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HOW TO CLOSE THE VAT GAP:

An analysis of the approaches by EU Member States

A TMF Group briefing

Contents

Introduction

In 2015 the European Commission sponsored studies to quantify and analyse the VAT gap in the EU Member States. To ensure correct methodology, studies were carried out based on the latest fully-processed data provided by governments. The project began at a point in 2015 when data from 2014 was not yet entirely verified - therefore studies were carried out on data up until 2013.

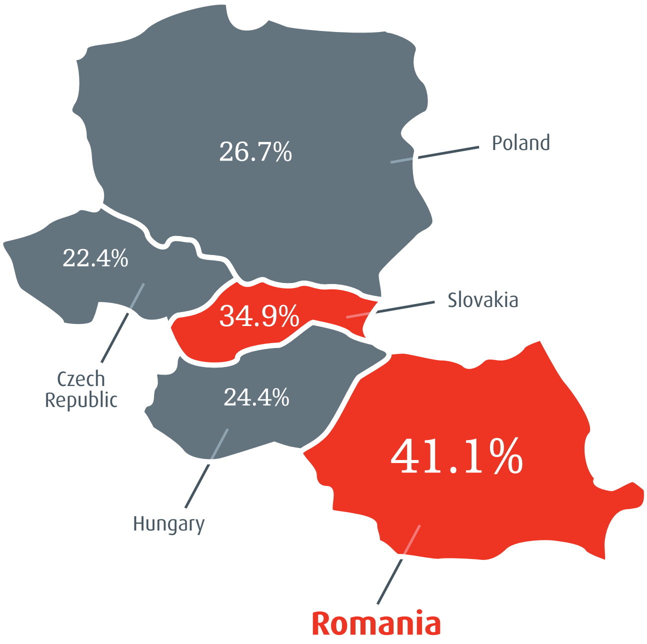
What is VAT Gap?

Pursuant to methodology applied in the EU report, VAT gap is the difference between the amount of VAT actually collected and the VAT Total Tax Liability (VTTL). The VTTL is an estimated amount of VAT that is theoretically collectable based on the VAT legislation and ancillary regulations. In other words it is the difference between what could be, and what is actually collected from VAT by countries.

According to the European Commission EU member states from Central and Eastern Europe had the highest VAT gap in 2013, ranging between 22.4% in the Czech Republic, 41.1% in Romania, 24.4% in Hungary, 26.7% in Poland and 34.9% in Slovakia. This common problem of VAT gap throughout the region is costing the state budgets of CEE countries around €27bn annually.

Overall, 15 EU Member States decreased their VAT gap. Among the Eastern European countries, the largest improvements were noted in Latvia and Slovakia. 11 EU Member States saw an increase in the VAT gap, generally of small magnitudes.

This handful of statistical facts indicates the VAT gap is a problem across the European Union. If this problem remains unsolved, it will continue to cause headaches for EU Ministers of Finance when constructing state budgets.



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Database full of invoices

What is this idea all about?

States are trying to find a solution to the VAT gap by implementing new provisions in their local VAT laws. One of the most common ideas is to improve the transparency of VAT. To be precise - improve the transparency of transactions from the perspective of the tax authorities.

The method that is used to achieve this goal is to build a database of invoices issued by taxpayers and make it accessible from tax authority-level. Ideally invoices would be copied to the database in real time, meaning authorities should have the ability to check the invoice and have knowledge about the transaction, seconds after it's issued by the taxpayer.

No matter how attractive that idea is for tax authorities, questions and doubts must be raised - both technical and legal in nature.

Firstly, we must remember that currently invoices may be issued in two ways:

- electronically
- traditionally (in paper form).

