are moving towards finding solutions which will improve and enhance the methods of combating a problem which attacks the very integrity of the VAT system at Community and national levels.

In dealing with the VAT collection and control procedures applied in the Member States, this report takes account of a wide range of work and activities which have been carried out by various bodies.

¹ Council Regulation (EEC, Euratom) No 1553/89 of 29 May 1989, OJ L 155 pp 9-13, 7.12.1989.

² The first report (SEC(92)280 final) was produced in February 1992; the second (COM(95)354 final) was published in July 1995.

Of these activities, the main sources for drafting this report have been:

1. the VAT seminars organised by the Commission³ in response to the Second Article 12 Report recommendations on setting up special programmes to tackle the most relevant risks; their conclusions are given in detail in the specific working document;
2. the work of the Committees provided for by Regulation (EEC) No 219/92⁴ (SCAC and SCAF);
3. the seminars organised under the Matthaëus Tax programme.⁵

2. FRAUD AND IRREGULARITIES

Any reference to combating fraud implies that at least basic information is available concerning the problem facing the national supervisory services. But, in the case of tax fraud, it is first necessary to clarify the coverage of the word "fraud", mainly because of the different definitions used in the Member States⁶ and difficulties of a linguistic nature (one example will suffice: "evasion" in English indicates illegal non-payment of tax, whereas "évasion" in French corresponds to "avoidance" in English).

In this report, fraud means any activity which, in direct breach of the law or through unlawful abuse of such standards, leads to a deliberate evasion of proper compliance with tax obligations, and consequently, to the non-taxation of any taxable amount and/or to non-payment of tax.

Since tax systems are generally based on a number of obligations (registration of the taxable person, keeping of accounts, invoicing, returns, etc.), the main purpose of which is to prevent fraudulent behaviour (potential or probable), the form and content of tax fraud differs and its seriousness varies widely, from the simple failure to comply with formal obligations to criminal acts of "suppression", forgery, concealment, etc.

³ "VAT control and audit procedures in high risk sectors" (construction, retail trade, hotels, restaurants, cafés), Helsinki, 8 and 9 June 1995; "Control and audit problems in the car sector", Brussels, 11 and 12 December 1995; "VAT collection and control of phoenix companies, shadow companies, and companies involved in the use of contrived insolvencies", Vienna, 13 and 14 June 1996.

⁴ Council Regulation (EEC) No 218/92 of 27 January 1992, OJ L 24, 1 February 1992. Article 10(1) provides that the Commission shall be assisted by a Standing Committee on Administrative Cooperation in the field of Indirect Taxation (SCAC) within which an "Anti-Fraud Sub-Committee" (SCAF) has been established to deal more directly with questions connected with tax fraud and the fight against such fraud.

⁵ In particular the following Matthaëus Tax seminars:
"VAT control and the textile sector", Crawley, United Kingdom, October 1995;
"Computer audit for VAT control", Malmö, Sweden, February 1996;
"Invoice control and invoice-related fraud", Madrid, Spain, December 1996;
"Planning VAT control and audit", Luxembourg, September 1997.

⁶ See Annex 16 to the Second Article 12 Report.

Leaving aside cases of petty irregularities or errors (which nevertheless, taken together, can generate substantial tax losses for the Treasury), the following paragraphs concentrate on the activities which are designed to obtain an improper tax advantage (by the unlawful diminution of the taxable amount).

Because of the way VAT actually works, we find that fraud is generally aimed at reducing or suppressing the tax owed on sales and/or at increasing or creating a deductible tax on purchases, so as to “distort” the final (debit or credit) tax balance.

2.1 Fraud types

The methods of achieving fraudulent results may be fairly simple, e.g. the non-invoicing of sales or the deduction of non-deductible purchases, but may also be the result of more complex activities (creation of false tax subjects, abuse of special taxation schemes, abuse of the rules of international trade, etc.), or may even involve several taxable persons, as in cases of “carousel” frauds.

According to the information available, in particular the study carried out by the Anti-Fraud Sub-Committee (SCAF),⁷ the following points can be made about VAT fraud:

1. The principles underlying the transitional arrangements (in particular the exempt movement of goods in intra-Community trade) have facilitated or increased certain types of fraud. The three special sets of arrangements under which tax is levied at the place of destination (new cars, distance sales, purchases by non-taxable legal persons and exempt taxable persons) are also complex and difficult to monitor; this opens the way for abuse or types of fraud which did not previously exist.
2. the most frequent types of fraud are the “suppression” of output tax and the abuse of deduction rules, in their simplest and most direct forms (in the SCAF study they account for 57% of the sample concerned). On the sales side, this fraud is represented by failure to issue invoices, no registration of sales, non-payment of the invoiced VAT; on the purchases side, the most frequent fraud is deduction without any evidence of an invoice (increase in the deductible VAT declared) and deduction by use of falsified invoices; the latter fraud uses a wide range of mechanisms, with fraudsters continually seeking new control-proof systems: falsified invoices of true companies (copies, composite photographs, etc.), creation of invoices from non-existent suppliers and for fictitious goods, creation of invoices from genuine suppliers who know nothing about the transaction, double use of the same invoices appropriately amended, etc.;
3. the types of fraud which generate the highest amounts of evaded tax for each case are those which are referred to in this report as “*major organised fraud*” i.e.:

⁷ The SCAF has, *inter alia*, carried out a full study on VAT fraud in Europe. It covers 479 fraud cases (chosen by the Member States from among the most important in terms of amounts evaded and fraud mechanisms) representing in total evaded tax of ECU 573 million. The examination of these cases is particularly detailed and it is based on several parameters (information on the taxable person, fraud types and mechanisms, detection method, cooperation, etc.) which give a significant overview.

