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# VAT FRAUD PREVENTION

***Summary***
*Making a clear distinction between tax fraud and activities related to the so called tax optimisation, appears to be most relevant in the fight against fiscal offences. VAT leaking is not only a problem for Polish state authorities, but also for all countries with value added tax in their fiscal system. The paper attempts to define tax fraud and present its consequences for the state budget, it also offers description of system procedures of VAT fraud prevention.*

***Key words:*** *value added tax, tax fraud, state revenue*

***JEL Classification:*** *G24, H74*

## Introduction

The amount of VAT fraud has remained relatively high for years. The actions undertaken by government authorities are not effective in the fight against value added tax leaking. The authorities do not provide enough support in terms of leaking, which is the result of discrepancies between theoretical amount of value added tax due, and actual budget revenues. This is confirmed by the reports published by the Supreme Audit Office[1] (NIK).

VAT leaking is not only a problem for Polish state authorities, this phenomenon is present in all countries which possess value added tax in their tax system. Therefore, it can be concluded that the revenue tax gap

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[1] NIK (the Supreme Audit Office) Information regarding inspection results: *Zwalczanie oszustw w podatku od towarów i usług* Reg. No. 17/2014/P/13/042/KBF; *Przeciwdziałanie wprowadzaniu do obiegu gospodarczego faktur dokumentujących czynności fikcyjne* Reg. No. 24/2016/P/15/011/KBF.

is not only a result of fiscal office weakness, but also, to a certain extent, a design of a tax itself, which due to a set of immanent features, does not lead to the elimination of fraud. Due to the existence of the common market and intra-community trade within the European Union, VAT issues have become the transnational problem. Moreover, the harmonisation of turnover taxes requires widely understood cooperation between national fiscal authorities, relevant institutions in other Member States as well as in the European Union structures.

The paper attempts to define tax fraud together with its consequences on the grounds of the Polish legal system, and presents ways used to counteract tax fraud at two levels: introduction of systemic changes and use of modern information and communication technologies.

## 1. Fiscal system in Poland and its legal administrative framework

In the binding Act on Tax Ordinance, tax is defined as public, unpaid, obligatory and non-returnable cash liability toward the State Treasury, province, district, or municipality resulting from the Tax Ordinance Act, which determines tax entity and object of taxation, incurrence of tax liability, tax basis, tax rates, and rights and obligations of tax authorities, taxpayers, payers and debt collectors[2]. The provisions including the Constitution of the Republic of Poland[3] indicate that only the relevant Acts may regulate the way of imposing taxes, and other public levies, establishing at the same time the beginning of the Polish tax system, perceived as all legal and organisational solutions concerning the form of taxation. All tax administration bodies, including state fiscal authorities (offices and tax chambers), as well as self-governing tax authorities (in accordance with local government unit, a municipality mayor, a head of district, a province governor, as the body of the first instance and the local government appeals board as the second instance) are the superstructure of the system. The Administrative Court[4] is responsible for monitoring of the final tax decisions. The Minister competent for public finance has an important position amongst all the authorities, and the Tax Ordinance Act provides the Minister with the

[2] Article 3, paragraph 1, Article 6, The Act of 29 August 1997 - Tax, Journal of Laws from 1997 no137 item 926, as amended.
[3] Article 217, *The Constitution of the Republic of Poland of 2 April 1997*, Journal of Laws from 1997 no 78 item 483.
[4] B. Gnela, *Podstawy prawa dla ekonomistów*, Warsaw 2015, Wolters Kluwer, p. 107.

series of competences, including an extremely significant meaning of a competent authority concerning the interpretation of tax law. Hence, the Minister of Finance has a right to issue, pursuant to the Act, general or more detailed interpretation of tax law, as well as posting to the subordinate authorities.

