Ministry of Finance
of the Czech Republic

Closing VAT GAP through Reverse Charge Mechanism

Collection of the tax conference of the Ministry of Finance with the support of International Fiscal Associaton, CR

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Foreword by the Finance Minister

Dear Ladies and Gentlemen,

One of the main priorities I am systematically pushing through as the Finance Minister is seeking effective solutions to combating VAT fraud. When I assumed my office, I was surprised how much money is lost upon VAT collection not only in the Czech Republic, but in the whole EU. The VAT gap has remained too high for a number of years (it reached nearly EUR 165 billion in 2012 and even EUR 168 billion in 2013), and I consider this situation to be completely unacceptable. The most important part of VAT fraud is carousel fraud which could not be effectively eliminated for the whole period of the VAT existence in the EU. The common VAT system in the EU needs to be reformed, and the cooperation of the European Commission is necessary for that as the area of VAT is harmonised by EU law. For nearly eighteen months now I have been attempting to ensure that appropriate attention is paid to this issue. I am convinced that Member States and the European Commission should ensure the combating of VAT fraud in the near future, at least with the same emphasis as when fighting against aggressive tax planning in the corporate tax. VAT fraud influences the budgets of the Member States more than the aggressive planning of corporate tax. It is more and more evident that a possible solution is a considerable extension of the possibility of applying the reverse charge mechanism which is effective, at least against carousel fraud. The main advantage would be removing carousel fraud and ensuring level palying field. I have always been very open to discussions of effective alternatives, but obviously there are not many of them. In June 2015, I applied, together with the other three finance ministers, for the approval of the derogation according to Article 395 of the VAT Directive in the matter of testing and proving the proper functioning of the reverse charge mechanism. However, the European Commission unfortunately found our request to be unlawful. I respect this decision, however, I will continue striving for better VAT collection. I am convinced that an alternative to the wider application of the reverse charge method has to be subject to expert discussion as VAT fraud in the EU is a serious economic and political problem of the region. Therefore, the Ministry of Finance organised the tax conference on this topic on 4 December 2015 and the experts participating in its panel discussions developed their ideas and arguments in expert papers. I am honoured to offer you a set of analyses on this topic. I believe that it will be a valuable impulse for further considerations and discussions which will hopefully lead to finding a timely and effective solution.

Andrej Babiš
1st Vice Prime Minister and Finance Minister

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Reverse charge – many pros and few cons

Jan Čapek

In 2014, the amount of CZK 322 billion was collected in VAT for the Czech state budget. VAT is an important tax as its collection considerably exceeds the sum of collected corporate income tax and personal income tax.

Current VAT problems

In the Czech Republic, VAT is characterised by three basic problems:

1) A part of VAT is stolen in carousel fraud.
2) The tax administration spends considerable human and material sources on combating this fraud.
3) For VAT payers, it is a considerable burden which has various forms from the mere costs of calculation and the correct payment of tax to the negative impacts on cash flow as well as to tax additionally assessed for payers who became part of tax fraud without their efforts.

The VAT problems have their roots in its own functioning. VAT collection (the aforementioned amount of CZK 322 billion) requires so that more than CZK 1,600 billion *is paid* in the price of goods and services. The entitlement to the deduction of tax really paid in the price of goods and services equals approx. CZK 1,300 billion.

Expected changes in the Czech Republic

In 2016, the VAT system in the Czech Republic will be enriched by the following two system tools:

1) Electronic VAT reporting which will interconnect issued and claimed tax documents.
2) Fiscalisation of cash payments which is focused on the completeness of the sales reported.

Although some European countries have already introduced one of these tools, their combination in one state is unique. Both systems have the fact that they considerably support the introduction of reverse charge method in common.

General reverse charge

Complex tax problems usually do not have any simple solutions. However, the current VAT-related troubles seem to be the exception proving the rule.

Let us imagine a VAT system where taxpayers would mutually supply goods and services when using the principle of reverse charge. In other words, the same procedure would be applied to supplies within a country as to supplies to another Member State. Nothing more, nothing less. Minor supplies to payers in retail trade would be subject to the current regime.

The VAT principle would not change *at all.* The same amount of tax would be collected from the same end consumer. Everything would be reported in the same way. The only change would consist in removing gradual payments backward and forward.

Advantages of the proposed system

This system would have the following advantages:

1) Carousel fraud would disappear completely. The state would acquire the stolen billions and fair VAT payers (who are the majority) would stop being an object of time and financially demanding tax controls that sometimes end up with an additional payment of VAT due to the liability for fraudsters.
2) VAT payers' cash flows would improve considerably as tax which is not paid cannot be withheld.
3) VAT administration would be simplified considerably. Removing the payment liability inside the chain of payers would dramatically simplify tax administration, both on the side of payers and tax administration. Where no tax is applied, the tax administrator cannot assess it additionally!

Disadvantages of the proposed system

The general reverse charge also has its disadvantages:

1) Transition to the new system would mean single implementation costs.
2) The improvement of payers' cash flow would have to manifest itself, of course, as a disadvantage for the state budget. However, this problem can be solved by the acceleration of tax collection at the end of the chain (as retail trade will be paid by end consumers immediately).

3) Concentration of the tax collection at the end of the chain increases the impacts of the failure to pay the tax by the last link in the chain. It is obvious that this risk is considerably limited if the systems of electronic VAT reporting and the fiscalisation of cash payments are introduced.