- (a) the creation of bogus companies or entities (which are known by a variety of names⁸) with the sole aim of evading the tax due by means of a variety of mechanisms (creation of new companies which operate lawfully but which disappear before the first date for submitting returns and paying the tax, or after obtaining refunds on the basis of fictitious activities or false documents, the disposal of assets before contriving insolvency to escape the payment of taxes, the creation of customers/suppliers to simulate transactions, etc.); such false tax subjects are found at both domestic and international level;
- (b) “carousel” fraud, in which commercial transactions are carried out by a chain of companies (real or fictitious) with a view to obtaining, for each company involved, a number of improper VAT advantages (improper deduction or refund) and, at the same time, covering the tracks of goods (real or fictitious) which are finally declared for export but which in reality are sold on the black market. These types of fraud are connected with international and intra-Community trade for two main reasons:
 - (i) the system of taxation at destination enables fraudsters to take advantage of the exemption from VAT for intra-Community supplies or for exports;
 - (ii) the greater difficulties of the tax administrations in detecting fraudulent schemes “organised” abroad.

4. some of the other most frequent types of fraud are:

- (a) failure to register (the administration is unaware of the activity conducted and it therefore forms part of the underground economy);
- (b) application of the wrong VAT rates;
- (c) the abuse of intra-Community and import/export rules;
- (d) contrived insolvencies (a company disposes of its assets before going into insolvency to escape payment of VAT due).

5. limited to the sample studied by the SCAF, other interesting inferences, in particular for control and risk analysis (see Chapter 3), can be drawn;

- (a) a very small percentage of traders were totally unknown to the tax authorities (traders not identified for VAT) at the time when the fraud was detected;
- (b) the (voluntary) deregistration of taxable persons is often close to the year of fraud;
- (c) almost half the taxable persons involved in carousel fraud or fictitious companies were registered after 1992;
- (d) most of the taxable persons had less than 5 employees and 20% were sole traders.

⁸ A variety of names are used to describe this type of company which is created for fraudulent ends but which at the same time has to look like a normal company: phoenix companies, front companies, ghost companies, taxi companies, dormant companies, filter companies, letter-box companies, etc.

2.2 The risk sectors

Since fraud is an activity which is continually adapting to the different situations in which it operates and which always tries to take advantage of new ones, it appears in many guises. Fraud mechanisms change and adapt in response to several factors, such as the sector involved (construction, clothing and textiles, motor car sales, hotels/restaurants/cafes), the type of activity (production, retailing or wholesaling, services, large-scale distributive trades, etc.), and the legal designation and nature of the taxable person.⁹ Nevertheless, it is possible to identify certain sectors which seem to be more exposed to the risk of fraud.

The construction industry is considered to be a high-risk sector, because of its size and the mobility of traders, which make it difficult to control. One of the main features of the construction industry, which includes the maintenance of property and all other activities complementary to construction, is the failure to register and the suppression of the tax on supplies of goods and services, in particular by individual small or micro firms whose customers are private individuals. Three methods have been developed to camouflage receipts and undeclared turnover:

- work “in the black” which is attractive to customers who are not taxable persons because of the price discount offered (generally tempting for customers who in any case are not entitled to apply for VAT refunds);
- manipulation by means of subcontractors (including falsified invoices for fictitious transactions, non-itemised or non-transparent invoices, use of subcontractors by non-resident companies without registering for VAT);
- manipulation by means of the equipment used and the prices charged (e.g. discounts on purchases not recorded in the accounts, fictitious inventories, claims and thefts).

The non-declaration of sales and the suppression of the corresponding VAT is frequent throughout the retail trade, in which there are a large number of traders, a huge number of small transactions, cash payments, and customers who are particularly sensitive to the final price, irrespective of the VAT. But the situation is not the same throughout the category: distinctions have to be drawn on the basis, for example, of the vendor’s sales structure (large stores or small shops) or the type of goods (goods for which the purchasers ask for the sale to be recorded or for a supporting document for non-tax reasons, such as being eligible for the guarantee).

A widespread fraud in the retail trade consists of the manipulation of rates: this type of fraud is particularly pronounced in the “HORECA” sector (HOTels, REstaurants, CAfes), especially in the Member States which apply different rates for supplies of goods (take away meals) and supplies of services (meals consumed in situ). The failure to keep accounts in particular concerns itinerant traders, seasonal trade and the trade in second-hand cars.

The wholesale trade is particularly exposed to “major organised fraud” (false tax subjects, carousel fraud, etc.) because its purpose is to provide goods which are “tax-free” and consequently at more competitive prices on the market. These frauds are sometimes on a very large scale and can even cause real distortions of

⁹ The decision-making process of an individual firm differs from that of a public limited company which has management and supervisory departments within its structure).

competition. Some very important cases at Community level have been detected in the following sectors: wholesaling of meat and live animals, textiles, portable telephones, audio-visual equipment and motor vehicles, and electronic components, which are very high value added, easily transportable goods.