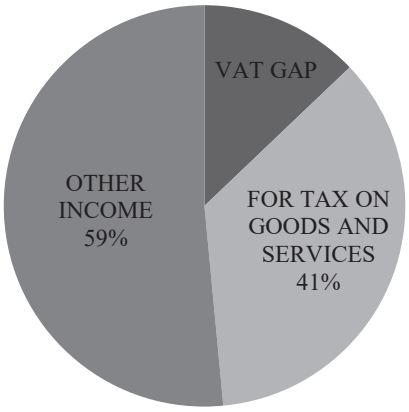
Amongst all of the state budget revenues taxes are the most important. Income from taxes constituted 89.9% of total revenues in the year 2014, 89.8% in 2015 and 86.8% in 2016[5]. The tax system performing a fiscal function actually makes it possible for the state to execute its basic activities. Moreover, the literature on the topic emphasizes a non-fiscal aspect of tax system, which includes a redistributive role[6] - activities connected with redistribution of a primary domestic product, aimed at realisation of widely understood rules of social justice[7], and stimulating role[8] - actions directed at running an interventionist macro- and micro-economic policy, in order to ensure a stable and long-term economic growth, including low unemployment rate[9].

Among varied tax classifications, the distribution due to object of taxation ratio to the source of tax, distinguishing indirect and direct taxes, is prevailing[10]. In Poland indirect taxes, including tax on goods and services as well as excise duty, generate the highest portion of budget revenue. For example, for the year 2015 it amounted to 123 120,8 million PLN on account of taxes on goods and services (47.4% of total tax revenue) and 62 808,6 million PLN due to excise duty (24.2% of total tax revenue)[11]. Unfortunately, indirect tax revenue, constituting the largest source of state income, repeatedly becomes an extremely attractive income source for criminal organisations. Tax related criminal activity results in budget deficits reaching billions of PLN. The VAT gap for the

[5] CSO data (Central Statistical Data, *GUS* ), *Roczne wskaźniki makroekonomiczne – część III*, update 28 April 2017.
[6] M. Podstawka, *Finanse*, Warsaw 2010, PWN, p. 35.
[7] The importance of this role is more often emphasised in numerous studies nowadays. The examples are edited by Jerzy Osiatyński: *Kazimierz Łaski Wykłady z makroekonomii*, Warsaw 2015, PTE; Joseph E. Stiglitz, *Cena nierówności*, Warsaw 2015, Wydawnictwo Krytyki Politycznej; T. Piketty, *Kapitał w XXI wieku*, Warsaw 2015, Wydawnictwo Krytyki Politycznej.
[8] St. Owsiak, *Finanse publiczne*, Warsaw 2005, PWN, p. 181.
[9] O. Blanchard, *Makroekonomia*, Warsaw 2011, Wolters Kluwer.
[10] J. Osiatyński, *Finanse publiczne*, Warsaw 2006, PWN, p. 101.
[11] CSO data, *Roczne wskaźniki makroekonomiczne – część III*, update 28 April 2017.

year 2016 was estimated at 45 billion PLN[12] (Fig. 1). Combining the amount with total state budget revenue, for the same year, equal to 313,8 billion PLN, it appears that a potential deficit caused by VAT issues is equal to 14.3% of total annual income of Poland.

**Fig. 1 State budget revenues in the year 2016.**




| | |
|---|---|
| TOTAL REVENUES | 313 MLD ZŁ |
| VAT | 128,6 MLD ZŁ |
| OTHER INCOME | 185,2 MLD ZŁ |

| | |
|---|---|
| ESTIMATED VAT GAP | 45 MLD ZŁ |

Source: own source based on The Budget Act for the year 2016 of 25 February 2016 (Journal of Laws 2016, item 278); http://www.pwc.pl/pl/media/2016/2016-11-23-luka-vat-2016.html

In the discussion of crimes and offences against the Polish tax system, it is essential to mention issues connected with penalties for the abovementioned violations. Generally, the provisions of the Act of Fiscal Penal Code apply, or in more severe cases e.g. belonging to an organised crime group committing fiscal offences - respectively the Criminal Code. The judicature usually takes place in common courts of law, or in cases when a given offence is committed by a soldier - military courts. Pre-trial proceedings concerning fiscal offences are conducted by: the National Tax Authority, the Border Guard Service, the Police, the Military Criminal Police. While, the Internal Security Agency and the Central Anticorruption Bureau deal with pre-trial proceedings only in cases of fiscal offences.