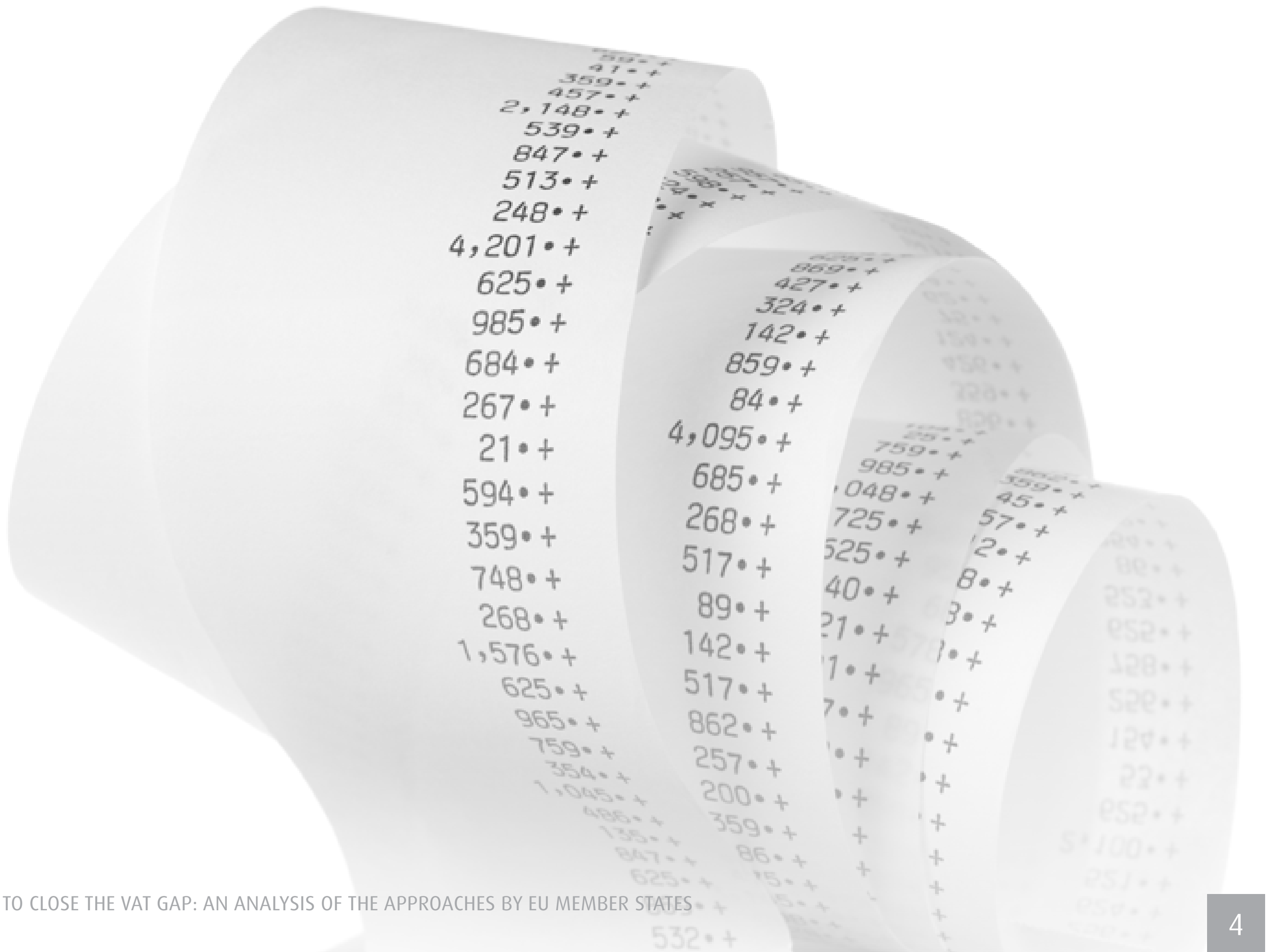
To make the presented method effective, VAT law should change to eliminate the possibility to issue invoices solely in paper form. Paper form could still exist but as an accompanying document, whereas invoices from a legal perspective would only be documents issued electronically. Otherwise companies issuing invoices in a form other than electronically would be put in an unfavourable position, as extra work would be required from them (scanning the invoice and registering the document manually in a created database).

Current EU legislation does not give an obvious green light to eliminating paper invoices. According to Article 218 of the VAT Directive; Member States shall accept documents or messages on paper or in electronic form as invoices if they meet the conditions laid down in this Chapter. That means that pursuant to the current VAT Directive, the taxpayer could take tax authorities to the Court of Justice of the European Union (CJEU) if he or she suffers some negative consequences due to the fact the invoice was issued only in paper form.

However there is a tendency within the EU to move into fully electronic invoicing as this method is promoted, and taxpayers are encouraged through different incentives to switch to e-invoicing.

