EU persuaded to act to halt €100 billion carbon market fraud

VAT fraud in European carbon markets may cost tax authorities in the EU up to £100 billion per year. Although individual countries have tried to halt the fraud, European organisations say that attempt has failed and a pan-European approach is needed to stop it spreading into the electricity and gas sectors. HMRC has already warned companies trading in gas and electricity markets to make sure their due diligence is appropriate. *David Nisbet* explains how it works.

Missing trader fraud, also known as Missing Trader Intra-Community Fraud (MTIC), is an abuse of the value added tax (VAT) rules whereby fraudulent businesses interpose themselves in a supply chain trading in goods or services within the European Union (EU) in order to obtain – and disappear with – large amounts of VAT.

MTIC fraud traditionally involved the supply of high-value, low-weight goods that are easy and inexpensive to transport, such as mobile phones and computer chips. However, there is nothing, in principle, to prevent MTIC fraud involving the cross-border supply of other goods or services between businesses.

In recent years fraudsters have infiltrated the trade in EU Emissions Allowances, Certified Emissions Reductions and Emission Reduction Units (carbon credits) and the wholesale gas and electricity market.

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HM Revenue & Customs (HMRC), says MTIC fraud is the costliest form of VAT fraud facing the UK. In one instance in 2011 seven UK men were charged with a £38 million fraud and forced the EU to suspend trading in carbon markets for a week. Across the EU, estimates of the VAT lost by tax authorities as a result of MTIC fraud range up to €100billion per annum.

In addition to the considerable budget losses for members of the EU, MTIC fraud affects competition and the operation of the internal market. It is also a major concern for legitimate businesses that could unwittingly become part of a MTIC supply chain.

What is MTIC fraud? At its most basic, MTIC fraud involves a trader acquiring goods without VAT, selling the goods with VAT and then disappearing before paying the VAT to the appropriate tax authority. However, in reality, it is far more complex, with fraudsters using a number of methods to hide their tracks, including the use of numerous buffer companies within a supply chain.

There are two main types of MTIC fraud: acquisition fraud and carousel fraud. Acquisition fraud is a commodity-based fraud in which goods are purchased from a supplier based in another EU member state and sold in the UK for domestic consumption. It involves the following steps:

- Company A, based in the UK, acquires goods from its supplier in another member state free of VAT (because supplies between businesses in different member states are generally not subject to a VAT charge).

- Company A then sells the goods to a legitimate company also based in the UK, Company B, and charges VAT at the standard rate.

- Company A receives the VAT from Company B but never accounts to HMRC for the VAT and will then usually disappear, thus becoming the “missing trader".

- Company B recovers the VAT from HMRC and HMRC loses the VAT.

With a carousel fraud the goods or services do not become available in the UK for consumption, but are sold through a series of companies in the UK and then exported or dispatched, prompting a repayment from HMRC to the exporter. This process can be repeated over and over again using the same goods or commodities.

Consequences for business involved in MTIC fraud
The consequences for fraudsters convicted of involvement in MTIC include criminal proceedings. In the UK, a number of individuals involved in MTIC fraud have been convicted and received prison sentences of up to 17 years.

There are also potentially serious consequences for legitimate business that unwittingly become involved in a MTIC supply chain. For example, a business involved in the supply of certain types of electronic goods can be held joint and severally liable for the VAT lost as a result of MTIC fraud, provided that the business knew or had reasonable grounds to suspect that the VAT on the supply or on any previous or subsequent supply had been unpaid. A business will be presumed to have reasonable grounds to suspect if it has purchased goods for less than their lowest open market value or the price payable by a previous supplier in the chain.

The joint and several liability rules are only relevant to supplies of certain types of electronic equipment. But HMRC can also deny a business the right to recover input tax where it can be shown that a business knew or ought to have known it was entering into a transaction which was connected with MTIC fraud.

HMRC's ability to deny the recovery of input tax can apply to any supply (not just electronic goods).

HMRC recently issued a warning to UK energy businesses regarding the possible risk of MTIC fraud in the gas and electricity market and stressed the need for an adapted and specific due diligence process.

HMRC emphasised the importance of businesses' ensuring the integrity of their supply chains and making sufficient checks on their customers and suppliers.

MTIC fraud involving carbon credits and electricity and gas trading has shown that anti-fraud measures must be constantly undertaken and that, due to the complexity and sophistication of MTIC fraud in these sectors, a more tailored approach to VAT risk management is required.

What can businesses do? HMRC has published guidance on the types of checks that a business should carry out in order to avoid being unwittingly joint and severely liable. HMRC recommends checking:

- the legitimacy of customers or suppliers (eg their trade history);
- the commercial viability of the transaction (eg the existence of a market for the goods) and
- the viability of the goods (eg the existence and condition of the goods).