[12] http://www.pwc.pl/pl/media/2016/2016-11-23-luka-vat-2016.html [access 01 May 2017].

In recent years, a trend towards strengthening of the sentences issued in cases of tax fraud may be observed. A breakthrough in this matter was the resolution of the Supreme Court of 18 December 2013[13], which was given a status of a legal provision. In cases such as issuing so-called 'blank invoices', it enabled application of the provisions of the Criminal Code, which according to principles, expected stricter sanctions, in place of Fiscal Penal Code. The next important step was taken on 14 February 2017 with respect to the Criminal Code[14], and it consisted of implementing regulations with regard to VAT fraud only. In cases of the most serious fiscal offences an imprisonment which can go up to 25 years was provided. The presented solution raises a question whether courts will really employ such severe penalties in their judicature, and if it really reduces the number of fiscal offences.

## 2. Tax fraud and tax optimisation

A clear distinction between tax fraud and activities with respect to the so-called tax optimisation appears to be very important in dealing with fiscal crime. Balancing on the border of science, law, and tax administration one may find various definitions of the same concept. A lack of clarification concerning the relevant issues within the law itself, seems to be particularly confusing. Generally, a theory of public finance, in a readable way enables to capture a borderline separating fraud from optimisation. It is a question of compliance with applicable law. Hence, according to academic fields, it is assumed that:

- tax fraud[15] is an activity connected with tax evasion and obtaining of unduly tax, which obviously and blatantly does not fall within the limits set by applicable law;
- tax optimisation[16] are activities aimed at achieving tax benefits, acceptable and falling within the law.

Unfortunately, taking into consideration the Polish legal system, similar and clear distinction of the concepts is not that simple. The provision concerning tax avoidance originally introduced in 2003 was

[13] Resolution of the Supreme Court of 18 December 2013, file no. I KZP 19/13.
[14] The Act of 10 February 2017 on the amendment of the Criminal Code and some other Acts .
[15] It is equivalent to *tax evasion.*
[16] It is equivalent to *tax avoidance.*

questioned in a judgement of the Constitutional Tribunal[17], which inter alia demonstrated that it is unacceptable to recognize tax avoidance as illegal, with legal means. Due to this fact, optimisation together with the achieved fiscal aim, could not be regarded as banned. In this case, the Constitutional Tribunal in the judgement referred to the principle of protection in the state and law, and the principle of legality. Moreover, judges also paid attention to a slight degree of precision of the established regulations, which consequently would allow for too far-reaching interpretation by tax authorities. The removal of the first provision concerning tax avoidance as well as further amendments introduced in the Act on Tax Ordinance, as a consequence of the judgement, considerably limited the power of tax authorities in terms of omitting tax consequences of disputed legal actions.

On 1 January 2016, once again, an institution preventing from circumvention of tax law by taxpayers was introduced into the Polish jurisprudence. According to the new provision, all tax benefits reached as a result of lawful activities performed in an artificial way (tax avoidance)[18] were questioned. The Act defined a minimal quota of the mentioned benefits at the level of 100 thousand PLN. The legislator intended the clause mainly to refer to income tax. Its complement is added to the Act on the taxation of goods and services, as a completely new paragraph regarding the so called misuse of laws[19]. According to the paragraph, violation of law involves activities due to taxation of goods and services, within the transaction, which despite meeting the formal conditions set by the provisions of the Act, were fundamentally aimed at obtaining tax benefits, what would have been contrary to the objective the regulations comply with[20]. Classification of a given activity as a misuse, in turn results in the development of such tax consequences which would have taken place in case of the absence of law violation.