Secondly, creating a database is not the end of the story. Tax authorities need to hire and train people who will know how to handle and process such a huge amount of data on a daily basis. One of the benefits of having that database would be to more swiftly react in cases of suspicious transactions from a VAT perspective. But to identify potentially fraudulent cases, two conditions must be met:

1. the data is processed swiftly
2. the data is processed accurately.



How is this going to work? – the Spanish example

One of the countries currently in the process of implementing a system that will help to monitor VAT transactions is Spain.

Spain introduced a new strategy to modernise VAT administration through the new system of 'Immediate Supply of Information' (SII). The system is expected to be fully operational from 2017. This shows that implementation does take a while, and requires commitment and consistency from tax authorities.

The idea of SII is that qualifying companies need to electronically supply data from Spanish VAT books within four working days, and in cases where third-party billing or customer self-billing is involved, the deadline is extended to eight days.

The tax authorities believe that this would improve tax control and assist taxpayers to obtain data for VAT returns and speed up the refund process. It will be compulsory for all taxpayers who are:

- part of a VAT group
- considered a large size company (invoicing over €6.01m a year)
- applying the monthly refund scheme ie. REDEME group.

Under SII, taxpayers will need to provide:

- invoices issued and received
- VAT calculations
- the application of the reverse charge
- intra-community arrivals and dispatches
- certain additional information which at present is not included in such books (like description of the transactions, the VAT period, etc.)
- the method to rectify prior registry entries
- intra-community arrivals and dispatches.

Of course having access to the data is not the end of the story. Spanish authorities will have to train tax officers and most probably hire new ones who will be able to analyse data and make correct conclusions.

Other variants of the idea – control statements in the Czech Republic and Slovakia

Another variation on this idea was presented by Czech and Slovakian tax authorities. Both of those countries introduced an additional report called the 'control statement' to ensure all transactions are reported.

Slovakia introduced control statements in 2014 while the Czech Republic followed two years later. Control statements are additional listings that are due on monthly basis. These additional reports must contain invoices issued and received by the VAT-registered taxpayer. For most transactions, additional information on the counterparty, number of the invoice, VAT amount, VAT base and tax point has to be included.

This new requirement, as an idea, is intended to increase transparency of business and also to give tax authorities another tool to cross-check VAT-able transactions. In the Czech Republic, information provided on the control statement by the vendor is automatically checked with information reported by the purchaser and where there is any discrepancy, officers are notified.

The solution is less swift than the Spanish one (as information is provided on a monthly basis, not in real time), however the implementation costs are significantly lower.

Bearing in mind that the EU report on VAT gap was based on data until 2013, we will have to wait another year to see whether the control statement in Slovakia has in fact helped to decrease the VAT gap.

Poland, like the Czech Republic and Slovakia, is battling with significant VAT gaps. Polish authorities are in contact with Slovakia and the Czech Republic to understand the impact of control statements on closing the VAT gap. Warsaw is also thinking about introducing some additional reporting or a database where invoices are collected and stored.

It is also worth pointing out that additional reporting has been introduced in Estonia (as annex KMD INF). The scope of Estonian reporting is limited to local transactions which shows another path taken to close the VAT gap; increase control over local taxpayers and transactions.

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VAT liability remains in the country; expansion of the reverse-charge mechanism

The idea of reverse-charge mechanism

Tax is usually defined as a compulsory contribution to state revenue levied by the government on workers income and business profits, or added to the cost of some goods, services, and transactions. Every tax consists of following elements:

- rate
- subject
- taxpayer.

The reverse-charge mechanism is focused on the third element – the taxpayer. In general, VAT is paid by the vendor. However in special circumstances the purchaser may be obliged to calculate and pay VAT. It is nothing extraordinary, but recently we have observed an expansion of this rule. Mainly, countries introduced the reverse-charge application to transactions where a non-resident entity registered for VAT purposes in a discussed country, supplies goods or services to a resident entity registered for VAT.

One of the reasons behind this is to protect tax authorities from having debt executions involving more than one jurisdiction. Any kind of debt execution, as a rule, is made in line with the laws of the country where the company is incorporated. Therefore, if the taxpayer is resident of a different country than where he/she is registered for VAT, in a case of any unpaid liabilities, the tax office in the country of registration must ask tax authorities in the country of residence for assistance. This prolongs the process to the extent that it makes it extremely ineffective.

