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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Report by the Comptroller and Auditor General

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Sir Amyas Morse KCB
Comptroller and Auditor General
National Audit Office

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This investigation describes how online VAT fraud and error takes place, its impacts and the actions taken by HM Revenue & Customs to address this problem.

Investigations

We conduct investigations to establish the underlying facts in circumstances where concerns have been raised with us, or in response to intelligence that we have gathered through our wider work.

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Contents

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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.

Part One

The scale and nature of online VAT fraud and error

1.1 This part describes the issue of online sellers based outside the European Union (EU) not charging Value Added Tax (VAT) on goods located in the UK when sold to UK customers, thereby not complying with their legal obligations.

How does the VAT system work?

1.2 VAT is a tax on consumption with a wide range of exemptions and zero rates applied to different goods and services in different circumstances. When a UK consumer buys a good in the UK the price, where applicable, includes VAT. A registered seller should account for the VAT charged to HM Revenue & Customs (HMRC). This principle applies equally whether a good is bought in a shop or through an online marketplace. Amazon and eBay are two of the most well-known online marketplaces but there are many others. VAT may not be due in some circumstances, such as if the seller is based in the UK and their turnover is below a certain threshold or the item is exempt from VAT.[4] Compliance with the VAT rules is a legal requirement. Not knowing about the rules is not an excuse for non-compliance.

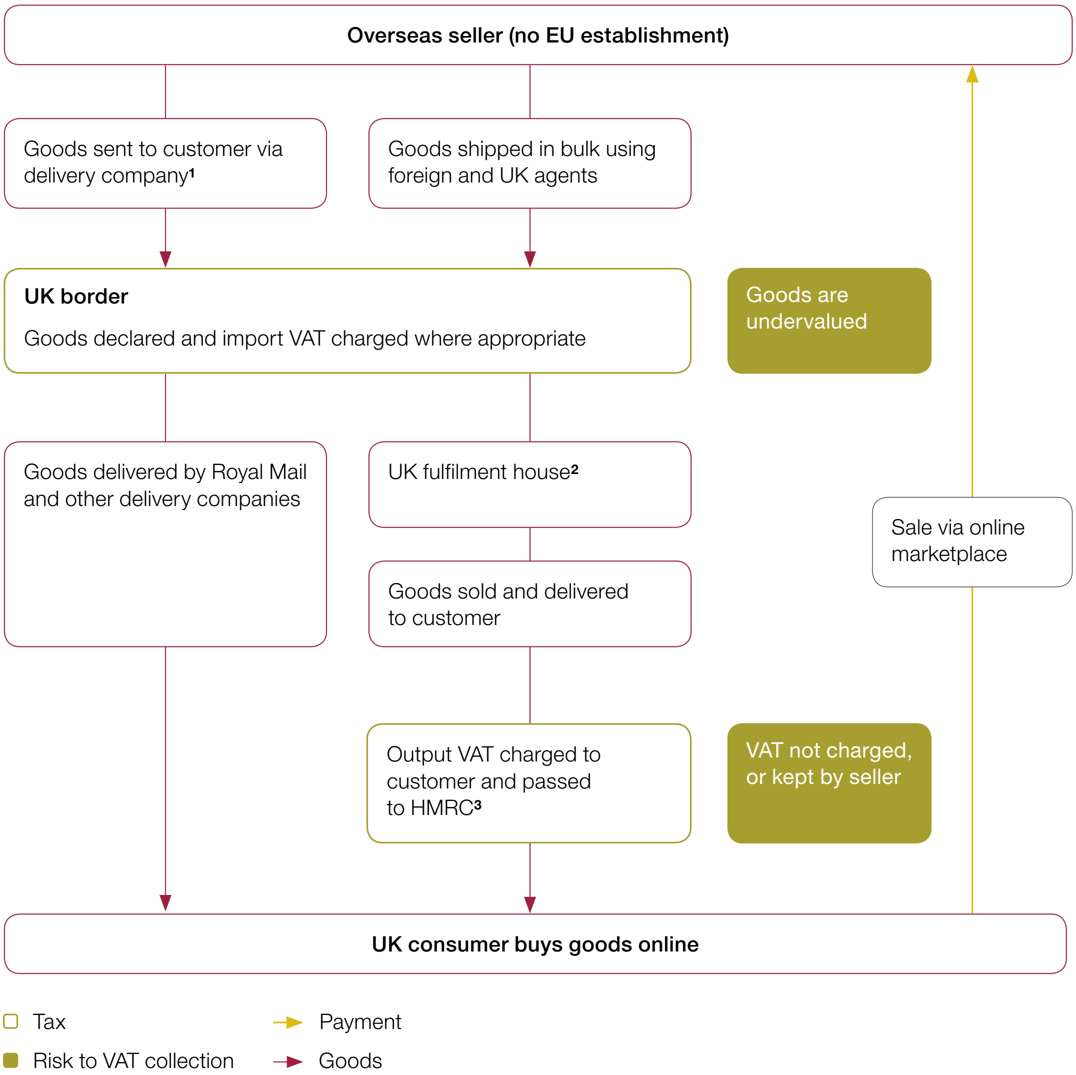
1.3 VAT may not be due where the goods are purchased from a seller based elsewhere in the EU. Where this occurs, the seller would charge VAT in the country they are based, up to a threshold over which they would need to register and charge VAT where the customer is based. Where goods are purchased from outside the EU no VAT would need to be charged on the sale. Instead, import VAT would be payable by the customer at the point the goods enter the UK.

1.4 There is no VAT registration threshold for sellers based outside the EU. If such businesses sell goods located in the UK they must register for VAT in the UK, charge VAT to their UK customers and pay the appropriate amount of import VAT when the goods enter the UK. The business must account to HMRC for the VAT charged to customers, reclaiming any eligible import VAT through its VAT return. Import VAT effectively acts as an advance payment on the total VAT due, providing a cashflow advantage to government. Imports from outside the EU are taxed so that EU producers can compete on equal terms with suppliers from outside the Union.

4 VAT registration in the UK is required if a business's rolling 12-month turnover exceeds a threshold value (£83,000 for the UK in 2016-17).

1.5 This report focuses on the concern that online sellers based outside the EU are not charging VAT on their goods located in the UK when sold to UK customers. **Figure 1** shows, for such a scenario, the points at which VAT should be charged.

Figure 1
How VAT should be charged on overseas goods destined for UK customers



Notes

1. These goods have been purchased by consumers before they are imported into the UK.
2. Overseas seller still owns the goods in fulfilment houses, decides on their movement and sale, and is responsible for charging VAT on behalf of HMRC.
3. Sellers can reclaim any eligible import VAT through their VAT return.

Source: National Audit Office

What concerns have been raised about online VAT fraud?

1.6 We have received allegations from two groups of UK businesses – VATFRAUD.ORG (an independent pressure group tackling online VAT fraud) and Retailers Against VAT Abuse Schemes (RAVAS – an independent pressure group of UK retailers). They are concerned that a potentially significant number of sellers based outside the EU, mainly in China, are using online marketplaces to sell their goods in the UK without charging VAT, when they should. In some cases, these traders are alleged to be using fake VAT numbers or legitimate VAT numbers that do not belong to them. The groups claim online VAT fraud has been a problem from as early as 2009, and has become significantly worse in the past five years. This view is also shared by the Chartered Trading Standards Institute (CTSI). As a result of such practices, VAT compliant traders who charge VAT face unfair competition and risk, ultimately, going out of business.

1.7 VATFRAUD.ORG undertook test purchases of online sales and found examples where non-EU sellers do not appear to have charged VAT. In each case VATFRAUD.ORG requested a VAT receipt from the seller. Reasons given by sellers for being unwilling or unable to provide a VAT receipt included various exemptions or relief schemes, not being registered or being in the process of registering. Some sellers offered to refund the VAT amount to the customer even though it had not been charged. **Figure 2** shows examples of sellers' responses when the customer requested a VAT receipt.

1.8 VATFRAUD.ORG has worked with RAVAS to identify more than 500 sellers who they claim do not display VAT registration information or display apparently fraudulent VAT information. VATFRAUD.ORG also carried out a mystery shopping exercise, which included what they claimed was the biggest seller of smartphone cases in the UK. When the buyer asked for a VAT receipt this seller said it was in the process of registering and offered a VAT refund instead. In other instances VATFRAUD.ORG found examples of receipts that did not account for VAT and came from a company with different details to those displayed on the online marketplace. **Figure 3** is a case example of VAT not being charged on an online sale. It should be noted that there are genuine reasons why an online seller's information may not match the VAT registered details of the business or why they are not required to display VAT registration details.

Figure 2

Examples of responses from sellers on request of a VAT invoice

- We applied for VAT registration a month ago and it is being processed now. Can we send you a giftcard as compensation?
- We are unable to provide you with a VAT invoice as we are part of the VAT margin scheme.
- We are in the process of obtaining our VAT number. We can refund you the VAT in the meantime.
- We are from Jersey Channel Island and we are exempt from VAT.
- You were not charged VAT so we can not offer a VAT invoice.
- We are temporarily unable to provide a VAT invoice.
- We are a small online business at a very early stage. We are also under the VAT registration threshold.
- We are located in USA and do not pay VAT.
- We did not know VAT well. Other sellers around us were not VAT registered and they had been doing business for a long time.
- We have submitted our VAT number to Amazon. But Amazon will take a while to audit it.
- If you require items that hold VAT, may I suggest that you use a company that displays this in the first place in future.

Source: VATFRAUD.ORG's own analysis, based on a non-representative sample of test purchases on Amazon from non-EU sellers for which a VAT invoice was requested. This analysis is for illustrative purposes only, and the methodology has not been validated by the National Audit Office

Figure 3

Case example: VAT not charged on sale of goods located in the UK at the time of sale

Company A is an American company with stock located in the UK and Germany.

A customer purchased, from Company A, a Macbook, located in the UK, to the value of £2,099.99, and requested a VAT receipt. Company A in response confirmed VAT was not charged.

Company A is making sales of £5.2 million per year on eBay.co.uk selling Macbooks, iPads, cameras and accessories. On Company A's listing the following statement can be found: "Dispatched from our new UK warehouse in [address provided] via Royal Mail (1–3 days Delivery). Final Price and Postage is all you have to pay and NO additional VAT".

Source: VATFRAUD.ORG

How does HMRC consider this type of online VAT fraud is carried out?