Motor car sales are particularly vulnerable to fraud. The differences between VAT rates and prices on the national markets, and the relatively high level of the investment for purchasers, make it worthwhile for fraudsters to devise schemes with the aim of shifting the place of taxation. The sector is also affected by serious carousel fraud (three refunds of VAT on the same vehicle can be enough to cover its total cost).

3. CONTROL

3.1 Background and definition

The Member States' various control systems stem from different experiences and a variety of factors such as organisation¹⁰ and administrative procedures, the legislative framework,¹¹ technical equipment, the structure of the Member States' economic and social fabric, etc.

Nevertheless the experiences of the Member States in control mean that certain general principles can be identified which should guide them in their efforts to improve the effectiveness of control methods and to adapt their procedures more closely to a rapidly evolving situation.

The activities taken into account in this report are not merely verification procedures as such (on-site inspection, investigations, etc.), but cover a broader range of earlier activities (prevention, risk analysis, planning, setting of priorities and other activities designed to increase the level of voluntary compliance), and subsequent activities (actual recovery of the adjusted tax, which is the natural corollary of control and fundamental for guaranteeing the deterrent effect, and evaluation of the performance of administrative action).

3.2 Control: a basic deterrent to fraud

The obligation to pay tax has always conflicted with the individual's interest in being able to keep as much as possible of the income and wealth produced by his work net of taxes, in an eternal opposition between the interests of taxpayers and those of the tax authorities. But today, a broadly accepted principle in relation to

¹⁰ Some Member States have integrated their VAT control functions with those of other taxes or closely aligned them on those taxes, e.g. direct taxes, taxes collected by means of assessment books, excise and customs duties. This can facilitate the detection of any VAT fraud that stems from fraud in other sectors. The administration of VAT is increasingly integrated with that of direct taxes in most Member States, as indicated in the earlier Article 12 reports.

¹¹ The current system is marked by wide differences in the application of the VAT rules in the Member States.

taxation is that the key purpose of every tax system is to promote voluntary compliance¹² with tax obligations, namely self-assessment, declaration and correct payment of the tax without first being subject to administrative control. The basic idea is the existence of an implicit "contract" under which the taxable person pays his taxes and the State provides quality services, including the efficient detection of taxable persons who do not comply with their obligations.

The decision to commit fraud can be partly but not exclusively related to the likelihood of detection,¹³ i.e. the nature and severity of sanctions. In any event, tax control, or rather the risk of a tax control, remains a fundamental deterrent in order to maintain an acceptable level of compliance with tax obligations and consequently of revenue.

If the problems of tax fraud are to be approached properly the possibility of being detected must therefore become a "virtual certainty" and control procedures must be reliable and effective (and accompanied by really fair and deterrent penalties¹⁴ and by efficient and rapid disputes procedures).

Faced with a very large population of taxable persons, a growing number of returns, and limited resources, the authorities have to select those taxable persons which are to be controlled. This involves two stages:

1. first, an acceptable rate of coverage for inspections must be decided (percentage of taxable persons inspected during the reference period). What must not be allowed to happen is for verifications to be reduced to perfunctory, purely formal controls as a result of an increase in their frequency (e.g. to inspect all taxable persons every two years).¹⁵ Such a system would sharply reduce the deterrent

¹² It must be pointed out that the recommendations which follow will not fill all the gaps in the frequently very complex mechanisms of the VAT system and that only new VAT arrangements based on the principles set out in the Commission's work programme (A common system of VAT - a programme for the single market (COM(96) 328 final)) will significantly improve voluntary compliance with obligations and the controllability of the system.

¹³ In fact, a variety of complex factors influence the non-compliance decision. For example, from an economic point of view, the amount which might possibly be involved, in the future, if this fraud were detected determines whether the immediate benefit of the fraud is acceptable. Other obstacles to voluntary compliance may be the general pressure of taxation, the complexity and fairness of the taxation system, the relations between the tax authorities and taxable persons, the weaknesses of control and sanctions, and the perception of how the public authorities use taxes.

¹⁴ The Mattheus Tax seminar "Sanctions applicable in the field of VAT", Viterbo, Italy, December 1996, stressed the role of the system of sanctions (which should be flexible, effective and proportionate) in order to encourage taxpayers to fulfil their obligations spontaneously.

¹⁵ The problem is more complex since it concerns the general principles underlying the control system and in particular the methods of control adopted. The average length of an inspection and therefore the number of them, assuming that there is no change in the resources available, is heavily influenced by whether or not they are combined with the control of direct taxes, the period taken into account (one or more years), the thoroughness of checks, the physical controls of stocks, accounting analyses, formal controls, and so on. This is why some Member States have developed flexible procedures with the aim of optimising the use of resources by tailoring the method and the thoroughness of the inspection to the particular case.

effect of the inspection, in particular as regards frauds which can be detected only by more thorough inspections;

2. Once the number of taxable persons to be controlled has been decided, it is necessary to determine those who should actually be controlled and which priority should be used. The better the choice, the more effective the control action will be: traders must be made to feel that it is “virtually certain” that the fraud will be detected. The choice is mainly influenced by risk analysis which, by defining certain tax “risk” indicators, allows the administration to target its efforts and define control priorities.