The introduction of additional control mechanisms in respect to residents and local supplies led to the reasonable conclusion to expand the catalogue of transactions where the resident becomes a taxpayer for VAT. That is another reason for the expansion of the reverse-charge mechanism.

Quick Reaction Mechanism (QRM) – one of the ways to introduce the reverse-charge

The European Commission is aware that countries are facing problems with the execution of VAT due to ie. carousel frauds. So to give authorities tools to prevent frauds, the Quick Reaction Mechanism (QRM) has been introduced.

The QRM allows Member States to respond more swiftly and efficiently to VAT fraud. Under the QRM, a Member State faced with a serious case of sudden and massive VAT fraud is able to implement certain emergency measures, which require prior notification to the European Commission. Italy used QRM to introduce a domestic reverse-charge mechanism. One of the benefits of the QRM is that notification can be sent just 30 days before the introduction of new provisions (whereas usually a three-month standstill period is applicable).

Italy, using the QRM, in its 2015 Finance Bill introduced a domestic reverse-charge mechanism.

Amendment enumerates the following trading situations where the customer is now responsible for the reporting of both the input VAT and output (sales) VAT:

- domestic supplies of energy and fuels around the supply of electricity and gas
- trading in carbon emission credits
- services related to construction, including building works, renovations and clearing sites.

Italy has also become the latest country to impose the domestic reverse charge on sales of laptops, game consoles and computer tablets.

Taxpayer status connected with residency – Slovakia's case

Domestic reverse-charge is a popular mechanism across EU Member States; nevertheless it does not mean there is one unified version of it. For example in the Netherlands reverse-charge applies to the supply of all goods by non-established businesses to businesses established in the Netherlands. In Belgium on the other hand, reverse-charge applies if the supplier of goods is not established in Belgium or does not have a fixed establishment in Belgium and supplies goods to a taxable person established in Belgium; filing periodic VAT returns or to a taxable person not established in Belgium, that has appointed an individual tax representative.

Besides, all EU Member States apply the reverse-charge mechanism to transactions involving commodities that were subject to the most carousel frauds:

- some electronic devices (ie. laptops, notebooks, tablets, mobile phones including smartphones and video games consoles)
- scrap metal etc.

But there is also a 'new wave' of expansion of the domestic reverse-charge mechanism. One of the examples is Slovakia, which introduced domestic reverse-charge this year. In Slovakia, domestic reverse-charge applies when a non-resident (even if registered for VAT in Slovakia) supplies goods to a resident registered for VAT in Slovakia. In that case, liability for VAT remains entirely with the purchaser. Although it may sound like relief for foreign entrepreneurs operating in Slovakia, it is not that straightforward. In a case of incurring input tax relating to the sale to a resident, the vendor cannot recover this input tax through a VAT return but must use alternative mechanisms (8th Directive or 13th Directive). That will obviously have an impact on cash-flow of non-residents registered in Slovakia which happen to be on a position of credit.

Secure VAT on the spot – split payments

Another idea to close the VAT gap is to secure that VAT is paid instantly to authorities. Usually VAT is paid by the taxpayer on the basis of VAT-able transactions performed during the reporting period. And output tax needs to be paid by the deadline given for VAT return filing.

The split payment mechanism changes this approach. In general, authorities appoint a third party (which may be a public body or a bank) to collect output VAT on the spot. What this means in practice is that the purchaser pays the net price to the supplier, and calculated VAT to a third party appointed by authorities. As a consequence, the supplier is no longer obliged to pay his output tax.

One of the countries that introduced split payments is Italy. Italy has been granted approval from the European Commission (EC) to continue its split payments regime. The approval has retrospective effect from 1 January 2015 and will run until 31 December 2017.

Italy implemented this regime in order to cut down on the level of fraud it was experiencing in this sector. It was estimated that Italy was losing €900m per annum on public body VAT payments.

The split payment system obliges public bodies to pay the VAT they incur on their costs directly to the state and not to the supplier. Previously the VAT paid by public bodies would not reach the government as the suppliers who should have been declaring it either disappeared, or fraudulently held onto the money.

