National Audit Office

Report
by the Comptroller
and Auditor General

HM Revenue & Customs

Investigation into overseas sellers failing to charge VAT on online sales

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What this investigation is about

1 Online sales accounted for 14.5% of all UK retail sales in 2016, up from 2% in 2006. This covers all types of online shopping, including food and goods from major UK retailers. Just over 50% of these were non-store sales, mainly through online marketplaces, where buyers and sellers can meet and transact. The range of online selling platforms continues to grow and diversify, with sellers offering their goods for sale through multiple channels. Amazon and eBay are two of the most well-known online marketplaces but there are many others.

2 Some overseas sellers now choose to export their goods to the UK and store them in fulfilment houses, before selling these goods to UK consumers through online marketplaces. This model allows the overseas seller to offer a speedier and more reliable delivery to UK consumers. Some of these fulfilment houses are owned by online marketplaces (for example Amazon) and some are independent businesses, some of which provide fulfilment services for sellers on online marketplaces.

3 Online sales attract Value Added Tax (VAT) in the same way as goods bought in person. The VAT rules require that all traders based outside the European Union (EU) selling goods online to customers in the UK should charge VAT, if their goods are already in the UK at the point of sale. In these cases, sellers should pay import VAT and customs duties when the goods are imported, based on their value, and charge their customers VAT on the final sale price. The sellers should also be registered with HM Revenue & Customs (HMRC), and are required to submit regular VAT returns. The sellers must account to HMRC for the VAT charged to customers, reclaiming any eligible import VAT through their VAT return.

4 This investigation focuses on the issue that some sellers from outside the EU who bring goods into the UK and store them in fulfilment houses, before selling them online to UK customers, are not charging VAT on those online sales. This may be due to deliberate fraud, a mistake, or because they do not understand the rules. We refer to this collectively as online VAT fraud and error. This investigation does not examine other types of VAT fraud or error, such as the non-collection or under-collection of import VAT or customs duties at the border when goods enter the UK.[1]

1 VAT is generally due on goods imported to the UK, based on their value, although there are various reliefs and exemptions and it depends on where the goods are imported from. Customs duties may also be due depending on what the goods are, their value and where they are from. The correct amount of import VAT may not be paid if the goods are misdeclared or undervalued.

5 HMRC is responsible for collecting and enforcing payment of VAT. In 2015-16 net VAT revenue totalled £116 billion, with a tax gap which HMRC estimated to be £12.2 billion (about 10% of total VAT that should have been collected). According to a report on VAT tax gaps in the European Union, by the Centre for Social and Economic Research (CASE), relating to 2014 data, the UK tax gap, at 10%, was comparable with Germany's (at 10%) and was less than the VAT tax gaps of France (at 14%), Italy (at 28%) and the EU average of 14%.

6 The Committee of Public Accounts (the Committee) has previously expressed concern about HMRC's response to the growing risk of VAT fraud by online sellers.[2] In 2016 it recommended that HMRC should identify the size of the problem. UK trader groups, VATFRAUD.ORG and Retailers Against VAT Abuse Schemes (RAVAS), have also expressed concern to the Committee, HMRC and the National Audit Office.[3] These traders claim there is a risk that they will go out of business if they are routinely undercut by online sellers who do not charge VAT when they should. They told us they believe the size of the problem is significant, based on their own experience and analysis. The trader groups began to share their findings with HMRC in 2014 and believe HMRC has not done enough, or acted quickly enough, to tackle the problem.

7 In this report we examine:

- the scale and nature of online VAT fraud and error;
- HMRC's response to tackling online VAT fraud and error; and
- legislative changes introduced to tackle online VAT fraud and error.

8 Appendix One sets out our methodology. Appendix Two provides a summary of the issues that stakeholders have raised with us and how these relate to our findings.

2 HC Committee of Public Accounts, *Tackling Tax Fraud*, Thirty-fourth Report of Session 2015-16, HC 674, March 2016.

3 VATFRAUD.ORG is a campaign set up by a group of UK eBay and Amazon business sellers; Retailers Against VAT Abuse Schemes (RAVAS) is an independent pressure group of UK retailers.