1.9 HMRC believes that this type of online VAT fraud occurs when goods sold by companies based outside the EU are imported into the UK before sale (**Figure 4**). Typically, the goods are imported into the UK in bulk, with the import VAT due often being underpaid, and stored in a fulfilment centre (a type of warehouse where goods can be stored before delivery to the customer). The seller, who will be based outside the EU, will offer the goods for sale to UK customers through an online marketplace and not charge VAT.

1.10 As shown in Figure 4, the chance of this type of online VAT fraud succeeding is enhanced if non-EU sellers can import their goods into the UK either without payment of import VAT or at a reduced rate. There are various illegitimate ways that goods can be imported into the UK and into fulfilment houses without paying the correct amount of import VAT. For example, sellers can undervalue their goods to qualify for the reliefs from import VAT that exist for low-value consignments. Other reliefs that can be abused include Onward Supply Relief, reliefs for gifts and samples and relief for use of private imports.[5] Where non-EU sellers are VAT registered they would be able to reclaim import VAT and therefore it would not be necessary to mis-declare the goods at import in order for the fraud to succeed.

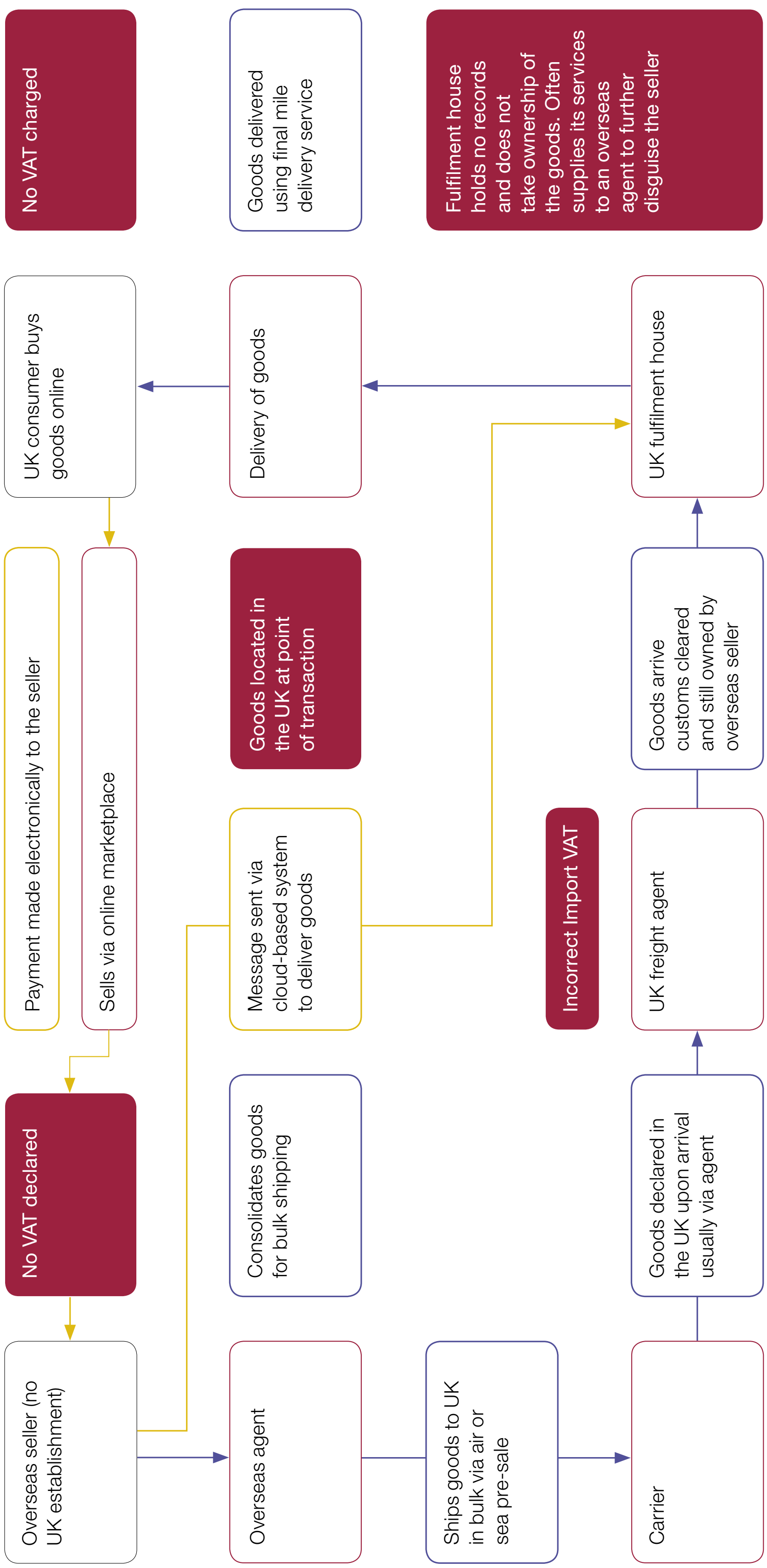
1.11 Fulfilment houses operate on the principle that, for overseas sellers, importation is made before the final customer is known. The fulfilment house operating model makes it easier for sellers outside the EU not to charge VAT. Fulfilment houses are not regulated and do not, in the majority of cases, own the goods they store. As a result, no checks are required to be carried out to ensure the correct taxation, valuation or classification of the stored goods.

1.12 This investigation focuses on concerns about VAT fraud committed by sellers using online marketplaces. HMRC defines an online marketplace as a website which allows others to offer goods for sale. The operator of an online marketplace may also use it to sell its own goods alongside third-party sellers, as in the case of Amazon. The internet makes it much easier for foreign companies to sell to UK customers, either directly through their own website, or through third-party platforms such as Amazon, eBay and other online marketplaces.

5 Onward Supply Relief allows an importer to import goods from outside the EU specifically to forward them on to another EU country without paying UK VAT on them. Instead, the VAT is accounted for in the destination country. Goods sent as a gift that are more than £39 in value are liable to import VAT in contrast to the threshold of £15 for other goods. Commercial Samples Relief is intended for importations made for trade promotion purposes only. Import VAT relief on commercial samples of certain goods can be claimed on meeting certain requirements. Relief for use of private imports is a special relief that can be claimed for goods that are used in a private capacity.

Figure 4

HMRC's analysis of how non-compliant overseas sellers use online marketplaces and fulfilment houses to evade VAT



Elements of the supply chain that do not own the goods but facilitate the trade

Movement of goods

Flow of digital information

Source: HM Revenue & Customs

1.13 Amazon and eBay are two well-known online marketplaces operating in the UK, both with different business models. Amazon provides third-party sellers with a marketplace for selling their goods, along with additional fulfilment services (such as storage and shipping of goods to customers). Amazon also acts as a seller on its own marketplace, by buying goods from third parties or producing Amazon-branded goods and selling those goods itself. Unlike Amazon, eBay does not fulfil any orders.

1.14 Amazon and eBay make it clear that it is the legal responsibility of the sellers who trade on their platforms to determine and declare any VAT that arises from the sale of goods or services.[6] Amazon and eBay told us they take the issue of non-compliance very seriously, as illegal activity exposes them to financial liability and reputational damage and harms their UK sellers. They consider their interests are therefore aligned with those of HMRC. Amazon and eBay can remind the sellers of their obligations, and request VAT invoices on behalf of customers, but it is not their legal responsibility to enforce the charging or payment of VAT. Any retailer selling to customers in the UK through an online marketplace should charge VAT where required. It is not, however, a requirement for these sellers to display their VAT number on such online marketplaces.

The growth of e-commerce

1.15 Non-store online sales in the UK grew to £26.1 billion in 2016. Annual growth averaged 18% in the preceding five years. The UK's total online market, which includes sales made through stores, is the largest in Europe (**Figure 5**). There are no official data on the proportion of UK online sales originating from companies outside the EU.

1.16 Online sales represent around 14.5% of all retail sales in the UK, up from 2% in 2006. This covers all types of online shopping, including food and goods from major UK retailers. Just over 50% of online sales were non-store sales, mainly through online marketplaces, where buyers and sellers can meet and transact.[7] Although official data show country of origin for imports they do not classify whether they were purchased online or destined for the online market.[8]

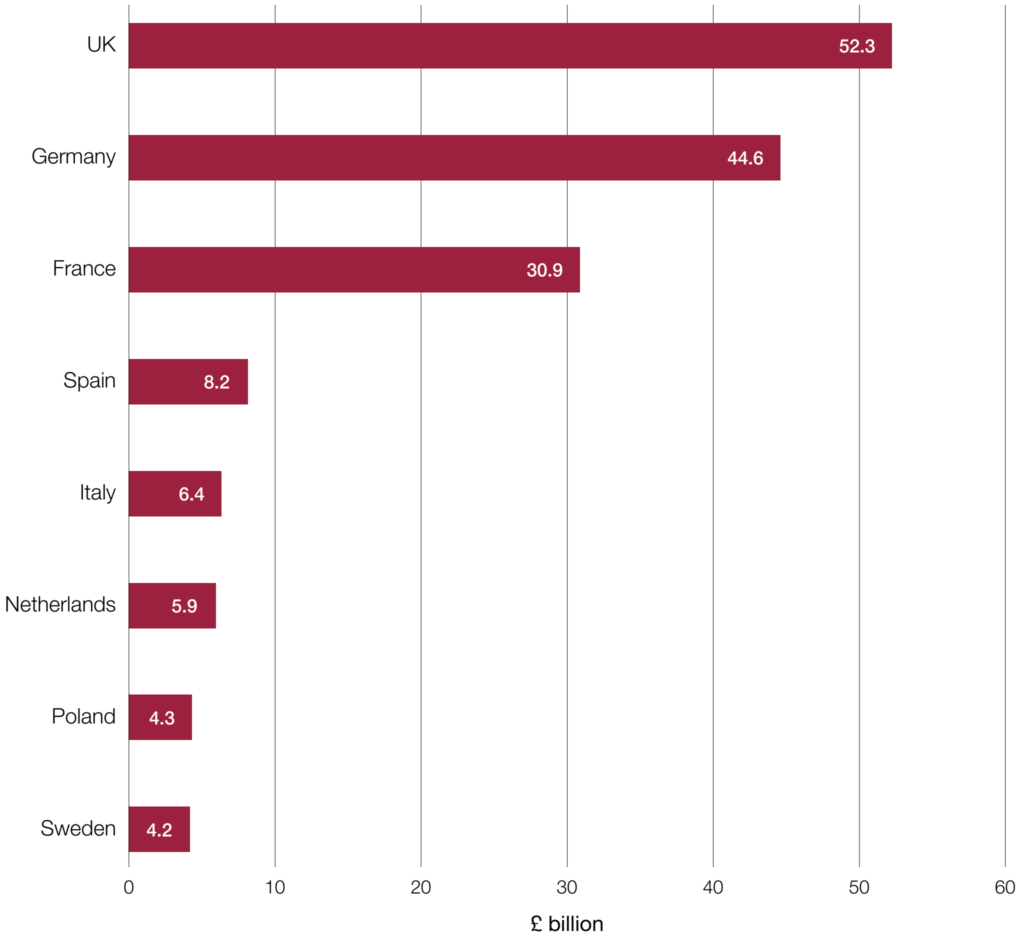
6 Amazon's Participation Agreement explicitly states that all sellers on Amazon.co.uk marketplace agree that it is their responsibility to determine and declare any VAT charges that arise from the sale of goods and services by the seller to the buyer. Similarly, eBay's policy pages (which are agreed to on registration and incorporated into the eBay User Agreement) state: "If you are required to charge VAT on your items, you are responsible for paying that VAT to the relevant tax office in accordance with the appropriate laws and regulations."