The aforementioned analysis of the advantages and disadvantages of the proposed system must inevitably lead to the question why nobody has come up with this ingenious idea yet. The proposal to apply the general reverse charge, however, is not a brilliant idea. On the contrary, the basic VAT principle (its neutrality) is brilliant. Since 1954, when the idea of VAT first appeared, the number of mobile telephones, payment cards and data transfers has increased considerably. Therefore, it is not necessary any more to keep on paying the brilliant tax.

Arguments against the general reverse charge must cope with one more crucial fact. Today, the completely same principle is already used for some domestic supply and basically for all supplies to payers in other Member States. The volume of these supplies reaches one third (!) of all taxable supplies. What it should not be the same situation for the remaining two thirds is difficult to understand.

Summary

1) The current technologies can serve VAT better than the so-called principle of gradual payments when the tax is paid (and returned back) at all degrees of the chain.
2) The general reverse charge would bring great advantages for both VAT payers and tax administrators.

The only important disadvantage in the Czech tax environment is the implementation costs, i.e. the costs of a change in the system and (resolvable) impacts on the cash flow of the state budget.

Development of legal regulation of the reverse charge mechanism

Hana Štulajterová, Radka Prachařová

Legislative regulation before adopting the current VAT Directive

In Europe, value added tax (VAT) was first introduced in 1954 in France. In 1967, the Member States of the European Economic Community at that time agreed upon the replacement of their national systems of turnover tax with the joint system of value added tax. The current system of value added tax is characterised in particular by partial payments when the tax is collected in each step of the production and distribution chain and the obliged person in respect of the tax is a supplier of goods and services. Nevertheless, the experience so far shows that such a system leads to the risk of fraud at the level of the so-called missing traders when the supplier avoids paying the tax, while the buyer is entitled to tax deduction on the basis of the valid tax document. The method of how to avoid such fraud is to use the so-called reverse charge when the recipient of goods or services is the person obliged to pay the tax.

The legal regulation of this mechanism is not anything new. The predecessor of the current VAT Directive[1], the so-called Sixth VAT Directive of 1977[2], included the provision of Article 27 which enabled the Member States to ask for granting the derogation of some provisions of the Directive in order to simplify the procedure for tax collection or preventing certain types of tax fraud or avoiding tax duties. Nevertheless, the procedure of such a request was simpler compared to the present time. If some of the states or the European Commission did not ask, within two months from the moment when the other Member States were informed of the requested derogation, to discuss the derogation by the EU Council, it was assumed that the Council decision on the derogation was approved. According to the aforementioned provision, the Member States have been asking for the possibility to use the reverse charge mechanism for several decades[3] and the number of their requests has been gradually increasing.

By the Amendment of 1998, the special regime for investment gold was included in the Sixth VAT Directive enabling, among other things, the Member States to identify, in the event of the supplying of gold in the form of raw material or semi-finished products or in the event of the supplying of investment gold, the buyer as the person obliged to pay the tax. This provision was subsequently transferred to Article 198 of the current VAT Directive.

[1] Council Directive No. 2006/112/EC of 28 November 2006 on the common system of value added tax

[2] Directive No. 77/388/EEC on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment.

[3] For example, by the Communication of 31 July 1982, the Netherlands was authorised to transfer the duty to pay VAT from subcontractors to suppliers in the sectors of construction, ship construction and metal working.

A similar procedure was applied in the case of some individual derogations provided to individual Member States according to Article 27 of the Sixth Directive. A number of these derogations were included in Article 199 of the current VAT Directive defining sectors[4] in the case of which the Member States can determine that the person obliged to pay tax is the buyer of goods or services. It was thereby enabled that the reverse charge mechanism in these sectors can be used by all Member States. They only have to inform the VAT Committee of this step, unless it concerns measures allowed by the Council before 13 August 2006, which are still valid.

Gradual extension of the reverse charge mechanism

The reverse charge issue has been discussed very intensively in the European Union since 2006 when the European Commission refused the request of Germany and Austria to use the general reverse charge mechanism on all taxable supplies exceeding EUR 10,000 or 5,000, respectively. The Commission justified its refusal by the fact that such a wide measure is above the framework of Article 27 of the Sixth Directive at that time and a legislative change in this Directive is necessary for the introduction of such a measure. Subsequently, these issues appeared several times on the agenda of the Council of Ministers Ecofin (e.g. on 28 November 2006[5]) and became one of the priorities of the German chairmanship in the EU Council in the first half of 2007, which resulted in the Council's conclusions[6] in which the finance ministers of all EU Member States asked the EC to analyse the effects of the general reverse charge to the single internal market, including a possible launching of the pilot project, and it submitted its conclusions to the Council until the end of 2007.

Subsequently, the Commission submitted the analysis in February 2008 through its Communication[7] the conclusion of which was that the general reverse charge system is obviously a new concept having both positive and negative consequences. According to the Commission statement, however, it differs considerably from the system used at present. For this reason, it expressed its opinion that the general reverse charge system should either be obligatorily introduced in the whole EU or this concept should be abandoned. In this connection, the Commission asked the Council to i) consider whether a pilot project should be planned that should find out whether transferring the reverse charge would be an appropriate tool for dealing with VAT fraud or not, and ii) in the event that the given pilot project should be planned, it confirmed that the Commission is to initiate preparatory works which enable the country willing to participate in launching the pilot

[4] Performance of construction work, supplies of real estates, supplies of used materials, supplies of goods provided as a guarantee, etc.