Summary

Key findings

The scale and nature of online VAT fraud and error

1 **HM Revenue & Customs (HMRC) estimates that online VAT fraud and error cost between £1 billion and £1.5 billion in lost tax revenue in 2015-16 but this estimate is subject to a high level of uncertainty.** This estimate of VAT lost represents between 8% and 12% of the total VAT tax gap of £12.2 billion in 2015-16. The estimate is calculated from an assessment of the extent of under-valuation in a sample of medium- and high-risk imports from high-risk non-EU countries, underpinned by assumptions informed by operational data and intelligence. This method uses an estimate of import VAT fraud as a proxy for the scale of online VAT fraud and error, and HMRC considers it to be the best estimate from data available at the time. HMRC does not have estimates of online VAT fraud and error losses before 2015-16. HMRC does not currently plan to repeat this exercise but will review the estimate of the losses where it believes there is sufficient new evidence to do so (paragraphs 1.18 to 1.20).

2 **The scale and impact of the problem is difficult to measure.** In reviewing HMRC's measures to tackle overseas trader VAT evasion, as part of its independent review of Budget costings, the Office for Budget Responsibility (OBR) commented that the tax base could not be precisely estimated and was derived from import data using assumptions and judgement. HMRC estimates do not account for the wider impacts of online VAT fraud and error such as distortion of the competitive market landscape. UK trader groups believe the problem is widespread, and that some of the biggest online sellers of particular products, such as mobile phone accessories, are not charging VAT (paragraphs 1.6 to 1.8, 1.20 to 1.22).

Tackling online VAT fraud and error

3 **HMRC recognised online VAT fraud and error as a priority in 2014, although the potential risk from online trading generally was raised before this.** In 2013 the National Audit Office (NAO) reported that HMRC had not yet produced a comprehensive plan to react to the emerging threat to the VAT system posed by online trading. The report found HMRC had developed tools to identify internet-based traders and launched campaigns to encourage compliance but had shown less urgency in developing its operational response. Trader groups claim that online VAT fraud has been a problem as early as 2009, which has got significantly worse in the past five years. The Chartered Trading Standards Institute (CTSI) shares this view. Based on the emergence of the fulfilment house model, HMRC recognised online VAT fraud and error as one of its key risks in 2014 and began to increase resources in this area in 2015. In 2016, HMRC acknowledged in evidence to the Committee of Public Accounts (the Committee) that online VAT fraud was a growing problem (paragraphs 1.6, 2.2 to 2.4).

4 **HMRC's assessment is that online VAT losses are due to a range of non-compliant behaviours but has not yet been able to assess how much is due to lack of awareness, error or deliberate fraud.** Amazon and eBay consider that lack of awareness of the VAT rules is a major element of the problem. Amazon and eBay have focused on educating overseas sellers and providing tools to assist with VAT reporting and compliance. HMRC's strategic threat assessment, carried out in 2014, concluded it was highly likely that both organised criminal groups based in the UK and overseas sellers in China were using fulfilment houses to facilitate the transit of undervalued or misclassified goods, or both, from China to the UK for sale online. HMRC's enforcement and compliance activities to tackle this issue cover this spectrum of non-compliance, and are framed within the principles of its general tax compliance strategy (paragraphs 1.18, 2.6 to 2.16):

- promote – making compliance easier;
- prevent – stopping non-compliance entering the system; and
- respond – detecting and correcting non-compliance.

5 **HMRC seeks to detect and correct online VAT non-compliance by using intelligence to identify suspected fraudulent traders.** Intelligence, information of value about potential tax evaders, plays an important part in HMRC's efforts to tackle online VAT fraud. HMRC works with various third parties, such as National Trading Standards, local authority trading standards services and Border Force, to gather intelligence on risks. UK trader groups have told us there is more that HMRC and online marketplaces could do with seller data which would identify potentially non-compliant sellers. HMRC has started to collaborate with online marketplaces to gather data; this data exchange is in its early stages and HMRC plans to make it more systematic and extensive. Gathering intelligence informs HMRC's fraud investigations, which brought in compliance yield of £28.6 million in 2016-17, with another £163 million in the pipeline (paragraphs 2.6, 2.8 to 2.13 and 2.18).