Other ideas implemented by EU Member States

Teams within tax offices to combat VAT frauds

Some governments decided that the current setup of tax authorities is not effective enough to fight VAT fraud. To investigate and analyse whether VAT transactions are fraudulent or genuine, officers need to look at VAT from an angle different to that in their day-to-day work. They cannot examine transactions individually but must see it as a bigger picture. That means checking entire chains of traders, often located in several jurisdictions. It also means liaising with teams such as police, customs officers and other law enforcement agencies.

In Slovakia, 'Tax Cobra' has been formed – a special financial law enforcement unit composed of tax specialists, investigators and prosecutors, the unit has been operational since July 2012. The unit is tasked with helping to reduce tax evasion activity.

Tax Cobra has mainly intervened in cases of risky companies that are revealed through VAT ledger statements. The inspections have found that the worst offenders came from firms selling commodities like nickel, sugar, cereals, used cars, meat, wood, stone and wine.

However this financial law enforcement unit is far from unique to Slovakia; potentially fraudulent transactions will often involve more than one jurisdiction and tax offices are encouraged to form joint teams to investigate and ultimately, prosecute.

The Czech Republic formed a joint investigation team (JIT) together with Germany, the Netherlands and Poland. The joint action called Operation VERTIGO 2, is part of a VAT fraud investigation (July 2015). It has been coordinated and partially funded by Eurojust since July 2013 and has involved several bilateral and multilateral coordination meetings held at Eurojust with more than 250 law enforcement officers from all over Europe engaged in the project.

Receipt lotteries

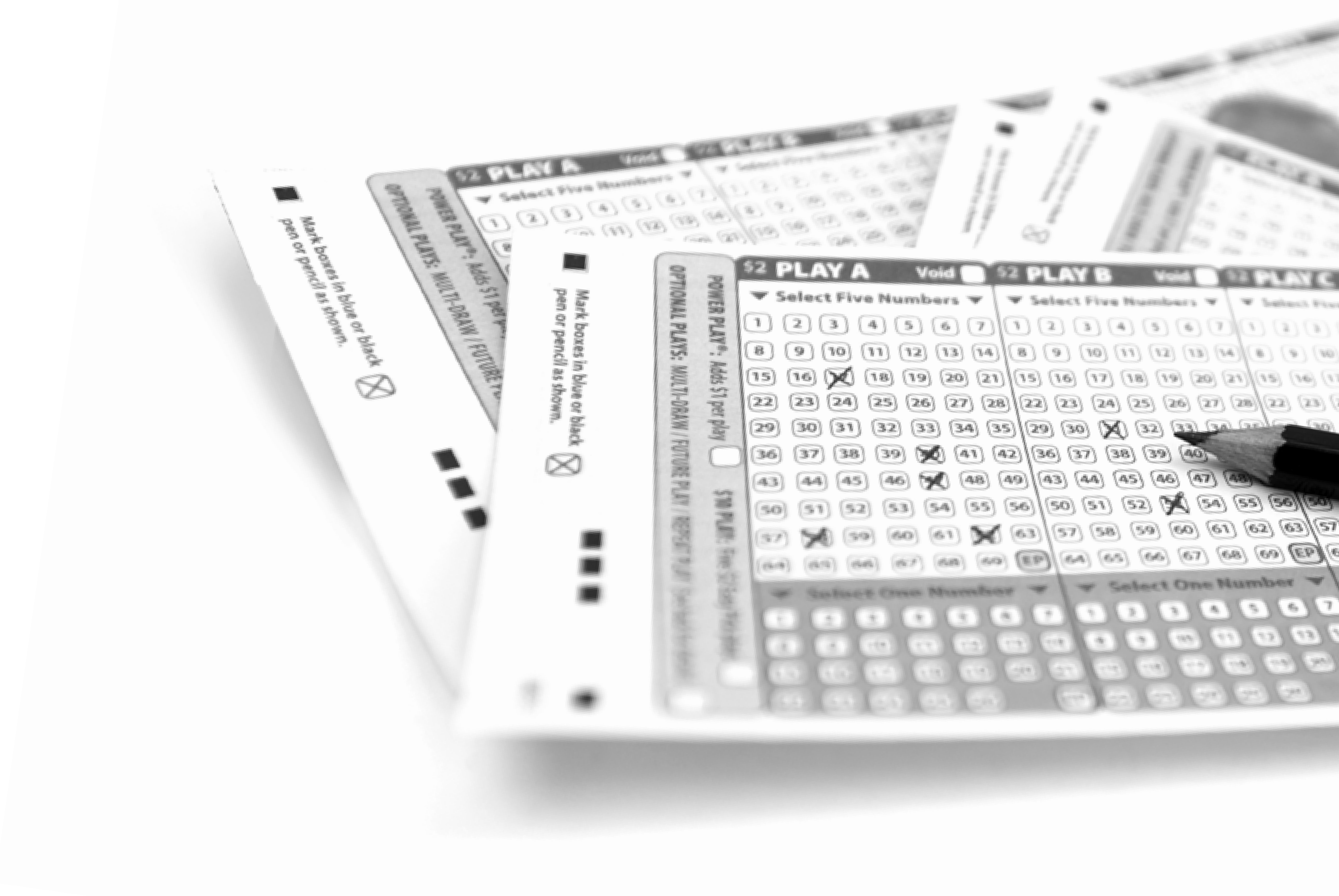
There are also solutions that aim to promote the VAT behaviours desired by tax authorities within the general public. One of the most common approaches is a state lottery draw where people may win attractive prizes. Usually the only condition to participate in the draw is to register a receipt that is obtained from the supplier (for groceries, etc.). According to governments that take this approach, it creates pressure on the supplier to record every transaction in the cash register.

