EXCISE DUTY FRAUD, VAT FRAUD AND MONEY LAUNDERING: MISCONCEIVED LAW ENFORCEMENT PRACTICES AND POLICIES?

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Introduction

It has been argued before[2] that to misapply the law in the name of law enforcement is ultimately ineffective and counter-productive. Procedures and principles may not be set aside in order to make law enforcement easier. If they are, short-term gains (if any) come at the expense of a long-term loss to the law or legal system one seeks to protect. Infringements of the law must therefore be combated by using the law as it is, not by changing the law or discarding tested principle ad hoc. The law may not be changed to suit the case.

In this short contribution this thesis is discussed by reference to the failed attempt by the British tax authorities to combat excise duty fraud by by-passing the requirements of the criminal justice system and by revisiting British and German attempts to prevent VAT carousel fraud by wholly disregarding the fundamental principles of the common VAT system. In the light of that discussion some questions are asked about the wisdom of some aspects of the proposed third anti-money laundering directive.

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[2] Crosby & Bauschulte, The Law Alone can give us Freedom - Gulagging in VAT Law, ECTJ 7/2 [2003/2004] 89; Publisher's Note to "Gulagging in VAT Law", ECTJ 7/3 [2004] 1

Outward Diversion Fraud: the Butterfield Report

The Butterfield Report[3] was commissioned inter alia, as a result of a prosecution by the former H.M. Customs and Excise ('HMCE') in an excise fraud case which collapsed, because the prosecution decided to offer no evidence. It was later followed by a police investigation into the practices of HMCE, which led to the suspension of a number of high level officials, called "Operation Gestalt".

The case, known as *Fajita II*, concerned a type of fraud, known as "outward diversion fraud". Outward diversion fraud comprises:

- removing excisable goods from a bonded warehouse on which excise duty is suspended;
- claiming that the goods are for shipment to another EU jurisdiction or to another bonded warehouse and not for release for consumption, release for consumption being the taxable event;
- selling the goods on the domestic market;
- forging the receipt of delivery to another jurisdiction or bonded warehouse, and so
- acquiring and selling goods free of excise duty.

The *Fajita II* case was one in a series involving a bonded warehouse called London City Bond. Convictions had been obtained in cases preceding *Fajita II*. Over a period of some years before the cases came to court, HMCE had used a Mr Alf Allington as a participating informant. Mr Alf Allington was the owner of the bonded warehouse. He knew that fraudulent transactions were going on in respect of goods leaving his warehouse. He could have stopped them. He did not, because it was HMCE policy to allow the frauds to continue. HMCE and Mr Allington were thus colluding to allow the frauds to take place. This was part of HMCE's investigation technique. Alf Allington's evidence was crucial in all the trials. It was also crucial to the success of these trials that this collusion remained secret.

In the preceding trials, the prosecution obtained permission from the judge not to disclose to the jury the true nature of the relationship between HMCE and Mr Alf Allington. In *Fajita II* the judge refused to allow witness protection. Thus the prosecution could not proceed in that case without revealing the nature of the

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[3] Available at http://www.hm-treasury.gov.uk/newsroom_and_speeches/speeches/statement/butterfield03_report_index.cfm

relationship and inviting a persuasive accusation from the defence of illegal entrapment. Mr Allington refused to waive his immunity. So, HMCE decided to protect the informant, and offered no evidence, thereby causing the trial to collapse.

In the midst of another trial Mr Gordon Smith, former senior prosecuting solicitor at HMCE, went to the police and stated that HMCE were deliberately deceiving the courts. Later Mr Smith gave evidence in court to this effect. Operation Gestalt ensued.

All the trials were thus vitiated. The revenue loss is estimated at something approaching £700 million.

There is no need to go into the detail of the many trials and appeals here. The report identifies a whole range of failures on the part of the HMCE, failures which

> *"…stemmed from systematic weaknesses within (HMCE), in particular,…a culture where the need to fulfil the requirements of the criminal justice system was not accepted as an essential part of the investigation process; …".*

In the light of the foregoing, it seems apparent that it is simply counter-productive to attempt to enforce excise duty law by infringing the criminal justice system.