7 Office for National Statistics, *Pounds data, total retail sales,* March 2017.

8 Office for National Statistics, *Publication tables UK trade*, March 2017.

Figure 5
Online retail markets in Europe

Europe's eight largest online retail markets in 2015



Source: Centre for Retail Research, *Online Retailing: Britain, Europe, US and Canada 2016*, February 2017. Available at: www.retailresearch.org/onlineretailing.php

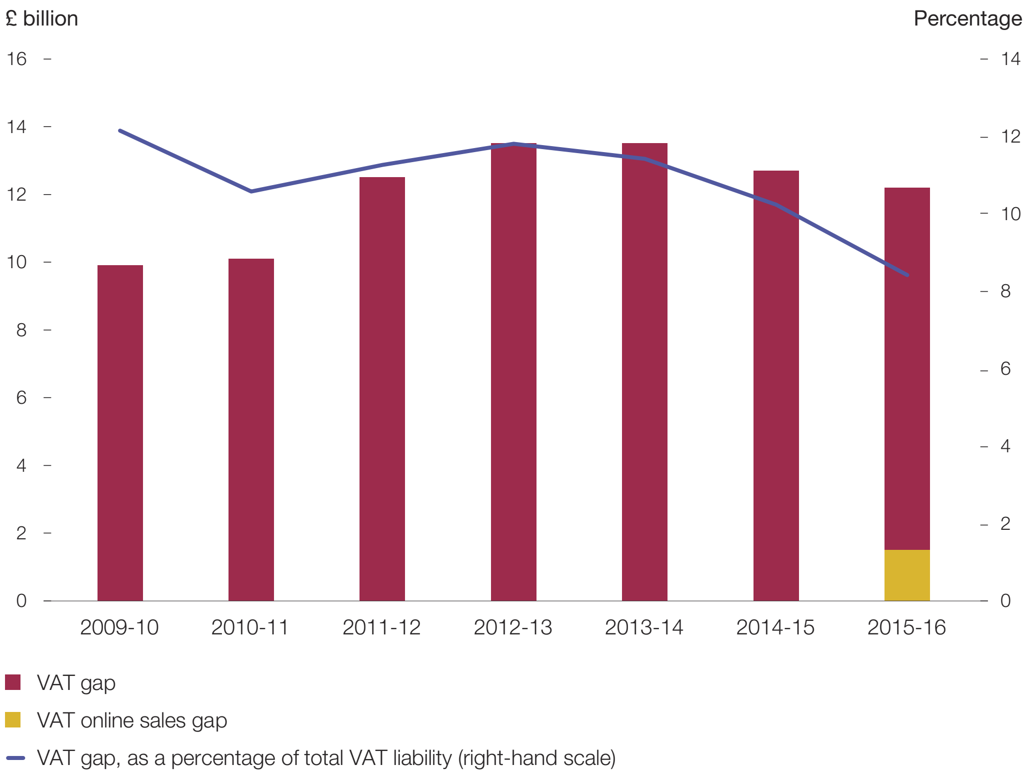
What is the scale of online VAT fraud?

1.17 HMRC publishes a tax gap report each year which sets out the scale of losses for all taxes, including VAT.[9] HMRC's latest report estimated the VAT tax gap for 2015-16, the most recent year for which data were available, at £12.2 billion (10% of total VAT that should have been collected) (**Figure 6**). According to a report on VAT tax gaps in the EU, 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%.[10]

Figure 6

The VAT tax gap and online VAT fraud tax gap

VAT tax gap (in £ billion, and as a percentage of VAT total theoretical liability)



Notes

1 The VAT tax gap for 2015-16 is HMRC's second estimate and was published in March 2017.

2 There are no VAT online sales gap estimates for previous years.

Source: HM Revenue & Customs

9 The tax gap is HMRC's estimate of the difference between the amount of tax it should theoretically be able to collect and what it actually collects. For further detail on how it is calculated refer to: HM Revenue & Customs, *Measuring tax gaps 2016 edition*, October 2016.

10 Centre for Social and Economic Research, *Study and Reports on the VAT Gap in the EU-28 Member States: 2016 Final Report*, August 2016.

1.18 In 2016 HMRC undertook an exercise to estimate the size of the online VAT fraud and error tax gap, primarily to inform costings for the effect of its new powers (paragraph 3.3). This exercise estimated the extent of online VAT fraud and error by non-EU sellers in 2015-16 to be in the range £1 billion to £1.5 billion. HMRC does not estimate how much of its online VAT tax gap can be attributed to error and how much to fraud. HMRC estimated the relevant tax base by combining UK import data with intelligence and evidence from border activities. The tax base was based on the 29% (£54 billion) of non-EU imports deemed to be of medium and high risk, and from high-risk countries. HMRC then estimated the extent to which goods were undervalued based on evidence from parcel postal depots, Border Force case reviews and an article in the *World Customs Journal*.[11]

1.19 In its analysis, HMRC assumed between 1% and 9% of such imports were undervalued, by an average of 70% for goods declared above the £15 VAT threshold, and by 80% for those declared below that amount (with the higher, true value, likely to attract VAT). A review of 95% of imports for one category of goods, from a known high-risk country of origin, at a UK port suggests revenue losses could be higher. Our analysis of evidence collected by the exercise found the level of revenue loss per every pound of declared value for that category of goods was four times higher than HMRC assumed in its estimate of £1 billion to £1.5 billion. However, that higher level of loss cannot be applied across all categories to create an estimate of total revenue loss from online VAT fraud.

1.20 This method defines the tax base as the total value of under-declaration of imported goods from outside of the EU. It uses import VAT fraud and error as a proxy, since there is no information on the destination of imports once in the UK. This produces an estimate of £9.1 billion in undervalued goods, or £1.9 billion VAT revenue foregone. HMRC tested these assumptions for reasonableness internally with policy and operational teams. The Office for Budget Responsibility (OBR) carried out its own review of HMRC's analysis as part of its independent review of Budget costings. Following OBR's comments, HMRC revised its estimate to £1.3 billion.

- OBR's review of HMRC's analysis was carried out in the context of costing HMRC's new measures to tackle overseas trader VAT evasion (see paragraph 3.3) to forecast their impact on future public finances.
- The OBR's review was mainly based on sense-checks of the outputs of HMRC's analysis, and some of the underlying inputs, by reference to the overall VAT tax gap and Office for National Statistics survey data for retail sales. HMRC subsequently decided to report its estimate of the amount of VAT revenue forgone on such under-declarations as being in the range of £1 billion to £1.5 billion to reflect the level of uncertainty in its estimate.[12]

11 S Pope, C Sowiński and I Taelman, 'Import value *de minimis* level in selected economies as cause of undervaluation of imported goods', *World Customs Journal*, volume 8, number 2, September 2014.

12 The range was based on HMRC's judgement and was not based on statistical analysis.

- In reviewing HMRC's costings, OBR commented that the tax base (HMRC's estimate of £9.1 billion in undervalued goods) could not be precisely estimated and was derived from import data using assumptions and judgement.
- Overall, OBR gave HMRC's measure a 'high' uncertainty rating.[13]

1.21 Drawing on analysis of sales by sellers, the CTSI had previously estimated in 2015 that up to £2 billion of VAT could be lost each year due to online VAT fraud.[14] After receipt of new information, CTSI's latest position is that, based on its analysis of sales on Amazon and eBay, the size of the VAT losses due to online VAT fraud or error on transactions taking place on Amazon's and eBay's online platforms could be up to £1 billion a year.

1.22 There is a direct cost to the taxpayer through the loss of revenue resulting from the non-payment of VAT, but it also distorts the market. Sellers are able to undercut, by up to 20%, the prices offered by compliant businesses who pay the right amount of VAT. This thereby gives an unfair competitive advantage and legitimate businesses can make fewer sales, as a result of losing market share to non-compliant businesses. HMRC's estimate of the extent of online VAT fraud of £1 billion to £1.5 billion corresponds to £6 billion to £9 billion in lost gross sales revenue for VAT-compliant companies in 2015-16.[15] Law-abiding businesses as a result pay less corporation tax, and employ fewer people. Non-payment of VAT also has an adverse impact on taxpayers' perceptions of the equity and fairness of the tax system, which can lead to non-compliance in other areas of the tax system. The practices used to not charge VAT can also be used to distribute unsafe and counterfeit goods. HMRC's estimate of the size of the problem excludes these wider effects.

13 HM Government, *Budget 2016: policy costings*, March 2016, B.15.
14 Reported in *Hansard*, 14 January 2016, volume 604, column 418 WH, (paragraph 3).
15 Calculated as follows: £5 billion of sales excluding VAT would be needed to generate VAT, at 20%, of £1 billion; these two figures added together equal £6 billion gross sales revenue. £7.5 billion of sales excluding VAT would be needed to generate VAT, at 20%, of £1.5 billion; these two figures added together equal £9 billion gross sales revenue.

Part Two

HMRC's response to tackling online VAT fraud and error

2.1 This part of the report covers HM Revenue & Customs' (HMRC's) approach to tackling online Value Added Tax (VAT) fraud and error, including the results of HMRC's enforcement and compliance activities to date.

