

JOINT PUBLIC HEARING

**“THE USE OF TAX FRAUDS –INCLUDING VAT OR CAROUSEL
FRAUD- TO FINANCE TERRORISM”
QUESTIONS**

Dr Marius-Cristian Frunza, Director with Schwarzthal Kapital

Introduction to uber-terrorism

Presumably, the Islamic State has learned valuable lessons from the experience of other terrorist groups. Its vision of terrorism focuses on low-cost actions and strong media impact. Why ?

Probably, because to finance and organize a global extremist network, managed by a centralized chain of commands has become a difficult task.

Consequently, ISIS aimed to a lesser extent for complex actions such as the attacks of September 11, 2001 that would require lengthy preparations and implicitly substantial financial resources. Rather, it focused on actions organized by local groups managed in a decentralized manner requiring minimal funding.

The recent attacks in Boston, Paris and San Bernardino marked the entrance in a new era of low-cost terrorism. Under this model, the organization of the attacks should not rely solely on centralized commands or on a clear hierarchy. The manufacturing and acquisition of weapons may be provided near the area where the attack are planned. The logistics of the attacks may be financed by means that do not involve significant fund transfers, which would be easily detectable by the banking network..

Financing terrorist activities relied traditionally on massive long-term funding involving overseas money transfers from generous donors. Modern terrorism changed the paradigm and understood that the main resources are not the financial ones but the human ones.

To finance and to organize a global extremist network, managed by a centralized chain of commands has become a difficult task, due to the increase scrutiny and monitoring of financial transactions. Banks and financial institutions dispose of Counter-Terrorism Financing system that generate alerts when suspicious transfers are detected.

Thus, the way modern terrorism works involves amounts, below the thresholds of processes and systems designed to tackle the terrorist financing. Moreover, terrorist organisations focused on actions organized by local groups managed in a decentralized manner requiring minimal funding. Modern terrorists aim to a lesser extent for complex actions such as the attacks of September 11, 2001 but targets actions with a higher frequency and lower severity. For example the Bataclan terrorist attacks in Paris were budgeted at 50 000 euros.

A potential terrorist on a radicalization path or even a simple adept can attack a target independently. Eventually, the terrorist "social network" provides him with links to other people nearby, able to quickly supply with funds, logistics or skills and rapidly perform an attack.

Daech managed to establish the foundations of a "terrorist social network" that can facilitate the interaction of Islamists and the organization of a terrorist actions. Daech is no longer a centralized structure which ensures the financing, organization and preparation of a terrorist group. Daech seeks to link its followers and transmit technical expertise, thereby strengthening the potential terrorist locally. Apparently, for this reason, that Daech opted to develop the uber-terrorism at global level, there by becoming a trademark of fear.

The uberisation of terrorism makes the task much more complex for the intelligence services because the target is not a clearly defined entity. The fight against the financing of terrorism becomes also difficult as the uber-terrorism does not require a structured and long-term funding or significant transfers of funds.

Any "radicalized" individual may at any time become a threat. Current surveillance systems are too focused on the cyberspace and funding and risk becoming obsolete in this new era of low cost uber-Terrorism. The enemy would be invisible yet ubiquitous. Therefore, the defeat of ISIS in Syria and Iraq will not signify by any means the end of the terrorist attacks, have ISIS's signature.

Q&A

1) How VAT fraud is taken into account in terrorism financing?

RE: Figure 1 presents in a synthetic manner the way VAT fraud can support and finance terrorist activities. Company X buys items from other EU countries and resells them domestically without clearing the VAT liability to the national tax office. Similarly, to any other MTIC scam, the pocketed VAT is sent to another company which can be based in another country. Finally, the funds arrive to a sole trader or a physical person. The funds can be transferred as part of a service, donation, sponsorship or a religious tax in concerned countries (i.e. Zakat)

The final receiver of the funds uses them to support terrorist activities.

Those funds are used to the benefit of various recipients for renting, cars or accommodation, buying travel tickets of prepaid cards, purchasing material etc. The recipients will be finally those in charge with the act of terror. The perpetrators are disconnected from the people who run the MTIC fraud and in many cases they do not even know the MTICers.