Moreover, the effectiveness of the control is not measured solely in terms of the number of taxable persons actually controlled, but also by its multiplier effect: traders who follow the rules are bound to welcome a control which restores the fairness of taxation and the conditions of fair competition, which are upset by fraud; fraudsters (and potential new fraudsters from the same sector, or the same region or town) will become more aware of the vigilance exercised by the authorities and the risk that their frauds will be detected. This explains why an accurate evaluation of the effectiveness of control should go beyond the mere sums involved in the fraud detected and attempt to take account of the deterrent effect.

Several national administrations widely publicise their control activity and in particular the results obtained.

In conclusion, the Commission feels that in the present situation all the administrations of the Member States must undertake to attain the following two objectives:

- to maximise voluntary compliance with tax obligations;
- to enhance the deterrent effect of control, which means increasing the perception that fraud is “virtually certain” to be detected; the key elements in this objective are the selection of taxable persons on the basis of risk parameters, and the multiplier effect of action which is genuinely and visibly effective and efficient.

3.3 The management of control

3.3.1 Risk analysis

The purpose of risk analysis is to determine the indicators which can improve the targeting of controls and to put them in order of priority. The Member States are making increasing use of risk analysis and of the other analytical techniques which enable them to determine in advance where fraud is most likely to be found and therefore to establish an order of priority for control activities.

This means the systematic and organised collection of all available information so as to determine the general reference framework and the risk indicators. As regards sectors, analysis is based on macroeconomic data (markets, commercial flows, imports, etc.), refined and completed by data concerning the traders in the sector (size, organisation, net worth, turnover, economic and financial situation, etc.). It is

desirable to have an overall assessment of the risks at the same level of fraud (regional, local, etc.) so as to target the use of resources in the most effective way.

The analysis can also be completed by any other information: registration, examination of tax returns, control results,¹⁶ cross-checking of tax data with that from other sources (professional associations, social security organisations), etc.

The dissemination of results to the peripheral levels and/or the inspection offices enables the detailed information available for individuals to be supplemented: as a rule, any information directly or indirectly concerning each taxable person should be collected and kept in an individual file established by that person's inspecting department.

Inspection results are certainly the most important source of information since - in particular in the case of VAT - irregularities concerning transactions are bound to have repercussions for suppliers and customers (taxable persons). Other important facts at individual level may be refund requests, the particulars on recapitulative statements of intra-Community trade, licences and administrative authorisations, newspaper announcements and publicity offers, etc.

When establishing risk elements the attention of tax inspectors is also drawn to certain points deserving special vigilance, such as:

- trading activity in high value added, easily transportable goods (electronic components), or in sectors where there is a high likelihood of carousel fraud;
- companies generating huge sales after only a short period of trading or only reduced or non-existent activity, and ceasing to trade just as suddenly;
- companies declaring a high level of sales, but without the corresponding production facilities. In this case, as in the previous one, it can be assumed that these activities are entirely bogus, but result in the issue of invoices which their clients will use to obtain an unjustified VAT deduction or refund;¹⁷
- companies managed by persons with the profile of men of straw (persons who are too young or too old, poor, with criminal records, etc.);
- origin of the possession of the company assets and "history" of the company and its directors. In this case it is necessary, for example, to check whether the company structure has emerged from another phoenix company (whose name or trade name has simply been changed) or whether directors, managers, etc. have been involved in previous fraud cases;

¹⁶ The SCAF fraud study demonstrated that a good system for recording fraud information is an essential tool which is very important for analysing the operation of the system itself, and for evaluating the reasons for fraud. The heterogeneous structure of national recording systems means that it is very difficult to obtain a general picture of the fraud situation in the Community.

¹⁷ In the two cases referred to above, the high level of company activities, although recent and conducted over a short period, may be real but stimulated by the increased competitiveness obtained throughout the commercial chain because of the improper VAT advantages (reduction in cost prices and sales prices).

- applications for large VAT repayments, in particular when the applicant is an exporter or is supplying goods within the Community.

The availability of several sources of intelligence and their exploitation by computer is of paramount importance in this area¹⁸ and most of the national administrations possess and/or are developing technical equipment and the necessary computer programmes.¹⁹ All these data have to be recorded in appropriate data banks and compared in order to determine the trends in sectors and fraud risk indicators. Some Member States have set up tax intelligence departments which collect all information possible from any available source (from the data held by government bodies to anonymous calls) and centralise it in a single department which examines, evaluates, sorts, stores and distributes it.

Some Member States have set up special information networks which concentrate on tracking traders involved in earlier frauds, information about which is widely disseminated throughout the national tax administration. One Member State has set up a system which assigns to persons previously involved in certain frauds a unique identification number under which all relevant information concerning their business and professional activities is recorded. Other data bases relate to firms which have issued or used falsified invoices, and fictitious companies created explicitly for fraudulent purposes.