Previous parliamentary interest in online VAT fraud

2.2 The National Audit Office (NAO) and the Committee of Public Accounts (the Committee) have previously been interested in, and have raised, issues relating to online VAT fraud (**Figure 7** overleaf). In 2006, an NAO report on VAT on e-commerce identified online VAT fraud as a potential concern.[16] The report noted that "The Department's judgement that the overall risk to VAT revenue from e-commerce is currently low appears reasonable. … As activity increases in this fast-changing environment, it will be important that the Department builds on the work already done to keep abreast of possible changes in the patterns and levels of risk to VAT." The 2013 NAO report on HMRC's 2012-13 Accounts found that HMRC had yet to produce 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 the Department had shown less urgency in developing its operational response.[17]

2.3 In 2013 the Committee took evidence on issues relating to VAT fraud, including specific references to VAT on sales of electronic services into the UK and on whether non-UK companies trading online with a UK presence require a VAT registration number.[18] Most recently, the Committee reported on tax fraud as a whole in 2016.[19] The Committee concluded that HMRC had been slow to respond to the growing risk of VAT fraud by internet traders. The Committee also noted that HMRC could not provide a firm estimate of the tax losses associated with the growing problem of online VAT fraud, although they could be billions of pounds a year.

16 Comptroller and Auditor General, *HM Revenue & Customs: VAT on e-commerce*, Session 2005-06, HC 1051, National Audit Office, May 2006.
17 Comptroller and Auditor General, *HM Revenue & Customs 2012-13 Accounts*, HC 10, June 2013.
18 HC Committee of Public Accounts, *Tax avoidance: the role of large accountancy firms,* Forty-fourth Report of Session 2012-13, HC 870, April 2013, Qs 112–127.
19 HC Committee of Public Accounts, *Tackling tax fraud*, Thirty-fourth Report of Session 2015-16, HC 674, April 2016.

Figure 7

Timeline of key online VAT fraud and error events and growth of the online share of retail sales

2006

circa 2%

May 2006: NAO report: *VAT on e-commerce*

2012

9.3%

Apr 2012: Government withdraws Low Value Consignment Relief (LVCR) from goods imported from Channel Islands

Dec 2012: All Non-Established Taxable Persons (NETPs) supplying goods in the UK are required to register for VAT

2013

10.4%

Jun 2013: NAO's Standard Report addresses *Tackling VAT Fraud*

Finance Act 2013: HMRC powers to request data on debit and credit card transactions

2014

11.3%

Jul 2014: VATFRAUD.ORG informs HMRC about widespread VAT fraud on Amazon and eBay

Oct 2014: HMRC recognised 'online VAT fraud' as a significant risk on its Strategic Picture of Risk

2015

12.5%

2015: Ongoing engagement by HMRC with eBay, Amazon and other online platforms

Aug 2015: HMRC's Anti-Fraud Strategy

Dec 2015: NAO report: *Tackling tax fraud*

2016

14.5%

Jan 2016: Backbench debate on VAT evasion by internet retailers in Westminster Hall

Apr 2016: Committee of Public Accounts report on *Tackling tax fraud*

Sep 2016: VATFRAUD.ORG informs HMRC of more than 600 alleged VAT evaders on Amazon

Finance Act 2016: HMRC powers to require appointment of a VAT representative and security from NETPs and to make e-platforms jointly and severally liable for unpaid VAT

■ Proportion of retail sales which were online

Source: National Audit Office

HMRC's strategy to tackle online VAT fraud

2.4 HMRC, based on its various intelligence sources, recognised the problem of online VAT fraud in its 'Strategic Picture of Risk' in October 2014.[20] HMRC commissioned a strategic threat assessment in September 2014, which was completed in March 2015. The focus was mainly on goods imported into the UK from China which avoid import VAT through under-valuation or misclassification, or both. The assessment reviewed whether, and to what extent, UK-based fulfilment houses were being used to facilitate the threat under consideration. The assessment concluded that 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 through e-commerce. While it was not possible to fully quantify the threat, HMRC considered substantial revenue was at risk from this type of fraud.

2.5 HMRC does not have a strategy solely aimed at tackling online VAT fraud. However, HMRC completed its general Anti-Fraud Strategy in August 2015 in recognition of the emerging risk of systematic under-valuation of imported goods and the use of fulfilment houses for stock storage and transit for online sales. This consolidated HMRC's compliance efforts to test and understand the nature of what was seen as a concerted criminal evasion of tax at the border and within domestic supply chains. It explicitly recognises the risks posed by the fulfilment house business model, particularly in light of the growth in non-store internet shopping. HMRC plans to update its Anti-Fraud Strategy in the first quarter of 2017-18.

2.6 HMRC attributes the problem of VAT not being charged by non-European Union (EU) overseas online sellers to a spectrum of behaviours ranging from a lack of awareness of UK VAT rules to deliberate fraud. HMRC has not yet made an assessment of how much can be attributed to these causes. HMRC's enforcement and compliance activities to tackle the problem of online VAT fraud and error are therefore framed within HMRC's general tax compliance strategy, which has three strands:

- Promote: where HMRC encourages voluntary compliance via a range of mechanisms, for example through publishing guidance notes, explaining the consequences of non-compliance, and designing compliance into its systems and processes.
- Prevent: where HMRC stops non-compliance from entering the system.
- Respond: where there is non-compliance, HMRC detects it and corrects it.

20 HMRC's Strategic Picture of Risk is a record of all risks to tax revenue exceeding £250 million alongside the risks to the integrity of the tax system or HMRC's reputation for running it.

HMRC's operational response to online VAT fraud and error

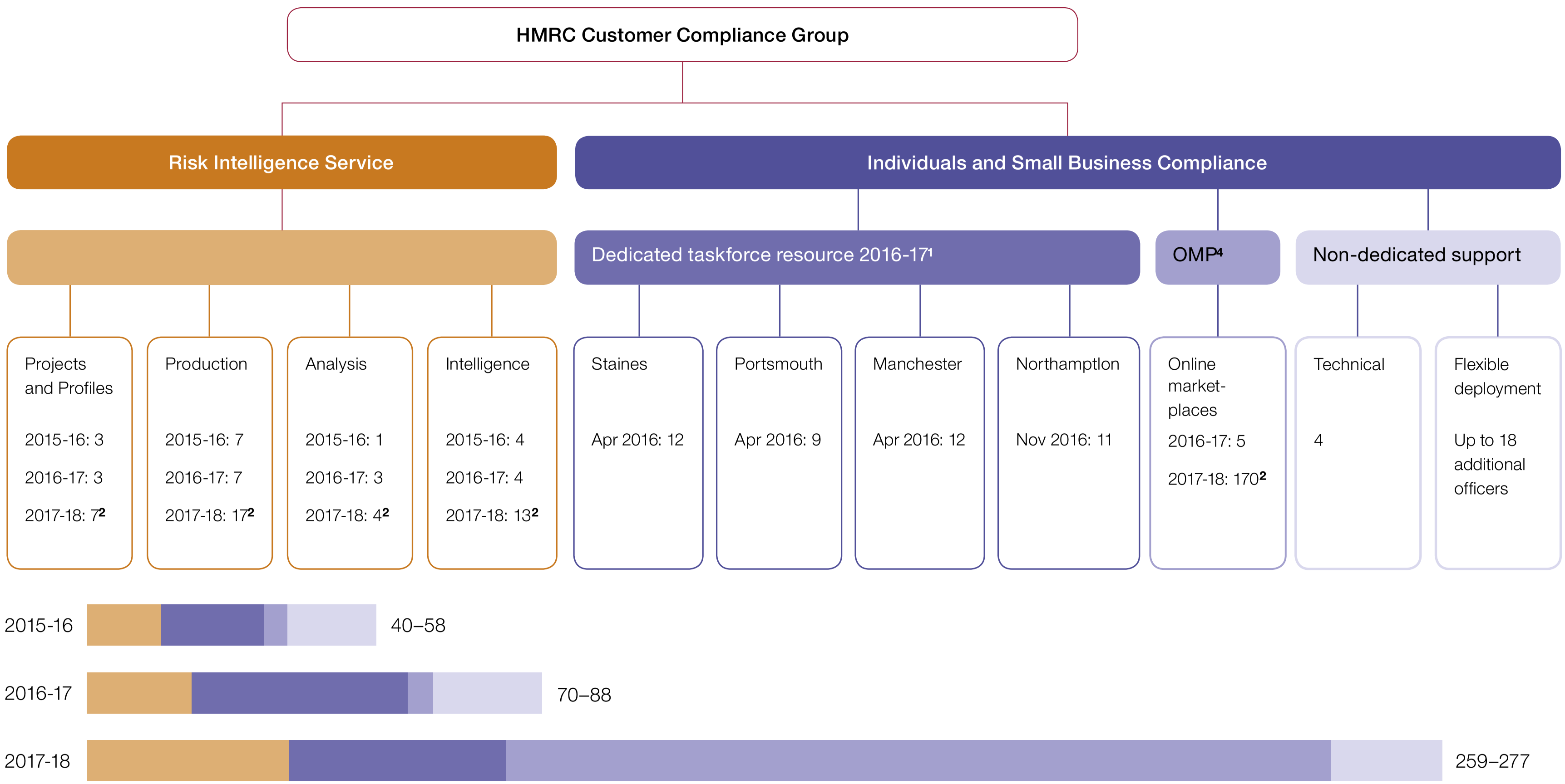
2.7 HMRC's approach to tackling this issue involves several teams which cover intelligence gathering, threat assessment, policy development and operational responses:

- Indirect Tax and Customs business areas are responsible for the rules and processes underpinning VAT and Indirect Tax is the risk owner for this issue.
- Knowledge, Analysis and Intelligence (KAI) team provides analytical and statistical support to policy teams, such as the estimation of losses resulting from online VAT fraud.
- Risk & Intelligence Service (RIS) provides intelligence analytical capability. Operational and policy teams can commission risk assessments from RIS, which they use to determine the focus of their work.
- For online VAT fraud, the majority of the operational compliance response is undertaken by HMRC's Individuals and Small Business Compliance (ISBC) directorate, supported by colleagues in Large Business, who manage the relationships with the largest online marketplaces, and Fraud Investigation Service (FIS), who carry out any appropriate investigations of fraudulent or criminal activity.
- In 2015 HMRC assigned resources from the areas outlined above to form a group to specifically tackle the problem of online VAT fraud and error (**Figure 8**).

