

# Tax Fraud and the Rule of Law

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# TAX FRAUD AND THE RULE OF LAW

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*This article presents a new conceptual framework for research into tax fraud. Informed by research approaches from across tax law, public economics, criminology, criminal justice, and regulatory theory, its proposed analytical framework assesses the effectiveness, and the legitimacy, of current approaches to combating tax fraud. The last decade has witnessed significant intensification of anti-tax fraud policy within Europe, with an upsurge in both legislative and administrative measures that purportedly target tax fraud. Using VAT as a case study, it is argued that these measures display a fundamental misunderstanding of the phenomenon of tax fraud, and in particular of the various costs it carries, by concentrating upon combating the revenue costs of fraud, rather than the fraud itself. Whilst measures deployed to combat revenue costs, and those deployed to combat the tax fraud, will often coincide, this will not always be the case. In those cases where they do not coincide prevalence is consistently given to enforcement measures addressing revenue costs, rather than combatting the fraud itself, even where the effect is to aggravate other costs of tax fraud, such as distortions to competition, or tax inequity, or to create an incentive to future non-compliance. A concentration solely upon the revenue costs of fraud can no longer be regarded as either deterrent or punishment, but merely as a compensatory mechanism for the lost revenue. These developments in anti-tax fraud policy demonstrate a significant shift –one that appears to be motivated by public finance concerns– from tax fraud suppression to tax fraud management. The article concludes that this shift not only undermines tax equity and overall tax compliance, but may also lead to selective tax enforcement, thus representing a significant risk to the rule of law.*

## I. INTRODUCTION

Tax fraud is, by its very nature, difficult to measure. Although tax administrations commonly use adjustments of unreported activities, these are rarely made public, the methods used vary widely, and are often unsuitable.<sup>1</sup> No-one doubts, however, its significance, with EU estimates going up to €1 trillion

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\* Professor in Tax Law, University of Leeds. This paper was the subject of my Inaugural Lecture at the University of Leeds (February 2017). In the four years prior, parts therein were also presented at various conferences and seminars around Europe, as follows: Bilbao (May 2013), Sofia (February 2014), Riga (June 2014), Trier (November 2014), Newcastle (December 2014), Helsinki (February 2015), Lisbon (March 2015), Berlin (May 2015), Milan (May 2015), Lisbon (June 2015), Warsaw (October 2015), and Munich (June 2017). I am grateful to the organisers and the participants at these events for the comments received therein. Many specific points were also often discussed within social media, and I am grateful to the many tax law and policy experts on Twitter for their helpful comments. Finally, I am grateful to Conor O'Reilly for his invaluable suggestions, as well as for initial research assistance provided by Radu Petrescu. The usual disclaimer applies.

<sup>1</sup> IMF, *Current Challenges in Revenue Mobilization: Improving Tax Compliance*, IMF Staff Paper, April 2015, at 10.

revenue loss a year.<sup>2</sup> In countries, such as the UK, which do publish official aggregate estimates of non-compliance, usually designated as the tax gap,<sup>3</sup> the estimated revenue lost to fraud runs into the many billions of euros.<sup>4</sup> Although these measurements cannot be taken to be fully accurate, and the gap is a measure of non-compliance, rather than of just revenue loss due to fraud and evasion, the size of it is indicative of the scale of the problem. To the official numbers, recent tax scandals, involving evidence of widespread tax fraud, such as the Swiss Leaks,<sup>5</sup> and the Panama Papers,<sup>6</sup> not only presented concrete evidence on its scale,<sup>7</sup> but equally it added to public perceptions and awareness of the problem.

Given its significance, it is unsurprising that in the sequence of the economic and financial crisis in 2008/2009, when EU Member States priorities were first and foremost to ensure fiscal consolidation, attention turned more intensively towards tax fraud. Long a priority in developing countries, the crisis ensured that tax compliance also assumed greater priority in advanced and emerging economies,<sup>8</sup> such as those within the EU. This was particular evident within VAT, given its revenue gathering potential, and its perceived limited impact on economic growth.<sup>9</sup>

VAT, like any other type of tax, is vulnerable to fraud. Traditionally the inclusion of consumption taxes in the tax mix is seen as spreading the risk of enforcement,<sup>10</sup> and VAT perceived as less susceptible to fraud than its principal alternative, and economically equivalent, the Retail Sales Tax (RST). This comparative advantage is attributable to the multi-stage nature of VAT, which requires the tax to be collected on business-to-business transactions, but also allows businesses to credit the VAT paid on their purchases (inputs) against the VAT charged on their sales (outputs). This multi-stage collection process ensures: (i) that buyers of intermediate goods have opposing interests to the sellers, thus reducing the scope for evasion;<sup>11</sup> and, (ii) that the risk of evasion is spread across the different elements of the production chain. However, whilst the incentive for traders to ensure that suppliers provide them

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<sup>2</sup> European Commission, *Huge sums are being lost due to tax evasion and avoidance*, available at: [https://ec.europa.eu/taxation\\_customs/fight-against-tax-fraud-tax-evasion/a-huge-problem\\_en](https://ec.europa.eu/taxation_customs/fight-against-tax-fraud-tax-evasion/a-huge-problem_en).

<sup>3</sup> On the use of tax gaps and methods to calculate it, see generally OECD, *Tax Administration 2017 – Comparative Information on OECD and Other Advanced and Emerging Economies* (OECD Publishing, 2017), Chapter 14, 181 et seq.

<sup>4</sup> In the UK the 2016 tax gap is estimated to have been £34 billion, see HMRC, *Measuring Tax Gaps 2017: Tax gap estimates for 2015-2016*, 26 October 2017.

<sup>5</sup> J. Garside et al, "HSBC files show how Swiss bank helped clients dodge taxes and hide millions", *The Guardian*, 8 February 2015.

<sup>6</sup> L. Harding, "What are the Panama Papers? A guide to history's biggest data leak", *The Guardian*, 5 April 2016; and B. Obermayer and F. Obermaier, *Panama Papers: Breaking the Story of How the Rich and Powerful Hide Their Money* (Oneworld Publications, 2016).

<sup>7</sup> A. Alstadsenter et al, "Tax Evasion and Inequality" (2017) *NBER Working Paper No. 23772*. See also estimates by G. Zucman, *The Hidden Wealth of Nations: The Scourge of Tax Havens* (University of Chicago Press, 2015).

<sup>8</sup> IMF, n. xx above, at 7.

<sup>9</sup> As explained in R. de la Feria, "Blueprint for Reform of VAT Rates in Europe" (2015) *Intertax* 43(2), 154-171, at 162.

<sup>10</sup> R. Broadway et al, "Towards a Theory of the Direct–Indirect Tax Mix" (1994) *Journal of Public Economics* 55(1), 71-88.

<sup>11</sup> A. Sandmo, "The Theory of Tax Evasion: A Retrospective View" (2005) *National Tax Journal* LVIII(4), 643-663, at 654.

with credit-allowing invoices provides some guarantee that VAT is, to some extent, self-enforceable,<sup>12</sup> it is also true that this self-enforceability is somewhat illusory.<sup>13</sup> Firstly, there is some evidence that “bad production chains” can form, particularly in developing countries: where traders are non-compliant they tend to give preference to suppliers that are also non-compliant, so as to minimise the amount of input tax paid, which may not be deductible.<sup>14</sup> Secondly, and more importantly perhaps, even where bad chains do not form, self-enforceability does not cover all aspects of the production chain. This is because, the incentive to request an invoice is only present where the acquirer is a business registered for VAT purposes, but not where it is a final consumer or a non-registered business, as those consumers are not entitled to deduct input VAT; and in addition, even for registered businesses, who have the incentive to request the invoice, the incentive does not extend to ensuring that VAT has actually been paid, since the invoice is sufficient to prove entitlement to input tax refund. It is precisely at these two moments, when the elements of self-enforceability are absent, that fraud tends to occur.<sup>15</sup>

Whilst concern regarding VAT fraud had been a constant presence within EU countries’ tax administrations for many years,<sup>16</sup> the last decade has witnessed increasing anxiety about the revenue losses that naturally result from it. The exact level of fraud is, by its own nature, difficult to estimate, but few would contest its significance. In 2014 the VAT Gap in the EU, broadly defined as the difference between the amount of VAT collected and the total VAT liability, was estimated to be over €16 billion, which accounts for 14% of the revenue collected.<sup>17</sup> Given the significance of these numbers and of VAT to overall tax revenue,<sup>18</sup> it is unsurprising, therefore, that attention turned arguably even more intensively towards VAT fraud than to other types of tax fraud. However, the economic crisis, and namely the need to ensure fiscal consolidation, seems to have also had the effect of encouraging EU Member States to adopt legislation and administrative practices which have concentrated on eliminating the revenue costs of fraud, rather than fraud itself.

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<sup>12</sup> As recently confirmed by D. Pomeranz, “No Taxation Without Information: Deterrence and Self-Enforcement in the Value Added Tax” (2015) *American Economic Review* 105(8), 2539-2569.

<sup>13</sup> M. Keen and S. Smith, “VAT Fraud and Evasion: What Do We Know and What Can Be Done?” (2006) *National Tax Journal* LIX(4), 861-887.

<sup>14</sup> Empirical evidence of this phenomenon has been found in Brazil, for example, see A. de Paula and J.A. Scheinkman, “Value-Added Taxes, Chain Effects and Informality” (2010) *American Economic Journal: Macroeconomics* 2, 195-221.

<sup>15</sup> The first moment, namely the sale to final consumers, is also identified in D. Pomeranz n. xx and in A. Sandmo n. xx, but interestingly neither identify the second moment, namely the remittance of collected tax.

<sup>16</sup> Due to what has been designated as a quasi-symbiotic connection between the evolution of the EU VAT system and the development of fraud, see C. Tussiot, “La Fraude à la TVA, un Instrument de Modernisation Fiscale”, in C. Herbain (ed.), *La Fraude à la TVA* (Larcier, 2017), at 24.

<sup>17</sup> European Commission, *Study and Reports on the VAT Gap in the EU-28 Member States: 2016 Final Report*, TAXUD/2015/CC/131.

<sup>18</sup> Whilst VAT accounted for over 18% of total tax revenues of EU Member States, in some Member States, such as Bulgaria and Hungary, consumption taxes amount to as much 50% of total tax revenue, see European Commission, *Taxation Trends in the European Union*, 2017 Edition, at 20-21, and 159.

The new commitment to combating tax fraud seems, *prima facie*, to have worked: available estimates for developed countries indicate a general narrowing of compliance gaps,<sup>19</sup> even within VAT where this was not initially the case. In the UK, the overall tax gap has decreased from 7.9% in 2005-2006 to 6% in 2015-2016, representing £34 billion in revenue; the VAT gap increased slightly between 2011 and 2013, but overall there has been a decrease of nearly 4% between 2005 and 2016, from 13.6% to 9.8%.<sup>20</sup> This decrease has not been unanimously welcomed. It has been argued that measures which reduce the gap may also have a long-term negative effects on revenue and general welfare, where a business activity is worth undertaking if the associate tax paid is below that due, but not if tax is fully paid.<sup>21</sup> Such criticisms assume, however, that the decrease in the tax gap results from increased compliance by fraudsters, and that is indeed also the official explanation by tax administrations. Yet, recent developments indicate that this may not be (fully) the case. Whilst some concerns have been raised about potential distortions in this area, for example, on the effect of over-payments in the gap level, or the incentive to concentrate efforts on compliant taxpayers,<sup>22</sup> there seems to be a widely held assumption that a reduction in the gap represents a reduction in fraud levels. This is, however, a false equivalence.

Tax amnesties allow tax fraudsters to voluntarily repay all or parts of unpaid taxes without being subject to criminal prosecutions or full penalties. Although they have been present within the policy sphere since the 1980s,<sup>23</sup> they have become particularly popular in the last few years, since the financial crisis, due to budgetary pressures.<sup>24</sup> Policy makers often view amnesties as an efficient method of obtaining additional revenue, but beyond empirical evidence showing that their financial success varies widely and cannot be guaranteed,<sup>25</sup> they raise some fundamental concerns. Whilst tax amnesties may eliminate the revenue costs of the fraud, it does not address fraud itself: indeed there is strong empirical evidence that the lack of punishment creates a moral hazard which negatively impacts on tax compliance, increasing the incidents of fraud.<sup>26</sup> Yet tax amnesties are far from being the only manifestation of a new approach on anti-fraud policy, which prioritises short-term revenue benefits over long-term increases in tax compliance. Rather they are symptomatic of a much wider trend which has been particularly evident in VAT, whereby the decrease in the gap may be partly attributed not to the

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<sup>19</sup> IMF, n. xx above, at 13.

<sup>20</sup> HMRC, *Measuring tax gaps 2017: Tax gap estimates for 2015-2016*, 26 October 2017.

<sup>21</sup> N. Gemmel and J. Hasseltdine, "Taxpayer's Behavioural Responses and Measures of Tax Compliance 'Gaps': A Critique and a New Measure" (2014) *Fiscal Studies* 35, 275-296.

<sup>22</sup> IMF, n. xx above, at 7 and 13.

<sup>23</sup> A. Malik, "The Economics of Tax Amnesties" (1991) *Journal of Public Economics* 46, 29-49; H.B. Leonard and R.J. Zeckhauser, "Amnesty, Enforcement and Tax Policy" in L. Summers (ed.), *Tax Policy and the Economy* (MIT Press, 1987), 55-86.

<sup>24</sup> R.C. Bayer et al, "The Occurrence of Tax Amnesties: Theory and evidence" (2015) *Journal of Public Economics* 125, 70-82.

<sup>25</sup> J. Hasseltine, "Tax Amnesties: An International Review" (1998) *Bulletin for International Fiscal Documentation* 52(7), 303-310; and K. Baer and E. Le Borge, *Tax Amnesties: Theory, Trends, and Some Alternatives* (Washington DC: IMF, 2008).