New legal standards seem to offer a significant assistance for state authorities in the fight against tax fraud. However, legislative changes concerning circumvention of tax law may become problematic. The main

[17] The judgement of 11 May 2004, file no. K 4/03.
[18] The Act of 29 August 1997 - Tax Ordinance, Journal of Laws from 1997 no. 137 item 926, as amended Section IIIA, Chapter 1 Clause against tax avoidance .
[19] The Act of 11 March 2004 on the taxation of goods and services, Journal of Laws from 2004 no. 54 item 535, Article 5 paragraph 4 and 5.
[20] The limit mentioned with the clause concerning income tax (100 000 PLN) is not valid in terms of law misuse on VAT.

objection may be the fact that the provisions are not free from accusations, originally posed by the Constitutional Tribunal regarding the first clause on tax avoidance. The scope of information is still relatively small, and the wording concerning *tax benefits, which granting would have been contrary to the objective, of which the regulations comply with* seem yet again to provide inspection bodies with far too many interpretation possibilities, potentially raising threat for honest entrepreneurs. Moreover, the fact that supplemented regulations to a small extent refer to a mass phenomenon, which is VAT fraud committed by organised criminal groups, and whose operations bring the greatest losses, is questionable.

The adoption of the Act on taxation of goods and services on 11 March 2004, was mainly the result of the accession of Poland to the European Union [21]. Tax related issues are also regulated by regulations of the Minister of Finance and subsequent by the Minister of Finance and Economic Development. Because of the affiliation to the EU, Poland is also supposed to implement EU directives. However, the Acts generally comply with the objective, while in case of VAT tax there is a possibility of referring to them in a direct way[22], only when a given country failed to carry out a suitable implementation, it was performed after the deadline, or it was not performed correctly. In such a case, the possibility of direct EU law application, first before the national jurisdiction, is only given to taxpayers (such option is not given to tax authorities).

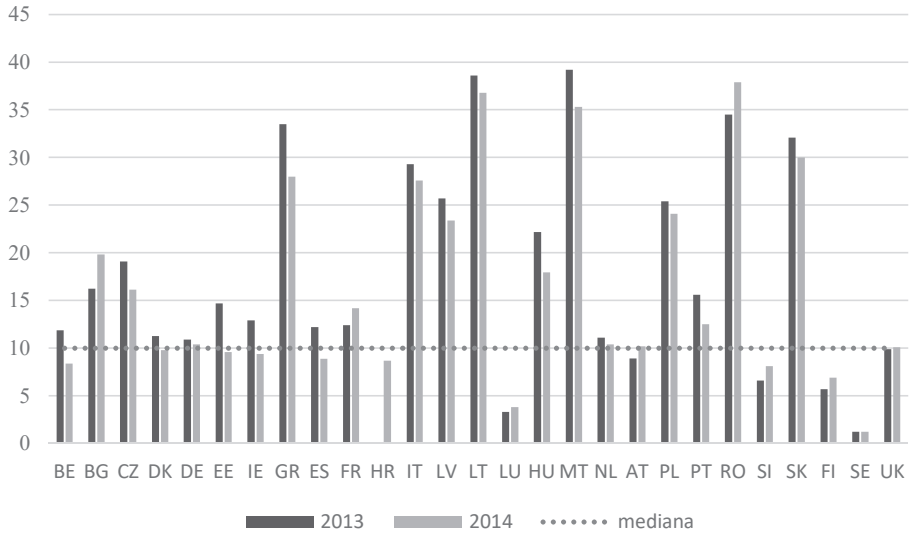
The tax gap regarding VAT is not only a problem for Poland, it is a phenomenon known throughout the European Union, though at different levels. According to data published by the European Commission, in the EU in 2014, 159,5 billion EUR of value added tax income (VAT) was lost. The tax gap fluctuated from 37.9% of uncollected VAT in Romania to just 1.2% in Sweden. In Poland the gap amounted to 24.1%. In absolute terms, the greatest gap equal to 36.9 billion EUR was recorded in Italy, whereas Luxembourg presented the lowest gap equal to 147 million EUR. In Poland, in 2014, the gap of 9.3 billion EUR was estimated (Figure 1).