2.8 Intelligence, information of value about potential tax evaders, plays an important part in HMRC's efforts to tackle online VAT fraud. The Department's intelligence relevant to online VAT fraud originates from a variety of sources including its fiscal crime liaison officers (FCLO) network, cases under investigation by FIS, seizures of goods at ports, airports and delivery depots, other EU member states and from whistle-blowing (also known as 'human intelligence').[21] HMRC has a specific unit, the National HumInt Centre, which assesses the sources of any given human intelligence, the reasons why it was forwarded to HMRC, how the intelligence was gathered and whether using the intelligence could put people at risk. All of these assessments are legal requirements. HMRC has a policy not to confirm or deny the existence of sources or informants. A reliable and regular flow of intelligence is vital in targeting non-compliant sellers as HMRC focuses its limited resources on activities that have a high 'hit rate' (frequency of detecting non-compliant activities). HMRC does not conduct any test purchases to detect cases of non-compliance from overseas online sellers as its assessment is that its other information sources provide better intelligence to target the problem.

21 Fiscal crime liaison officers are responsible for facilitating the overseas seizures of illicit goods destined for the UK market by sharing intelligence with overseas enforcement authorities. They possess valuable knowledge of international supply chains and can provide HMRC with intelligence obtained from other states' operational enforcement activities.

Figure 8
HMRC resources allocated to tackling online VAT fraud and error



Notes
1 Non-dedicated resources in 2015-16: 21.
2 Based on 2016 budget proposal.
3 Assumptions: resources are ongoing unless otherwise stated; all figures are full-time equivalents.
4 OMP – Online Marketplace Project.

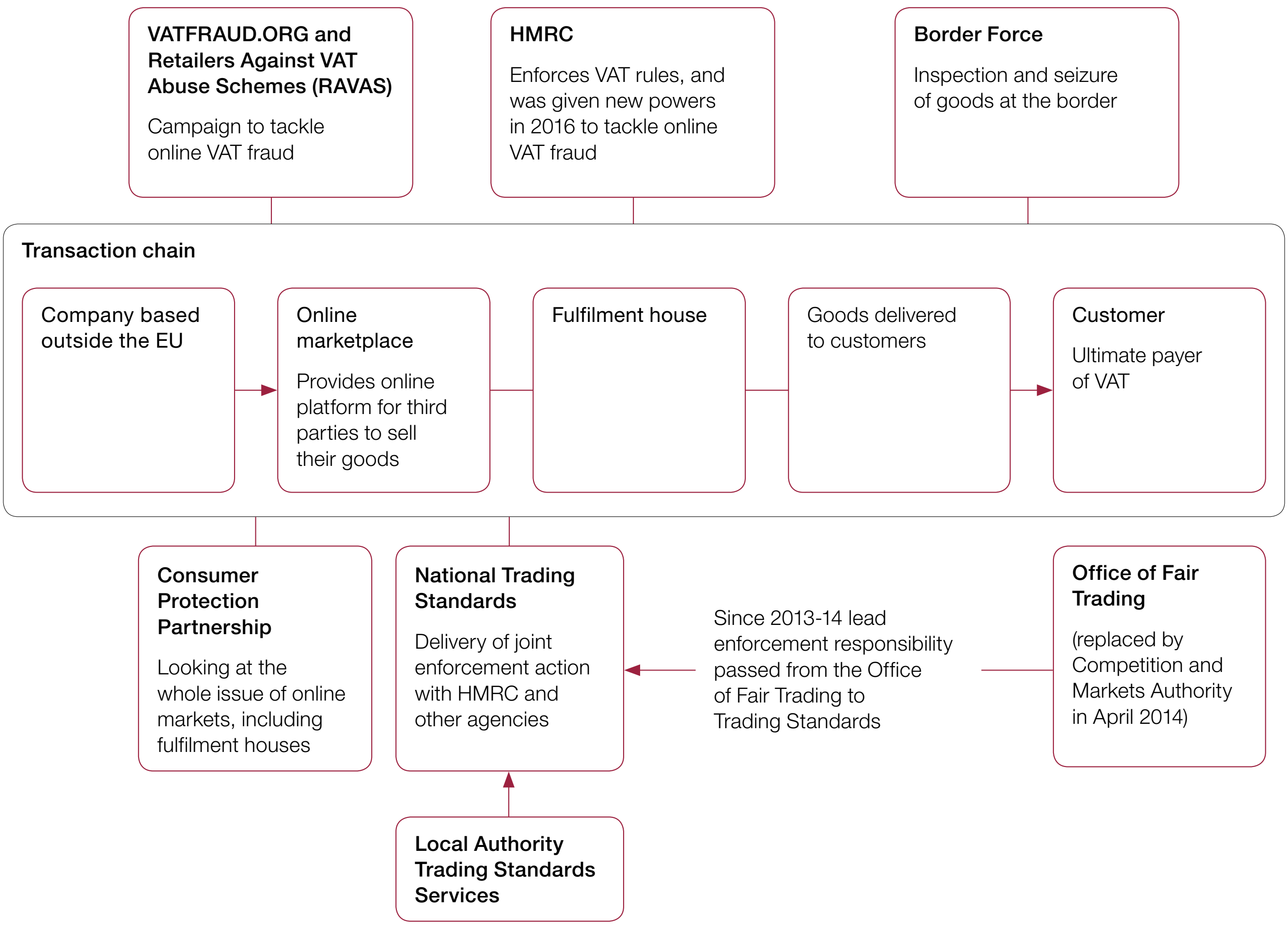
Source: HM Revenue & Customs

Collaborative working

2.9 There are a number of stakeholders that, directly or indirectly, have an interest in tackling the problem of online VAT fraud and error, and regulating the online markets (**Figure 9**). HMRC has the ultimate responsibility for ensuring the compliance of online traders with UK VAT law.

2.10 In tackling online VAT fraud and non-compliance HMRC works with several bodies, including National Trading Standards, developing interventions that target the points of risk in the supply chains used by non-EU sellers for fulfilling their orders in the UK. HMRC's National Imports Taskforce has carried out joint investigations with Trading Standards Services and Border Force. Over the past year HMRC and Trading Standards Services have carried out nine joint operations against fulfilment houses, two led by Trading Standards Services, with seizures of goods by at least one agency on each of these events. Two of these joint operations resulted in the fulfilment house closing down, disrupting both the supply of unsafe goods and tax losses.

Figure 9
Stakeholder map



Source: National Audit Office

2.11 Border Force enforces customs regulations at UK borders including whether imported goods have paid the correct amount of import VAT. HMRC and the Home Office have a Partnership Agreement, which sets out the collaborative working arrangements with Border Force.[22] Border Force is responsible for anti-smuggling operations, protecting revenue and duty, tackling VAT and revenue fraud at the border and referring suspected fiscal frauds to HMRC. Border Force carries out targeted inspections of goods informed by various sources of intelligence including from HMRC.

2.12 Although Border Force does not carry out specific checks in relation to online VAT fraud, its controls at the border generate valuable intelligence. This intelligence is referred to HMRC to be risk-assessed for potential appropriate compliance activity undertaken by, for example, its National Imports Taskforce. HMRC and Border Force, in determining the extent of border checks and the level of resources devoted to them, concluded that inland enforcement actions in relation to 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. However, HMRC's Fulfilment House Due Diligence Scheme (see paragraph 3.16) will not come into effect until April 2018, more than three years after HMRC's recognition of this risk. The implementation of the scheme should result in better intelligence on the fulfilment house industry and enhance HMRC's targetting of its enforcement activities.

Working with online marketplaces

2.13 Since 2015, HMRC has engaged with online marketplaces, principally Amazon and eBay, as part of its efforts to tackle non-compliance with VAT law. HMRC works with online marketplaces to promote compliance, for example through educational campaigns, better information on the VAT rules and more information in other useful languages (such as Mandarin and Cantonese). HMRC has also focused on what data the marketplaces can supply to HMRC, and how HMRC would apply its new powers to regulate fulfilment houses and hold platforms jointly and severally liable for their clients' unpaid VAT. HMRC has sought both aggregate data, to gauge the extent of VAT evasion on the sites generally, and information regarding particular businesses. This data-sharing approach is still at an early stage and HMRC plans to make it more systematic and extensive from April 2017 (see paragraph 3.13). UK trader groups and Trading Standards told us they have been raising cases of specific non-compliant sellers with Amazon and eBay, after conducting their own data analysis, mystery shopping and searches of listings, but have not seen sufficient action taken, as these sellers are still trading.

22 Home Office and HM Revenue & Customs, *Partnership Agreement*, July 2016. Available at: www.gov.uk/government/publications/partnership-agreement-between-hmrc-and-border-force

2.14 Amazon and eBay carry out their own initiatives to help sellers comply with their VAT obligations. Amazon offers sellers a range of educational activities and compliance tools to help reduce VAT errors and the cost of compliance. These include advice and guidance on whether and how to register for VAT and reminders about the need to be compliant. Since 2014 Amazon has engaged third parties to provide low-cost VAT compliance tools and services to sellers. More recently, it has developed a low-cost VAT reporting and compliance tool with an external provider to make compliance cheaper and easier for sellers. Amazon is reviewing what additional solutions it can offer to sellers and any additional policies and procedures it can implement to encourage seller VAT compliance by:

- educating sellers;
- making compliance cheaper and easier; and
- having a strong process for taking down sellers where there are appropriate indications from credible sources.

2.15 eBay told us it has a three point strategy to help sellers comply with their VAT obligations, covering enablement, education and enforcement:

- eBay enablement has included updating its platform to enable Chinese sellers to display VAT numbers automatically, as well as contracting with third-party providers that sellers can use to assist with VAT registration, filing and other compliance tasks.
- eBay has a range of education initiatives such as specialised guidance on its site, targeted seller outreach and a variety of seller communications including emails and seller seminars specifically targeted at Asia-Pacific sellers.
- For reasons of taxpayer confidentiality eBay does not have visibility of a seller's tax affairs, for example in terms of whether the seller has filed a tax return or paid their tax. Therefore, eBay's enforcement activity is focused on where there are cases of verifiable non-compliance such as when they have been notified by HMRC or where sellers fail to comply with eBay's own policies. eBay may check, for example, whether a seller is displaying a VAT number and whether that number is valid.