<sup>26</sup> See in particular R.C. Bayer et al, n. xx above. See also A Malik, n. xx above; and B. Torgler and C.A. "Tax Amnesties and Political Participation" (2005) *Public Finance Review* 33(3), 403-431.

reduction of fraud, but to the implementation of measures designed to collect revenue from non-fraudulent businesses, so as to compensate that lost through fraud. Moreover, whilst these practices represent a massive shift in the approach to tax law enforcement, they are reminiscent of current trends in other crime control in criminal justice systems in developed Western societies.<sup>27</sup>

The aim of this paper is to reflect upon both the effectiveness, and the legitimacy, of these practices. The remainder of the paper is divided into four sections. Section Two begins by presenting a new conceptual framework of tax fraud, using VAT as a case study; it presents a broad typology of VAT fraud, and it considers the various costs of tax fraud. In Section Three existing measures to tackle tax evasion resulting from informality are discussed, namely the increase in the levels of penalties' and a formalistic approach to compliance. In Section Four attention shifts to measures adopted to combat organised tax fraud, and in particular, developments such as third-party tax liability will be considered in terms of similar criminal justice approaches, most notably trends towards responsabilisation of crime control, and asset confiscation. In this Section, the notion of *aggravated responsabilisation* is presented, as part of a proposed reconceptualised of the phenomenon of responsabilisation in the context of tax fraud. Section Five concludes by considering the risks that this policy shift from *tax fraud suppression* to *tax fraud management* present, both in terms of the potential creation of a moral hazard that may further lead to the further propagation of tax fraud, but crucially also through the establishment of selective tax enforcement which undermines the rule of law.

## II. UNDERSTANDING THE TAX FRAUD PHENOMENON

VAT fraud can be defined as behaviour aimed at obtaining an unlawful VAT advantage and/or causing unlawful VAT loss.<sup>28</sup> Although the means of obtaining such advantage vary greatly, as do the potential costs resulting from the fraud (beyond obvious revenue loss), there is often a failure to grasp the complexity of the phenomenon. In particular, revenue loss is often perceived to be the only cost of fraud.<sup>29</sup> This lack of understanding is reflected in the measures adopted to combat this phenomenon. Understanding the phenomenon of VAT fraud phenomenon is therefore a necessary preliminary step towards critical assessment of measures to address it.

### A Typology of VAT Fraud

There have been a number of attempts to provide a typology of VAT fraud. Some have focussed on the distinction between those types of fraud that are common to all taxes, and those that are specific to VAT (or other consumption taxes),<sup>30</sup> whilst others have concentrated on the differences between the types of

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<sup>27</sup> See discussion below in Section IV.

<sup>28</sup> For a definition of fraud more generally see M. Levi and J. Burrows, "Measuring the Impact of Fraud in the UK" (2008) *British Journal of Criminology* 48(3), 293-318.

<sup>29</sup> This seems to be the approach adopted in the UK, see UK National Audit Office, *Tackling Tax Fraud: How HMRC responds to tax evasion, the hidden economy, and criminal attacks*, HC 610, Session 2015-2016, 17 December 2015.

<sup>30</sup> M. Keen and S. Smith, n. xx above.

perpetrators,<sup>31</sup> and others yet have concentrated on the chronology of types, and their changes over time.<sup>32</sup> Given the constant mutations in behavioural patterns, providing a definitive typology of VAT is, by its nature, difficult. However, it is argued that the main distinction is that between *evasion* and *organised fraud*. Although this distinction does connect with the type of perpetrator, its primary focus is on the means used to obtain an unlawful tax advantage. Evasion results from, what is commonly designated as, informality, and it can be defined as the deliberate omission, concealment or misrepresentation of information to reduce VAT liability. Organised fraud, on the other hand, involves coordinated and systematic actions, with varying levels of sophistication and organisation towards obtaining a VAT financial advantage. These two behavioural types are also characterised by divergent characteristics in terms of perpetrators, geographical reach, methods, and costs. Evasion tends to be carried out by small companies,<sup>33</sup> operating at national level –although no longer exclusively so, particularly as a result of the digitalisation of the economy– who take advantage of national administrative limitations and distinctions in the tax base. Organised fraud tends to be carried out by criminal gangs, operating at a trans-border level, who take advantage of tax authorities’ enforcement limitations regarding cross-border trade; in particular lack of real-time information exchange between different tax authorities. These two categories of VAT fraud also give rise to different types of costs (further discussed below): organised fraud tends to result in higher levels of revenue loss and a subsidy to organised crime networks; whilst, evasion tends to have a bigger impact upon taxpayer inequity and creates an uneven playing-field. These distinctions are summarised in Table 1.

**Table 1: VAT Evasion vs Organised Fraud**

	EVASION	ORGANISED FRAUD
<b>Definition</b>	Results from informality Deliberate omission, concealment or misrepresentation of information to reduce VAT liability	Coordinated and systematic actions, with varying levels of sophisticated and organisation, with the aim of obtaining a VAT financial advantage
<b>Type of Perpetrators</b>	Primarily small companies	Carried out largely by criminal gangs
<b>Geographical Reach</b>	Traditionally operating at national level, although spreading as a result of the digitalisation of the economy	Operating primarily at borders
<b>Method</b>	Take advantage of national administrative limitations, and distinctions in the tax base	Take advantage of enforcement limitations by tax administrations on cross-border trade

<sup>31</sup> This is the case of HMRC, which divide fraud into three types: that perpetrated by registered businesses who conceal or omit information (evasion); that carried out by non-registered individuals (hidden economy); and that carried out by criminal gangs (criminal attacks), see UK National Audit Office, n. xx.

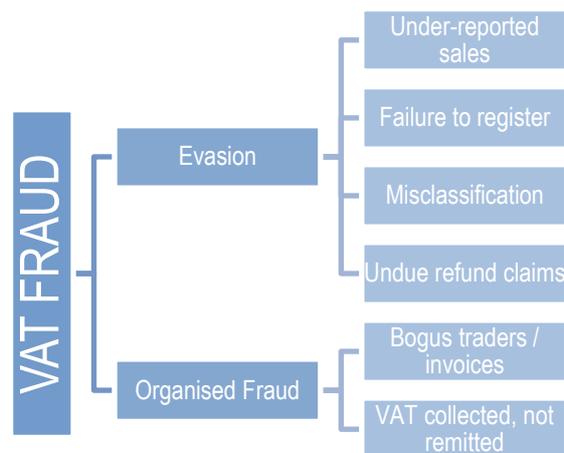
<sup>32</sup> M. Lamensch, “Fraude TVA et Commerce Digital” in C. Herbain (ed.), *La Fraude à la TVA* (Larcier, 2017), 127-145.

<sup>33</sup> UK National Audit Office, n. xx. On the impact of firm size on evasion, see D. Pomeranz n. xx; and H.J. Kleven, C.T. Kreiner, and E. Saez, “Why Can Modern Governments Tax So Much? An Agency Model of Firms As Fiscal Intermediaries” (2016) *Economica* 83(330), 219-246;

<b>Type of Costs</b>	Primarily taxpayer equity and level playing field	Primarily revenue loss, subsidy to organised crime, compliance and administrative costs
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Both evasion and organised fraud can be further subdivided into various sub-types, as set out in Diagram 1. It should be noted that these types/sub-types, are indicative rather than rigidly distinct: there are reports of hybrid fraud, which combines evasion (under-reporting of sales) with organised fraud (bogus traders / invoices).<sup>34</sup>

**Diagram 1: Typology of VAT Fraud**



*Under-reported sales* happen where a trader reports only a proportion of sales, falsifying records/accounts, or keeping sales off-the-books by not issuing invoices. With modern accounting software programmes, this type of evasion has evolved from destruction or falsification of accounting documents to much more complex systems that are harder to track. In cases where software – automated sales suppression systems, colloquially referred to as zappers – is connected to a cash register system, these programmes are able to change the entire chain, adjust stock records and recorded employees’ work time. Some programmes are even able to alter accounting entrances for official purposes, whilst keeping accurate buyers’ invoices. Recent versions of these software programmes operate on the basis of a foreign (or extra-jurisdictional) zapper that is provided to users over the internet. These alter domestic records from a distance with minimum risk for both the programme and the developer.<sup>35</sup> The growth of the digital economy, and in particular online sales, has further increased the risks of under-reporting, as it is difficult for tax administrations to know when and

<sup>34</sup> K.V. Pashev, “Countering cross-border VAT fraud: the Bulgarian experience” (2007) *Journal of Financial Crime* 14(4), 490-501.

<sup>35</sup> For a comprehensive explanation of the fascinating world of zappers, see R.T. Ainsworth, “Zappers – Retail VAT Fraud” (2010) *International VAT Monitor* 3, 175-182. See also R.T. Ainsworth, “California Zappers: A proposal for California’s Commission on the 21<sup>st</sup> Century Economy” (2009) *Boston University School of Law Working Paper* 09-01, January 2009.

where a sale has been made.<sup>36</sup> Like failure to register, this type of evasion is traditionally more common in firms primarily engaging in B2C sales.

*Failure to register* occurs most often, albeit not exclusively, when small businesses have annual turnovers just above the registration threshold. This type of evasion is most common where businesses sell to final consumers (B2C), since they do not have an incentive to request invoices. It is also common in labour-intensive areas with little or no input VAT (such as hairdressing, plumbing or electric repairs); since non-registered traders are not able to deduct input VAT.<sup>37</sup> Evidence of this type of evasion is demonstrated by the strong bunching up of firms just below the VAT threshold.<sup>38</sup>

Evasion by *misclassification* of sales occurs where traders reduce their liability by exaggerating the proportion of sales in products subject to reduced rates of VAT. This type of fraud is most likely where reduced rates apply, since these grant the right to deduct VAT whilst exemptions do not, which is the case in all EU Member States,<sup>39</sup> and indeed in most countries around the world, with the notable exclusion of New Zealand.

Evasion through *undue refund claims* for VAT may occur in one of two ways. The first involves a partially-exempt trader, supplying both taxable and exempt outputs; in this case there is an incentive to allocate inputs to the taxable portion of outputs so as to claim refunds. The second way, which is particularly common, consists of misrepresentation of items, such as a home computer or a car, bought for private consumption as business inputs, allowing for VAT input recovery.

*Bogus traders* are companies that may be set up solely for the purpose of selling invoices that allow recovery of VAT, or “invoice mills” for short; bogus invoices can also be sold by otherwise legitimate businesses. This fraud exploits the practical impossibility for tax administrations of cross-checking whether every transaction evidenced by the invoice did actually occur. In it, the underlying sale of goods or services never took place, and the actual sale is that of the invoice giving the right to deduct VAT. The fraud is therefore exclusive to B2B transactions, and requires collusion between seller and purchaser, as well as a significant level of organisation. Current levels of litigation concerning alleged bogus traders seems to indicate high levels of this type of fraud, primarily in Eastern European Member States.<sup>40</sup>

The final type of fraud is that resulting from *VAT collected but not remitted* to the Government. Whilst there are various possible methods to commit this type of fraud – such as false accounting, or engineering bankruptcy after collecting the tax but before it is remitted – the most important is

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<sup>36</sup> IMF, n. xx 2015 above, at 30.

<sup>37</sup> B. Lockwood and L. Liu, “VAT Notches, Voluntary Registration, and Bunching: Theory and UK Evidence” (2016) *Oxford University Centre for Business Taxation Working Papers*, WP 16/10.

<sup>38</sup> Source B. Lockwood and L. Liu, n. xx.

<sup>39</sup> R. de la Feria, (2015) n. xx above.

<sup>40</sup> Cases C-527/11, *Ablissio*, ECLI:EU:C:2013:168 (Latvia); C-78/12, *Evita-K*, ECLI:EU:C:2013 (Bulgaria); C-18/13, *Maks Pen*, ECLI:EU:C:2014:69 (Bulgaria); C-107/13, *FIRIN*, ECLI:EU:C:2014:151 (Bulgaria).

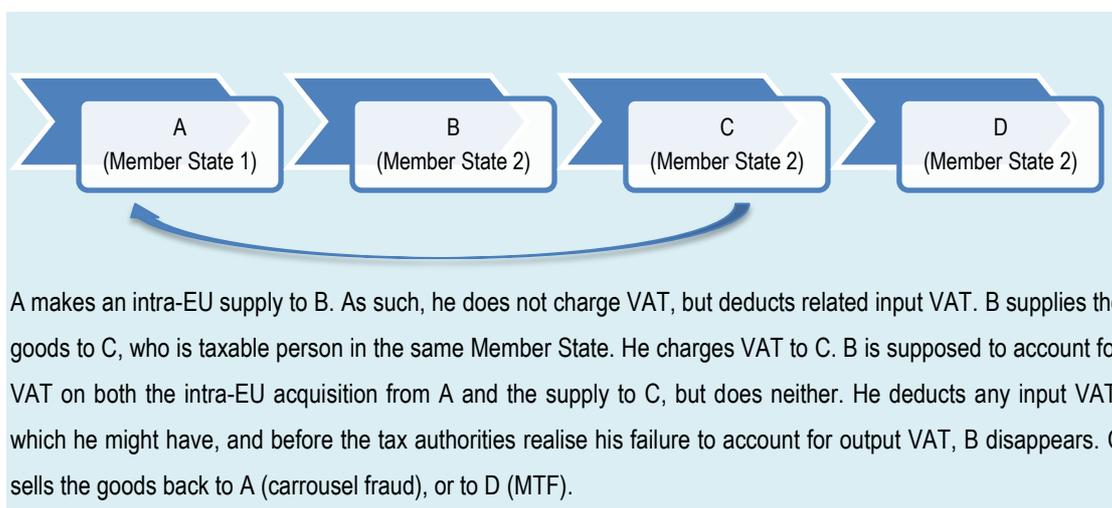
undoubtedly the so-called carousel fraud, or missing-trader fraud (MTF). EU legislation (no longer in force) has previously defined a missing trader as:

“...a trader registered as a taxable person for VAT purposes who, potentially with a fraudulent intent, acquires or purports to acquire goods or services without payment of VAT and supplies these goods or services with VAT, but does not remit the VAT due to the appropriate national authority”.<sup>41</sup>

This fraud exploits two key features of the VAT system: the time gap between the collection of the tax and its remittance; and the destination principle, which requires all exports to be VAT-free, with the tax collected solely on imports. In its simplest form, a trader – the MFT – collects VAT paid to him by a supplier without accounting or remitting to the tax authorities, disappearing soon after, and before the authorities realise what has occurred.<sup>42</sup> There are numerous variations to this basic model: the same goods may move around different chains continuously, with all the traders in the chain involved, or at least aware that the fraud is occurring (carousel fraud); or different goods are sold by fraudsters to unsuspecting third parties, inserting themselves into legitimate production chains (MTF). A more recent version of the MTF is reportedly the insolvent trader, in which instead of a missing trader, the scheme includes an existing firm, which is stripped of any assets before the tax authorities reach it.