[5] http://eu2006.fi/NEWS_AND_DOCUMENTS/CONCLUSIONS/VKO49/EN_GB/1165407474344/_FILES/76376149009956906/DEFAULT/ST15502_EN06.PDF

[6] https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/94513.pdf

[7] KOM (2008) 109

project on the basis of the exactly defined conditions. The pilot project has not been developed in detail so far since then.

Considering the constantly increasing extent of carousel fraud, and the related increase in requests for using the reverse charge regime, the European Commission submitted a draft directive to the Council in 2009 which should have enabled the Member States to introduce, temporarily and on a voluntary basis, the reverse charge mechanism in respect of some goods and services. The defined group of goods and services also included emission allowance trading where a massive amount of carousel fraud appeared in summer 2009. Finally, the Council reached a unanimous agreement as regards emission allowances[8], with the remaining goods and services being postponed until a later time. In the meantime, carousel fraud also expanded into some other sectors and the Commission was forced to add new goods and services to the remaining part of the proposal of 2009, for which the reverse charge could be used. In 2013, the Member States agreed unanimously that they could use the reverse charge until the end of 2018 in connection with supplies of gas and electricity, the provision of telecommunication services, supplies of mobile phones, game consoles, tablets and laptops, cereals, technical crops, including oil seeds and sugar beet, raw or semi-processed metals, including precious metals, as well as in connection with supplies of integrated circuit devices, such as microscopes and central processing units.[9]

With respect to the experience of the Member States which proved that the procedure defined in Article 395 of the VAT Directive is not able to ensure a sufficiently quick reaction to their requests to adopt urgent measures, the best guarantee of a quick and extraordinary reaction to other cases of sudden fraud appeared to be the special measure of the Quick Reaction Mechanism. It consists of the possibility to use the reverse charge system for a short period in relation to the respective notification of the respective Member State and confirmation by the Commission that it has no objections to such a special measure. The Member States adopted the respective legislation for a Quick Reaction Mechanism in 2013[10], nevertheless, this is a tool which is virtually not used.

Last, but not least, it is necessary to mention the possibility of applying the reverse charge mechanism on the basis of Article 395 of the VAT Directive which consists in the fact that the Member State must convince the Commission and subsequently all other states that this mechanism is a special measure which can prevent certain types of tax fraud. If the Commission identifies itself with the opinion of the Member State, it submits

[8] Council Directive 2010/23/EU of 16 March 2010 amending Directive 2006/112/EC on the common system of value added tax, as regards an optional and temporary application of the reverse charge mechanism in relation to supplies of certain services susceptible to fraud.

[9] Council Directive 2013/43/EU of 22 July 2013 amending Directive 2006/112/EC on the common system of value added tax, as regards an optional and temporary application of the reverse charge mechanism in relation to supplies of certain goods and services susceptible to fraud.

[10] Council Directive 2013/42/EU of 22 July 2013 amending Directive 2006/112/EC on the common system of value added tax, as regards a Quick Reaction Mechanism against VAT fraud.

the respective legislative draft and the Council must approve it unanimously. However, the Commission shall not always submit such a proposal, on the contrary, it can refuse the request of a Member State referring to its negative impact on the single internal market.[11]

Above the framework of the aforementioned provisions, it is necessary to add, in order to have the complete picture, that the reverse charge mechanism is regulated in some other parts of the VAT Directive. This method appears in Articles 194 to 197. Last, but not least, Article 200 also speaks about the fact that the person carrying out the taxable acquisition of goods inside the Community is obliged to pay tax. Nevertheless, these provisions are not the subject of this paper.

[11] KOM (2015) 538, KOM (2014) 0623, KOM (2013)148, KOM (2013)0105, etc.

Development of the application of the reverse charge mechanism in the EU

Hana Zídková

The transfer of the tax liability to the recipient of a supply is also called the reverse charge principle.
In the following text, both these terms will be used equally. In the standard VAT regime, the tax is paid via its tax return by the supplier of the supply. In the reverse charge regime, the tax is paid to the tax authority not by the supplier, but by the recipient of the taxable supply.

The transfer of the tax liability is not a new concept. In the original, so-called Sixth Directive[12], the principle of taxation by the recipient of a supply, i.e. the transfer of the tax liability, was included in Article 21 (Tax debtors vs. tax authority). It was the possibility of the Member States to define as the person who will pay VAT to the tax authority, the recipient of a supply from a person not based in the given Member State. For the so-called intangible services (e.g. advisory services or licences) purchased from persons not based in the given Member State, the regime of tax liability transfer to the recipient of a service pursuant to the second paragraph of Article 21 was obligatory. In 1992, this Article was amended by Article 28g[13] in connection with the regulation of tax legislation due to the introduction of the single internal market of the EEC. In order to achieve the taxation of goods and services in the country of their consumption and at the same time that the necessity of registering suppliers in more EU countries is limited, after unification of the European market the so-called transitional rules were introduced for the taxation of goods trading within the Community. Since 1993, the amended wording of the Sixth Directive stipulated in Articles 28a et seq., among others, that the supplies of goods into another Member State will be exempt from VAT and the acquisition of goods from another Member State will be taxed by the person who acquired goods in the state where the transport of these goods was terminated. The rules for the payment of tax to the recipient of certain services purchased from persons not based in the Member State of the recipient continued to be valid and the group of these services has been expanding. However, it was still the regime for taxation of international transactions.