2.16 Both Amazon and eBay point out that while they offer advice and guidance on UK VAT requirements for overseas sellers, ultimately only HMRC has access to confidential taxpayers' data to review and decide whether sellers are VAT-compliant. Amazon and eBay noted that UK legislation does not require that non-EU sellers display their VAT numbers. eBay also noted that it has passed on all third-party reports of non-compliance to HMRC for further investigation.

International approach

2.17 Online VAT fraud is a global problem, although the risk is particularly acute in the UK due to the volume of e-commerce. HMRC aims to work with European counterparts through its FCLO network and international partnerships, and maintains dialogue with other countries, for example through Organisation for Economic Co-operation and Development (OECD) meetings. HMRC has provided resources to support joint operations requested by the European Anti-Fraud Office (OLAF) and overseas customs authorities. The EU proposals on e-commerce are part of a package of measures that include reform of the current exemption for the importation of low-value consignments into the EU. The proposals consider ways to address some of the market distortion between domestic and overseas businesses as well as simplification measures for tax collection.[23]

Summary of performance

2.18 HMRC has undertaken a range of targeted enforcement and compliance activities (**Figure 10** overleaf). These included setting up the National Imports Taskforce, Operation Breach,[24] Fraud Investigation Service visits, working with Fast Parcel Operators, working with online marketplaces, introducing new legislative measures and increasing resources, in tandem with Border Force, for seizure of goods.

2.19 To date, there have been no prosecutions in relation to online VAT fraud. HMRC faces difficulties in prosecuting non-EU sellers for online VAT fraud. The sellers are based outside the EU, where HMRC has no jurisdiction and in the majority of cases there is no party based in the UK who has ownership of the goods imported into the UK for subsequent sale to consumers. Establishing intention to commit fraud is also a significant barrier to undertaking prosecutions.

23 European Commission, *Digital Single Market – Modernising VAT for cross-border e-Commerce*, *VAT Digital Single Market Package*, 1 December 2016.

24 Operation Breach was set up to investigate the abuse of the Onwards Supply Relief (OSR), focusing on textile commodities exported from China.

Figure 10

Impact of HMRC's civil activities against non-compliant sellers

Compliance and enforcement activity	Outputs
National Imports Taskforce	As of March 2017: • £15.3 million of compliance yield achieved, of which £9.7 million was VAT • £75.2 million of compliance yield in the pipeline, of which £50 million will be VAT • 365 pallets of goods seized • 16 fulfilment houses investigated via 'Days of Action' resulting in the seizures and compliance results above • 279 businesses investigated resulting in the compliance results above
Operation Breach	As of March 2017: • £6.2 million of compliance yield achieved, all of which was Customs and International Trade • £78.8 million of compliance yield in the pipeline, of which £1 million will be VAT
Working with online platforms (Online Marketplace Project)	Between October 2016 and 16 March 2017: • 373 compliance interventions • £7.1 million of compliance yield achieved • £9.4 million of compliance yield in the pipeline • 53 compulsory registrations of businesses for VAT • 4 voluntary registrations of businesses for VAT • 27 notifications issued to marketplaces of upcoming notices of joint and several liability • 205 joint and several liability notices in preparation for issue • 37 joint and several liability notices issued to marketplaces • 4 businesses removed as sellers by the marketplaces

Source: HM Revenue & Customs

Part Three

Legislative changes introduced to tackle online VAT fraud and error

3.1 This part describes the legislative changes introduced in 2016 designed to tackle online Value Added Tax (VAT) fraud and error, the impact they have had so far in tackling the problem and HM Revenue & Customs' (HMRC's) longer-term plans.

Legislative changes to tackle online VAT fraud and error

3.2 There are difficulties in enforcing the compliance of traders based outside the European Union (EU) – outside HMRC's jurisdiction – and in establishing the ownership of non-EU sellers' goods once in the UK. Ownership of the goods remains with the overseas seller who therefore remains responsible for any taxes not paid. HMRC gained new powers in the 2016 Finance Act to address some of these inherent difficulties, particularly the absence of any entity based in the UK with responsibility for compliance with VAT law.

3.3 The new measures against online VAT fraud in the Finance Act 2016, which mostly took effect on 15 September 2016, made the following main changes:

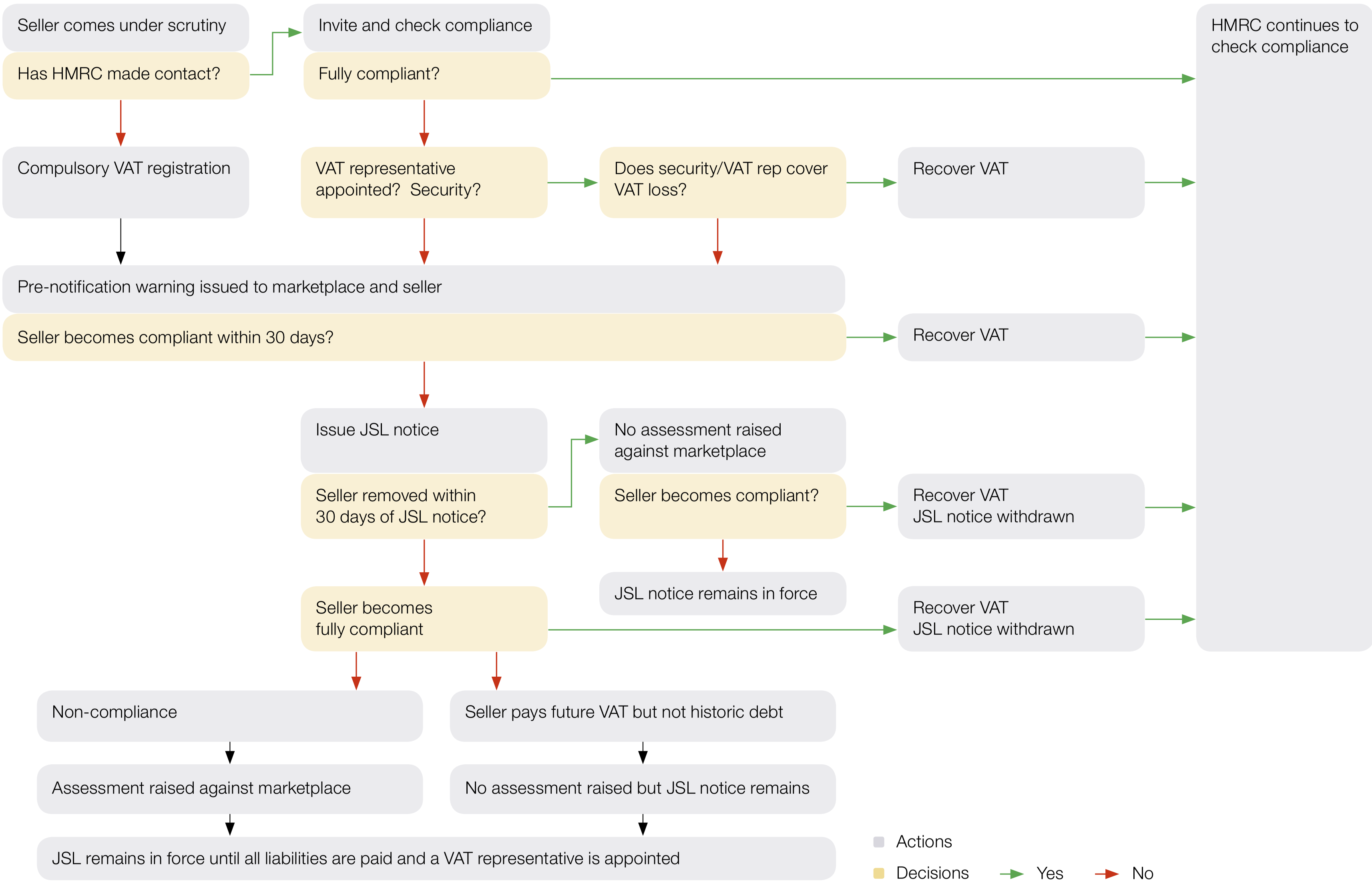
- made online marketplaces potentially jointly and severally liable for the future undeclared VAT of online sellers, once HMRC had spotted cases of non-compliance and reported the seller to the online marketplaces;
- gave HMRC the power to require that companies from outside the EU that engage in online sales in the UK appoint a UK-based VAT representative; and
- imposed new regulations on fulfilment houses, with effect from April 2018.

3.4 The joint and several liability power gives HMRC a new way to tackle suspected non-compliance, and is the first time any country has introduced joint and several liability powers for this purpose. When applying these, HMRC first seeks to secure the compliance of the overseas business (**Figure 11** overleaf). If this is unsuccessful HMRC will notify the online marketplace that it intends to make the marketplace jointly and severally liable for the future VAT liabilities of the non-compliant seller. The removal of non-compliant businesses is then a decision for the online marketplace, who thereafter could become jointly and severally liable with the seller for the VAT.[25] The new measures do not give HMRC the power to remove non-compliant businesses from online marketplaces or to issue 'take-down notices'.

25 The HMRC notice will set out a period of time (normally 30 days) during which the online marketplace can avoid being held jointly and severally liable either by securing compliance from the overseas business or removing it from its online marketplace.

Figure 11

The process by which HMRC uses the powers gained in the Finance Act 2016 against potentially non-VAT compliant online sellers



Source: National Audit Office analysis of HM Revenue & Customs strategy

3.5 For a seller to be deemed compliant, all of its VAT returns will have to be accurate and submitted to HMRC on a timely basis. All payments, including the trader's historical VAT debts, will also have to be made on the due date and, where directed, a VAT representative should be appointed. In practice, HMRC expects the effect of the new legislation to be the removal of non-compliant sellers by online marketplaces from their platforms or for the seller to become fully compliant to avoid being removed. There are, however, no barriers for removed traders to resume illegal business activities on other platforms. HMRC is already aware of this risk. The risk is mitigated by the fact that if a seller is removed they lose their feedback history and customer rating, which HMRC judges will be disruptive to their business. HMRC will also continue to risk-assess new sellers appearing on the marketplaces and will take action if previously non-compliant businesses reappear. Where a seller has multiple seller identities, HMRC will notify the marketplace of all the identities that belong to the same legal entity. If they appear on multiple marketplaces all marketplaces will be notified. HMRC considers that the intention of the new legislation is to ensure compliance from overseas sellers or else face being removed from the online marketplaces. HMRC believes the legislation will create a strong deterrent effect.