A diagrammatic example of these basic types is shown below. Whilst these fraud schemes had traditionally operated within the EU, similar schemes have now developed involving third countries, taking advantage of VAT rules on imports.<sup>43</sup>

### Diagram 2: How Missing Trader Fraud Works



A makes an intra-EU supply to B. As such, he does not charge VAT, but deducts related input VAT. B supplies the goods to C, who is taxable person in the same Member State. He charges VAT to C. B is supposed to account for VAT on both the intra-EU acquisition from A and the supply to C, but does neither. He deducts any input VAT, which he might have, and before the tax authorities realise his failure to account for output VAT, B disappears. C sells the goods back to A (carousel fraud), or to D (MTF).

Whilst evasion has been receiving growing attention over the last few years, MTF has been the main focus of EU institutional attention since the late 1990s. This is partially due to the scale and organised nature of the MTF, which often requires EU coordinated action, but also the fact that evasion was for a

<sup>41</sup> Commission Regulation (EC) No. 1925/2004 of 29 October, OJ L 331, 05/11/2004, 13-18.

<sup>42</sup> Case C-354/03 *Optigen and Others*, ECLI:EU:C:2005:89, para. 8.

<sup>43</sup> F. Borselli, "Pragmatic Policies to Tackle VAT Fraud in the European Union" (2008) *International VAT Monitor* 5, 333-342.

long time perceived as a domestic-only problem, whilst MTF is to a large extent a direct consequence of arrangements put in place in 1993 for intra-EU trade, as a consequence of the abolition of physical frontiers within the EU.

### **Costs of Tax Fraud**

Measuring the costs of fraud, like measuring its level is, by its nature, difficult.<sup>44</sup> As regards tax fraud, the two are intrinsically linked, and calculation of revenue losses is generally used as the basis to estimate the level of fraud.<sup>45</sup> Insofar as VAT is concerned, since 2004, it has often been asserted that fraud accounts for approximately 10% of VAT revenue within the EU;<sup>46</sup> more recently, however, the measure most commonly used by the European Commission is the VAT Gap. Whilst in 2014 the VAT Gap within the EU was estimated to be 14% of revenue,<sup>47</sup> since the GAP is a measure of compliance and enforcement, and not just fraud, the revenue costs attributable to the latter should be taken to be considerably smaller. Similarly in the UK, whilst HMRC has estimated the VAT GAP to be at 9.8% of total revenue for 2015-2016,<sup>48</sup> no estimates are offered for overall VAT fraud, although some types of fraud are quantified, such as MTF, estimated to be 0.5% of total revenue.<sup>49</sup> Total tax fraud – not just VAT – is estimated to be 3% of revenue for the same period.<sup>50</sup> Europol has also offered estimates for MTF, reporting that EU countries lose €100 billion annually to that one type of fraud; a perhaps all too convenient figure but certainly one that symbolises the significance of the problem.<sup>51</sup>

Whilst the above are, of course, mere estimates –and methodological difficulties are openly acknowledged by tax administrations– and the lack of comparable data regarding VAT fraud across the EU has been identified as a significant limitation to understanding of the phenomenon,<sup>52</sup> it is reasonable to assume that the share of revenue lost within EU to VAT fraud is quite considerable. This is also supported by evidence on the increased scale of fraud, with some individual instances of fraud so massive as to account in isolation for a significant amount of revenue loss. In this regard, one of the most infamous cases was the so-called CO2 fraud, a missing trader fraud in the Emissions Trading System, which in the 18 months that it lasted – between 2008 and 2009 – is said to have resulted in

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<sup>44</sup> M. Levi and J. Burrows, n. xx above.

<sup>45</sup> For a review of the literature on measurements of VAT fraud see L. Barbone et al, *The Costs of VAT: A Review of the Literature*, CASE Network No. 106/2012, at 46 et seq; see also C.W. Nam et al, "Measurement of Value Added Tax Evasion in Selected EU Countries on the Basis of National Accounts Data" (2001) *CESifo Working Papers* 431, March 2001.

<sup>46</sup> European Commission, *Report from the Commission to the Council and the European Parliament on the use of administrative cooperation arrangements in the fight against VAT fraud*, COM(2004) 260 final, 16 April 2004, at 5.

<sup>47</sup> See above.

<sup>48</sup> HMRC, n. xx above.

<sup>49</sup> HMRC, n. xx above.

<sup>50</sup> UK National Audit Office, n. xx above.

<sup>51</sup> Europol, *EU Serious and Organized Crime Threat Assessment*, SOCTA 2013.

<sup>52</sup> European Court of Auditors, *Tackling intra-Community VAT fraud: More action needed*, Special Report No. 24, 2015.

losses of approximately 5 billion euros for several national tax revenues;<sup>53</sup> several other instances of massive fraud have more reported in the media.<sup>54</sup>

These estimates also highlight the extent to which measuring VAT fraud has been equated with measuring the revenue costs of VAT fraud. Whilst this is a natural approach, given the difficulties in measuring fraud directly, it also gives rise to the common misconception that the *only* costs of VAT fraud are revenue costs. Despite some institutions, such as the European Commission or the IMF, having on occasion, acknowledged the existence of other costs beyond lost revenue,<sup>55</sup> it is clear that the focus in reports concerning VAT fraud is largely on the revenue loss element. Yet, like other types of fraud, that loss – or transfer costs – in VAT fraud is but one of the problems associated with it. Generally fraud costs can be disaggregated into various components, namely costs of preventing fraud (anticipatory costs), costs of responding to fraud, and negative externalities.<sup>56</sup> All are evident in VAT, and more broadly, on tax fraud. Apart from the revenue loss, and as demonstrated in Diagram 4, tax fraud gives rise to significant compliance and administrative costs for both tax administrations and for businesses, and significant negative externalities, namely distortions to competition, taxpayer inequity, and subsidies to organised crime. Some of these are new resource costs, rather than transfer costs, which has detrimental effects on economic welfare.<sup>57</sup>

#### Diagram 4: The Costs of Tax Fraud

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<sup>53</sup> Europol Press Release, *Carbon Credit fraud causes more than 5 billion euros damage for European Taxpayer*, December 9, 2009. For detailed accounts and effects of this instance of fraud, see P. Efstratios, “Halting the Horses: EU Policy on the VAT Carousel Fraud in the EU Emissions Trading System” (2012) *EC Tax Review* 1, 39-51; R.A. Wolf, “A Sad History of Carbon Carousels” (2010) *International VAT Monitor* 21(6); M. Berritella and F.A. Cimino, “The Carousel Value-Added Tax Fraud in the European Emission Trading System” (2012) *Fondazione Eni Enrico Mattei Nota di Lavoro* 75.2012; R.T. Ainsworth, “CO2 MTIC Fraud – Technologically Exploiting the EU VAT (Again)” (2010) *Boston University School of Law Working Paper* 10-01, January 2010; and R.T. Ainsworth, “The Morphing of MTIC Fraud: VAT Fraud Infects Tradable CO2 Permits” (2009) *Boston University School of Law Working Paper* 09-35, August 2009.

<sup>54</sup> Eurojust *EU-wide fuel oil and precious metals VAT fraud and money laundering network dismantled*, Press Release, 21 December 2016; Europol, *Eight Member States take action against international VAT fraud*, Press Release, 29 June 2016. See also media reports: J. Oliver, “On the run: the plumber who worked a £15m VAT fraud”, *The Guardian*, 4 March 2005; J. Oliver, “Scams steal £8.4bn from taxpayer”, *BBC One Panorama*, 2006; J. Moncur, “Father and son fraudsters who made off with £109m in ill-gotten gains are tracked to African bolthole”, *Mirror*, 4 April 2016.

<sup>55</sup> As the Commission stated in 2004: “In addition to the loss of national revenue, this fraud jeopardises legitimate trade in certain economic sectors and distorts competition to the benefit of dishonest traders.” in n. xx above, COM(2004) 260 final, 5. See also IMF, n. xx 2015 above, at 7

<sup>56</sup> M. Levi and J. Burrows, n. xx above.

<sup>57</sup> M. Feldstein, “Tax avoidance and the deadweight loss of income” (1999) *Review of Economics and Statistics* 81, 674-680; and R. Chetty, “Is the taxable income elasticity sufficient to calculate deadweight loss? The implications of evasion and avoidance” (2009) *American Economic Review: Economic Policy* 1, 31-52.



Tax fraud can also impose significant costs upon legitimate traders by creating distortions to competition. A lobby group set up by UK-based SMEs has been drawing attention to the distortive problems caused by alleged VAT fraud perpetrated online by non-EU traders,<sup>58</sup> and research does seem to substantiate these anecdotal reports. Economic models indicate that tax-evading firms are likely to drive non-evading ones out of the market;<sup>59</sup> and although there are few studies showing empirical evidence of this impact, the few that do exist confirm that this impact can be significant for affected industries.<sup>60</sup> The impact is also likely to affect SMEs more strongly than bigger firms, as the latter's cash-flow levels allows them to better respond to these distortive effects. There is also evidence that fraud results in less frequent trade and lower quality trade in affected industries, as non-evading firms refrain from engaging in trade or divert trade, where they suspect that businesses are involved in tax fraud.<sup>61</sup> Designated by authors as fraud's hidden costs, the research seems to again confirm reports suggesting that bigger businesses are now refraining from trading with SMEs, for fear of being inadvertently involved in VAT fraud. It also indicates the potential presence of other distortive effects to fraud, and particularly to evasion, that have not yet been measured or identified.<sup>62</sup>

<sup>58</sup> *Campaign Against VAT Fraud on eBay & Amazon in the UK*, available at: [www.vatfraud.org](http://www.vatfraud.org).

<sup>59</sup> J. Strand, "Tax distortions, household production, and black-market work" (2005) *European Journal of Political Economy* 21, 851-871.

<sup>60</sup> M.C. Frunza et al consider the impact of VAT fraud on the European carbon allowances markets between 2008 and 2009, and find it to have been extremely significant on the markets' overall performance and its volatility, see M.C. Frunza et al, "Missing trader fraud on the emissions market" (2011) *Journal of Financial Crime* 18(2), 183-194.

<sup>61</sup> L. Boulafoutas et al, "The Hidden Costs of Tax Evasion – Collaborative Tax Evasion in the Markets for Expert Services" (2015) *Journal of Public Economics* 129, 14-25.

<sup>62</sup> *Ibid.*

Directly connected with the distortive costs of tax fraud, are its effects on taxpayer equity. Tax equity is one of the key taxation principles, and it is usually divided into horizontal equity and vertical equity.<sup>63</sup> Tax fraud tends to undermine vertical equity, and thus result in a more regressive tax system,<sup>64</sup> as in the absence of a counteracting effect of tax morality,<sup>65</sup> those with higher incomes are more likely to be able to engage in fraud.<sup>66</sup> Whilst there is an ongoing debate on the role of vertical tax equity concerns within consumption taxes,<sup>67</sup> tax equity, in its horizontal dimension, which demands that similarly situated taxpayers face similar tax burdens, is a key principle of VAT, as it is of any tax.<sup>68</sup> Violations of horizontal tax equity are therefore regarded as serious flaws in any tax arrangement.<sup>69</sup> Tax fraud, by definition, introduces an element of horizontal tax inequity into the tax system, insofar as it results in similarly situated taxpayers facing dissimilar tax burdens. In the case of consumption taxes, such as VAT, how that element is felt and by whom may vary, depending on the type and circumstances of the fraud. Assuming that the incidence of these taxes falls on consumers as taxpayers,<sup>70</sup> inequality can arise amongst consumers. Where fraudulent businesses charge less tax, and thus a lower price, than non-fraudulent business, in order to obtain a competitive advantage inequality may also arise. However, amongst collectors of consumptions taxes, namely businesses in charge of remitting the tax, where tax is charged to consumers equally by all businesses, but fraudulent ones fail to remit it to tax administrations, they also obtain a financial advantage. In between these two poles there are many hybrid situations, where tax inequality arises amongst both consumers and businesses – e.g. where fraudulent business charge only part of the tax due to consumers, but fail to remit any to tax authorities. That VAT fraud creates horizontal tax inequity is not only relevant in its own right, but equally because there is strong evidence that perceptions of tax equity impact upon compliance levels.<sup>71</sup> In particular, tax inequity undermines what has been designated as tax moral thinking: taxpayers’ self-regulatory mechanism that cognitively frames paying taxes as doing “the right thing”.<sup>72</sup> Where there is perceived

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<sup>63</sup> Whilst the concept of vertical tax equity goes back centuries, the concept of horizontal tax equity seems to have been first identified only more recently, in H.C. Simons, *Personal Income Taxation* (University of Chicago Press, 1938). See D. Elkins, “Horizontal Equity as a Principle of Tax Theory” (2006) *Yale Law and Policy Review* 24, 43-90.

<sup>64</sup> J. Slemrod and S. Yitzhaki, “Tax Avoidance, Evasion and Administration” in A. Auerbach and M. Feldstein (eds.), *Handbook of Public Economics*, Volume 3 (Elsevier, Amsterdam, 2002), 1423-1470.

<sup>65</sup> K. Lee, “Morality, tax evasion and equity” (2016) *Mathematical Social Sciences* 82, 97-102.

<sup>66</sup> As recently demonstrated by A. Alstadsenter et al, n. xx above.

<sup>67</sup> R. de la Feria, n. xx 2015 above.

<sup>68</sup> Although this assertion is not universally accepted, see L. Kaplow, “Horizontal Equity: New Measures, Unclear Principles” in Hasset and Hubbard (eds.), *Inequality and Tax Policy* (American Enterprise Institute, 2001).