The targeting of inspections on the basis of certain parameters should be supplemented by random audits. As a result, first, the validity of the criteria used would be verified and enhanced and, second, taxable persons would not feel that they were protected from inspection merely because they were “artificially” outside the risk parameters.

The Commission considers that the basic elements of a risk analysis system which can ensure the effectiveness of control are therefore:

- **the development of and rapid access to all sources of relevant information, from tax and non-tax sources, so that they can be collected, exploited and disseminated;**
- **a specialised department to analyse and refine the information;**
- **the provision to all operational and control departments of risk analysis systems and warning systems on known or suspected fraud, so that potential risk traders can be kept under rapid and permanent surveillance;**
- **the maintenance of an appropriate percentage of random audits.**

¹⁸ This need was made very clear at the joint OECD/HM Customs & Excise Conference “Information and intelligence systems in the field of indirect taxes”, Gatwick, United Kingdom, 17-19 March 1997. The SCAF study confirms the usefulness of such external intelligence: cooperation with other administrations or departments (national or foreign) for purposes of tax control was indicated in a quarter of the cases.

¹⁹ The conclusions of the Malmö Matthaeus Tax seminar leave no doubt as to the fact that computer audit techniques will become increasingly important for the detection of fraud.

3.3.2 *Ways of preventing fraud*

The Member States are devoting increasing attention to fraud prevention by the systematic collection of data which can be used to establish fraud risk evaluation indicators.

The registration of a new taxable person²⁰ is an important moment for prevention since it provides an opportunity for establishing initial contact with traders to inform them of their obligations, to collect important information for the data bases on taxable persons and to complete the risk analysis. The population of European firms is very varied and volatile because it is mainly composed of frequently changing, very small units, which require close and constant monitoring from the administrations.

Depending on the Member State, registration can give rise to systematic controls or just to information visits. Some Member States make "educational visits" to advise newly established traders of their rights and obligations, and also to assess the potential tax at risk.

In general the data recorded is electronically available and accessible to all the national offices, but the registration procedures and information requested vary widely according to the Member States, in particular as regards the amount and type of particulars.

The preventive role of registration may become crucial in cases of fraudulent schemes based on phoenix companies. In such cases, registration may help to make it more difficult to create and use this type of company. Registration can be made subject to the payment of a security, in particular in cases where the authorities have doubts as to whether activities are genuine, or a higher minimum amount of starting capital can be required; in the case of contrived bankruptcies, directors who, in the past, have wound up their companies on one or more occasions may face stricter conditions under common law for setting up a new company, such as the provision of a guarantee.

Some Member States require the provision of minimum information on their activities from inactive companies whereas other States have them deleted from the register.

The Member States who implement such measures (not always permitted by law) nevertheless stress the inherent risks they involve for the free creation of businesses and the fact that too strict a registration system would deter traders from leaving the underground economy.

A further key aspect of VAT fraud prevention is careful checking of VAT refund applications, not only in the case of new taxpayers but also for all other VAT refund claims. One Member State has developed a strategy for checking the entire chain of enterprises back to the initial phase where a substantial amount of deductible VAT is claimed. The taxpayer in question is asked to produce invoices, which are checked by computer to establish whether the traders who issued them are

²⁰ These arguments were developed and expanded at the Matthaëus Tax Seminar "Registration and deregistration" held in Athens in June 1997.

registered. If a non-registered trader is discovered, an inspection visit aimed at acquiring further information is carried out.

The Commission therefore stresses that:

- with a view to making control more effective, the registration of taxable persons is important for voluntary compliance and in order to improve prevention, and is a key element in risk analysis.
- a system of checking the chain of companies or transactions be used to detect any improper VAT refund claims.

3.4 Control and investigation methods

3.4.1 Control techniques

As a rule, the purpose of control is to check whether the tax has been accurately assessed, and whether the activity conducted corresponds to the one which has been declared. This involves a range of research on compliance with legal obligations (invoicing, deduction, registration, keeping of accounts, returns, payment, etc.) and checks on whether the accounts correspond to economic reality (verification of stocks, did the transactions recorded really exist? do they really have anything to do with the taxable person's activity? do sales match productive capacity? etc.).

Techniques may be based on internal research (monitoring of compliance with tax obligations, checking accounts, examining the conditions in which the firm is run, etc.) and external research, which is based on the use of any information available elsewhere than in the firm itself so as to be able to check whether the real activity corresponds with the one recorded in the accounts. For example, the cross-checking of invoices with customers/suppliers or with public or private bodies (see point 3.4.4.) is an external technique which is widely used because of its effectiveness in detecting falsified invoices, the abuse of the right to deduct and the suppression of the tax on sales.

The relationship between the two types of research and their content and direction depends on the situation found in each case, but first and foremost it is connected with the nature of the taxable person under examination, namely whether he is a "true taxable person" or a "false taxable person" that was created with the sole purpose of committing fraud. A concealment of activity cannot be detected just by examining accounts and returns (possibly) signed, or by internal research on a structure which is virtually non-existent. In this case inspectors are faced with a much more vague and indefinite reality (no registered office or no fixed place of business, no accounts, difficulty in finding the real people in charge/directors, etc.) which becomes more difficult to reconstruct and to verify after the event, i.e. after a lapse of time.

