# *Tackling the VAT Gap*

*9 June 2017*

## *In brief*

VAT is a major source of tax revenues within the EU, raising almost €1 trillion, or 7 per cent of EU GDP, a year. The current system of VAT collection, though, is struggling to keep up with the challenges of today's international, digital and mobile economy. The VAT Gap in the EU 27 – the difference between expected VAT revenues and the amount actually collected by tax authorities – is nearly €160 billion a year,[1] of which cross-border VAT fraud in goods accounts for €50 billion. Countries with a history of a cash economy face a particular challenge. Romania, for example, is failing to collect an estimated 40 per cent of the VAT due, some €8 billion.

The challenge for the tax authorities is to come up with a solution that addresses the many causes of the VAT Gap, without placing undue pressure on businesses and taxpayers. One of the difficulties is that it's notoriously difficult for the authorities to distinguish between a genuine oversight or mistake in a VAT return and an indication of a larger fraud. "Tax authorities and businesses both are in a difficult position," says Björn Ahrens of PwC Germany. "The tax authorities have the tax Gap to tackle, but the measures they take when a business makes a mistake or correction in their VAT return sometimes can overshoot the mark."

Historically, EU-wide initiatives to tackle VAT fraud or standardise the VAT system have stalled – a plan to develop a standard EU VAT return for all Member States, begun in 2013, was dropped at the end of 2016. Concerns about VAT fraud across the EU, however, have prompted several Member States to develop their own measures. These have developed regionally to cope with different types of problems and there's little coordination between jurisdictions. Nevertheless, many of the measures, which we highlight below, are locally effective.

## *In detail*

### *Reverse charge mechanism*

The reverse charge mechanism for cross border intra-EU supplies of goods was created at the launch of the Single Market in 1993, as a way of simplifying VAT reporting across EU Member States, as Member states could not agree on the application of a full origin-based system. It was, as the inventor of VAT, Maurice Lauré, indicated at the time[2], recognised as a potential source of fraud. Under the reverse-charge mechanism, VAT is declared by the customer rather than the supplier – the original intention was to

[1] http://europa.eu/rapid/press-release_MEMO-16-2909_en.htm
[2] Maurice Lauré, 'Le champ ouvert à la fraude criminelle' - Traité de Science Fiscale, PUF 1993 (A field day for criminal fraud). He also said: 'Douanes en moins – fraude en plus' ('fewer customs (controls) – more fraud')

eliminate the need for sellers to register for VAT in each country where the supply is made under a full destination based system.

The reverse charge mechanism has been increasingly used within jurisdictional borders since then, with varying degrees of success. A number of Central and Eastern European countries, for example, applied the system to fraud-affected sectors such as agriculture but have generally found it ineffective in tackling small-scale fraud as the reverse charge mechanism often only applies above a certain value threshold. The EC is currently considering a legislative proposal[3] that will allow individual Member States to apply a generalised reverse charge mechanism to domestic supplies above a certain threshold (most likely €10,000), but it remains to be seen if this will be adopted, or if it is, if it will have a significant impact on VAT fraud or even if it is adopted.

***Split payment***

Under 'split payment', the VAT that is due on a purchase is paid by the purchaser direct to the tax authorities, rather than collected and passed on by the supplier. Italy introduced a split payment mechanism in January 2015 to domestic transactions by suppliers to most public sector and government bodies, which was intended to address a VAT shortfall in the public sector. According to some estimations, the tax revenue increase (after implementation of the split payment system) for the state in 2015 was €2.2bn; the measure, however, has caused cashflow issues for some suppliers.

***VAT receipt lotteries***

VAT receipt lotteries work well in regions with significant black market or cash economy activity. In Portugal, which introduced the system in 2014, black market activity accounts for a quarter of the country's total GDP.[4] Italy, which has one of the highest VAT gaps in the EU at 28 per cent, is also considering introducing a receipt lottery system; the country suffers from significant black market activity, particularly in the south. Lottery systems have also been used in parts of Brazil, Argentina, Puerto Rico, South Korea and Slovakia.

Portugal's Factura da Sorte ('Lucky Invoice') system involves a weekly lottery drawn from coupons that are exchanged by consumers for receipts for any goods and services. The receipts can be for transactions of any amount but must include the purchaser's personal tax identification number and the amount of VAT paid. Consumers (companies are not eligible) receive coupons for each genuine receipt which are then entered into the draw for a chance to win a prize, for example a car.

Poland launched its own scheme in October 2015, allowing anyone over the age of 18 to enter online using VAT receipts to the value of at least 10 zloty for the chance to win a computer or new car. While the system does undoubtedly encourage consumers to ask for official receipts and invoices – VAT revenue increased by 4 per cent in Portugal in the first 10 months the system was in place – there have been complaints from smaller businesses about the burden of registering a tax number for every small purchase. Small businesses have estimated that this costs them an extra 130m working hours a year.

***Increased penalties***

Some countries have concentrated on increasing the penalties for non-compliance and fraud. In Italy, for example, penalties are at least 100% of the amount in question, plus a jail term and Poland is considering jail terms of 25 years for tax evasion. In the UK, the Government introduced a measure in 2016 that potentially holds 'online marketplaces' jointly and severally liable for unpaid VAT of overseas businesses that sell goods (imported into the UK) through their sites.