VAT Carousel Fraud: the Gulagging Policy

The term "gulagging" is used to denote the punishment of innocent parties, where it proves difficult or impossible to punish the guilty parties. Two variants of this have been discussed previously[4].

The first is the British variety. This is exemplified in the rulings by the VAT tribunals of Manchester and London, whereby taxable persons, found to be wholly innocent of any criminal conduct, were denied the refund of input tax on the grounds that the purchase transactions took place within an overall carousel fraud structure, which, according to the tribunals, deprived the transactions of all

[4] See Crosby & Bauschulte, op.cit.supra

economic substance[5]. These rulings were criticised as being wrong in economics and law[6].

The second is the German variety. This comprises the disallowing of the intra-Community supply exemption to German taxable persons even when all the conditions for granting the exemption are met in cases where the purchaser in another Member State sells the goods on and fails to remit the VAT collected on the resale to the Member State of the purchaser. This policy was criticised for placing the risk of illegal conduct by taxable persons further down the supply chain on unconnected suppliers further up it, amounting to the antithesis of the principles of the common VAT system.

Under both variants the criminal is not punished, but those who inadvertently trade with him are.

The British variant may not survive for much longer.

In his opinion of 16th February 2005 in joined cases C-354/03, C-355/03 and C-484/03, *Optigen Ltd*, *Fulcrum Electronics Ltd (in liquidation)* and *Bond House Systems Ltd v Commissioners of Customs and Excise*, Advocate-General Maduro has concluded *inter alia* that the fact that transactions made in the context of a carousel "*ne cessent pas pour autant de constituer une activité économique au sens de l'article 4, paragraphe 2, de la sixième directive*" (do not for that reason cease to constitute an economic activity within the meaning of Article 4(2) of the Sixth Directive). If the Court of Justice follows the Advocate-General, then all the efforts and considerable amount of public money put into "gulagging" the innocent companies will have been squandered; the non-observance of the law by the law enforcement agencies will prove to have been counter-productive.

In respect of the German variant the same result may be on its way.

In Case C-439/04 *Axel Kittel v Belgium* and Case C-440/04 *Belgium v Recolta Recycling*[7], answers are sought to the question whether Belgian taxable persons, who *purchase* goods in good faith and without any criminal intent from another taxable person who has been trading fraudulently, are entitled to recover the input tax paid for the purchase of the goods, despite the fact that under Belgian public order laws the transactions in question were invalid. The correct answer to these

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5 This took the transactions outside the scope of the VAT system. What seemed to be input VAT was, thus, not VAT at all, but a payment in error. As such it was forfeit to the state.

6 Crosby & Bauschulte, op. cit.supra.

7 See (2005) O.J. C6/25.

questions must, it is submitted, be in the affirmative, because otherwise, the onus will be on every trader to check the legality of every previous transaction in a chain of transactions, a process which would bring trade to a halt. Such a ruling would be consistent with Advocate-General Maduro's opinion in respect of the British cases cited above.

If the answer is in the affirmative then the reverse case, where a taxable person unwittingly **sells** to a fraudulent trader in another Member State and is denied for that reason the right to claim the intra-Community supply exemption, would also have to be decided in favour of the claimant (the vendor), because otherwise an intolerable burden would be placed on suppliers to ensure that their customers do not act illegally, a burden which would likewise bring trade to a standstill. Again this would be consistent with Advocate-General Maduro's opinion in the British cases.

In summary, infringing the Sixth VAT Directive as a means of eradicating carousel fraud may yet founder on judicial disapproval. If it does, the errors of the authorities will speak eloquently for themselves.

The Relevance for EU's Money Laundering Rules

Dirty money may be generated by any number of illegal activities, including excise duty and VAT fraud. Accordingly there is an obvious link between the two types of crime. Beyond that, the criminal techniques required to generate dirty money and subsequently to launder it are different[8]. However, the law enforcement techniques bear certain similarities to those used hitherto in respect of indirect taxation fraud.