Furthermore, the attention will be focused on the reverse charge regime in the case of a domestic supply within one Member State. “Domestic reverse charge“ works on the

[12] Sixth Council Directive of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment (77/388/EEC).
[13] Council Directive of 16 December 1991 supplementing the common system of value added tax and amending Directive 77/388/EEC with a view to the abolition of fiscal frontiers (91/680/EEC).

same principle as for international transactions, but it was gradually introduced with a completely different objective than the “international reverse charge”. In the following text, the reasons for the introduction of the local transfer of tax liabilitywill first be explained. Furthermore, when and for what commodities the reverse charge was gradually introduced in the EU Member States will be explained briefly, and finally, the so-called VAT gap, expressing the amount of VAT fraud, will be compared in the EU countries.

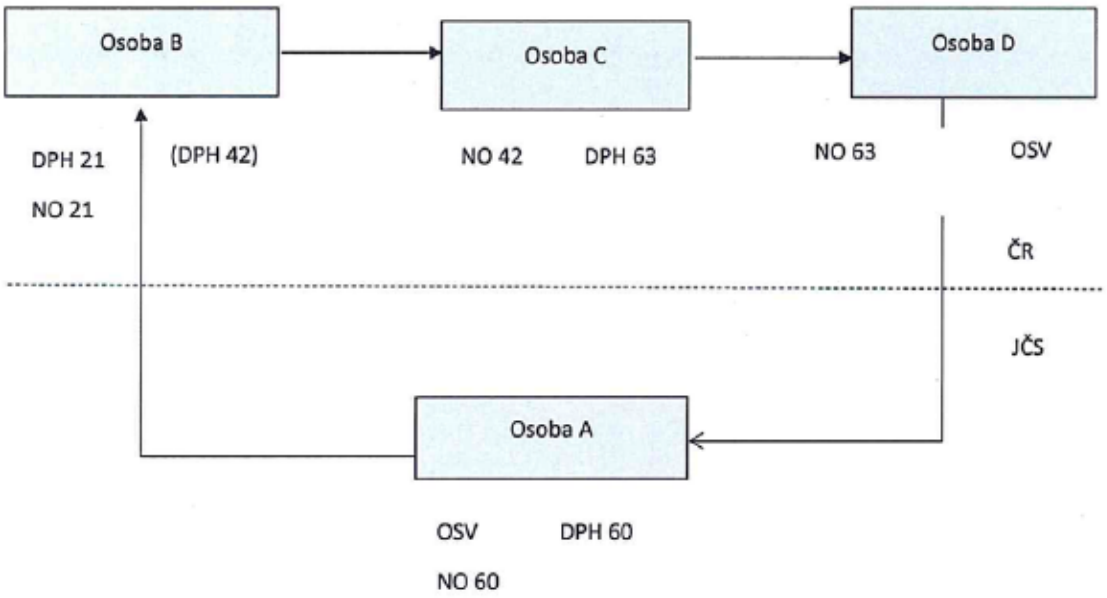
Reasons for introducing the local transfer of the tax liability

The transfer of the tax liability in respect of supplies within one Member State started to be introduced to a larger extent as a reaction to a certain type of tax fraud. Today, this fraud is known as chain or carousel fraud and it started expanding after the aforementioned year of 1993 when customs frontiers among the Member States were abolished. Carousel fraud is based on the accumulation of tax payments and entitlements to a deduction in respect of a person acquiring goods or purchasing services from another Member State. The delivery of goods into another Member State is VAT-exempt with the entitlement to deduction for the supplier and the buyer pays output tax from the value of the purchased goods. Similarly, when providing services among taxable persons from various Member States, tax is paid by the recipient of services in the state where it is registered for VAT. The buyer of goods or the recipient of services pays output tax itself from the purchased supply instead of paying it to suppliers in the price of goods or services as in the event of local purchases. This tax assessed by the buyer itself in its tax return shall be reclaimed on input by the buyer in the same tax return. Thereby the principle of the so-called divided payments is interrupted when goods are sold for the price including VAT paid by the supplier as its output tax and reclaimed by the buyer as its input tax. The system of divided payments was always considered as a guarantee of the VAT system resistance against tax fraud. This guarantee should be the buyer’s requirement for the tax document from the supplier so that it could apply the entitlement to deduction. Hereby the supplier should have been forced to acknowledge the output tax. However, it turns out today that divided payments will not prevent fraud, on the contrary, the system of entitlements to deduction enables tax fraud far higher than in the event of other taxes.

Carousel fraud works on the following principle: Everything starts by the acquisition of goods (or services) from another Member State. As was already explained, both output tax and input tax is accumulated with the buyer of goods who resells goods in its Member State. It issues the tax document for this resale, but it does not file the tax return, does not pay VAT and becomes non-contact. However, the tax not paid is claimed as input tax by the buyer who purchased goods from a fraudster. If the tax authority pays it (or allows it to be deducted in the buyer’s tax return from its output tax), a loss incurs in the public budget in the amount of this tax. If the local purchase of the given goods precedes domestic supplies

"affected by fraud", the unfair trader would lose the possibility of claiming input tax paid upon the purchase of goods by its failure to file the tax return. When the acquisition of goods from another Member State precedes the unfair sale of goods, the fraudster does not lose any input tax. When the buyer pays output VAT from the price of purchased goods and at the same time it reclaims it as its input tax from received supply, the total effect of this transaction in the tax return is zero. If it does not file the tax return, the fraudster shall only get rid of its liability to pay output tax from local supplies. The following scheme makes carousel frauds clearer.