<sup>69</sup> D. Elkins, n. xx above, at 44.

<sup>70</sup> Which is far from clear, and will often depend on market circumstances, see R. de la Feria, n. xx 2015 above.

<sup>71</sup> For a summary of research in this area see J. Slemrod, “Cheating Ourselves: The Economics of Tax Evasion” (2007) *Journal of Economic Perspectives* 21(1), 25-48, at 38 et seq; see also D. Onu and L. Oats, “The Role of Social Norms in Tax Compliance: Theoretical Overview and Practical Implications” (2015) *Journal of Tax Administration* 1(1).

<sup>72</sup> V. Braithwaite, *Defiance in Taxation and Governance – Resisting and Dismissing Authority in a Democracy* (Edward Elgar, 2009), at 148-158.

tax inequity, taxpayers are less likely to think morally, and can respond to taxation through defiance,<sup>73</sup> as the sense of fairness of the tax system is important for general tax compliance.<sup>74</sup> Recent experiments using behavioural science, undertaken by the tax authorities in the UK, have confirmed previous empirical studies in this regard.<sup>75</sup>

The connection between organised crime and organised tax fraud, and its use as a financing method for illegal activities, have been acknowledged by EU institutions,<sup>76</sup> and are a common feature of media reports.<sup>77</sup> Whilst this connection is not exclusive to missing trader fraud, and there are reports of other types of VAT fraud perpetrated by organised crime networks,<sup>78</sup> that particular type of fraud seems to be a particularly attractive source of financing for organised crime groups. Although official acknowledgment of such links may be recent, its existence has been described in criminological research since the early 1990s.<sup>79</sup> Previous experience in the Benelux countries with the Postpone Accounting System (PAS) – the inspiration for the intra-EU VAT system that applied from 1993 onwards –<sup>80</sup> had already indicated that the system was susceptible to fraud;<sup>81</sup> and in the late 1980s and early 1990s research alerted to the possibility that intra-EU VAT fraud was about to establish itself in the form of crime networks. The problem is said to have been brought to the attention of the then Director-General of the European Commission's Internal Market, who is said to have remarked indifferently that this form of organised cross-border crime was not the Commission's problem.<sup>82</sup> This implies a willingness to accept the creation of a permissive environment for fraud, for fear of undermining the positive case for European integration, or the belief that the costs of fraud could be set against the

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<sup>73</sup> Ibid, at 200. See also V. Braithwaite, "Tax Evasion" in M. Tonry, (ed.), *Handbook on Crime and Public Policy* (Oxford University Press, 2009), 381-405, at 384.

<sup>74</sup> H. Filipczyk, *Tax Avoidance and Rationality of Law* (Wolters Kluwer, 2017), at 357-358.

<sup>75</sup> D. Halpern, *Inside the Nudge Unit – How Small Changes Can Make a Big Difference* (WH Allen, 2015), at 112-115.

<sup>76</sup> European Court of Auditors, n. xx above; Europol, n. xx above; and Europol, *Eight Member States take action against international VAT fraud*, Press Release, 29 June 2016. See also HM Government, *Serious and Organised Crime Strategy*, October 2013; and Center for the Study of Democracy, *Financing of Organised Crime*, 2015, at 61 et seq.

<sup>77</sup> S. O'Driscoll, "Man who paid dissident's bail ran Northern Ireland's biggest ever money-laundering scam", *Belfast Telegraph*, 28 April 2017; H. McDonald, "Fourteen held in largest ever Northern Ireland anti-fraud operation", *The Guardian*, 13 March 2013; S. Rayment, "Northern Ireland: The new war on terror", *The Telegraph*, 14 March 2009; and A. Travis and A. Seager, "Reid wants Europe to fight VAT fraud linked to terror funds", *The Guardian*, 26 October 2006.

<sup>78</sup> J. Ware, "Stakeknife: Spy linked to 18 murders, BBC Panorama finds", *BBC News*, 12 April 2017.

<sup>79</sup> P. van Duyne, "VAT Fraud and the Policy of Global Ignorance" (1999) *European Journal of Law Reform* 1, 425-443. See also S White, "VAT revenue and organised crime: time for action?" (1999) *European Law Review* 24(4), 433-439.

<sup>80</sup> For a review of the process that led to the introduction of a transitional VAT system, based on the PAS see R. de la Feria, *The EU VAT System and the Internal Market* (Amsterdam: IBFD, 2009), at 68 et seq. On the connection between PAS and fraud see Y. Fedchyshyn, "Postponed Accounting in the European Union" (2014) *International VAT Monitor* 1, 11-15.

<sup>81</sup> R. Wolf, "The Sad History of Carbon Carousels" (2010) *International VAT Monitor* 6, 403; C. Amand and K. Boucquez, "A New Defense for Victims of EU Missing-Trader Fraud?" (2011) *International VAT Monitor* 4, 234, 236.

<sup>82</sup> See the remarkable account by P. van Duyne, "VAT Fraud and the Policy of Global Ignorance" (1999) *European Journal of Law Reform* 1, 425-443, at 434.

overall benefits of that integration. Whether this is an accurate account of events or not, tax administrations had indeed been pointing out that the system was susceptible to fraud since its inception in 1993. According to field experts, the feared flow of mega frauds did not emerge immediately after 1 January 1993; instead criminal activity is said to have started 18 to 24 months later: at first so-called veterans tested the system and how easy it was to cash the VAT by making a few loops across the border; these were then followed by some legitimate traders;<sup>83</sup> and finally the 'legitimate' and 'criminal' entrepreneurs started to cooperate.<sup>84</sup>

Compliance and administrative costs are mostly second order costs, resulting not from fraud itself, but its spread across various entities, and at various moments. For non-fraudulent businesses and for tax administrations, there are two main type of costs, namely: anticipatory costs, where those entities take measures to prevent involvement in fraud (businesses) or deter fraud (tax administrations), such as implementation of new software or due diligence; and reactive costs, where fraud has taken place, and costs arise in the context of inadvertently engaging with fraudsters (businesses), or pursuing civil or criminal remedies against fraudsters (tax administrations).<sup>85</sup> There is evidence, however, that evasion in particular also gives rise to resource costs for fraudsters, as they try to conceal the fraud,<sup>86</sup> or in the case of risk-averse fraudsters, as a result of the uncertainty that engaging in fraud creates.<sup>87</sup>

Although the above costs of tax fraud are significant, and often nominally recognised,<sup>88</sup> as the analysis below demonstrates, they seemed to have been to a large extent ignored in the context of anti-fraud policy.

### III. TACKLING TAX EVASION

The policy to tackle tax evasion resulting from informality has traditionally been relatively unsophisticated, relying primarily on penalties, surcharges and other administrative and criminal sanctions. Despite attracting significant academic attention,<sup>89</sup> there was a sense that, from a tax administration perspective, further investment in tackling evasion may have been perceived as inefficient, as the difficulties in implementing and the human resources costs involved in adopting a stricter approach, such as audits, outweighed the potential revenue benefits. The last decade, however, has seen a massive shift in this approach, with increased attention being paid to anti-evasion

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<sup>83</sup> For example, one of the biggest meat trader in the Netherlands, see P.C. van Duyne, "Organized Crime, Corruption and Power" (1997) *Crime, Law and Social Change* 26, 201-238.

<sup>84</sup> For criminological research into intra-EU VAT fraud, including discussion on the parasitic relationship between legitimate and organised crime traders, and their *modus operandi*, see A. Aronowitz et al, *Value-Added Tax Fraud in the European Union* (Amsterdam: Kugler Publications 1996).

<sup>85</sup> M. Levi and J. Burrows, n. xx above.

<sup>86</sup> R.C. Bayer, "A contest with the taxman – the impact of tax rates on tax evasion and wastefully invested resources" (2006) *European Economic Review* 50, 1071-1104.

<sup>87</sup> S. Yitzhaki, "A note on optimal taxation and administrative costs" (1979) *American Economic Review* 69, 475-480.

<sup>88</sup> See references in n. xx above.

<sup>89</sup> The initial work on tax compliance dates back to the early 1970s; see landmark work by M.G. Allingham and S. Sandmo, "Income Tax Evasion: A Theoretical Analysis" (1972) *Journal of Public Economics* 1(2-3), 323-338.

policy. This shift has undoubtedly been due in part to promising developments in behavioural science – from responsive regulation to nudge theories<sup>90</sup> as well as the use of new technologies,<sup>91</sup> to encourage tax compliance, both of which allow a stricter approach to enforcement, at lower costs than traditional methods. Although these are clearly positive developments, and initial results concerning the (still) geographically limited use of these scientific and technological methods of tax enforcement are extremely encouraging, the wider picture on anti-evasion policy gives is not as inspiring.

From the mid-2000s onwards VAT anti-evasion policy has been primarily characterised by a toughening of compliance regimes in several EU Member States, with the adoption of increased penalties, interest, and other sanctions, as well as a stricter, formalistic, approach to tax compliance obligations. Even where new approaches, such as the use of behavioural science and of new technologies, have been implemented, they have been accompanied by renewed reliance on traditional negative incentives to ensure compliance.<sup>92</sup> These new legislative and administrative compliance measures have given rise to significant litigation at CJEU level,<sup>93</sup> some of which concerns allegations of violation of the Charter of Fundamental Rights of the European Union.<sup>94</sup> This highlights the severity of both the new practices and the legal concerns that they give rise to. As the analysis below lays bare, the judgments in those cases not only confirm the legitimacy of these concerns, with the Court siding in the large majority of cases with the taxpayer, but they are also further demonstrate a prioritisation in anti-evasion policy of combating the revenue costs of fraud, over combating fraud itself.

### **Penalties, Interest and Other Negative Compliance Incentives**

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<sup>90</sup> On the use of responsive regulation in tax, see J. Freedman, *Responsive Regulation, Risk, and the Rules: Applying the Theory to Tax Practice* (2012) *University of British Columbia Law Review* 44, 627; and the influential work by I. Ayres and J. Braithwaite, *Responsive Regulation: Transcending the De-Regulation Debate* (Oxford University Press, 1992). On the use of nudges in tax see D. Halpern, n. xx above. For an overview on these and other contributions from behavioural science to tax, see H. Filipczyk, n. xx above, at 338 et seq.

<sup>91</sup> A survey of best practices can be found in OECD, *Technologies for Better Tax Administration – A Practical Guide for Revenue Bodies*, 2016; and OECD, *Technology Tools to Tackle Tax Evasion and Tax Fraud*, 2017.

<sup>92</sup> As it is the case in the UK, see R. de la Feria and P. Tanawong, “Surcharges and penalties in UK tax law” in R. Seer and A.L. Wilms (eds.), *Surcharges and Penalties in Tax Law*, EATLP International Tax Series, Vol 14 (IBFD, 2016), 703-735. The continued use of penalties and other traditional compliance methods, in conjunction with new behavioural science methods is common, see L. Lederman, “Tax Penalties as Instruments of Cooperative Tax Compliance Regimes” in *ibid*, 31-44, at 38-39.

<sup>93</sup> A tendency noted also by I. Lejeune et al, “Chronique Jurisprudentielle de la Cour de Justice” in C. Herbain (ed.), n. xx above, 34-95. See in particular cases: C-368/09, *Pannon Gép Centrum*, ECLI:EU:C:2010:441; C-385/09, *Nidera*, ECLI:EU:C:2010:627; C-280/10, *Polski Trawertyn*, ECLI:EU:C:2012:107; C-263/11, *Redlihs*, ECLI:EU:C:2012:497; C-284/11, *EMS-Bulgaria Transport*, ECLI:EU:C:2012:458; C-527/11, *Ablessio*, ECLI:EU:C:2013:168; C-259/12, *Rodopi-M 91*, ECLI:EU:C:2013:414; C-563/12, *BDV Hungary Trading*, ECLI:EU:C:2013:854; C-272/13, *Equoland*, ECLI:EU:C:2014:2091; C-337/13, *Almos Agrárkülkereskedelmi*, ECLI:EU:C:2014:328; C-183/14, *Salomie and Oltean*, ECLI:EU:C:2015:454; C-516/14, *Barlis 06*, ECLI:EU:C:2016:690; C-518/14, *Senatex*, ECLI:EU:C:2016:691; C-24/15, *Plöckl*, ECLI:EU:C:2016:791; C-564/15, *Farkas*, ECLI:EU:C:2017:302; C-624/15, *Litdana*, ECLI:EU:C:2017:389; C-101/16, *Paper Consult*, ECLI:EU:C:2017:775; C-374/16, *Geissel*, ECLI:EU:C:2017:515. Similar trends can be detected in other areas of the tax system, see e.g. Cases C-431/08, *FG Wilson (Engineering) and Caterpillar*, ECLI:EU:C:2008:628, on customs duties; C-497/15, *Euro-Team*, ECLI:EU:C:2017:229, on vehicle taxes; and C-682/15, *Berlioz Investment Fund*, ECLI:EU:C:2016:94, on tax administrative cooperation.

<sup>94</sup> OJ C364, 18/12/2000, 1-22. See Case C-217/15, *Orsi*, ECLI:EU:C:2017:264.

Whilst behavioural science has provided new insights into tax compliance and the reasons behind tax evasion,<sup>95</sup> the traditional view stems largely from economics-of-crime theories according to which taxpayers weigh the expected benefits of tax evasion/crime with the uncertain prospect of detention and punishment.<sup>96</sup> Under this view, audits, penalties, and other negative compliance incentives were not only effective anti-evasion methods, but indeed the only methods.<sup>97</sup> Following this traditional approach, all EU Member States have been applying penalties and other negative compliance incentives for a long time, with the majority dividing these into two categories: civil penalties, applied to minor compliance offenses, and criminal penalties, applicable to tax evasion actions.<sup>98</sup> The last decade, however, has seen in many EU Member States a marked toughening of the penalties' regime.