The destruction of the Twin Towers in New York by terrorist attack took place on 11th September 2001 (9/11)

Less than three months later, on 4th December 2001, the second anti-money laundering directive was adopted. This was controversial not least because it increased the scope of persons addressed and included, notoriously, the legal profession, who were required effectively to report their clients to the authorities where they suspected that the clients were engaged in money laundering, but were

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[8] According to a former leading Italian "mani pulite" prosecutor, Antonio Di Pietro, MEP, the cost of laundering dirty money amounts to 25% of its value. In his view, expressed at an address in the European Parliament in February 2002, the tax amnesty granted by the current Italian government to Italian residents who held funds abroad, amounted to a gesture of great value to those who held dirty money: they were able to repatriate it without having to go to the laundry.

forbidden to tell the clients that they were betraying them[9]. This rule was subject to a limited exception available at the discretion of the Member States.

The 2001 Directive left open the definition of serious offences and left the actual punishment of offenders to national law. This Directive was to be implemented by 15th June 2003. All but three Member States missed the deadline.

Little experience has been gathered as to the effectiveness of the second directive.

There is now a proposal for a third directive. It is being rushed through the legislative process as quickly as possible. Fighting terrorism is a stated reason. Under the Dutch Presidency it was given priority treatment and met with no resistance. By November 2004 all twenty five Member States were agreed on the text[10].

The duties imposed on the legal profession remain unchanged[11].

Otherwise the proposal is longer than the second Directive by 42 provisions. These contain for example the following new features:

There is extended customer due diligence.

Companies have to subject their third country subsidiaries to the requirements of the directive, so there is extra-territorial reach.

The categories of persons addressed have been expanded to include:

~ trust service providers[12]

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9 For the rule of secrecy, see Article 8 of the First Anti-Money Laundering Directive: Council Directive 91/308/EEC of 10 June 1991 on prevention of the use of the financial system for the purpose of money laundering [(1991) O.J. L166/77]. For the inclusion of lawyers, see new Article 2a, as set out in Article 1(2) of the Second Directive: Directive 2001/97/EC of the European Parliament and of the Council of 4 December 2001 amending Council Directive 91/308/EEC on prevention of the use of the financial system for the purpose of money laundering [(2001) O.J. L344/76].

10 At the time of writing the proposal [COM (2004)448 final] is at first reading.

11 For critical comment see Shaughnessy, "The new EU money-laundering directive: lawyers as gate-keepers and whistle-blowers", Law and Policy in International Business 2002, v. 34, n. 1, p.25-44; Raphael, "The gatekeeper's role and legal professional privilege", ERA-Forum: scripta iuris europaei 2004, n. 2, p. 208-224.

~ insurance intermediaries

~ persons trading in goods or providing services where payment is in cash exceeding €15,000 in one payment or several linked payments[13].

There is one new feature of especial interest:

The proposal provides that legal persons shall be criminally liable for non-observance of the directive. Punishment is to include fines, suspension from commercial activities, judicial winding up[14].

These penalties are to be applied *not* for engaging in money laundering activities but for defective record keeping, customer identification and suspicious transaction reporting[15].

So far as companies are concerned, therefore, the EU has claimed competence[16] to impose criminal law sanctions and hopes to use that power to introduce the supreme penalty, compulsory judicial winding up being the corporate equivalent of capital punishment.

Without stretching the point too far it can be argued that companies guilty of inadequate due diligence or defective reporting will receive a stiffer sentence than those actually laundering the money. The latter may go to jail but they will eventually be released, or they may not be caught and sentenced at all. For the former the sentencing seems unavoidable and could be rather permanent.

By like token, members of the legal profession, who decide upon their professional consciences not to report a client, suspected of involvement in money laundering,

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12 No analysis seems to have been conducted as to whether British Isles trusts can be used for money laundering purposes or of the repercussions on trust management of the proposed directive.