Scheme No. 1: Carousel frauds in the EU



Osoba A	*Person A*
Osoba B	*Person B*
Osoba C	*Person C*
Osoba D	*Person D*
DPH	*VAT*
NO	*ED*
OSV	*EXEM*
ČR	*CR*
JČS	*AMS*

***Legend**: A, B, C, D … persons are registered for value added tax; VAT … output tax; ED … full entitlement to deduction; EXEM – VAT-exemption with entitlement to deduction; AMS … another EU Member State; arrow – shows the direction of supply*

The person A, e.g. a person registered for tax in Austria, sells goods to person B, a taxpayer in the CR, for 100. The person B purchases goods and "self-assesses" output tax in the amount of 21 which the person B also reclaims as input tax. Furthermore, it sells goods for 200 to the person C. The person B does not file the tax return deliberately and does not

pay VAT in the amount of 42 (hereby the person B will not lose input VAT as it has "self-assessed" it and did not pay it in the price to the supplier). The person C is the so-called "buffer", there can even be more of these persons in the chain. For enlargement, there is a distance in the chain between the purchase of goods at the beginning and the delivery of goods at the end of the chain. The person C sells goods for 300 to the person D, pays output VAT from this delivery of 63, and at the same time it reclaims input VAT of 42 in its tax return. The person D as the last one in the chain in the territory of the CR claims an excessive tax deduction of 63 units, as its delivery of goods to Austria is VAT-exempt with the entitlement to deduction. The person A in Austria shall tax the acquisition of goods with the Austrian VAT of 60 and at the same time it claims the entitlement to deduction in the same amount. If goods are sold to the same person, i.e. the original person A, the carousel is hereby closed. If we look at the carousel from the perspective of the countries, than the CR lost 42 in tax revenues, and the transaction ended up having zero tax impact for Austria. As it was already mentioned, tax administrations attempt to face chain and carousel fraud by introducing the reverse charge system to buyers also for a domestic supply, at least for commodities susceptible to tax frauds. The protection against these frauds consists in the fact that the supplier sells goods in the CR excl. VAT and its buyer pays output tax from purchased goods and at the same time it claims it on input, in other words, the payment of tax and the entitlement to deduction accumulate with the buyer. Thereby, for example, the fraudster (the person B) from the previous scheme would supply goods to the person C for the price excl. VAT. It means that the fraudster would not claim any output tax which it could collect from its buyer (the person C) in the price of sold goods and then not to pay to the financial authority. The person C could not reclaim the non-paid tax from the tax administrator as it would pay it itself on output and at the same time claim it on input. This type of fraud would stop being functional.

In the reverse charge system, even though VAT is charged among VAT payers (with the full entitlement to deduction), it is shown in their tax returns, but it is not paid effectively to the tax administrator's account. VAT is paid in this system to the state budget only after a supply provided to the end consumer or entrepreneur who is not a VAT payer.

Gradual introduction of the reverse charge in the Member States

The local reverse charge started to be introduced by the Member States as a measure against VAT frauds on the basis of relevant provisions of the VAT Directive. At first, the reverse charge appeared in the spheres with VAT arrears due to insolvency. For example, in the Netherlands the reverse charge has been applied to construction works and the provision of labour force in the construction industry since 1982. The other countries joining the reverse charge mechanism for construction works included Austria in 2002 and Germany in 2004. In Germany, reverse charge has been used since 2002 for transfers of goods as a guarantee in the event of a principle implementation or real estate transfer. In

this area, this was not carousel fraud yet, the reverse charge was rather aimed at the cases of corporate insolvency. The typical sphere was the construction industry where firms collected VAT from their buyers, but they did not pay this tax to tax administrators due to their financial difficulties. Later, the reverse charge system was also introduced for construction works by other states, such as Sweden in 2007, Slovenia in 2010, Finland in 2011 or the Czech Republic (hereinafter referred to as the "CR") in 2012. Such countries decided to use the reverse charge for waste and metal scrap, as Romania in 2005, Greece and Italy in 2007 and later also Slovakia (2009) or Latvia, Poland and the CR (2011) or Sweden (2013).

Since 2007, the reverse charge has already been introduced in some countries in a targeted way against carousel fraud; for example, it concerned mobile phones and computer chips in the United Kingdom and personal computers and their accessories in Italy. At that time, carousel fraud started to be revealed based on the exemption of intra-Community supplies and the accumulation of tax with the buyer of goods or services that are described in the text above. Most Member States started to introduce the reverse charge for other types of goods and services after 2010. For example, the following countries introduced the reverse charge system for emission allowances which were largely affected by tax fraud: Denmark, Finland, Luxembourg and Ireland in 2010, further France, Hungary, Poland and the CR in 2011 and Slovakia in 2012. Later, the reverse charge was introduced by the Netherlands (2013), Denmark and Slovakia (2014), the CR (2015) for mobile phones, integrated circuits, game consoles and tablets. For cereals and useful crops, the reverse charge mechanism was introduced e.g. in Hungary in 2012 or in the CR since 2015. Some countries have the reverse charge allowed according to Article 395 of the VAT Directive for specific commodities that are subject to tax frauds in their territories. They include e.g. Latvia or Romania where the reverse charge is applied to the sale of wood.