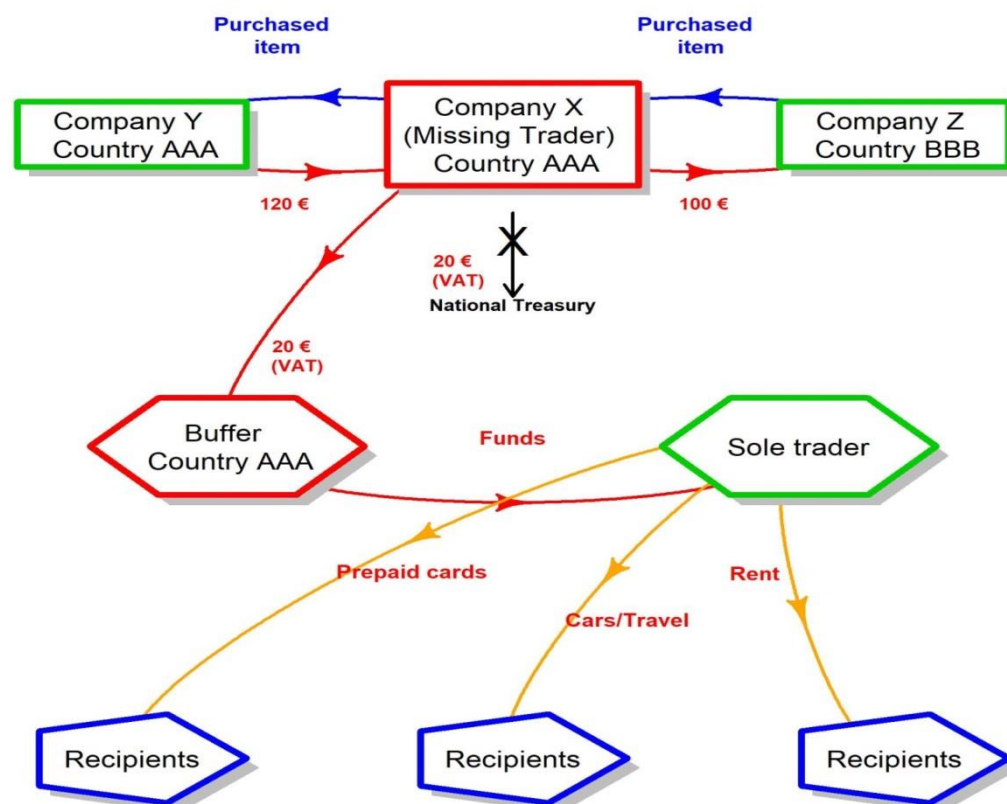


Figure 1. MTIC fraud and terrorism funding. The amount of the pocketed tax fuels the terrorist backbone through various recipients and avenues

The “economy of terror” unveils a universe underlying the terrorist networks, less violent, and yet very powerful and with ramifications in all levels of society. We are witnessing also to the development of a true transnational criminal infrastructure and designed to take advantage of those countries whereas the economic system is based on trust and individual responsibility.

- 2) Do you have estimates of how much carousel fraud serves to finance terrorism?

RE: 412 Million euros

In Denmark and Holland cases involving VAT fraud for financing terrorism were accounting for 1-5 million euros. That represents 0.5% of the MTIC fraud of Denmark for instance. Keeping this ratio and extrapolating to the whole Union the final figure for 2015 would be 412 million euros. This figure concerns only financing of “uber -terrorism”, encompassing small and medium scale VAT frauds. Big cases like SF Energy in Italy do not enter in this estimate, as it is considered an outlier for the model. The estimate corresponds to a low range scenario.

This amount represents not only the sum entailing violent terrorism, but also financing the support groups and the spread of terrorist propaganda

- 3) Which features of VAT explain that VAT carrousel fraud is used to finance terrorism?

RE: Recent events show that in fact the economic and financial aspects of terrorism play a crucial role. Yet, governments and the public seem little sensitized to the problems related to economic crime which supports terrorism worldwide.

Terrorists allegedly linked to ISIS involved in bloody attacks represent only a minority among Islamists or the peak of the iceberg. A segment less known, but more significant is represented by those adepts who have built across Europe and worldwide an economic and financial backbone supporting the criminal attacks. This category of terrorist is involved in the economic crime and has various businesses with doubtful character.

Among the financial crimes, the VAT fraud seems to be the favourite tool for these "economic terrorists". This fraud is based on a network of shell companies taking advantage of the laxity in European Union's tax system.

VAT fraud is particularly easy to implement, requires relatively little seed-funding and can be leveraged across markets and countries. The products targets are: electronic gadgets, the food and agricultural commodities, but also intangible goods or services including CO2 emissions, electricity, "cloud memory " or Voice Over IP(VoIP).

This crime remains barely detectable and investigations are usually long and winding. In addition, the recovery of the embezzled funds is almost illusory, the money being lost as quickly in the meanders of the tax havens and "shadow banking" .

The terrorists engaged in the economic side of terror are generally directors of small and medium enterprises, sole traders or merchants. Their business turnovers do not account

more than a few million dollars and this makes them less visible to the banking systems that are focused on the detection of large financial flows.

Amongst the tax evaders with links to terrorist have an Asian or Middle Eastern background or ties with companies from those regions. Asian and Middle Eastern civilizations have a long tradition in overseas trading. For some citizens issued from these cultures, establishing companies in few countries and doing global business is a natural pattern in life.