The Portuguese government has added a state draw lottery to address tax evasion and fraud. They offer high-end cars and, as a ticket, Portuguese authorities recognise an invoice issued with individual taxpayer numbers. Invoices or receipts are automatically registered in the authorities' system.

Customers who request a bill with their taxpayer number on it automatically qualify for a draw ticket for each €10 worth of purchases. People can verify online if sellers submitted their invoices to the tax authorities, and where there is any failure on the seller's behalf, they can submit receipts themselves.

It is this sort of civic control of tax payments by businesses that the government wants to stimulate, according to the Portuguese finance ministry, which also denied suggestions of any monitoring of private spending.

Recently a similar concept was introduced in Poland to increase the pressure on taxpayers to record every sale and issue receipts (or invoices upon request) to customers.



Conclusions

Countries are trying to find ways to maximise tax revenues to cover public spending. As increasing taxes is never welcomed by future voters, states are tending towards increasing the effectiveness of currently binding taxes. And the VAT gap is a serious issue for many EU Member States. The level of the VAT gap can also be used to assess the general effectiveness of regulations in EU Member States. Therefore, to boost budget incomings and to help an EU nations' image, many are working hard to decrease their VAT gap.

The main ideas introduced to help to close the VAT Gap are:

- **introduction of a domestic reverse-charge mechanism**
- **creating a database of invoices to help monitor transactions**
- **lotteries to ensure that all transactions are recorded**
- **a split payment mechanism.**

It looks like it should result in a decrease of VAT gap in the coming years in EU Member States. On the other hand, tax authorities may misuse the newly given tools to overburden business with audits, reviews and assessment proceedings.

As we know, in theory VAT is supposed to be fiscally neutral for fully taxable businesses, in practice it is unfortunately not the case. This is another type of VAT gap for companies. As a general principle the obligation to collect and account for VAT lies with companies and increasingly, the responsibility for any missing VAT also in cases of VAT fraud, is put on companies.

Next to this there are the usual massive penalties for non-compliance and cut-off from recovering VAT which should otherwise have been deductible if they are not completely on top of their processes and data, and are able to explain it at any time to the tax authorities.

TMF Group is also evolving and our future VAT service offerings will provide for even more checks, controls and visibility; so that clients will be well prepared, and not run into surprises in tax audits.

References:

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[3] The Court of Justice of the European Union.
[4] www.oxforddictionaries.com/definition/english/tax [09/03/2016].
[5] In Portugal, every individual is granted with tax number that can be stated on receipt or invoice.

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Contact TMF Group's VAT Services team

contact@tmf-group.com

Writer:

Patryk Karczewski
VAT Technical Manager
patryk.karczewski@tmf-group.com

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