The complete overview of goods and services on which the individual Member States impose the reverse charge is included in the study drawn up by the company EY for the EU Commission[14]. Its authors summarise that the reverse charge is used most in the construction industry, supplies of used materials and waste or metal scrap, and further in emission allowance trading. The reverse charge is applied by seventeen Member States to construction works and even by 23 countries to supplies of waste and scrap, and the buyer pays VAT for supplies of emission allowances in 21 Member States.

Development of VAT fraud in the EU

[14] Ernst & Young, LLP, 2014. *Assessment of the application and impact of the optional ´Reverse Charge Mechanism´ within the EU VAT system.*

The reverse charge towards buyers is a tool used to combat carousel fraud. Therefore, it would be desirable to find out whether this tool is effective. The evaluation of effectiveness of introducing the reverse charge for goods and services according to Article 199a of the VAT Directive is finally imposed directly by legislation. However, the impact level of the introduction of the reverse charge on the tax fraud size is not officially known yet, as the calculation of the impact of this measure on the tax fraud extent is very difficult. The estimate of tax fraud itself is relatively difficult and it is not easy to distinguish whether changes in the tax fraud amount in individual years are related to the introduction of reverse charge mechanism, both as there are no sufficiently long time series of estimates for tax fraud from which it could be possible to derive econometrically the dependence between their extent and implementation of the reverse charge in a specific year and as the tax fraud amount is, of course, influenced by a number of factors.

The traditional methods of estimating VAT fraud compare statistical data from national accounting books from which the theoretical VAT amount is estimated with financial administration data on the actually collected tax. The methods of tax fraud quantification are described in studies estimating the so-called VAT gap in the EU Member States since 2000 that were drawn up for the EU Commission by the company Reckon in 2009[15] and by the Center for Social and Economic Research Institute (hereinafter referred to as "CASE") in 2013[16]. The VAT gap is calculated as a difference between the theoretical VAT amount that should have been collected from all taxable transactions in the whole country and the actually collected VAT. When comparing individual states, it is usable to calculate the VAT gap in relative terms as the ratio of the VAT gap to the theoretical VAT amount for the given country. A detailed methodology of the tax fraud calculation is also included in the paper of the International Monetary Fund[17]. Estimates of the VAT gap do not usually distinguish in what sphere (i.e. in trading of what commodities) fraud occurs. Therefore, it is difficult to evaluate whether the fraud carried out in the trading of the commodity to which the reverse charge was introduced ended, and tax is collected in the full amount from these transactions thanks to the reverse charge. Moreover, frauds are mostly transferred to the market of another commodity after the introduction of the reverse charge system for certain goods or services, so tax fraud is not reduced in total.

One of the first estimates of the relative VAT gap was mentioned in their paper by the German authors Nam, Gebauer and Parsche[18] in 2003. They expressed VAT fraud in 1994 to 1996 for several EU countries. Other estimates were published in the aforementioned study by the company Reckon and later CASE. Estimates of the VAT Gap are also published

[15] RECON LLP (2009). Study to quantify and analyse the VAT gap in the EU-25 Member States.
[16] CASE (2013). Study to quantify and analyse the VAT gap in the EU-27 Member States.
[17] International Monetary Fund (2013). United Kingdom: Technical Assistance Report – Assessment of HMRC's Tax Gap Analysis.
[18] GEBAUER, A., Chang W. N., and Parsche, R. (2003). *Is the Completion of the EU Single Market Hindered by VAT evasion?*

by some analytical units of financial administrations of individual EU countries[19]. To see the complete picture, the following table shows the selected values of the VAT gap in individual EU Member States published in the CASE reports and in an article by the German authors Parsche et al. for 1995 (2003).

[19] For example, the United Kingdom, Sweden.

Table 1: VAT gap in the EU Member States expressed as a percentage in the theoretical tax liability in 1995 to 2013

	1995	2000	2005	2010	2011	2012	2013
Austria		9	11	10	13	12	11.4
Belgium	19.9	9	13	10	12	10	10.5
Bulgaria		23	10	10	24	20	17.2
Czech Republic		30	10	29	17	22	22.4
Denmark	4.3	11	9	9	8	8	9.3
Estonia		13	14	15	14	14	16.8
Finland		12	12	15	5	5	4.1
France	8.5	11	14	19	14	15	8.9
Germany	5.1	11	13	13	10	10	11.2
Greece	20.5	25	31	31	38	33	34
Hungary		22	27	28	24	25	24.4
Ireland		9	7	11	12	11	10.6
Italy	35.5	23	28	25	32	33	33.6
Latvia		16	15	37	37	34	29.9
Lithuania		30	36	36	36	36	37.7
Luxembourg		15	9	17	5	6	5.1
Malta		17	9	9	29	31	26.4
Netherlands	1.7	9	3	3	4	5	4.2
Poland		17	9	12	19	25	26.7
Portugal	13.0	3	3	16	11	8	9
Romania		42	34	48	44	44	41.4
Slovakia		27	20	38	33	39	34.9
Slovenia		4	5	10	9	9	5.8
Spain	24.6	6	1	16	19	18	16.5
Sweden		6	4	1	4	7	4.3
United Kingdom	4.4	12	11	13	10	10	9.8

Source: CASE (2014), 2012, *Update Report to Study to Quantify and Analyse VAT Gap in EU-27 Member States,* TAXUD/2013/DE/321; GEBAUER, A., Chang W. N., and Parsche, R. (2003). *Is the Completion of EU Single Market Hindered by VAT Fraud?;* VAT gap: questions and answers, available from: http://europa.eu/rapid/press-release_MEMO-15-5593_en.htm.