In addition, businesses should obtain copies of all relevant documents including certificates of incor-

Energy industry organisations respond to the threat

Nine associations joined to lobby the EU to ask it to make its legislative changes on VAT fraud.
The groups are
- the Council of European Energy Regulators,
- the European Association of CCP Clearing Houses,
- the European Federation of Energy Traders,
- the European Network of Transmission Operators for Electricity,
- the European Network of Transmission Operators for Gas,
- Eurelectric,
- Eurogas,
- the Association of European Energy Exchanges
- the London Energy Brokers Association.

In a press release calling for support from other industries potentially open to fraud, the nine organisations set out actions that individual member states wanted to take to try to stop fraud from spreading into the gas and electricity markets.
They said that in 2012 France had adopted a reverse charge mechanism for gas and electricity and The Netherlands had adopted a zero VAT rate on suppliers who opt to supply through a specially provided "VAT warehouse" scheme.
In addition, Germany and Austria had both sought derogations from the VAT directive for wholesale gas & electricity for measures to combat the fraud.
The European Commission refused the derogations, saying that the existence of VAT fraud cases had not been evidenced, and also said that a reverse charge would have "a considerable negative impact on other Member States".
But it gave as its reason that "fraud in these types of goods and services can quickly move from one Member State to another," raising the possibility it would be open to a pan-EU solution.
The nine organisations urged the EU to take forward the two mechanisms proposed on a pan-European basis, saying they would "equip EU countries with real armour against fraudsters".
They have been supported by Ireland during its presidency of the EU.

In addition, businesses should

- obtain copies of all relevant documents including certificates of incorporation and VAT registration certificates;

- verify VAT registration details with HMRC;

- obtain signed letters of introduction on headed paper; obtain some form of written and signed trade references;

- obtain credit checks or other background checks from an independent third party;

- insist on personal contact with a senior officer and, where practicable, visit their premises.

Documentation, and any other evidence of checks that have been made, should be kept to support the view of a transaction's legitimacy.

"the challenge for businesses is to ensure that sufficient risk management procedures are in place without causing undue disruption to the business and its relationships with customers and suppliers"

In considering the sufficiency of the checks carried out, HMRC will look into the actions or precautions taken in response to any indicators of risk. This will focus on the due diligence checks undertaken and the actions taken in response to the results of those checks.

In each case, HMRC will consider the level of due diligence checks, to what extent the checks were appropriate, adequate and timely in relation to addressing the risks identified, and whether appropriate action was then taken in response.

HMRC suggests that indicators of risk include transactions involving newly established or recently incorporated companies where there is little or no trading history in that market, business making unusual efforts to appear as trustworthy as possible (including extensive references to VAT), individuals with prior history of MTIC fraud, traders whose business or economic model is not suitable for or compatible with the sector in which it is operating, and businesses that trade from unusual locations, short-term lease offices or facilities without actual trading floors and normal amenities.

If HMRC considers that appropriate checks were carried out, they should not apply the joint and several liability rules or deny recovery of input tax. However, the challenge for businesses is to ensure that sufficient risk management procedures are in place without causing undue disruption to the business and its relationships with customers and suppliers.

Businesses in markets such as carbon credits, electricity and gas, and other susceptible commodities should create awareness of MTIC fraud throughout the company (not just in the finance, tax and risk management teams), put in place procedures aimed at dealing with potentially risky customers or suppliers, undertake a risk assessment of current supply chains for potentially fraudulent parties, and include checks regarding MTIC fraud as part of due diligence when acquiring new businesses.

"the European Commission recently announced two major legislative changes that are intended to prevent MTIC fraud in high risk sectors"

Future changes So far individual member states have introduced their own anti-fraud measures to deal with fraud in certain sectors. This piecemeal approach has resulted in differences in the VAT treatment of certain supplies across the EU.

In response to this, the European Commission recently announced two major legislative changes that are intended to prevent MTIC fraud in high risk sectors.

The proposed changes, which will apply in all member states, consist of:

- a reverse charge mechanism, in respect of certain specified goods, (including the supply of gas and electricity), so that the customer, rather than the supplier, is required to account for the VAT on the supply; and

- a quick reaction mechanism, which will enable the European Commission to grant member states special derogations for a maximum period of one year in case of major fraud attacks.

The proposed changes are intended to be temporary, pending a strategic review of the VAT regime, but the EU believes they should give member states sufficient powers to curtail suspected MTIC fraud in high risk sectors.

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