Tax audits have proved to be the most effective procedure for observing and really verifying the genuineness of the taxable person and for comparing this with accounting documents. It becomes indispensable to verify the actual situation directly whenever control requires the verification of stocks or flows of goods (in particular to establish the turnover of retail businesses whose takings are mainly in the form of cash). According to the experience of one Member State, the yield from documentary control is half that from tax audits, particularly in the case of VAT.

The checking of invoices is one of the priority controls: the invoice is one of the key elements in the accounts, representing the formal proof of activity and the basis underlying the accounts. A thorough analysis of this aspect²¹ shows the desirability of concentrating on forms of controlling selected invoices (on the basis of risk analysis or other criteria) instead of the systematic control of all invoices.

One Member State has experimented with a new form of control designed to monitor the degree of compliance with tax obligations by on-site observation: the business is informed of an impending control visit (but not of the exact date), and on arrival at the trader's premises the controllers collect several types of information (including data on employees) which will later be compared with that shown in the periodic returns. The likelihood of irregularities can thus be assessed and prompt action can be taken. The results obtained by this technique are reflected in the fact that such visits now comprise 10% of all visits to taxable persons.

Several Member States have developed specific VAT controls based on rapid and immediate visits; others pay prompt attention to the control of companies which trade over a short period.

Most of the Member States are making increased use of intra-Community cooperation.²² Directive 77/799/EEC on mutual assistance and Regulation (EEC) No 218/92 on cooperation offer a variety of possibilities for exchanges and information: assistance on request, spontaneous or automatic, interrogating the VIES system and "Article 5" requests (requests for information on specific transactions), and direct contacts between competent authorities or other departments delegated by the latter, in cases of bilateral interest.

In conclusion, the Commission suggests that:

- preference should be given to control procedures based on on-site observation because they have proved more effective for a full and exhaustive assessment of the activity really carried on by the taxable persons;
- control procedures should be flexible enough to adapt to the various control requirements, so that specific VAT problems can be dealt with immediately and rapidly;
- systematic and increased use be made of the opportunities provided by current legislation on administrative cooperation between Member States.

3.4.2 Sectoral approach

Some Member States have developed specific control programmes and methods based on a sectoral approach. They vary according to a number of factors, such as the sector being

²¹ Matthaeus Tax seminar, "Invoice control and invoice-related fraud", Madrid, December 1996.

²² See the Commission's first two reports pursuant to Article 14 of Regulation (EEC) No 218/92 [COM (94)262 final, of 23 June 1994 and COM(96) 681 final, 8 January 1997].

controlled, the size of the firm and the nature of the taxable person (industry, agriculture, liberal profession).

Experience shows that such an approach:

- enables inspectors to acquire a thorough knowledge of the machinery and specific features of the sector and, therefore, the latest developments and trends in fraud; the control procedures are particularly well-adapted and refined;
- makes it easier to collect specific data for risk analysis and prevention purposes and, at the same time, to check the validity of previous analyses and the results already obtained;
- enables stricter relations to be established between the representatives of the sector and the administration.

This approach enabled one Member State to uncover 30% more irregularities in the car industry in the 1994-95 period.

To assist with these measures, some Member States issue audit guides, handbooks or monographs summarising and explaining current practices in the sector which may be of interest to investigators: market trends, standard margins, *modus operandi*, specific accounting documents, output, working procedures, the percentage of wastage, etc. These guides and handbooks should be available on-line and constantly updated to include the latest developments. Some Member States organise training courses or issue newsletters to keep their control departments up-to-date.

Some very important information requiring distribution relates to the practical means of detecting certain types of fraud, e.g.:

- indicators which have made it possible to identify false invoices (poor-quality paper, vague details in addresses, telephone numbers, etc., photocopied or hand-written invoices, constant use of round figures, etc.);
- analyses of the flow of goods and cash in order to check for the incorrect application of VAT rates in the case of large retailers.

Increasing use is being made of specialist units to carry out controls on account of the specific characteristics of the taxable persons operating in these areas. Such units endeavour, in collaboration with all the departments concerned, to control the entire commercial chain concerned.

If controls on very large firms and/or multinationals are to be efficient, administrations must try to adapt their procedures to the real situation prevailing in these circles. The complexity of company structures (which are often spread out over a number of sites and in several Member States) and of their accounting and financial-control systems, their degree of computerisation, the amount of tax involved and the scale on which tax avoidance is perpetrated in addition to fraud in the strict sense of the term have led some Member States to set up special departments or programmes to monitor firms continuously.

Some Member States have developed specific techniques for detecting fraud in individual sectors, such as "*test-eating*" in the catering trade.

In the light of experience of employing the sectoral approach, the Commission calls on Member States to:

- **develop and reinforce the sectoral approach;**
- **draw up and widely distribute audit guides and handbooks;**
- **exchange details of experience in this area;**
- **develop more specialist techniques for detecting fraud, especially in the more complex sectors.**

3.4.3 Powers of control

The powers of the inspection departments, which are in principle strictly delimited in order to safeguard the rights of taxpayers, vary extremely widely from one Member State to another.