In 2013, the average relative VAT was 15.2% in the whole EU. Therefore, values around 22% reported in the CR for the last two years are above-average values. It is apparent from the table that for a long time the highest tax gaps have been achieved in Romania, but also e.g. Italy, Greece and Lithuania. In contrast, good results have been seen, already from the beginning of measuring, e.g. in Sweden or the Netherlands.

The comparison of estimates of 1995 with later estimates is interesting, but it exists unfortunately only for some countries. In 1995, high tax fraud can be seen in the countries with traditionally worse morale, such as Greece, Italy or Belgium. In the countries with

traditionally good collection, such as Denmark, the Netherlands, Germany or the United Kingdom, the VAT gap values were maximally around 5% in 1995. In 1995, VAT fraud was very probably caused by traditional types of fraud, such as income concealing. In 2000, however, the situation changed considerably. In the latter countries, the VAT gap increased to values around 11 to 12%. This increase could be caused just by the longer functioning of the single market. For seven years of its existence, tax fraudsters could think up how to misuse the VAT system under the new conditions of goods trading inside the EU without customs frontiers. At that time, carousel fraud perhaps started to be carried out which first concentrated on open economies with considerable international trading, such as Denmark or the Netherlands.

Conclusion

It is difficult to calculate by how much tax fraud has decreased due to the introduction of the reverse charge in the trading of individual commodities. The reverse charge, however, definitely prevents carousel fraud as is apparent from the description of fraud chain functioning. The problem is that the reverse charge system focused only on a certain sector will cause the transfer of tax fraud into another sphere. Therefore, there is a possible solution to the situation with the so-called general reverse charge that would be applied to all goods and services.

As was already explained, in the reverse charge regime tax is paid only after goods or services are supplied to a non-payer or end consumer. Of course, thereby the responsibility for tax collection is transferred more to retail traders and providers of services to end consumers. This transfer of responsibility for tax collection to the last link in the distribution chain is often criticised by opponents of the reverse charge mechanism. Its defenders claim that the control of retail traders and providers of services to end consumers should be carried out more effectively if carousel fraud is limited and more tax administration staff is allocated to the retail trade sphere. Moreover, the fiscalisation of cash payments could also be used in order to verify the correctness of the output tax paid from supplies to end consumers. The negative impact of the reverse charge system is, however, the necessity of detailed record-keeping of individual transactions on the side of both suppliers and buyers, including its sending to the tax administrator. It is possible to control only in this way that output tax was reported by the buyer on supplied goods or services in the reverse charge system. This would increase, of course, the paper work of payers. Nevertheless, this record-keeping would not be of a greater extent than the VAT reporting planned in the CR from January 2016.

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VAT gap and its structure

Zdeněk Hrdlička

There are a number of concepts to estimate tax fraud the use of which differs according to the possibilities and needs of the given country. Generally, these methods can be classified as microeconomic, i.e. bottom-up methods, and macroeconomic, i.e. top-down methods. The microeconomic methods are based on questionnaire inquiring, i.e. random tax controls the results of which are approximated subsequently to the whole economy. The danger of the macroeconomic methods consists in an incorrectly chosen controlled sample. Moreover, these methods are usually relatively demanding in terms of money and time. On the other hand, however, they provide the opportunity to examine the tax fraud origin and structure in more detail. This concept is used, for example, in Sweden or the USA.

The macroeconomic concepts enable investigation of the whole economy at once, basically without any additional costs of obtaining necessary data. However, the disadvantage is undoubtedly that these methods do not provide any more detailed information on the tax fraud structure.

In the first phase, the Czech Republic should orientate on using the macroeconomic concepts. The most information in this sphere is devoted to value added tax – the detailed description of methodology can be found, for example, in the study Reckon (2009), CASE (2013), IFP (2012) or in the United Kingdom.

In order to estimate VAT fraud in the CR, the globally accepted VAT gap concept should be used from the beginning when the theoretical tax revenues are compared which would be achieved in the economy if all subjects would fairly acknowledge their incomes and transactions, with the actually collected VAT. If the theoretical VAT collection exceeds the actual VAT collection, we just speak of the VAT gap or the gap in VAT collection. The VAT gap cannot be considered, however, to be a synonym of tax fraud! For more information on the differences between these two terms – see e.g. in CASE (2013) or Reckon (2009).

For the calculation of the theoretical VAT revenues, the following two facts are key: the determination of the theoretical tax base in the economy and the determination of the average VAT rate.

The theoretical VAT revenues are estimated by means of the macroeconomic concepts, the average rate is taken from VAT returns. A more detailed description of the procedure is provided below.

1. Data

The data necessary for the calculation of the VAT gap in the CR are mainly taken from the website of the Czech Statistical Office. The main data source includes national accounts that went through an extensive revision in 2011.