[21] It substituted the earlier Act of 8 January 1993 on taxation of goods and services and excise duty.

[22] Such a possibility results from the judgements of the Court of Justice as well as the judgements of the Polish administrative courts. The example can be the Judgement of District Administrative Court of 23 October 2006 (file no. III SA/Wa 1744/06).

Generally speaking, the division of a negative phenomena into the phenomena resulting from human dishonesty, and those which are linked to certain, and specific law provisions and regulations, limiting economic activity are considered to be helpful while analysing reasons of tax fraud. The first category includes for example cases of unreported sale. The occurrence of this phenomenon seems to indicate that within a current tax system regarding VAT, not much can be done with the use of legislative changes only. Finally, a change of social mentality, which can be formed by campaigns such as the National Receipt Lottery[23] could be helpful in the fight against fraud. Summing up, much more can be gained from a detailed analysis of the second fraud category, which is a result of current, inaccurate legal structure.

**Figure 1. Estimates on the tax gap in the EU-27 in 2013 and 2014.**




Source: Study and Reports on the Gap in the EU-28 Member States:2016, Final Report, TAXUD/2015/CC/133.

[23] The National Receipt Lottery is an educational action of the Ministry of Finance, which started on 1 October 2015. Its objective is to inform Poles, what is a role of conscious consumers regarding an honest economic trading, and to show that receiving a receipt means supporting honest entrepreneurs and fair competition. http://www.mf.gov.pl/ministerstwo-finansow/dzialalnosc/dzialalnosc-edukacyjna/projekty/-/asset_publisher/2IKb/content/narodowa-loteria-paragonowa-1

The solutions in this field may primarily be: a fundamental change and clarification of provisions, the use of advanced and well-structured IT data which allows an effective selection of the entities to be controlled, or finally system changes which modify completely the way of collecting tax on goods and services.

## 3. Key elements of the structure of tax on goods and services

There is no doubt that as long as differentiated rates of tax on goods and services exist, they will be used in reducing the tax due through an intentional misclassification of the products or services. In practice, it appears that sale exempted from tax on goods and services or zero-rated is particularly favourable, taking into account that those concepts are not identical due to their legal consequences. Sale which is not subject to tax on goods and services does not entitle the seller to deduct input tax.

An occasion to avoid taxation may also be an action that is not sale. An example of this method is contractual penalties. According to the Civil Code, a contractual penalty is only a repair of the damage resulting from nonperformance or improper performance of non-monetary liabilities. It is not subject to tax on goods and services and regardless of the amount of the actual damage, it is as high as it was fixed on a flat-rate basis in the agreement between the entities. Due to such a legal structure, in a situation when, for example, a recipient of a given service is an entity not entitled to deduct input tax on goods and services[24], the entity has no interest in paying the tax. More profitable action for both parties of the transaction may be terminating the agreement at one of the last stages of the service and a *settlement* through a contractual penalty in lieu of settling liabilities under the VAT invoice. If the penalty is higher than the adequate net amount according to the invoice but lower than the gross amount, such a solution is more profitable both for the recipient and the provider of a given service. However, at a loss for the state budget.

Another form of fraud, using preferential VAT rates, is the so-called carousel fraud within intra-community trade in goods. A complicated network of entities, formally unrelated and controlled by one criminal group, usually take part in the procedure. The result is huge budget reductions related to double benefits based on both non-payment of tax due at one of the stages and tax refund at another. Such an action is enabled by settling within the Community area the so-called *taxation in*

[24] Such a situation may take place if it is related to: an association, a cooperative etc.