As evident also in recent CJEU case-law, this toughening has been reflected not only in the number of penalties issued, and the level of penalty charged,<sup>99</sup> but also in the diversity of penalties, which now include in some EU Member States not only financial charges, but the removal of tax rights, such as the right to deduct input VAT.<sup>100</sup> Whilst penalty regimes are not harmonised at EU level, and Member States are therefore free to choose the penalties which seem most appropriate, the CJEU has consistently reiterated that this power must nevertheless be exercised in accordance with general principles of EU law, and in particular the principle of proportionality,<sup>101</sup> as also now enshrined in Article 49(3) of the Charter of Fundamental Rights. In order to comply with the principle of proportionality, penalties must therefore be regarded as suitable – appropriate for attain the stated aim – and necessary – they do not go beyond what is necessary to attain that aim. The aim against which proportionality is to be assessed is the dual function which penalties, regardless of type, are perceived as having, namely a punitive function and a deterrence function. Proportionate penalties are therefore those that are appropriate to punish and deter non-tax compliance, and which do not go beyond what is necessary to act as a punishment, but particularly as a deterrent.<sup>102</sup>

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<sup>95</sup> For a review of the various experiments done around the world using behavioural science to increase tax compliance, see J. Slemrod, "Tax Compliance and Enforcement: New Research and its Policy Implications" (2016) *Ross School of Business Paper* 1302.

<sup>96</sup> See J. Alm et al, "Why do people pay taxes?" (1992) *Journal of Public Economics* 48, 21-38, at 21-22.

<sup>97</sup> See M.G. Allingham and S. Sandmo, n. xx above; this deterrence effect of audits and penalties was empirically confirmed by J. Dubin and L. Wilde, "An empirical analysis of federal income tax auditing and compliance" (1988) *National Tax Journal* 41(1), 61-74; see also J. Slemrod and S. Yitzhaki, "n. xx above.

<sup>98</sup> For a detailed analysis of penalties applicable in EU Member States, Turkey, Israel and US, see R. Seer and A.L. Wilms (eds.), n. xx above, Chapters 12 to 31.

<sup>99</sup> Ibid. See also for developments in the UK, R. de la Feria and P. Tanawong, n. xx above, at 733 et seq. For developments in Germany, see R.T. Ainsworth, "German VAT Compliance – Moving One step Closer to Automated Third-Party Solutions" (2011) *Boston University School of Law Working Paper* 11-37; and J. Meyer-Burrow and O. Stumm, "Recent Developments in German Criminal Law and their Impact on VAT Compliance" (2011) *International VAT Monitor* 3, 161.

<sup>100</sup> C-284/11, *EMS-Bulgaria Transport*, ECLI:EU:C:2012:458.

<sup>101</sup> Cases 68/88, *Commission v Greece*, ECLI:EU:C:1989:339, at para 23; C-210/91, *Commission v Greece*, ECLI:EU:C:1992:525, at para 19; C-210/94, *Siesse*, ECLI:EU:C:1995:351, at para 21.

<sup>102</sup> Cases C-95/07 and C-96/07, *Ecotrade*, ECLI:EU:C:2008:267, at paras 65-66; C-263/11, *Rēdlihs*, ECLI:EU:C:2012:497, at paras 45-46; C-284/11, *EMS-Bulgaria Transport*, ECLI:EU:C:2012:458, at para 67; C-259/12,

When evaluating whether the proportionality has been respected, the Court tends to concentrate on the second element of the proportionality test, namely whether the penalties in question are necessary or whether they go beyond what is necessary to deter fraud. In this regard, Member States must consider *inter alia* the nature and the seriousness of the breach, and the amount of penalty,<sup>103</sup> the correlation between the breach and the penalty imposed,<sup>104</sup> and whether there was actual revenue loss.<sup>105</sup> Therefore Latvian penalties for failure to register, which are aimed at recovering the estimated amount of tax that would have been due had registration taken place,<sup>106</sup> Hungarian penalties charged where no loss of revenue has occurred and there is no evidence of evasion,<sup>107</sup> or where the error has been rectified;<sup>108</sup> have all been deemed by the Court to be disproportionate. Although the Court has not yet been called to decide on the proportionality of interest charged on unpaid tax,<sup>109</sup> similar concerns have also been raised in this regard. As opposed to penalties, the purpose of tax interest is not to act as punishment or deterrence, but rather to neutralise the cash-flow advantage. The expectation would be therefore that level of interest charged would be based on market rates, yet in many countries the level of tax interest has continuously edged away from market rates.<sup>110</sup>

The Court has rarely, however, made reference to the suitability of penalties, the first element of the proportionality test. Rather their suitability seems to be assumed, based on the traditional understanding as regards the effectiveness of penalties, and the sense that the higher the penalty the stronger the deterrence.<sup>111</sup> Yet there is now empirical evidence that indicates that such effectiveness is far from guaranteed. Even disregarding recent developments in behavioral economics, and when comparing traditional instruments to tackle tax fraud, namely penalties and audits, recent empirical research indicates that the risk of audit is a much stronger incentive to compliance than penalties;<sup>112</sup> highlighting the risk of penalty can be an effective means to increase compliance, but primarily on late compliers, rather than non-compliers.<sup>113</sup>

Often unnecessarily burdensome, and with questions raised over its suitability, the toughening of the penalties, interest and other sanctions, is therefore difficult to equate in the context of deterrence or

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*RODOPI-M 91*, ECLI:EU:C:2013:414, at para 38; *C-183/14, Salomie and Oltean*, ECLI:EU:C:2015:454, at para 51; and *C-564/15, Farkas*, ECLI:EU:C:2017:302, at para 60.

<sup>103</sup> Case C-259/12, *RODOPI-M 91*, ECLI:EU:C:2013:414, at para 38.

<sup>104</sup> Case C-263/11, *Rėdlihs*, ECLI:EU:C:2012:497, at paras 49-50.

<sup>105</sup> Cases C-284/11, *EMS-Bulgaria Transport*, ECLI:EU:C:2012:458, at paras 73-74; and *C-564/15, Farkas*, ECLI:EU:C:2017:302, at para 67.

<sup>106</sup> Case C-263/11, *Rėdlihs*, ECLI:EU:C:2012:497.

<sup>107</sup> Case C-564/15, *Farkas*, ECLI:EU:C:2017:302.

<sup>108</sup> Case C-368/09, *Pannon Gėp Centrum*, ECLI:EU:C:2010:441.

<sup>109</sup> Although it has decided on interest applied for overpaid tax, see case C-591/10, *Littlewoods Retail and Others*, ECLI:EU:C:2012:478.

<sup>110</sup> K.D. Druen and P.J. Butler, "Interests in Light of the Proportionality Principle" in R. Seer and A.L. Wilms (eds.), n. xx above, 85-98.

<sup>111</sup> L. Lederman, n. xx above, at 43.

<sup>112</sup> D. Pomeranz n. xx.

<sup>113</sup> B. Meiselman, "Ghostbusting in Detroit: Evidence on nonfillers from a controlled field experiment" (2017).

even punishment of tax fraud, but much easier if seen in the context of revenue-gathering efficiency. Its potential for additional revenue collection however is clear; audits may be a better deterrent, but the fact that they carry significantly more administrative costs, makes them less efficient.<sup>114</sup>

### **Compliance Obligations and Formalism**

Although used in different contexts, legal formalism reflects a positivist theory of law. At the heart of legal formalism lies the view that decision making, or judicial adjudication, should follow the literal meaning of legal rules, autonomous from other reasoning, including their purpose.<sup>115</sup> In tax law legal formalism is often discussed in the context of substantive tax rules and tax avoidance, as a formalistic approach facilitates manipulation of legal rules, and the granting of tax advantages where the letter of the law is complied with, even where its purpose is not.<sup>116</sup> So that combating avoidance requires a non-formalistic approach to the law. In this sense formalist is perceived as having the potential to undermine the tax system.

Legal formalist in tax law has never been seen, however, from the perspective of adjective law, i.e. compliance rules. In this sense too, formalism has the potential to undermine the tax system, but in this case, formalism is being used not by taxpayers, but by tax authorities as a tool to, allegedly, combat evasion. The following cases concern instances of adoption of a formalistic interpretation of compliance rules by tax authorities, to justify the denial of rights where no evidence of fraud was presented or apparent.

In *Rusedespred* the Court made it clear that principle of neutrality must be interpreted as precluding a tax authority from refusing the supplier of an exempt supply the refund of VAT invoiced in error to a customer on the ground that the supplier had not corrected the erroneous invoice, in circumstances where that authority had definitively refused the customer the right to deduct that VAT and such definitive refusal results in the system for correction provided for under national law no longer being applicable.

In *Petroma Transports* it was held that the Directive and the principle of fiscal neutrality did not prevent the refusal of the right to deduct on basis of incorrect invoices, even if additional documents are supplied afterwards as proof.

*VSTR* concerned the refusal to exempt intra-Union transactions on the ground of failure to produce the VAT identification number of the person acquiring the goods. While the Court accepted that the VAT identification number is usually necessary, it stated: “the grant of that exemption should not be refused

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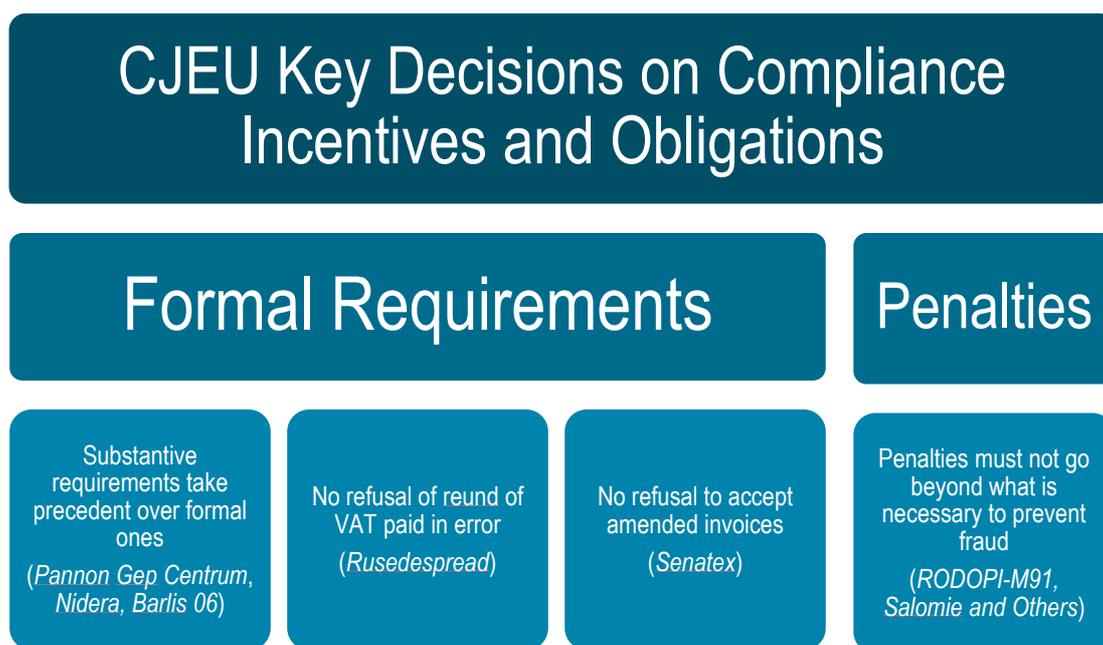
<sup>114</sup> D. Pomeranz n. xx

<sup>115</sup> F. Schauer, “Formalism” (1989) *Yale Law Journal* 97, 509; and B. Leiter, “Legal Formalism and Legal Realism: What is the Issue?” (2010) *Legal Theory* 16(2). See also leading formalist, R. Dworkin, *Taking Rights Seriously* (Harvard University Press, 1977).

<sup>116</sup> See D. Weisbach, “Formalism in the Tax Law” (1999) *University of Chicago Law Review* 66, 860; and J. Prebble, “Ectopia, Formalism, and Anti-Avoidance Rules in Income Tax Law” in W Krawietz et al, *Prescriptive Formality and Normative Rationality in Modern Legal Systems* (Duncker & Humbolt, 1994), 367.

on the sole ground that that requirement was not fulfilled where the supplier, acting in good faith and having taken all the measures which can reasonably be required of him, is unable to provide that identification number but provides other information which is such as to demonstrate sufficiently that the person acquiring the goods is a taxable person acting as such in the transaction at issue”.<sup>117</sup> This shows that even the presumption of VAT identification number is rebuttable.

**Diagram 3: Key CJEU Decisions on Compliance**



#### IV. TACKLING ORGANISED TAX FRAUD

Whilst the links between tax fraud generally and other criminal activity, such as money laundering, have long been suspected,<sup>118</sup> the links specifically between VAT fraud and organised crime are less well-known.<sup>119</sup> Yet, the risk of organised fraud, particularly through the use of fake invoices or supplies, is inherent to the invoice-credit VAT system,<sup>120</sup> and the abolition of border controls within the EU, in the first instance, and later the digitalisation of the economy, have created the conditions for organised fraud to flourish. This has occurred, not solely through the use of fake invoices, but crucially also through missing-trader fraud. Whilst initially there was comparatively less academic attention dedicated

<sup>117</sup> Case C-587/10 *VSTR*, para. 58.

<sup>118</sup> On these links see M Levi, *Money for Crime and Money from Crime: Financing Crime and Laundering Crime Proceeds* (2015) *European Journal of Criminal Policy Research* 21, 275-297.

<sup>119</sup> On crime networks and the organised crime construct, see M. Levi, "Organized fraud and organizing frauds Unpacking research on networks and organization" (2008) *Criminology and Criminal Justice* 8(4), 389-419.

<sup>120</sup> M. Keen and S. Smith, n. xx above, at 867-868. In 1988, A. Tait reported extensive fraud resulting from the use of fake invoices in the Netherlands, see *Value-Added Tax: International Practice and Problems* (Washington, D.C.: IMF, 1988), at 307.

to VAT organised fraud, than to VAT evasion, EU Member States were quick to express concerns, given in particular the significant loss of revenue allegedly involved in this type of fraud.