6 HMRC has decided to focus enforcement actions against online VAT fraud inland rather than at the border. HMRC and Border Force, in determining the extent of border checks and the level of resources devoted to them, concluded that inland enforcement actions to tackle online VAT fraud, particularly those targeting fulfilment houses and leveraging the online marketplaces through the new measures, are more effective and efficient compared to enforcement activity at the border. This included consideration of the balance between the UK's objectives of facilitating trade and tackling evasion. Border Force's checks and controls at the border generate intelligence to help focus HMRC's investigations. For example, HMRC typically focuses on fulfilment houses rather than asking Border Force to check individual consignments or packages at the point of import. HMRC cannot be certain how many fulfilment houses there are in the UK and, in 2017, estimated the number at between 500 and 3,000 (paragraphs 2.10 to 2.12 and 3.16).

7 To date, there have been no prosecutions for online VAT fraud but HMRC has carried out many civil operations against suspected evaders. These civil operations include 279 investigations of businesses and 373 compliance interventions in 2016-17. HMRC considers criminal prosecution is not the appropriate response to this type of fraud. There are particular difficulties in prosecuting suspected online VAT fraud which make this route lengthy, costly and with an uncertain outcome. These barriers include the sellers being based outside the EU, and the need to show the intent to commit fraud. In 2016 HMRC gained new legal powers to tackle online VAT fraud and error, which have the benefit of applying to all non-compliant behaviours, with no requirement to prove intent (paragraphs 2.18, 2.19, 3.3 and 3.4).

Legislative changes introduced to tackle online VAT fraud and error

8 HMRC introduced new legal powers to tackle online VAT fraud and error in September 2016. The new joint and several liability power gives HMRC a new way to tackle suspected non-compliance, and is the first time any country has introduced such a power for this purpose. The new powers include making online marketplaces potentially jointly and severally liable for non-payment of VAT when HMRC has informed them of an issue with a seller, and they do not subsequently take appropriate action. Since September 2016, HMRC has been testing the powers on 200 high-risk sellers and has issued 27 pre-notifications and 37 full notices as at March 2017. HMRC considers that this will have a wide deterrent effect and plans to increase the scale of its activities significantly from April 2017 (paragraphs 3.3, 3.4, 3.13 and 3.14).

9 HMRC has seen an increase in the number of new VAT registrations from non-EU sellers since the legislative changes were announced and came into force. HMRC is not aware of the proportion of these sellers that had been trading in the past and not charging VAT, or whether they will be compliant in the future. However, HMRC will have greater visibility of those businesses that are registered. HMRC will risk-assess the newly VAT registered businesses and undertake compliance activity, including using the joint and several liability measures. In addition, from April 2018, fulfilment houses will need to register with HMRC and carry out due diligence on their overseas customers. HMRC has estimated that the new powers could generate additional revenue of around £875 million between 2016 and 2021, and will cost £24 million in 2017-18 (paragraphs 3.2 to 3.4 and 3.9 to 3.15).

10 In the 2017 Budget, the government announced the possibility of a change to the VAT collection method, which would deduct VAT at the point of sale. The 2017 Budget included a call for evidence on a proposal to introduce an alternative VAT collection mechanism, known as split payments. Under this approach, payments by UK consumers would be deemed to be inclusive of VAT, and the VAT component of the sale would be withheld by the banks and paid over to HMRC (paragraph 3.18).

Concluding comments

11 Online VAT fraud and error causes substantial losses to the UK Exchequer and undermines the competitiveness of UK businesses. Compliance with the VAT rules is a legal requirement. Not knowing about the rules does not excuse non-compliance. The UK trader groups who raised the issue report having experienced the impact of this problem through progressively fewer sales. They consider HMRC has been slow in reacting to the emerging problem of online VAT fraud and error and that there do not seem to be penalties of sufficient severity to act as a substantial deterrent.

12 It is too soon to conclude on the effectiveness and impact of HMRC's new powers, and whether the resources devoted by HMRC to using them match the scale of the problem. We recognise that HMRC must consider effort and efficiency in collecting VAT but its enforcement approach to online trade appears likely to continue the existing unfair advantage as perceived by UK trader groups. This is contrary to HMRC's policy of encouraging voluntary compliance and it does not take account of the powerful effect that HMRC's enforcement approach has on the operation of the online market as a whole. We intend to return to this subject in the future.