*the State of destination*, which is related to zero-rate tax at the sale to another EU country, with the simultaneous right to deduct input tax on goods and services. The scheme is based on a multistage circulation of given goods from country to country. A product selected for such a type of trade is usually a product of small size and high value (mobile phones, expensive software etc.) Its transportation is not related to the easily controllable carriage by numerous trucks. Frequently, the trade turns out to be fictitious and is supported only with well-faked WZ documents, invoices, delivery documents etc. The goods sold previously with a VAT zero-rate and withheld input tax is finally delivered to an entity intended to be eliminated in advance – the so called *missing trader,* frequently registered under the so called *strawperson,* which additionally hinders legal sanctions. The buyer pays the missing trader the full gross amount but the missing trader does not pay the tax on goods and services according to the issued invoice. Despite the situation, according to the ruling of the European Court of Justice[25], the buyer who paid the gross amount keeps the full right to deduct input tax. There is a presumption of unawareness of a purchase from a tax fraud.

Unfortunately, the method of carousel fraud abovementioned is extremely difficult to fight against. The multitude of involved entities, well-faked documentation and participation of so-called *strawpersons* cause that the fight with this type of crime would require a well-organised cooperation of tax inspection bodies from particular countries, which often fails. Undoubtedly, in this field there is still a chance for improvement, which should be based on a faster exchange of required data and information. Unfortunately, it should be taken into account that this also may be insufficient and due to the tax structure it will not help eliminate carousel fraud. In this situation, indicating an alternative is difficult. In terms of intra-community trade, a significant tightening of the rules, instead of hindering the existing abuse, may bring strongly adverse effects in the form of an economic slowdown.

[25] The ruling of the Court of Justice in joined cases Axel Kittel / Recolta file ref. C-439/04 and C-440/04, the ruling in joined cases Optigen / Fulcrum / Bond House file ref. C-354/03, C-355/03 and C-484/03, the ruling in joined cases Mahageben / David file ref. C-80/11 and C-142/11.

## 4. Crime prevention with the use of modern information technologies

The fast development of information technologies should result in their equally fast implementation for the purposes of tax oversight. Those technologies enable a fast flow of the required information and a possibility of its analysis with the use of well-constructed algorithms. Currently, such methods are applied in Poland through a step by step implementation of an obligation to prepare a single control file (Jednolity Plik Kontrolny – JPK). The prototype named Standard Audit File for Tax (SAF-T) was developed by OECD in 2005 and implemented for the first time in Portugal in 2008 where it brought the required results. It was also rapidly implemented in other countries: Germany, Great Britain, Denmark, the Netherlands, Sweden, Slovenia. The JPK covers 7 structures including: books of account (JPK_KR), bank statements (JPK_WB), warehouses (JPK_MAG), records on purchase and sale liable to VAT (JPK_VAT), VAT invoices (JPK_FA), tax revenue and expenses ledger (JPK_PKPIR) and revenues records (JPK_EWP). In terms of the monthly preparation of JPK_VAT, large enterprises (since 1 July 2016) and small and medium-sized enterprises (since 1 January 2017) have been already covered by the obligation, whereas microenterprises will be covered by the obligation from 1 January 2018. Despite the fact that the implementation of JPK may turn out to be undoubtedly problematic for small companies, in the long run there is a chance for satisfactory effects, not only in terms of the improved collection of tax on goods and services. In the brochure issued by OECD[26] the following aspects are considered advantageous: a reduction of the costs related to the lack of necessity to employ specialised staff to draw up similar statements; unification and standardisation of financial data possible to apply in the exchange between the enterprises, public authorities etc.; a possibility of easy archiving of financial data; a reduction of administrative costs related to the oversight by the tax authorities.

Therefore, the implementation of unified financial data in the form of JPK may bring mutual benefits. In addition to the public administration, the entrepreneurs themselves may benefit from the process because they will be able to use the information for financial analyses or constructing econometric models. A disadvantage of such a solution is mainly

[26] OECD, *Guidance for the Standard Audit File* – Tax Version 2.0, April 2010.

a potential complication of the activity of the smallest economic units and, after all, also a little influence on the activity of organized crime groups.