The institutional EU response to these concerns consisted initially of a two-fold conservative approach, namely: to intensify administrative cooperation and facilitate information exchange;<sup>121</sup> and to expand the reverse-charge mechanism, particularly in specific industries susceptible to missing-trader fraud.<sup>122</sup> More recently, EU institutions have adopted, or suggested the adoption, of bolder approaches to tackling VAT organised fraud, in particular: the inclusion of serious cross-border VAT fraud within the remit of the new European Public Prosecutor Office;<sup>123</sup> and the use of new technologies, such as data warehouses, electronic invoices, and licenced software.<sup>124</sup>

Despite some of these more recent measures, the feedback from EU Member States indicated that traditional EU approaches to tackling organised fraud in particular were still lacking.<sup>125</sup> From the early 2000s onwards, therefore, a new trend starts emerging amongst EU Member States, with the adoption of new domestic legislation and administrative practices. Like measures concerning penalties or formalistic approach to compliance adopted in the context of anti-evasion policy, these new measures were purportedly aimed at strengthening VAT anti-fraud policy in the context of organised fraud, yet they are not designed to tackle fraud per se, but rather to minimise its revenue costs. Unsurprisingly, these measures have given rise to unprecedented levels of litigation, with those reaching the CJEU amounting to dozens.<sup>126</sup> At the centre of litigation at CJEU level – necessarily a small fraction of total litigation within the EU –<sup>127</sup> have been the legislative or administrative practices of only some Member

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<sup>121</sup> See Commission Regulation (EC) No 1925/2004 of 29 October, OJ L 331, 05/11/2004, 13-18; and Council Regulation (EU) 904/2010 of 7 October, OJ L268, 12/10/2010, 1-8.

<sup>122</sup> See Council Directive 2010/23/EU of 16 March 2010, OJ L72, 20/03/2010, p. 1; Council Directive 2013/43/EU of 22 July 2013, OJ L201, 26/07/2013, 4-6; and Council Directive 2013/42/EU of 22 July 2013, OJ L 201, 26/7/2013, p. 1. See also European Commission, *Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax as regards the temporary application of a generalised reverse charge mechanism in relation to supplies of goods and services above a certain threshold*, COM(2016) 811 final, 23 December 2016.

<sup>123</sup> See European Commission, *Proposal for a Council Regulation on the establishment of the European Public Prosecutor's Office*, COM(2013) 534 final, 17/07/2013. See also European Parliament, *Towards a European Public Prosecutor's Office (EPPO)*, Study for the LIBE Committee, 2016, at 23 et seq.

<sup>124</sup> See European Commission, *Action plan on VAT: Towards a single EU VAT area - Time to decide*, Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee, COM(2016) 148 final, 7 April 2016, at 10. Although the OECD has gone substantially further in their proposals, see OECD, *Technology Tools to Tackle Tax Evasion and Tax Fraud* (Paris, 2017).

<sup>125</sup> European Commission, *Report from the Commission to the Council and the European Parliament on the Application of Council Regulation (EU) No. 904/2010 concerning administrative cooperation and combating fraud in the field of value added tax*, COM(2014) 71 final, 12 February 2014. See also S. Fedeli and F. Forte, "EU VAT frauds" (2011) *European Journal of Law and Economics* 31, 143-166, at 162-163.

<sup>126</sup> For an overview of this jurisprudence, see C. Herbain, "Impact de la Répression sur les Fondamentaux de la TVA" in C. Herbain (ed.), n. xx above, (Larcier, 2017), 208-230.

<sup>127</sup> In the UK, for example, the number of cases decided by domestic courts is many times those that reached CJEU level. For a review of some of those cases, see M. Schofield, "S&I Electronics Plc v HMRC and the state of MTIC VAT fraud" (2015) *British Tax Review* 5, 663-678; and K. Rahman and I. Roxan, "Mobilx Ltd (In Administration) and others v HMRC: is this the end of fraudulent evasion of VAT?" (2010) *British Tax Review* 5, 492-500.

States, namely Austria,<sup>128</sup> Belgium,<sup>129</sup> Bulgaria,<sup>130</sup> Germany,<sup>131</sup> Hungary,<sup>132</sup> Netherlands,<sup>133</sup> and Poland,<sup>134</sup> and the UK.<sup>135</sup> The suspicion, however, is that similar practices are being adopted in many other EU Member States, but litigation is not reaching the CJEU;<sup>136</sup> equally, there is evidence of similar practices being adopted in other countries, outside the EU.<sup>137</sup>

What makes these cases so remarkable – and stands as evidence of the new approach to combating the revenue costs of fraud – is the fact that, in all but a few, the taxpayers involved in the litigation were not those allegedly committing the fraud, but a third person with some business connection to the presumed fraudster. This third person could be the seller of the goods to the alleged fraudster, the purchaser of those goods, an intermediary, or even a warehouse keeper. The phenomenon whereby private parties – not forming part of the criminal justice system – are legally, or administratively, held responsible for crime prevention, has been denominated *responsibilisation*, and is neither exclusive to VAT fraud, nor new. On the contrary, the *responsibilisation* phenomenon (discussed below) has been identified as part of a general trend within crime control during the late 20<sup>th</sup> century,<sup>138</sup> which has become widespread, in particular within financial crime, such as money laundering.<sup>139</sup> Why this phenomenon spread to VAT fraud and how it developed therein, can be understood by analysing the evolution of the CJEU case-law on organised VAT fraud.

### **Development of the Principle of Third-Party Liability**

Perhaps unsurprisingly given that the *responsibilisation* phenomenon was first identified in the Anglo-American context, the process of *responsibilisation* of third parties for VAT fraud seems to have started

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<sup>128</sup> Case C-245/04, *EMAG*, ECLI:EU:C:2006:232.

<sup>129</sup> Joined cases C-439/04 and C-440/04, *Kittel and Recolta Recycling*, ECLI:EU:C:2006:446; and, case C-499/10, *Vlaamse Oliemaatschappij*, ECLI:EU:C:2011:871.

<sup>130</sup> Cases C-285/11, *Bonik*, ECLI:EU:C:2012:774; C-642/11, *Stroy trans*, ECLI:EU:C:2013:54; C-18/13, *Maks Pen*, ECLI:EU:C:2014:69; C-107/13, *FIRIN*, ECLI:EU:C:2014:151; C-492/13, *Traum*, ECLI:EU:C:2014:2267; C-123/14, *Itales*, ECLI:EU:C:2015:511; C-159/14, *Koela-N*, ECLI:EU:C:2015:513; and C-576/15, *Maya Marinova*, ECLI:EU:C:2016:740.

<sup>131</sup> Case C-146/05, *Collée*, ECLI:EU:C:2007:549; case C-285/09, *R*, ECLI:EU:C:2010:742; and C-587/10, *VSTR*, ECLI:EU:C:2012:592.

<sup>132</sup> Cases C-80/11, *Mahagében*, ECLI:EU:C:2012:373; C-273/11, *Mecsek-Gabona*, ECLI:EU:C:2012:547; and C-324/11, *Gábor Tóth*, ECLI:EU:C:2012:549.

<sup>133</sup> Case C-430/09, *Euro Tyre*, ECLI:EU:C:2010:786; and joined cases C-131/13, C-163/13 and C-164/13, *Italmoda*, ECLI:EU:C:2014:2455.

<sup>134</sup> Cases C-33/13, *Marcin Jagiello*, ECLI:EU:C:2014:184; and C-277/14, *PPUH Stehcemp*, ECLI:EU:C:2015:719

<sup>135</sup> Joined cases C-354/03, C-355/03 and C-484/03, *Optigen, Fulcrum and Bond*, ECLI:EU:C:2006:16; and cases C-384/04, *Federation of Technological Industries and Others*, ECLI:EU:C:2006:309; and C-409/04, *Teleos and Others*, ECLI:EU:C:2007:548.

<sup>136</sup> On Italian practices, see M. Bancalari and F.T. Coaloa, “The Unlawful Consequences of Italy’s Registration Procedure” (2013) *International VAT Monitor* 3, 158-161; and on Swedish practices, see E. Kristoffersson, “Tax fraud, tax abuse and the right to deduct input VAT in Sweden” (2013) *World Journal of VAT/GST Law* 2(3), 261-267.

<sup>137</sup> On Canadian practices, for example, see M.C. Marcil, “The recipient’s knowledge of fraud and its impact on the recovery of refunds and credits” (2013) *World Journal of VAT/GST Law* 2(3), 214-223.

<sup>138</sup> D. Garland, *The Culture of Control: Crime and Social Order in Contemporary Society* (OUP, 2002).

<sup>139</sup> See E. Baker, “The legal regulation of transnational organised crime – Opportunities and limitations” in A. Edwards and P. Gill (eds.), *Transnational Organised Crime* (Routledge, 2003), 183-193.

–at least within the EU– in the UK. In 2002, HMRC started refusing the deductibility of input VAT to traders where the purchaser of those goods had turned out to be a (missing trader) fraudster. The general view is that – similarly to the rationale present in other countries –<sup>140</sup> this new approach was financially motivated and linked to the difficulty in catching fraudsters, and the near impossible task of recovering the revenue lost to the fraud.<sup>141</sup> Unsurprisingly, the new practice led to immediate litigation. Three cases, *Optigen*, *Fulcrum* and *Bond House*, were soon lodged before the UK courts,<sup>142</sup> and whilst initially won by HMRC in the lower courts, they were referred to the CJEU on appeal.

In *Optigen*, *Fulcrum* and *Bond House* HMRC sought to argue that, despite the taxpayers being unaware of the carousel fraud, the transactions did not constitute an economic activity for the purposes of VAT, within the meaning of the VAT Directive,<sup>143</sup> and consequently did not give rise to the right to deduct input tax. In its decision, the Court dismissed the argument. It rejected third-party liability, concluding that, in so far as the taxable person had no knowledge and no means of knowledge of the fraud, it should be allowed to deduct input VAT, regardless of the existence of prior or subsequent fraudulent VAT transactions in the supply chain.<sup>144</sup> Particularly strong in its criticism of third-party VAT liability was Advocate General Poiares Maduro, who in his Opinion on the case stated:

“The United Kingdom seems to envisage combating carousel fraud – or at least dispensing with the problems it poses – by limiting the scope of the VAT system. To my mind, the Court should not consent to this approach. It would drastically shift the burden of the problem from the tax authorities to the private sector, at the expense of legitimate trade and the proper functioning of the VAT system. Moreover, it would deter Member States from taking appropriate measures against carousel fraud.”<sup>145</sup>

This initial rejection of third-party liability was significantly qualified less than a year later in *Kittel and Recolta Recycling*, with the introduction of the concept of innocence.<sup>146</sup> Similarly to *Optigen*, *Fulcrum* and *Bond*, at stake was the limitation by the tax authorities, in this case Belgian, of the right to deduct input VAT of the acquirer of goods from a potential missing trader fraudster. The Court appeared to

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<sup>140</sup> See M.C Marcil, n. xx above.

<sup>141</sup> See the strong-worded criticisms of R. Pincher, “The costs of VAT frauds: *Bond House Systems Ltd and Optigen*” (2003) *British Tax Review* 5, 346–355.

<sup>142</sup> *Bond House Systems Ltd v CC&E* [2003] UK VAT two V18100; and *Optigen Ltd v CC&E* [2003] UKVAT V18112. For a commentary on these decisions see G. Richards, “Carousel fraud: absolving the innocent: *Optigen Ltd and others v Commissioners of Customs & Excise*” (2006) *British Tax Review* 147.

<sup>143</sup> Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ L347, 11/12/ 2006, 1-118.

<sup>144</sup> Joined Cases C-354/03, C-355/03 and C-484/03, *Optigen, Fulcrum Electronics, and Bond House Systems*, ECLI:EU:C:2006:16. For a comment on the perceived impact of these cases at the time see S. Vandenberghe and H.J. Sharkett, “Rights of Taxable Persons Involved in VAT Carousel Fraud from an EU, Belgian and UK Point of View Today and Tomorrow” (2006) *International VAT Monitor* 17(4), 254.

<sup>145</sup> Opinion in Joined Cases C-354/03, C-355/03 and C-484/03, *Optigen, Fulcrum Electronics, and Bond House Systems*, ECLI:EU:C:2005:89, at para 42.

<sup>146</sup> Joined Cases C-439/04 and C-440/04, *Axel Kittel v Belgian State and Belgian State v Recolta Recycling SPRL*, ECLI:EU:C:2006:446.

reiterate the decision in those cases, stating that innocent third parties cannot be made liable for VAT fraud; but it then went on to define innocent third parties as those that have not themselves committed the fraud, and have taken every precaution which could reasonably be required of them. *A contrario*, third-party liability for VAT fraud is possible where “the recipient tax payer knew, or should have known that the goods were connected with the fraudulent evasion of VAT”.<sup>147</sup> Ascertaining knowledge of fraud will be a proof matter, the expression “should have known”, however, raised immediate concerns as to its meaning and scope, even its translation, from the original judgment in French, has been questioned.<sup>148</sup>

The scope of the expression was further developed by the Court a year later in *Federation of Technological Industries*.<sup>149</sup> The Court started by confirming that third-party liability is possible, if principles of legal certainty and proportionality are met, but it can only be applied to persons who, at the time of the supply, knew or had reasonable grounds to suspect that some or all VAT would go unpaid. It then went on to set out the basic principles underpinning the burden of proof on third-party liability for fraud, by stating that a person is presumed to have reasonable grounds for suspecting that this is the case if the price paid was less than the lowest price that it might be reasonably expected to be paid for those goods in the free market, or less than the price paid on previous supplies of similar goods; this presumption is rebuttable, however, if proof is presented that the low price paid is attributable to other circumstances. The decision was significant, not only for confirming the criteria for determining the potential liability of third parties for VAT fraud, but crucially also for establishing the basic principles underpinning the burden of proof on VAT fraud cases. Henceforth the CJEU case-law on third-party liability for VAT fraud would be divided into two main streams, namely cases concerning the burden of proof for establishing liability, and cases concerning the scope of that liability.

In terms of scope of that liability, all initial cases on third-party liability for fraud had concerned the removal of the right to deduct input VAT from a business who had acquired products from a fraudster. The first question then was whether that liability could be extended to removal of other rights, in particular the right to VAT exemption on intra-EU sales, when the acquirer of those products turns out to be a fraudster. Whilst the CJEU implicitly accepted the potential denial of those rights in the context of

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<sup>147</sup> *Ibid*, at para 14.