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[3] Proposal 2016/811 (COM) for a Council Directive amending Directive 2006/112/EC on the common system of value added tax as regards the temporary application of a generalised reverse charge mechanism in relation to supplies of goods and services above a certain threshold, adopted by the Commission on 21 December 2016.

[4] http://www.euronews.com/2014/02/10/portugal-lucky-receipt-lottery-against-tax-evasion-fight

Many believe, though, that education and the encouragement of the right behaviour – combined with technological developments – provide the answer. “I think a combination of the stick and carrot is needed. The stick alone is not enough,” says Daniel Anghel of PwC Romania. “The mentality has to be right.”

***Technology and the VAT gap***

In April 2016, the European Commission formally adopted an Action Plan for modernising the EU VAT system. The ultimate aim is to set up a ‘definitive VAT system for intra-EU business-to-business cross-border trade’ that will be based on the destination principle and which, it is hoped, will be more suited to a digital trading environment and simpler for businesses to administer. The EC’s detailed proposals will be announced later this year.

Technological advances have greatly increased the options for tax authorities seeking to tackle the tax gap and are leading to demands for an even greater volume of tax data:

- E-invoicing and real-time reporting

Electronic VAT filing holds real potential for tackling the VAT Gap and is the focus for all tax authorities across Europe and the world.

China, where indirect taxes account for more than 50 per cent of tax revenue, uses an electronic system, known as the ‘Golden Tax System’, to monitor VAT. Under the system, businesses are legally required to issue tax invoices using government-approved tax software, which operates under a central monitoring system. The software captures the data and prints out an official, pre-formatted VAT invoice, which must be verified by the Tax Bureau before the customer can claim a VAT credit. “Under Stage Three of the Golden Tax System, paper based invoices will be phased out and replaced by electronic invoices, with a goal of achieving real time information communication, and a more efficient management of the VAT system,” says Alan Wu of PwC China.

In July 2017 Spain will introduce the Immediate Supply of Information (SIS) system, which will require any companies or individuals that file monthly VAT returns to transfer invoicing records electronically to the tax authorities within days of the transaction. The system is at present voluntary for other taxpayers. A proposal for a purchases only ‘real-time’ listing was nearly adopted in France last year – it may be represented later this year.

In 2017, Italy will introduce a similar system that requires VAT payers to report tax data electronically every quarter or half-year, in a set format. Taxpayers will have to detail invoices issued and received (including information about the other party involved in each transaction), along with their quarterly VAT calculations.

Luca Lavazza of PwC Italy points out that the new Italian system will require a software investment from the taxpayer. “Considering the past experience, there are also concerns about what the tax authorities may do with the information they receive,” he says. “Many complain about the increased compliance burden. Overall, though, I think electronic invoicing is the best solution. The digitisation of information makes VAT easier to check. It’s easier to manage the black economy and easier to tackle fraud.”

- SAF-T and tax audits

The OECD developed a Standard Audit File for Tax (SAF-T) in 2005, an international standard for the electronic exchange of tax data, along with a standard set of tests to be performed during a tax audit. Portugal, Austria, Germany, Poland, Norway, and France have all introduced limited-scope versions of the standard (and not all formats are the same) but to date, the only country to have fully adopted SAF-T is Luxembourg (where it is known as FAIA).

“The tax authorities can request a FAIA-compliant file but it’s not compulsory for companies to produce it every year,” says Frederic Wersand of PwC Luxembourg. “In practice you need to be prepared in case you are asked for it and producing a FAIA is exhaustive and time-consuming.”

Wersand points out that while SAF-T was initially introduced in Luxembourg to allow tax authorities to use tax engines to assess risks, the longer-term aim is to replace the tax return entirely: “Within 10 years it’s very likely that most countries will no longer leave it to taxpayers and companies to declare revenue themselves but will assess the tax data themselves through the data they collect.”

- Black box cash registers

Enforced communication between cash registers and the tax authorities has been seen as an effective way of tackling the VAT Gap. Sweden introduced a requirement in 2010 that any businesses that sold goods or services for cash had to install a certified cash register at their own cost. The registers included a ‘black box; which records transactions and to which only the Swedish Tax Agency has access. Slovenia introduced a similar requirement in 2015 and saw a 5% increase in VAT revenue in the first three months.

- Big Data

The massive volume of data that’s generated on a daily basis contains information that could be extremely valuable in tackling the VAT Gap, and as a result tax authorities have a growing interest in Big Data. Software companies are beginning to develop social network analysis tools that can seek out suspicious behavior, such as an apparently unaffordable lifestyle, from social media and other publicly available information.

- Blockchain

The ultimate long term solution to VAT fraud could lie in Blockchain – a secure distributed ledger that simultaneously records transactions on a large number of computers in a network. Blockchain offers the potential of real-time, secure and reliable execution and recording of transactions; what it does particularly well is track ownership of anything, and the origins of any transaction. The potential for VAT is significant, since it would allow several authorised parties to independently view the same piece of information. VAT collecting and filing could become seamless and efficient, but at this stage the technology is still under development.

## *The takeaway*

It remains to be seen where technology will take us in the fight against VAT fraud. “No system will ever be fraud-proof,” says Frederic Wersand. “There’s always room for fraud. But it’s becoming more difficult to organise.”

### *Let’s talk*

For a deeper discussion of how these issues might affect your business, please contact:

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