Conducting searches for accounting documents not made available is, for example, often prohibited; access to a private domicile generally requires the prior sanction of a legal authority; unannounced visits are normally authorised only if there are grounds for suspecting fraud and, in some Member States, are not allowed under any circumstances.

It is important that the national administrations should have the legal power to carry out certain control methods and, in particular, extensive controls providing them with access to subsidiary records (documentation which is not of a strictly fiscal or accounting nature) and to certain factual information and allowing them to observe operating conditions: such information, when it may be sought and used, often provides a basis for checking the accuracy of the official accounts (contracts, a diary in which table reservations or appointments with suppliers/customers are logged, records of maintenance work carried out on machinery and motor vehicles, etc.).

Estimated assessments may be made only when a firm has not produced certain documents or filed tax returns and it is then up to the firm to show that the assessment is wrong or too high.

Certain administrations may also send out questionnaires, which taxable persons are obliged to answer; copies of documents may also have to be produced. This option is often used to carry out extensive cross-checks without deploying or shifting important control resources.

The question of control powers is a very delicate matter, because it must strike the correct balance between administrations and taxpayers.

The Commission considers as priorities in this context:

- **striking the optimum balance between control requirements and the safeguarding of traders' rights;**
- **adapting control powers in such a way that they are reinforced to the extent demanded by suspicions of fraud or by the seriousness of a presumed or recorded fraud.**

3.4.4 *Investigations into organised fraud*

Where controls do not involve an actual taxable person, as is often the case with carousel frauds and fraudulent arrangements, detection of the fraud often requires complex, extensive investigations in order to reconstruct a situation which is not at all apparent.

Most Member States express concern about such practices as carousel fraud and bogus companies since they are generally planned and carried out by entire organisations whose sole purpose is tax fraud and which are often linked to fraud in other fields (direct taxation) or other kinds of criminal activity (money laundering, counterfeiting, smuggling, etc.).

The extraordinary difficulties involved in carrying out controls in this context derive mainly from the fact that:

- the bogus companies used are often established in another Member State or in a third country, which makes it more difficult to carry out controls and check on their real nature; it also enables them to benefit from exemption from VAT in the case of intra-Community supplies and exports. A classic example is the creation in another Member State or third country of fictitious taxable persons who are the declared consignees of tax-free goods which never actually leave the Member State of origin: this enables the seller to deduct the input tax paid and to acquire tax-free goods which he can resell on the black market;
- bogus companies, which are generally set up in the form of small and medium-sized enterprises or liaison offices of foreign undertakings, use the simplified tax arrangements introduced by most Member States for small businesses. As a result, they are subject to less stringent fiscal or legal obligations, which makes it more difficult for the national tax administrations to keep tabs on them.²³ This is particularly true when such companies fail to register;
- transactions are often split into a large number of smaller transactions which are not in themselves of interest in risk-analysis terms;
- finally, in addition to locating transactions in a number of different countries in turn, the commercial chains involve a large number of companies or intermediaries with an extremely short lifespan or period of actual activity.

In such a set-up, everything is designed to appear normal but, at the same time, to avoid leaving any trace: taxable persons spring up and disappear quickly, change their business name frequently, relocate within a short time, have no proper structure and keep either no accounts at all or only very sketchy and simplified accounts. A prompt and immediate clampdown on such fraudulent networks, the seizure of as much evidence as possible and identification of the real perpetrators is essential both to justify claims of back tax and for its actual recovery.

At intra-Community level, operational departments have on several occasions²⁴ argued for exchange and communication systems that are swift, direct, informal and unhampered by red tape.

²³ For example, SMEs are often subject to a **simplified tax regime** whereby declarations are less detailed and need not be submitted at such frequent intervals.

²⁴ At the following meetings among others: Helsinki, SCAF, European Conferences of VAT Inspectors, Mattheus Tax Seminars, OECD/HM C&E.

It is of paramount importance that tax administrations should have access to data held by public or private bodies²⁵ and to information collected from suppliers or customers of the firm concerned (invoices for goods purchased, contracts signed with the firm, etc.) if they are to detect concealed activities. Most Member States have, therefore, made it easier for their tax administrations to gain access to such information, which is subsequently cross-checked with the firm's tax file.

In some Member States, this data can be obtained through on-line connections to data bases.

By way of conclusion, the Commission:

- **emphasises that success in investigating these types of fraud depends on the immediate detection of the fraudulent scheme and, above all, in the prompt implementation of stricter preventive measures;**
- **in view of the international and intra-Community character of this type of fraud and in order to prevent any escalation in the situation, it calls upon the Member States to step up their cooperation in this area and to adopt the requisite measures.**

3.5 Recovery

Effective recovery procedures to ensure that the tax owed is collected are the natural corollary of controls. The Second Report dealt with the problems deriving from VAT debt management and made a number of recommendations in this connection (see Chapter 4 and 6.2(6)).

As indicated above, in cases of fraud; the administrations run the risk that the taxpayer will attempt to avoid paying his VAT debt and to remove goods which could be seized if the debt is enforced. This requires special attention and swifter intervention on the part of the administrations. This report therefore refers in particular to the obstacles encountered by Member States in enforcing VAT claims.