<sup>148</sup> See UK cases: *Universal Enterprises (EU) Ltd v HMRC* [2015] UKUT 311 (TCC) (Upper Tribunal), at paras 36-37; and *Lifeline Europe Ltd v HMRC* [2014] UKUT 135 (TCC) (Upper Tribunal), at paras 57-61.

<sup>149</sup> Case C-384/04, *CC&E and Attorney General v Federation of Technological Industries and Others*, ECLI:EU:C:2006:309.

organised VAT fraud soon after *Federation of Technological Industries*,<sup>150</sup> express confirmation came only in 2012, in the *Mecsek-Gabona* case.<sup>151</sup>

Whilst at the time this extension may have appeared as a small legal step, in reality it was an extremely significant one, substantively extending the scope of third-party liability for organised VAT fraud. Indeed, there are fundamental differences between making a business which acquired products from a fraudster liable, by denying the right to deduct input VAT, and making someone who supplied a good to a potential fraudster liable, by denying the right to exemption. Both instances constitute third-party liability for unknowing participation in organised VAT fraud, in the form of denial of rights, but there are key distinctions. Denying deductibility to the acquirer of goods constitutes the imposition of liability for a crime which has already occurred, committed in the same country that is now denying the right to deduct input VAT, not paid as output; on the contrary, denying the right to VAT exemption of intra-EU supply to the supplier of goods amounts to imposition of liability for a crime which has not yet occurred, and committed in another country, namely the Member State where the presumed fraudster was supposed to account for VAT on the intra-EU acquisition.<sup>152</sup> Using the MTF example in Diagram 2, where B is the missing trader, imposing liability on A, or imposing liability on C, is not legally equivalent even though both amount to denial of rights. The responsabilisation for a crime that has not yet occurred is not unique to VAT fraud, and can be seen as part of a wider shift to a pre-crime society, where crime is conceived essentially as risk or potential loss, and ordering practices are pre-emptive, as opposed to *post hoc*.<sup>153</sup>

Insofar as the extraterritoriality element is concerned, the extension of the scope of third-party liability creates the opportunity for the imposition of double liability for a single crime, yielding double the revenue than the one lost to fraud: where both the supplier (A) and the acquirer (C) are made liable for fraud committed by a missing trader (B), through the denial of the right to VAT exemption on intra-EU supplies, and the denial of the right to deduct input VAT unpaid as output. Instances of imposition of double liability for one instance of organised VAT fraud have already been reported in one Member State.<sup>154</sup> A further element of extra-territoriality was added a year after *Mecsek-Gabona*, in *Sunico*,<sup>155</sup> which concerned the enforcement in the UK of third-party liability for VAT fraud on Danish residents,

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<sup>150</sup> See cases C-409/04, *R. (on the application of Teleos plc and Others) v CC&E*, ECLI:EU:C:2007:548; and C-285/09, *Criminal Proceedings against R*, EU:C:2010:742.. For a review of various cases relating to the denial of the exemption for intra-EU supplies see S. Nathoeni and W. de Wit, "VAT Exemptions of Intra-Community Supplies of Goods: State of Play after VSTR" (2013) *EC Tax Review* 2, 100-105.

<sup>151</sup> Case C-273/11, *Mecsek-Gabona*, ECLI:EU:C:2012:547. For commentary on this case see also R. Wolf, "*Mecsek-Gabona*: The Final Step of the ECJ's Doctrine on Reliance on EU Law For Abusive or Fraudulent Ends in the Context of Intra-Community Transactions" (2013) *International VAT Monitor* 5, 280.

<sup>152</sup> An extraterritorial element, which has been wrongly attributed to a latter case, see M. Sutich and P. Centore, "Denial of a right and extraterritoriality: strengthening the fight against tax fraud" (2015) *World Journal of VAT/GST Law* 4(2), 101.

<sup>153</sup> L. Zedner, "Pre-Crime and Post-Criminology?" (2007) *Theoretical Criminology* 11(2), 261-281.

<sup>154</sup> M. Malecka, "Not your business but your liability: new VAT third-party liability in Poland" (2013) *World Journal of VAT/GST Law* 2(3), 253-260.

<sup>155</sup> Case C-49/12, *Sunico*, ECLI:EU:C:2013:545.

where they had not perpetrated the fraud, even if allegedly benefiting from it. The Court decided that Council Regulation (EC) No 44/2001, on enforcement of judgments in civil and commercial matters,<sup>156</sup> could be interpreted as to include within its scope an action brought in by the tax authorities of one Member State, against residents of another Member State, for damages in respect of loss caused by a conspiracy to commit VAT fraud in the first Member State.

As significant as these extensions had been, however, they still concerned the removal of rights. The most recent debate regarding the scope of the third-party liability has been, therefore, whether it extends beyond organised VAT fraud, to VAT evasion, and from the possible removal of rights to include the imposition of obligations. The first indication of the Court's willingness to extend third-party liability to obligations in the context of VAT evasion came in 2011 with two key decisions that went almost unnoticed. The first decision in *Jestel* concerned an intermediary who had sold goods produced in China on eBay, in respect of which neither customs duties nor import VAT had been paid. Without referring to any previous decisions on third-party liability for VAT fraud, the CJEU ruled that an intermediary could be held liable for unpaid custom duties where he "was aware, or should reasonably have been aware", that the introduction of the goods into EU territory was unlawful.<sup>157</sup> Although the decision concerned customs duties, it raised the possibility that the Court would have decided in a similar manner had import VAT been at stake.<sup>158</sup> The second significant decision came a month later. *Vlaamse* concerned the joint and several liability of a Belgian warehouse owner where the warehouse had been found to be used by a fraudster, in the context of organised VAT fraud. Whilst the CJEU denied liability on the case, the decision indicates *a contrario*, that liability would be possible had there been evidence of bad faith or negligence, therefore opening the door to the extension of third-party liability to the imposition of VAT obligations on intermediaries.<sup>159</sup>

Seen in isolation these decisions seemed relatively inconsequential for wider case-law, but they paved the way for the Court's landmark decision in *Italmoda*.<sup>160</sup> That case concerned, at its core, the possible imposition of third-liability for VAT fraud, in the form of denial of rights, in the absence of national provisions allowing it. The confirmation by the CJEU, that the liability for VAT fraud can indeed arise in the absence of national legislation providing for it, on the basis that this liability is inherent in the European legal system,<sup>161</sup> has significant theoretical and practical implications. In essence, it

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<sup>156</sup> OJ L12, 16/01/2001, 1-23.

<sup>157</sup> Case C-454/10, *Oliver Jestel v Hauptzollamt Aachen*, ECLI:EU:C:2011:752, para. 27.

<sup>158</sup> M. Vergeti, "E-Commerce Against Potentially Liable for Import VAT and Duties in the Case of Principal Fraud (CJEU, Case C-454/10)" (2012) *EC Tax Review* 5, 283-286.

<sup>159</sup> Case C-499/10, *Vlaamse Oliemaatschappij NV v FOD Financiën*, EU:C:2011:871, at para. 47. For a commentary on the impact of this case on the compliance obligations of intermediaries, see I. Lejeune et al, "Limited Third Party Liability in the EU VAT Matters" (2012) *International VAT Monitor* 6, 397-399.

<sup>160</sup> Joined Cases C-131/13, C-163/13 and C-164/13, *Staatssecretaris van Financiën v Schoenimport "Italmoda" Mariano Previti vof; Turbu.com BV v Staatssecretaris van Financiën; Turbu.com Mobile Phone's BV v Staatssecretaris van Financiën*, EU:C:2014:2455.

<sup>161</sup> This finding has led to concerns being raised as to its compatibility with article 7 of the European Convention on the Protection of Human Rights and Fundamental Freedoms, see J. Sanders, "The ECJ Decision in *Italmoda* in

transformed third-party liability for VAT fraud from a rule, into a principle, as only a principle has the legal force to remove rights or grant liability in the absence of concrete rules. Whether the Court regards third-party liability for fraud as an autonomous principle, a sub-principle of the principle of prohibition of abuse of law, or both as sub-principles of a wider principle, is unclear from the decision.<sup>162</sup> What is clear, however, is that a legal principle is capable of creating obligations, not just removing rights, and the emergence of third-party liability for fraud as a principle has natural consequences for its scope.<sup>163</sup> Read in the context of the previous decisions in *Jestel* and *Vlaamse*, the scope of the new principle of third-party liability for tax fraud, as developed by the Court, appears to apply to any type of fraud, and to extend to the potential creation of VAT obligations to any member of the production chain, including intermediaries, such as warehouse owners or online retail platforms.

As regards the burden of proof for establishing third-party liability for organised VAT fraud, in *Teleos* the CJEU set out the guiding principle, already implicit in *Federation of Technological Industries* namely that, whilst the onus of proof can be inverted in certain circumstances, such as the absence of market price, the onus generally rests with the tax authorities: the tax authorities must establish, on the basis of objective evidence, that the taxpayer concerned knew, or ought to have known, that fraud had been committed.<sup>164</sup> This guiding principle is consistent with the Court's previous case-law on burden of proof in the context of avoidance and evasion: whilst procedural tax rules are to a large extent determined at national level, the Court has set up limits to this autonomy insofar as the burden of proof is concerned,<sup>165</sup> stating in particular that the onus of proof in cases concerning tax avoidance and tax evasion should rest with the tax authorities, and its reversal to the detriment of the taxpayer is a prima facie violation of EU law, and is only possible if the reversal fulfils the principle of proportionality.<sup>166</sup>

Yet, despite its consistency, and the clarity of the principle, the Court has consistently asked in numerous cases to rule on the imposition of additional compliance obligations on taxpayers so as to prove their innocence,<sup>167</sup> on whether different burden of proof rules applied to missing trader fraud and to bogus traders,<sup>168</sup> and on whether the onus of proof could be inverted by general rules.<sup>169</sup> In all cases

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the Light of the Settled Case Law of the European Court of Human Rights" (2016) *International VAT Monitor* 6, 421-425.

<sup>162</sup> See detailed discussion on this point in R. de la Feria and R. Foy, n. xx above.

<sup>163</sup> On the legal force of EU principles, see generally A. Arnulf, 'What is a General Principle of EU Law?' in R. de la Feria and S. Vogenauer (eds.), *Prohibition of Abuse of Law: A New General Principle of EU Law?* (Oxford: Hart Publishing, 2011), Chapter 2.

<sup>164</sup> Case C-409/04, *R. (on the application of Teleos plc and Others) v CC&E*, ECLI:EU:C:2007:548.

<sup>165</sup> R. Seer, "Burden of proof and European tax law", in K. van Raad (ed.), *The Burden of Proof in Tax Law*, EATLP International Tax Series, Volume 10 (IBFD, 2013), at 57.

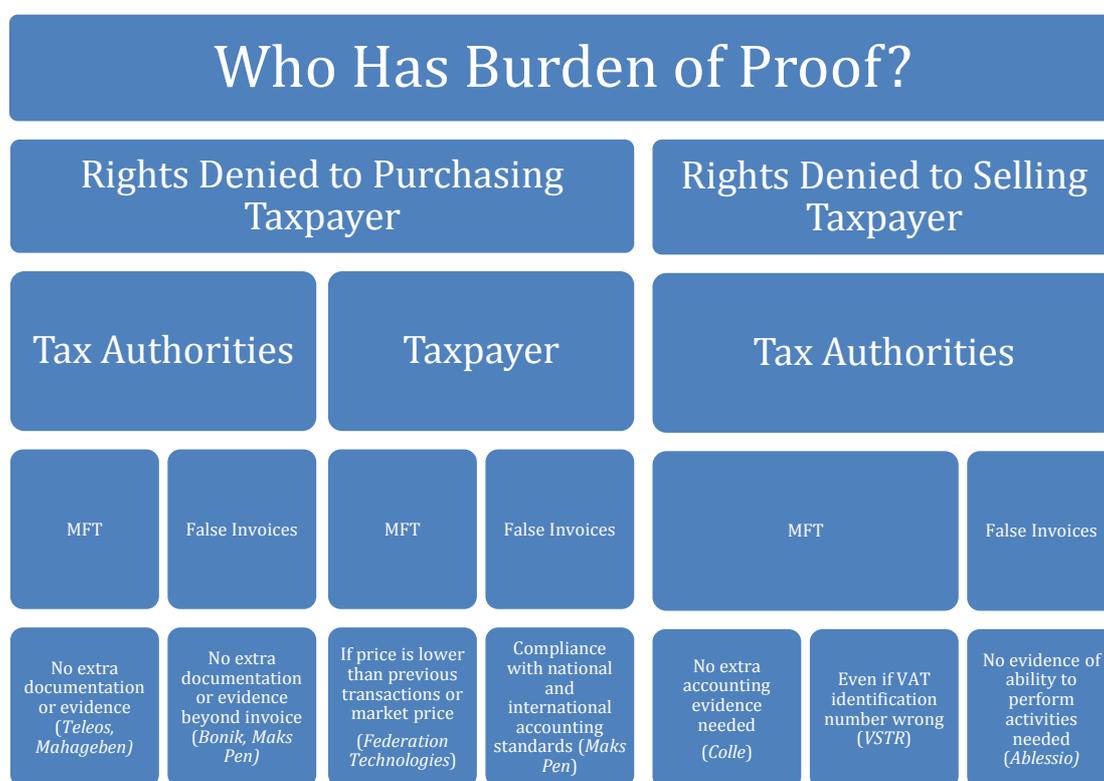
<sup>166</sup> See amongst others, cases C-28/95, *Leur-Bloem*, ECLI:EU:C:1997:369; and C-311/08, *SGI*, ECLI:EU:C:2010:26. See also G. Meussen, "Burden of proof and European tax law" in K. van Raad (ed.), n. xx, 35-38.

<sup>167</sup> Cases C-146/05, *Collee*, ECLI:EU:C:2007:549; C-80/11, *Mahageben and Dávid*, ECLI:EU:C:2012:373; and C-642/11, *Stroy trans*, ECLI:EU:C:2013:54.