3.6 Some external commentators have suggested that it might have been possible for HMRC to make online marketplaces liable as a third party by following a legal approach on this issue known as the Kittel Principle, but opinions differ about the interpretation of this principle.[26] The principle was first established in cases of missing trader VAT fraud. In broad terms, the principle means that parties in a supply chain can be held liable for missing VAT if they 'knew or should have known' the underlying transactions were fraudulent. This means traders need to take all reasonable steps to ensure they are not involved in a fraudulent supply chain. Taking all reasonable steps requires that, where HMRC presents objective evidence of fraud, traders can demonstrate their innocence if they are not to be held liable. Liability for VAT fraud can arise in the absence of national legislation providing for it since that liability is inherent in the European legal system.[27]

3.7 HMRC has used the Kittel Principle for more than 10 years to tackle Missing Trader Intra-Community fraud, with a success rate in excess of 90% protecting more than £3 billion of VAT. This includes just under 900 cases of missing trader fraud where the decision was appealed. In relation to online marketplaces, HMRC considers that it could not apply the Kittel Principle due to the platforms' supply position. The Kittel Principle denies a business its right to recover input tax where a trader knew or should have known that its transactions are connected with VAT fraud. Therefore, the Principle is limited in application to frauds within a supply chain or connected supply chains. Online marketplaces are not in the supply chain, as the supply is from the online seller direct to the end consumer, and to do so would require a change to EU law. Therefore, there would be no input tax for HMRC to deny. HMRC considers the suggestion in paragraph 3.6 above, that a wider principle of third party liability for VAT fraud could be applied to parties outside of the immediate supply chain, would go beyond the scope of existing caselaw. HMRC considers it would almost certainly be subject to legal challenge, as well as being extremely challenging for HMRC to discharge its burden of proof, as it would need to prove both the fraudulent nature of the default and that the marketplace knew or should have known about the default and its fraudulent nature.

26 For more on the Kittel Principle: Axel Kittel v Belgium; Belgium v Recolta Recycling SPRL (Kittel) (Joined Cases C-439/04 and C-440/04) [2006] ECR I-6161.

27 Italmoda (Joined Cases C-131/13 and C-164/13); Rita de la Feria and Rebecca Foy, 'Italmoda: the birth of the principle of third-party liability for VAT fraud', *British Tax Review*, No. 3, 2016, pp. 262–273.

3.8 HMRC opted to seek a new joint and several liability power through legislation (see paragraph 3.3). Even if the wider principle of third-party liability could be established as legally valid it would appear to be an unattractive option in comparison with the new joint and several liability measure. This measure does not require HMRC to prove a fraudulent default or that the online marketplaces had ‘knowledge’ of this. Therefore joint and several liability is a better-targeted option, easier to enforce and less likely to lead to protracted litigation.

3.9 HMRC estimated that the Finance Act 2016 measures to hold platforms jointly and severally liable for unpaid VAT, and to regulate fulfilment houses, would raise £65 million in 2017-18, rising to £365 million a year by 2020-21.[28] Since making these costings, HMRC has altered some of the legislative changes originally planned, based on consultations with major stakeholders. In particular, the alterations meant that those delivering to fulfilment centres would not be required to check an online register, there would be fewer record-keeping requirements and businesses fulfilling their own orders for imported goods would be exempted. HMRC does not expect the alterations to have any impact on the effectiveness of the measures. The cost of the 320 extra staff required to police the new measures is £24 million in 2017-18.

3.10 Amazon and eBay consider the new measures to be a reasonable and effective means of promoting VAT compliance. In particular, the pre-notice phase allows well-intentioned traders to have time to comply and rectify issues. The joint and several liability notice provides a fast mechanism to block non-compliant sellers. However, the new measures can only be effective if there is an open and ongoing collaboration and data-sharing between all marketplaces and HMRC.

3.11 In addition, Amazon considers that the Fulfilment House Due Diligence Scheme, currently in development, will be a disproportionate and ineffective proposal. It considers the compliance burden will increase without necessarily providing HMRC with the right tools to promote compliance and prevent evasion. It will make fulfilment activities carried out in the UK more burdensome and expensive in comparison with fulfilment activities carried out from outside of the UK. Amazon also believes there is a risk that fraudulent sellers will move to marketplaces or fulfilment options which fall outside of the reform (including direct shipment), where their affairs can be hidden from HMRC.

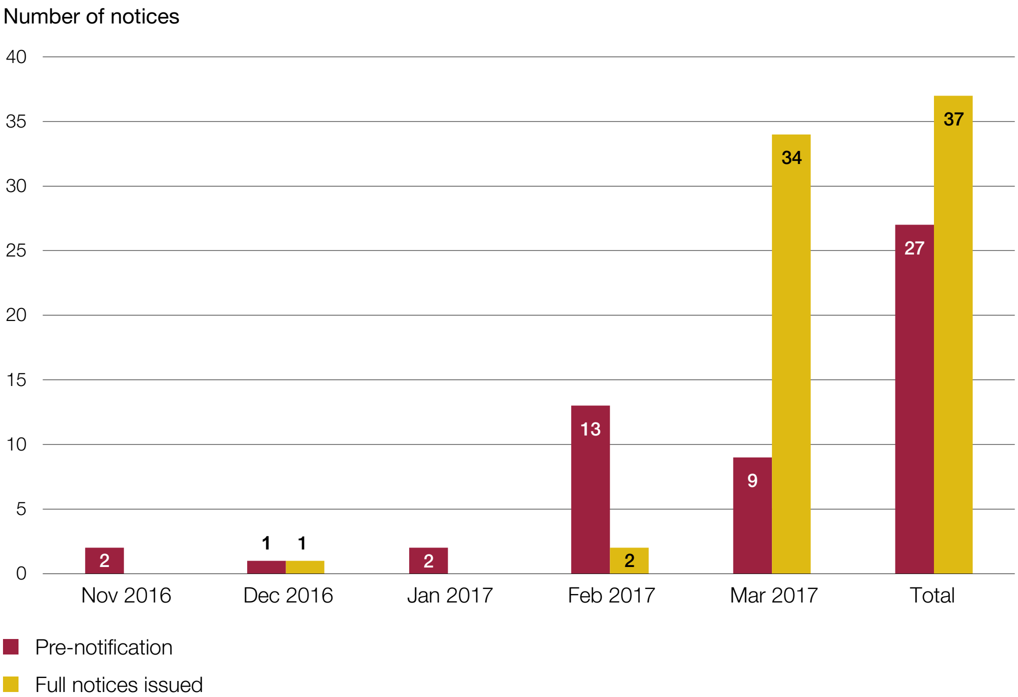
3.12 Amazon and eBay consider the new measures will be an effective way to incentivise sellers to become fully VAT compliant, but only if the new legislation is enforced across the e-commerce market as a whole. If enforcement is targeted at one or two marketplaces, Amazon and eBay have serious concerns that sellers will merely be displaced to other platforms. Amazon and eBay noted that it was in their interests to help their sellers be fully VAT-compliant so they were able to continue to trade on their marketplaces.

28 HM Government, *Budget 2016: policy costings*, March 2016, p. 44.

3.13 HMRC has deployed the new powers first to target 200 high-risk sellers. **Figure 12** shows that, as at March 2017, HMRC had issued 27 pre-notification letters to the online marketplaces about suspected cases of non-compliance and 37 full notices of joint and several liability. HMRC has identified another 400 overseas businesses as non-compliant and is preparing to send joint and several liability notices against them, starting in March 2017. HMRC plans to significantly increase the extent of its compliance work from April 2017 and risk-assess several thousand sellers a month to identify an appropriate compliance response. HMRC has assigned an additional 124 staff to this work in 2017-18.

3.14 eBay prevents affected sellers from selling on all EU sites, not just the UK, and it prevents UK buyers from buying from those sellers on other sites outside the UK. eBay also takes action against linked accounts, not just those referenced in the joint and several liability notices. In practice, eBay believes that this will be the normal outcome, unless sellers affected by a notice can subsequently demonstrate compliance. Amazon told us that if HMRC informed them a seller was non-compliant, they would prevent those sellers from selling in the UK on their site. HMRC has calculated that these interventions have led to compliance yield of around £7 million with a further £9 million in the pipeline.

Figure 12
Joint and several liability notices issued to online marketplaces by HMRC



Note
1 A further 205 joint and several liability notices were in preparation for issue as of March 2017.

Source: HM Revenue & Customs

3.15 In 2016, most (61%) of the VAT registrations by non-EU sellers for online trade were from China, 20% were from the USA, 5% from Hong Kong and 14% from other countries. The Department has cited the increase in the number of VAT registrations by non-EU sellers for online trade (see **Figure 13**) as an example of a positive behavioural impact.[29] It is likely that the number of applications for online trade on a monthly basis is affected by external factors, such as HMRC activities, for example the spike in September 2016 coincided with the coming into force of joint and several liability for online marketplaces. HMRC attributes this to a better understanding of UK VAT rules by traders outside the EU as a result of HMRC's engagement with the online marketplaces. Despite increased VAT registrations for online trade, HMRC is not yet aware what proportion of these sellers had been trading in the past or whether they will be compliant in the future. HMRC will risk-assess the newly VAT-registered businesses and undertake compliance activity, including using the joint and several liability measures.

3.16 The government will be legislating for the new Fulfilment House Due Diligence Scheme in the Finance Bill 2017. Draft Finance Bill legislation was published on 5 December 2016. The Scheme comes into effect in April 2018. From this date fulfilment businesses in the UK will have to register with HMRC, keep certain records and carry out due diligence checks on their overseas customers. HMRC considers this will make it more difficult for non-VAT compliant overseas businesses to trade in the UK and enable HMRC to identify and tackle them more easily. HMRC will publish the register to allow businesses to check whether they are dealing with compliant fulfilment businesses. As of late 2016, the population of fulfilment houses in the UK was still unknown. HMRC, in 2017, set up a group to estimate the number of fulfilment houses in the UK to inform the introduction of the Fulfilment House Due Diligence Scheme. HMRC considered various approaches to identify fulfilment houses in the UK, which included utilising HMRC existing data sets and searching the internet using a set of keywords. In March 2017 the group concluded with a high degree of confidence that there are a minimum of 500 fulfilment houses and with moderate confidence that the fulfilment house population is unlikely to exceed around 3,000 in total.