VAT fraudsters organized training sessions are organized for inducing beginners in the VAT fraud ring. "New blood" is crucial as many veterans of the VAT scams became banned from directorship. VAT fraudsters have significant research "departments", which analyse markets and countries for finding the favourable ground for implementing the fraud. VAT fraud boot-camps are organized for training and exchanging best-practice. Transnational organized crime and terrorist groups do intersect in the VAT fraud arena and in some cases work together even if they are from completely different avenues. Some extremist religious leaders encourage young adepts to engage in VAT fraud schemes as part of an economic warfare against the enemies of their religion.

In some religion like Islam, there are religious taxes applied to companies. In the view of some Islamist extremist activists, VAT might not be complaint with their view on religious taxation code. For example, VAT might not be compulsory with Sharia in the views of a religious extremists. They will push adepts to divert the official tax to other taxes which are complaint with religious role. The role of Zakat in the terrorism financing was pointed by (Chugani, 2008). Therefore, not paying VAT and diverting the funds towards the Zakat is a realistic scenario.

- 4) Which actions could serve as closing this specific VAT fraud? In particular, have you identifies margins of enhanced cooperation to close this fraud?

RE: Tax fraud as a tool of terrorist financing needs a paradigm shift in the way it is dealt with. Uber-terrorism is not centralized phenomena. It is like a puzzle spread over many countries and involves different strata of society. Therefore, a single investigative body from one country would not be able to tackle this phenomena. Also, distinguishing between, fighting terrorism and fighting VAT fraud that financing it is a major flaw.

Uber-terrorism and the underlying tax evasion should be addressed in holistic way. Therefore, the investigation teams should encompass people from various walks of life and with a multi-disciplinary background, including:

- Governmental intelligence agencies
- Private intelligence firms
- Financial Intelligence units in banks
- Police officers
- Serious organized crime agencies
- Custom and Tax officers

Tax evasion for uber-terrorism funding is a global phenomena and also a global threat. Only a transnational cooperation can address this issue in an efficient way. Few measures would facilitate this effort including:

- Creation of European Intelligence Office, that would reunite crucial intelligence from all Member States.
- Cooperation between the big countries affected by terrorism: the United Kingdom, the United States, European Union and Eurasian Union

5) Which actions could serve as closing this specific terrorism financing channel?

RE: This channel cannot be currently closed. Potentially it can be reduced and better surveyed by law enforcement.

In this new era, both financial institutions and intelligence services should reform their methods and systems of tackling the terrorist backbone. Anti-money laundering and terrorism financing are currently addressed and dealt with through the same framework. In reality they are two distinct phenomena very different in nature.

With the new operating model of terrorism the AML systems provided by the software suppliers would fail to come up with any prevailing signals about the way the terrorist actions are funded. This would leave banks and authorities into the dark.

The current methods and systems aim to track significant fund movements through domestics and international transfers. They also target mainly big size entities including corporates, family offices, investment vehicles as well as non-profit organizations.

The uber-terrorism finances its actions mostly through personal finances and from sole traders or SMEs. These potential sources are very difficult to label ex-ante, by a predictive tool. It is only when a terrorist event occurs that is clear which SME or person was backing a terrorist act. Not only the financing methods are difficult to detect but also there are less predictive factors which would tell if one is a potential terrorism backer.

A potential solution could come from a different walk of life which concerns the retail banking. Credit risk managers were confronted with similar problem in nature. Which client will be bankrupt? But they are not focused to predict what client will default, but to create clusters which would assess the potentially bad clients. In the same way financial institutions and authorities could come built models which would assess the potentiality of a person or a company to be involved in terrorist backbone. A fully fledged approach would include financial and non-financial information which would describe a pattern of behaviour. Those patterns would be analysed through statistical techniques and grouped in clusters. The clusters describing the behaviours of individuals or SMEs can be overseen by experts which would identify those outliers that show a different behaviour from their peer group. Unusual series of events (contacting a Islamist discussing group on Facebook followed by renting a car for a foreign person) could be a warning signal for the surveillance systems. This framework would require an efficient information pipeline between intelligence agency and financial institutions.

6) Have you identified adaptation of terrorism financing recently

Re: Few of the avenues taken for financing uber-terrorism include:

- Business loans: Companies take loans, that can be used for financing terror. The company files for bankruptcy and the loans are not reimbursed.

- Rents paid by sympathizers: People who follow a cause can help with paying flat rents, renting cars, etc...
- Personal loans: Application fraud is a loan taken by a person with the intention of never paying it back
- Social Security and benefits fraud: claiming benefits on fraudulent basis
- Crowdfunding: funds raised from the social network of the terrorists.
- Crypto-currencies: trading and mining
- Sanctions: Smuggling goods and service to bypass embargos