An elementary precondition for enforcing a claim efficiently and swiftly is that the administrations should have adequate legal powers, particularly for obtaining a distraint order. In this connection, Member States may, in general, levy a distraint on all the defaulter's goods and chattels. However, this process sometimes comes up against obstacles of a legal or practical nature (e.g. difficulty in identifying distrainable goods or in obtaining the information necessary to enforce recovery, particularly where the taxable person's distrainable liquid assets are concerned). While some Member States experience major problems in obtaining information on the existence of the taxable person's bank accounts and the money contained therein, others can obtain a distraint

²⁵ Useful information generally relates to contracts for telephone, fax and electricity supplies, car-registration, chambers of commerce, customs, public records departments, professional associations and any other data specific to individual sectors. In the case of the building industry, for example, information held by bodies responsible for issuing building permits or that contained in land or mortgage registers may prove useful.

order on the basis of agreements with the banking organisations. It should also be pointed out that the lack of harmonisation of national legislation in this area is one of the main reasons why Member States make limited use of (cross-border) mutual assistance for recovery purposes.²⁶

To be effective, enforced recovery measures must be initiated promptly. However, the Commission has noted that in many Member States fairly long periods elapse between assessment of the tax and its recovery. This is partly due to the fact that the tax demand is not normally directly enforceable on the due date if the tax is not paid and a new document must therefore be drawn up to initiate enforced recovery. If the debtor appeals against the enforcement order, the delay may be even longer.

Where recovery procedures are suspended as the result of an appeal, Member States do not always make a sufficient effort to prevent defaults on payment (e.g. by demanding securities or applying precautionary measures) by fraudsters, despite the major risk of default which they represent. Similarly, when the appeal does not succeed or is obviously unjustified, penalty interest running from the date on which the tax would normally be due and cancelling out the unwarranted financial advantage derived by the debtor is not always demanded.

Some Member States are unable to take precautionary recovery measures based on an estimate of the tax ultimately due, even in cases of tax fraud.

The cumbersome enforced recovery procedure may sometimes be avoided by offsetting the tax due against public benefits payable to the taxable person. In practice, however, this measure, though effective, is often limited to debts and claims managed by the same administration since there is no systematic exchange of information between different administrations.

Finally, where it is implemented, mutual assistance on recovery comes up against a number of difficulties, mainly as a result of the fact that only a few Member States give other Member States' claims the same priority as their own.

²⁶ See the Commission's Second Article 14 Report presented in accordance with Council Regulation 218/92 (COM(96) 681 final of 8 January 1997, p. 5). The Report identifies a whole series of obstacles to assistance in the recovery of claims: lack of harmonisation of legal or practical restrictions on distraint procedures, rules making it possible to extend the responsibility for recovering claims to the managers of debtor companies, time-limits for recovery, rules on banking secrecy, etc. Proposals aimed at remedying this unsatisfactory situation are currently being prepared by the Commission, which will shortly be proposing amendments to Council Directive 76/308/EEC on mutual assistance for the recovery of claims.

By way of conclusion, the Commission emphasises the importance of:

- **ensuring that the recovery authorities have adequate means (information, offsetting against other debts, inter-departmental cooperation, data bases, etc.) to recover the tax swiftly;**
- **organising recovery action through the thorough computerisation of procedures, so that the period that elapses between assessment of the debt and enforced recovery can be reduced;**
- **preventing defaults on the payment of VAT debts more effectively by applying precautionary measures, including precautionary recovery, by demanding securities and charging penalty interest when payment of the VAT debt has been delayed by an unjustified appeal;**
- **treating other Member States' VAT claims in the same way as domestic claims.**

4. CONCLUSIONS

Article 12 of Regulation (EEC, Euratom) No 1553/89 requires the Commission to consider with the Member States what improvements can be made to their VAT procedures to enhance their effectiveness. The Commission has to draw up a report on these improvements every three years.

This consideration of possible improvements to VAT controls has to be based on a common analysis of the problems and possible solutions. In Chapter 2, the Commission analyses the common problems facing the Member States regarding VAT controls. In Chapter 3, it sets out its view of the best way to tackle fraud, drawing on acquired understanding of the problem and combining the best practices identified by Member States and communicated to the Commission.

Many of these recommendations have already been implemented by a number of Member States. However, much work has still to be done. The Commission considers that all the Member States should examine the recommendations set out in the report, since they would enable them to improve VAT controls.

These recommendations are based on the determination to optimise compliance by taxpayers with their obligations and to prevent fraud through an effective inspection strategy based on the application of risk analysis to the selection of the taxpayers to be inspected. Such a strategy calls for immediate access to important information and for the use of appropriate and flexible controls and recovery methods designed to prevent tax fraud. Improved expertise in the fraud field, appropriate use of the powers of law enforcement authorities, and greater cooperation between Member States will be essential if fraud is to be countered. The Commission will make its contribution through programmes such as Fiscalis (e.g. by pooling experience of measures taken to combat fraud) and other committees involving the Member States (e.g. SCAF).

Over the next three years, the Commission intends to examine with the competent authorities in each Member State how the effectiveness of VAT control procedures might be improved. To that end, it will study, together with each Member State in turn, all the control procedures employed by them. The analysis and recommendations made in this report will serve as a basis for this joint assessment of potential improvements. The fourth report will set out the findings of that study.

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