Definitely, the most comprehensive solutions that may hinder tax fraud are systemic solutions. An example is the *split payment* model which completely changes the method of collecting tax on goods and services. It involves dividing in electronic form a given payment covered by tax into a net amount which is sent directly to the creditor's bank account and the amount of tax on goods and services which is transferred to a special individual account created for each taxpayer, which would be constantly overseen by the tax authorities. The *split payment* solution involves various possibilities of dividing the payment: by the fully automated special settlement system that splits the payment or manually by the taxpayer who directs the transfer into two different accounts. Depending on the applied solution, the tax account may be located in a commercial bank selected by the taxpayer or it may belong to the group of tax authorities accounts and be handled by the central bank.

As the Poland's Ministry of Finance reports,[27] the solution planned to be applied in Poland will be based on subaccounts handled through commercial banks and switching to this model will be generally voluntary. This form is planned to be implemented on 1 January 2018. The legislator considers various types of gratification to encourage potential taxpayers to implement the *split payment* system. Only for some industries particularly susceptible to tax fraud[28], there will be implemented an obligation of switching to the abovementioned payment system, albeit this must be accepted by the European Commission beforehand. It is also worth mentioning that the taxpayers will be able to use the funds collected on the subaccounts to settle their liabilities in part consisting of the tax on goods and services, which is to insure the financial liquidity at an appropriate level[29].

[27] http://www.mf.gov.pl/pl/ministerstwo-finansow/dla-mediow/wywiady/pawel-gruza/-/asset_publisher/P3qp/content/od-2018-r-wydzielone-konto-dla-kwoty-vat-rzeczpospolita-28-kwietnia-2017-r?redirect=http%3A%2F%2F [access 22 May 2016].

[28] Among others, these are industries in which currently the reverse charge mechanism is applied in relation to tax on goods and services. The *split payment* model is intended to replace this mechanism.

[29] The response of the Minister of Economic Development and Finance to the parliamentary question no 10951 of 22 March 2017.

The Ministry of Finance has great expectations towards the *split payment* system. The model tested previously in other countries[30] is expected to generate additional billions of PLN for the state budget. Taking into consideration the current condition of public finance related to the large budget deficit and the comparable in amount VAT gap, each act of sealing of the collection of tax on goods and services seems extremely valuable.

## Conclusions

Tax fraud in terms of tax on goods and services has numerous negative consequences – from the viewpoint of the state budget they are a critical factor. Moreover, they disturb competitiveness among the entities on the market. The analysis of the administrative and legal environment discussed in this paper helps realise how essential and effective the clarification of the provisions is, as well as the creation of a transparent and coherent legal system and the support of those actions with an effective analytical and information system. The processed statistical data will allow forecasting trends and entities that can participate in the fraud of tax on goods and services. It should also be emphasized that the preferred solutions should be those which do not burden excessively honest taxpayers.

Unfortunately, the coherence of the tax law system appears to be difficult to obtain. The implementation of changes in the law, except for the compliance with the elementary principles of the Constitution, must be in accordance with the European Community provisions, determined in numerous directives. The experience of other countries shows that the solutions such as the JPK or the *split payment* increase the budget revenues in real terms but they cannot eliminate crimes in the area of tax on goods and services.

[30] The *split payment* model was implemented in a limited scope in the Czech Republic and Turkey. In Italy it has been in force since 1 January 2015. According to the Italian tax authorities, the split payment model will enable the protection of the state budget from the risk of VAT non-payment by the provider and on the other hand, it will relieve the public law entities from the risk of involving into the schemes that lead to VAT fraud. Italy forecasts that the implementation of the *split payment* mechanism will allow the increase of VAT tax revenues of about one million euro annually. *Split payment Mechanism for Public Bodies*, Simonetta La Grutta, International VAT Monitor, 2015 (Volume 26), No. 2.

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