<sup>168</sup> Cases C-285/11, *Bonik*, ECLI:EU:C:2012:774; C-527/11, *Ablessio*, ECLI:EU:C:2013:168; C-18/13, *Maks Pen*, ECLI:EU:C:2014:69. See also P. Centore, "Personal responsibility of traders to VAT fraud: the *Bonik* case" (2013) *World Journal of VAT/GST Law* 2(1), 59-64.

the Court sought to confirm that, notwithstanding exceptional circumstances where the onus of the proof had been inverted, no additional obligations could be placed on the taxpayer, except for the provision of a standard invoice and compliance with international accountancy standards, and that the same rules applied for both types of organised VAT fraud. Yet, there is still evidence that some Member States are not applying even the guiding principle concerning the onus of proof, and placing the burden on taxpayers to prove that they did not know, and could not have known, that they were involved organised fraud.<sup>170</sup> This stance is in contrast with Member States' approach to burden of proof rules in the context of tax avoidance, where until recently they have been perceived as being broadly compliant with CJEU case-law.<sup>171</sup> Diagram 4 offers a summary of existing case-law on burden of proof in cases concerning organised VAT fraud.

**Diagram 5: CJEU Jurisprudence on Burden of Proof**



### Third-Party Liability as Aggravated Responsibilisation

<sup>169</sup> Case C-101/16, *Paper Consult*, ECLI:EU:C:2017:775.

<sup>170</sup> See case C-277/14, *PPUH Stehcemp*, ECLI:EU:C:2015:719, concerning administrative practices in Poland; Y. Serandour, "Establishing VAT fraud in the case of cross-border supply" (2012) *World Journal of VAT/GST Law* 1(1), 95-98, on administrative and judicial practices in France; and K.V. Pashav, n. xx above, at 500, on Bulgarian administrative practices.

<sup>171</sup> Although there have been reports for some time indicating that in some Member States, tax administrations had been adopting a stricter approach to VAT, than to income tax, even in the context of avoidance, see B. Leidhammar, "General report" in K. van Raad (ed.), n. xx, at 24.

The phenomenon of responsabilisation, emerged as a new mode of governing crime in the late 20<sup>th</sup> century.<sup>172</sup> Prompted by a series of transformations in perceptions of crime, criminal justice structures, and a new realisation that the State could no longer assume sole responsibility for crime control,<sup>173</sup> Governments sought to act upon crime indirectly, by devolving responsibility for crime prevention to organisations and individuals outside the state, instead of directly through state agencies and organisations. Once the new strategy was established, it became a case of identifying those private organisations and individuals who should have the responsibility to reduce crime opportunities effectively.<sup>174</sup> Responsibilisation of the private sector within fraud and money laundering became commonplace,<sup>175</sup> with financial institutions bearing the brunt of the responsibility,<sup>176</sup> spreading then to other areas, such as cybercrime, with telecommunications and financial industries acquiring key roles in crime control.<sup>177</sup> The extension to tax fraud was progressive, with some instances of responsabilisation dating back many years,<sup>178</sup> and empirical evidence indicating that third-party information-reporting plays an important role in tax compliance.<sup>179</sup> However, the development of the principle of third-party liability marks a new stage in both the acknowledgment,<sup>180</sup> and the scope, of responsabilisation of the private sector in tax enforcement.<sup>181</sup> This responsabilisation for tax enforcement, under the principle of third-party liability, carries a key difference from other instances of responsabilisation: like in other areas, responsabilisation privatised crime control, but unlike under areas, it also privatised (some of) the costs of crime. Under the principle of third-party liability, businesses are required to carry out due diligence to ensure that their business partners are not involved in fraud – and as such, carry responsibility for crime

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<sup>172</sup> Famously in D. Garland, “The limits of the Sovereign State: Strategies of Crime Control in the Contemporary Society” (1996) *British Journal of Criminology* 36(4), 445-471.

<sup>173</sup> *Ibid*, at 448. See also S. Schneider, “Privatising Economic Crime Enforcement: Explaining the Role of Private Sector Investigative Agencies in Combating Money Laundering” (2006) *Policing and Society* 16(3), 285-312.

<sup>174</sup> *Ibid*, at 452.

<sup>175</sup> M. Levi and J. Burrows, n. xx above.

<sup>176</sup> Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, *OJ L141, 05/06/2015*, 73-117. See also V. Mitsilegas and N. Vavoula, “The Evolving EU Anti-Money Laundering Regime- Challenges for Fundamental Rights and the Rule of Law” (2016) *Maastricht Journal of European and Comparative Law* 23(2), 261-293.

<sup>177</sup> K. Uchimira, “Third party Responsibilisation Through Telecoms Policing” in R. Broadhurst and P. Grabosky (ed.), *Cyber-Crime – The Challenge in Asia* (Hong Kong University Press, 2005), 109-124.

<sup>178</sup> Paramount example is the obligation placed upon employees to withhold tax due by employees on their employment income, which in the US, for example, dates back to the 1940s. See A. Desai, “What a history of tax withholding tells us about the relationship between statutes and constitutional law” (2014) *Northwestern University Law Review* 108(3), 859-904.

<sup>179</sup> See L. Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance* (2007) *Stanford Law Review* 60, 695-746; and D. Pomeranz, n. xx above.

<sup>180</sup> Members of the Dutch tax administration have argued that there is a social responsibility placed on every citizen to fight against tax fraud, see M. Griffioen and L. van der Het van Dijk, “New European Approach to Combat VAT Fraud” (2014) *Intertax* 42(5), 298-305.

<sup>181</sup> Whilst the focus here is on its manifestations in VAT enforcement, the scope of the principle is also spreading within enforcement of other taxes, see R. Seer and A.L. Wilms, “General Report”, in R. Seer and A.L. Wilms (eds.), n. xx above, 3-27, at 26.

control.<sup>182</sup> Where due diligence was not carried out, and the tax authorities present objective evidence that business should have known that fraud was being committed, those businesses lose the right to exercise their rights to a tax refund or tax exemption, and may be held liable for the tax that went unpaid; in this case, therefore, they carry the responsibility for the revenue costs of the fraud, which are transferred on to them through denial of tax rights, or imposition of new tax obligations. This transfer imposes a detriment upon businesses which, whilst uncommon in the context of responsabilisation, is quite common within criminal justice systems through asset confiscation regimes.

Asset confiscation regimes have existed in several countries for many years, but the same transformations which led to the development of responsabilisation in the late 20<sup>th</sup> century, also led to a renewed attention to these regimes, as the trend towards a “follow-the-money approach” in crime control settled in.<sup>183</sup> Of particular relevance is the fact that new confiscation regimes allow various types of confiscation, including non-conviction based confiscation, also known as civil forfeiture or civil recovery, in which the confiscation of assets is pursued under civil proceedings, detached from criminal proceedings and regardless of their existence. This type of confiscation regimes are usually justified on the basis of one or more of the following elements:<sup>184</sup> (1) deterrence, by preventing the use of proceeds of crime;<sup>185</sup> (2) prevention, by hindering re-investment; (3) restoration of the *status quo*, which would have existed if crime had not been committed; and (4) remedy, by compensating victims of crime conduct, or the State, for costs related to law enforcement. Underlying these justifications, two key considerations are said to permeate the non-conviction based asset confiscation, namely: efficiency, sometimes also referred to as expediency, as potential higher costs and risks of criminal proceedings are avoided;<sup>186</sup> and, a moral imperative, rather than a rational one, according to which no-one should benefit from their crimes.<sup>187</sup> Both justifications and underlying considerations assume that non-conviction based asset confiscation targets criminal proceedings, thereby targeting crime *in rem* and ensuring a restitutionary effect. Yet, insofar as the principle of third-party liability is concerned, it is not the proceeds of crime which are being targeted, and there is no restitutionary effect; rather a substitution effect, whereby the proceeds of crime – the revenue lost through fraud – is being collected

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<sup>182</sup> On the creation of a duty of due diligence, see B. Gunacker-Slawitsch, “The Knowing Participation in VAT Fraud: Reflections on the Contents and the Limits of a Reasonable Duty of Due Diligence” (2017) *British Tax Review* 5, 649-666.

<sup>183</sup> J. Boucht, *The Limits of Asset Confiscation – On the Legitimacy of Extended Appropriation of Criminal Proceeds* (Hart Publishing, 2017), at 5. On the “follow-the-money approach” see also C. King and C. Walker, “Emerging Issues in the Regulation of Criminal and Terrorist Assets” in C. King and C. Walker (eds.), *Dirty Assets – Emerging Issues in the Regulation of Criminal and Terrorist Assets* (Routledge, 2014), 3-26, at 5.

<sup>184</sup> *Ibid*, at 10.

<sup>185</sup> Economic models seem to confirm this deterrence effect, under certain conditions, see R. Bowles et al, “Economic analysis of the removal of illegal gains” (2000) *International Review of Law and Economics* 20, 537-549. Although there is limited evidence of it in practice, see J. Boucht, n. xx above, at 10.

<sup>186</sup> J. Boucht, n. xx above, at 10; and J. Hendry and C. King, “Expediency, Legitimacy, and the Rule of Law: A Systems Perspective on Civil / Criminal Procedural Hybrids” (2016) *Criminal Law and Philosophy* 10(33), 1-25, at 10.

<sup>187</sup> M. Beare and F. Martens, “Policing Organised Crime – The Comparative Structures, Traditions, and Policies Within the United States and Canada” (1998) *Journal of Contemporary Criminal Justice* 14(4), 398-427, at 415.

from a third-person. In this context, most justifications and underlying considerations for asset confiscation do not apply: there is no moral imperative, since the crime was committed by a different person from that from whom the tax is being confiscated; and, for similar reason, there is no element of deterrence, prevention, or restoration of *status quo*. There are, therefore, only two possible justifications for the existence of elements akin to asset confiscation in anti-tax fraud policy, namely remedy, to the extent that it allows compensation to the State for the revenue lost through fraud – although it does not compensate other victims of tax fraud, such as businesses who were put at a competitive disadvantage; and, efficiency, since it allows a quick recovery of the revenue lost through fraud, with minimal enforcement costs.

The principle of third-party liability for tax fraud can therefore be characterised as an instance of responsabilisation, with aggravating elements which are more akin to asset confiscation. Yet, even in their purer form, these criminal justice trends have been subject to intense scrutiny and their legitimacy questioned. Whilst non-conviction based asset confiscation is presented as recouping ill-gotten gains, in essence it operates as a sanction of criminal wrongdoing,<sup>188</sup> a paradigmatic example of the trend towards hybridisation procedures, which has been defined as the use of civil procedures to target criminal behaviour.<sup>189</sup> Yet, the absence of civil procedures of the procedural protections that are present in criminal proceedings, has been said to threaten civil liberties, and the rule of law;<sup>190</sup> as well as to create the risk of targeting legitimate possessions, with potentially stigmatising and reputational effects, and even adverse personal effects, on those who have been subject to asset confiscation.<sup>191</sup> Put in the context of the principle of third-party liability for tax fraud, these concerns are much more poignant because the features akin to non-conviction asset confiscation are applied in conjunction with responsabilisation. As a result the sanction is applied not to the wrongdoers – there is no presumption or pretence that the target are crime proceeds – but rather to a third-party, or more, who has not itself committed the crime; a crime which may have been committed extra-jurisdictionally, or which may even not have been committed yet. It is therefore those third-parties, not the wrongdoers, who will feel any potential stigmatising, reputational, or even personal negative effects resulting from the targeting of their property by tax authorities.

## V. FROM TAX FRAUD SUPPRESSION TO TAX FRAUD MANAGEMENT

Anti-tax fraud measures, like other criminal law measures, have traditionally had a dual function, namely punishment and deterrence. The recent legal and administrative developments discussed above have cast doubts over their function. These above developments as regards tax fraud are reminiscent of

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<sup>188</sup> J. Hendry and C. King, n. xx above, at 16.

<sup>189</sup> A. Ashworth and L. Zedner, "Defending the Criminal Law: Reflections on the Changing Character of Crime" (2008) *Criminal Law and Philosophy* 2(1), 21-51.

<sup>190</sup> J. Hendry and C. King, n. xx above, at 22.

<sup>191</sup> J. Boucht, n. xx above.

developments in criminal justice: a general move from crime control to crime management. At present, anti-fraud policy is directed at managing the revenue costs of tax fraud, rather than at suppressing or controlling tax fraud. Of course, in many situations, the two will coincide: measures aimed at addressing the revenue costs of fraud will have a positive effect in the reduction of the incidences of tax fraud itself. As demonstrated above, however, this will not be the case, or not necessarily the case, in many other situations.

## VI. CONCLUSION

The last decade has witnessed very significant developments in anti-tax fraud policy trends within Europe. Whilst many of these are positive developments, analysis of some of the characteristics of these trends unveils a fundamental lack of understanding of the phenomenon of tax fraud, and a consequently flawed approach to tax enforcement. Public finance concerns, tax administration incentives, and the significant difficulties and costs entailed in combating tax fraud, have led to a shift in tax enforcement whereby tax fraud has been equated to revenue loss, and anti-fraud policy can no longer be regarded solely as a deterrent or as a form of punishment for tax fraud, but rather has become a compensatory measure for the revenue that has been lost through fraud. Tax fraud has become a crime whose effects are to be managed, rather than a crime to be suppressed, and tax enforcement has come to be primarily driven by efficiency considerations.

Equating revenue costs of fraud with fraud itself, and basing enforcement decisions on efficiency considerations only, however, has the potential to undermine the credibility of our legal system, representing a serious risk to the rule of law. Efficiency, like neutrality and equity, is a key underlying principle of tax law, and as such it is appropriate that it should guide, in conjunction with the two other principles, tax policy design. A key distinction, however must be made between tax policy and tax enforcement: efficiency has a key role in first, but not in the latter; efficiency cannot, and must not, be the primary criterion applicable to tax enforcement decisions. To do so, inevitably leads to selective tax enforcement, fatally undermining both neutrality and equity; it leads to further inefficiency, by discrediting the tax system and undermining compliance;<sup>192</sup> and crucially, it undermines the rule of law, slowly corroding one of the core values upon which our society is based.

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<sup>192</sup> As a result of the theory of the second-best, pursuing efficiency with disregard to equity, may actually result in higher inefficiency, see R. Markovits, "The General Theory of the Second Best and Economic Efficiency Analysis" (2015) *Akron Law Review* 49(2).

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