13 Many innocent people do not have a bank account, but may have much money in cash. Only the national currency is legal tender. So the use of legal tender is being restricted.

14 See Article 36 of the Proposal.

15 See Article 35 of the Proposal.

16 There is, at the time of writing, no harmonised criminal code for Europe, although the approximation of criminal law is foreseen in the Constitutional Treaty, currently awaiting ratification: Article III-257(3).

to the authorities, even if they refuse to act for him, commit an offence and may lose their right to practice and hence their livelihood[17].

Arguably, then, the money laundering rules, actual and imminent, seek to punish the wrong persons or to punish the lesser offender more severely than the perpetrator of the primary offence, money laundering itself.

Misconceived Law Enforcement?

Where the law enforcement authorities take it upon themselves to disregard the rules of criminal investigation, to punish innocent traders in lieu or in default of guilty traders (until the highest judicial authorities are finally able to intervene)[18], come down severely on companies and lawyers, for nothing other than defective reporting, not to mention restricting the use of legal tender, then a climate of distrust and fear is created. The hope is presumably that this climate will lead to more useful information being made available than would otherwise be the case or in greater care being taken. Whether this is the result or not is scarcely relevant in the present context of determining whether or not a law is good or bad. What is relevant here is that the legislator and the law enforcement agencies are using exactly the same technique as the terrorist - creating an atmosphere of fear and distrust, the ultimate effect of which is surely but steadily to establish authoritarian rule. It is only where authoritarian rule (as opposed to government by consensus) obtains that the fundamentalist may hold sway.

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17 In Bowman v Fels [2005] EWCA Civ 226, judgment of 8 March 2005, Ms Bowman's solicitors decided, in the course of a routine case before a County Court, to notify the National Criminal Intelligence Service of a minor offence of which they suspected Mr Fels (the defendant), which had come to light during the preparatory stages. They ceased to act pending consent from NCIS. The Court of Appeal of England and Wales held that they were *wrong* to do so. This ruling appears to be a triumph for legal professional privilege, and may mark a turning of the tide. However, the case illustrates the difficulties lawyers may come under, *nolens volens*. Supposing they had not notified, had not suspended work and the court, holding they that they should have done both, had set the scene for sanctions?

18 By which time innocent parties may have suffered unnecessarily. There is a case currently pending before the Court of Human Rights in Strasbourg in which the owner of a company claims that the state infringed his right of peaceful enjoyment of property, protected by Article 1 of the First Protocol to the ECHR, by forcing the company, suspected by the tax authorities of participation in a carousel, into liquidation, despite two unequivocal findings of the competent criminal court that the company and its owner were above all suspicion of criminal intent or conduct. Judgment may be in the Applicant's favour, but it will not come in time to restore the company to the market.

So, we come back to the point of departure: threats to the law, the legal system, particular or general, must be countered in full respect of the rules and principles of the system perceived to be in danger. Neglect of these rules and principles poses as much a threat to the system as the external threat and merely does the iconoclast's job for him. In fact, the combination of the external and the internal threats may accelerate the corrosive process.

Conclusion

In fairness, it may be difficult to resist the temptation to adopt special methods to deal with special problems and to take the view that the end justifies the means. This temptation may be particularly difficult to resist in a society that expects performance. It is not possible, however, to know in advance whether the end will justify the means. Perhaps more pertinently, whilst we can see the means we may not always be certain as to what the end actually is. Apart from that where we perform by way of a reflex without full consideration of or in disregard for the consequences of our acts and in so doing abandon tried and tested rules and principles we perform at our peril[19].

[19] Since law is a social science, there is no reason not to cite those who comment on the way society behaves. For a graphic and highly amusing account of basing decisions and policies on society's demand for performance, and the potential unpicking of the social fabric resulting therefrom, the reader is referred to Heinrich Böll's Gruppenbild mit Dame, 21 Edition, December 2002, Deutscher Taschenbuch Verlag, Munich, pp 412 et seq.