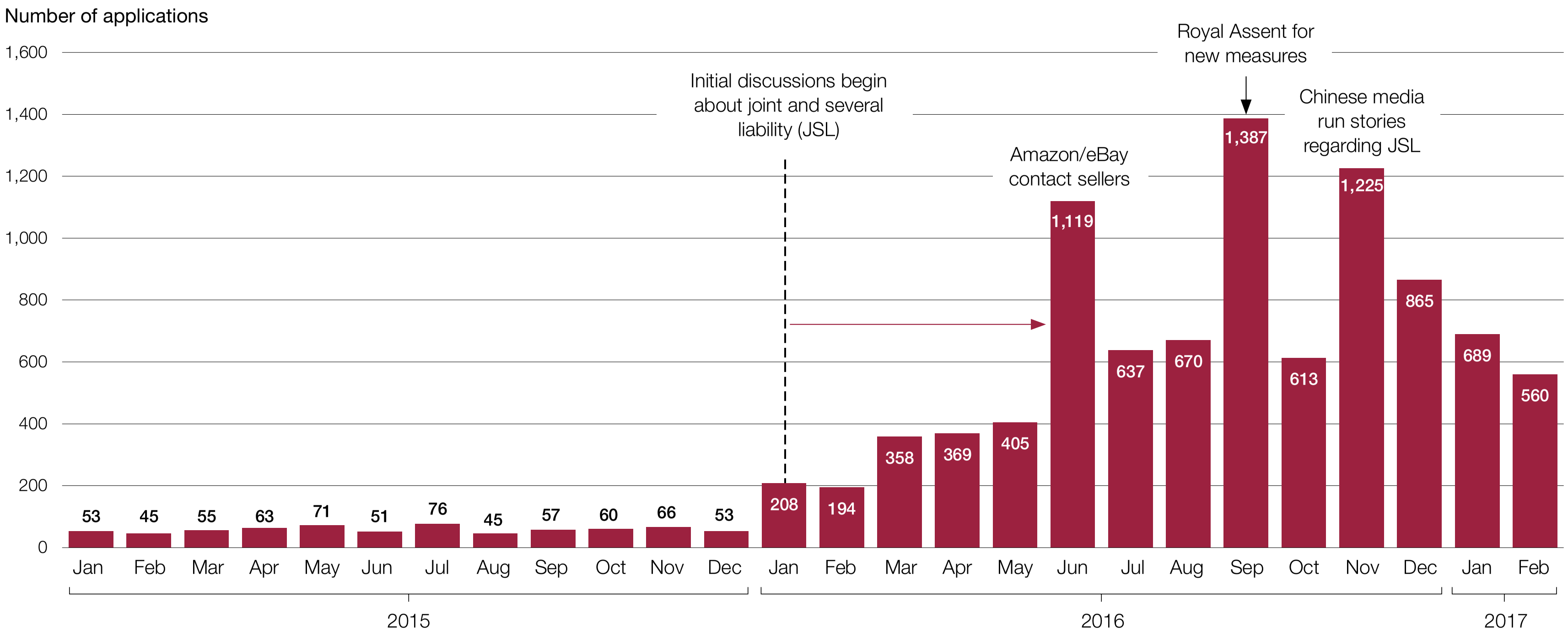
3.17 HMRC has estimated that its new powers, including the Fulfilment House Due Diligence Scheme, will generate revenue of around £875 million from 2016 to 2021. Traders have raised concerns that the Scheme may result in the displacement of risk by encouraging non-EU sellers to use a fulfilment house in a nearby EU country to fulfil their UK orders and potentially abuse Low Value Consignment Relief to avoid import VAT.

3.18 HMRC is exploring further options to tackle online VAT fraud to achieve a long-term solution to non-compliance with UK VAT rules by online retailers. One option under consideration is to introduce alternative VAT collection mechanisms, such as split payments. Under this approach, payments by UK consumers would be deemed to be VAT inclusive, the VAT component would be withheld by the banks and paid over to HMRC. Budget 2017 announced a call for evidence on this proposal.

29 HM Treasury, HM Revenue & Customs and Jane Ellison MP, *HMRC tackles online VAT fraud in time for Christmas,* press release, 21 December 2016. Available at: www.gov.uk/government/news/hmrc-tackles-online-vat-fraud-in-time-for-christmas

Figure 13

Applications for VAT registration made by non-EU sellers for the purpose of retail sales via internet[1]



Notes

1 HMRC terms non-EU sellers 'Non-Established Taxable Persons', that is, a person or company that makes taxable supplies in the UK but which is non-resident, has no UK establishment or is not incorporated in the UK.

2 HMRC takes on average 24.5 days to process each application. The application refusal rate is 6.2%.

Source: National Audit Office analysis of HM Revenue & Customs data

Appendix One

Our investigative approach

Scope

1 We conducted an investigation to assess:

- the extent of Value Added Tax (VAT) evasion by sellers from outside the EU supplying UK customers online;
- how online orders from UK consumers to non-EU companies are fulfilled, what checks are conducted at the border, and the delivery mechanisms used once goods have entered the country;
- HM Revenue & Customs' (HMRC's) understanding of, and response to, the evolving threat, including its new powers to regulate fulfilment houses and to hold online market places jointly and severally liable for unpaid VAT.

Methods

2 In examining these issues, we drew on a variety of evidence sources:

- Retailers Against VAT Abuse Schemes (RAVAS) and VATFRAUD.ORG, two independent pressure groups representing online traders which are campaigning to highlight the extent of overseas online VAT fraud and get action taken to tackle the problem. RAVAS and VATFRAUD.ORG provided us with valuable insights into the nature and scale of the problem of online VAT fraud.
- Interviews with key individuals from HMRC, including staff from the Indirect Tax, Customs and Individuals and Small Business Compliance teams, the Risk and Intelligence Service and the Fraud Intelligence Service to understand HMRC's strategy and operational response to online VAT fraud and error.
- Interviews with HMRC's Knowledge, Analysis and Intelligence (KAI) team to understand its methodology for estimating the extent of online VAT fraud and error.
- Interviews with UK Border Force and Paul Miloseski-Reid, Chartered Trading Standards Institute's e-Commerce lead.

- Document review, including HMRC minutes from meetings about implementing the new powers HMRC gained in the Finance Act 2016, and from its engagement with Amazon, eBay and other online marketplaces.
- Discussion with Professor Rita de la Feria, of Leeds University Law Department, to get a perspective on the legal powers available to tackle online VAT fraud and error, and a review of academic literature regarding the challenge of VAT collection in other countries.
- Engagement with Amazon and eBay to understand their view of this issue, how they work with HMRC to tackle non-compliance, and the broader market context.
- Discussion with the Office for Budget Responsibility, focusing on its review of HMRC's 2016 Budget costings and the estimate of online VAT fraud and error.

Appendix Two

Summary of VATFRAUD.ORG and RAVAS' concerns and how these are covered in the investigation

Trader concern	Investigation finding
A significant number of traders are using online marketplaces, such as eBay and Amazon, to sell their goods without charging VAT, in circumstances when VAT would be due.	HMRC estimates that online VAT fraud and error cost between £1 billion and £1.5 billion in lost tax revenue in 2015-16. See Summary paragraph 1 and paragraphs 1.18 to 1.20.
HMRC has not taken action, at least until recently, to address the problem of online VAT fraud. No one in government is prepared to take responsibility and uphold the laws they are tasked with enforcing.	HMRC recognised online VAT fraud and error as a priority in 2014, although the potential risk from online trading generally was raised before this. See Summary paragraph 3 and paragraphs 2.2 to 2.4.
Online VAT fraud, in addition to significant loss of revenue, distorts the competitive market landscape at the expense of UK businesses that charge the correct amount of VAT.	As a result of online VAT fraud and error, VAT-compliant traders who charge VAT face unfair competition and risk, ultimately, going out of business. HMRC's estimate of the extent of online VAT fraud of £1 billion to £1.5 billion equates to between £6 billion and £9 billion in lost gross sales revenue for VAT-compliant sellers in 2015-16. See Summary paragraph 11, paragraphs 1.6 and 1.22.
Online platforms should ensure that the sellers who trade on their platforms have valid VAT numbers.	Amazon and eBay make it clear that it is the legal responsibility of the sellers who trade on their platforms to determine and declare any VAT that arises from the sale of goods or services. See paragraphs 1.14 and 2.14 to 2.16.
Non-European Union (EU) companies that trade online without being VAT registered are breaking the law by committing tax evasion.	Compliance with the VAT rules is a legal requirement. Not knowing about the rules does not excuse non-compliance. See Summary paragraph 11 and paragraphs 1.2 to 1.5.

Trader concern	Investigation finding
Enforcement agencies should check that goods imported into the UK are correctly accounted for, in terms of valuation, classification and adequacy of legal documents.	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. See Summary paragraph 6 and paragraphs 2.10 to 2.12.
The new measure of joint and several liability will in practice never give rise to a third-party liability on the platforms as they will always take action to remove non-compliant traders when they have been notified by HMRC. HMRC's assessment of the impact of the new measures is misleading.	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. See Summary paragraph 8 and paragraphs 3.4, 3.5, 3.13 and 3.14.
Once the UK is no longer within the EU Single Market, EU online sellers, able to place stock in EU warehouses, would not, under current rules, be obliged to charge output VAT on mail order sales into the UK. There may be an increased risk that such sellers may be tempted to abuse the UK's VAT rules and reliefs (for example, if the UK retained an equivalent of the EU's Low Value Consignment Relief (LVCR)) when they send goods to UK customers. Given that the volume of mail coming from the EU into the UK will already be significant then this together with any additional abusive trade will have the potential to cause major distortions of competition that will force major UK retailers to also supply UK customers from warehouses within the EU in order to benefit from the same LVCR advantage, as was the case in the Channel Islands. In that case it was only when RAVAS complained to the EU Commission that the UK government removed the LVCR exemption from mail order goods sent from the Channel Islands.	It (HMRC) explicitly recognises the risks posed by the fulfilment house business model, particularly in light of the growth in non-store internet shopping. HMRC plans to update its Anti-Fraud Strategy in the first quarter of 2017-18. See paragraphs 2.5, 2.6, 2.17, 3.16 and 3.17.
HMRC has not recovered all undeclared VAT from newly VAT-registered overseas sellers who were previously trading and not VAT-compliant.	HMRC is not aware of the proportion of these sellers who 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. See Summary paragraph 9 and paragraphs 3.13 to 3.15.

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