Other necessary data are taken from internal databases and documents of the Ministry of Finance.

2. Calculation procedure

The whole calculation procedure can be divided into three phases: First, we have to identify the theoretical amount of the VAT base in the whole economy, i.e. the base which would be achieved if all tax subjects would acknowledge its activities and transactions correctly. The theoretical VAT base can be ascertained in two ways – by adjustment of VAT for items which are not subject to VAT or, on the contrary, by identifying transactions in the economy which are subject to VAT. After the theoretical VAT base is calculated, we have to determine the average VAT rate by which we finally multiply the theoretical base and ascertain the theoretical VAT that could be selected in the given economy. However, the average rate is not easy to determine. Moreover, it is a key quantity which has a crucial impact on the final result of the whole analysis.

Figure 1: Procedure for the VAT gap calculation in the CR

Ascertaining the VAT theoretical base	Multiplying by the average rate in the economy	Comparing the theoretical revenues on VAT with the real revenues	Resulting VAT gap

Source: own regulation.

2.1 Theoretical VAT base

The theoretical VAT base can be estimated in two possible ways – both by adjusting GDP for items which are not subject to VAT and by identifying all transactions which, on the contrary, are subject to VAT.

2.1.1 Adjustment of gross domestic product for items not subject to VAT

The adjustment of gross domestic product for items which are not subject to VAT was carried out, for example, by the Slovak IFP (2005) the target of which was not, however, to ascertain tax fraud or the VAT gap, but to forecast the development of VAT collection in the following years. The same method was again used by IFP (2002), this time already for the VAT gap estimate in Slovakia. The basic procedure in the Ministry of Finance's methodology is just based on the IFP concept.

The whole calculation is based on the basic macroeconomic equation:

GPD = C + I + G + NX

Where:

GDP … gross domestic product

C… consumption

I… investment

G … government expenditure

NX … trade balance (difference between exports and imports)

The purpose of all of the following modifications is to adjust GDP for all items and transactions which GDP includes and which are not subject to VAT. They are the following modifications:

a. GDP modification

GDP is reported in national accounts in current prices. It means that it also includes the VAT value in itself. Immediately at the beginning, it is necessary to adjust the statistically reported GDP for VAT impact. For adjustment, the average VAT rate was used in the Czech economy. For all other modifications, the values excl. VAT are also used.

b. Trade balance "NX"

According to the current VAT system, exports from the Czech Republic are VAT-exempt with the entitlement to deduction. However, GDP includes these exports. Exports from the CR must be deducted from GDP. On the contrary, we have to add imports, as these are not part of GDP, but they are subject to VAT at the moment of their consumption.

c. Government expenditure "G"

As it is known, VAT taxes a value added. The value added also includes, among other things, wages and salaries, i.e. VAT also taxes wages in the economy. However, the derogation includes wages in the public administration, and therefore they must be deducted. Investment expenditure of the government is resolved as part of the investment modification.

d. Investment "I"

The purpose of VAT is to burden mainly final consumption, therefore investment must be taken from GDP. Speaking more exactly, it is the gross capital formation. At the same time, however, we have to take into consideration these investment items which are subject to VAT. For example, the following items are added back:

- purchases of real estate by households that are included in investment according to the methodology, and not in consumption,

- investment expenditures of exempt sectors, as these sectors are not VAT payers, and therefore they are not entitled to tax deduction on input,
- investment expenditure of the government, as the government is not a VAT payer,
- goods to which the payer cannot claim deduction[20]

e. Consumption "C"

The consumption regulation is the most complicated, therefore it is schematically divided into three groups. There are three key facts for these modifications: there are VAT-exempt sectors in the economy, not all parts of final consumption of households are subject to VAT, and there are also companies with turnover below the registration limit. Everything leads us to the below-specified modification.

- **Exempt sectors**

Companies doing business in exempt sectors without the entitlement to VAT deduction[21] act, simply speaking, as end consumers, as they pay VAT in prices of their inputs which they cannot, however, claim as tax deduction due to their activity. It arises from this that all inputs which exempt sectors acquire from non-exempt sectors also include the VAT paid. The data on these supplies can be found in the input-output tables.

- **Final private consumption**

In final household expenditure, we can also find such expenditures that are exempt from VAT. This exempt consumption must be excluded from VAT. We make adjustments for exempt supply by deducting the value added of exempt sectors which belongs to household consumption. The data can again be calculated by means of input-output tables. Other modifications related to private household consumption are as follows:

  - adding foreign expenditure on local markets,
  - deducting refunded foreign expenditure on local markets,
  - deducting expenditure of residents abroad,
  - deducting own production and imputed household consumption.

- **Exemption threshold for VAT payers**

Persons obliged to pay tax become VAT payers only after exceeding a certain turnover limit. Therefore, activities of entrepreneurs are also included in VAT who

[20] This category mainly included purchases of cars by entrepreneurs. VAT payers could deduct VAT from purchases of a car only if such car had a grid installed which made a truck from the car "artificially". This rule was cancelled in April 2009 and now VAT payers can claim the entitlement to deduction for all cars.

[21] Supplies exempt from tax without the entitlement to deduction include, for example, postal services, financial activity or health service activity, goods, upbringing and education. The complete list and rules that must be met for exemption are stipulated in Act No. 235/2004 Coll., on value added tax, in sections 51-62.

are below the threshold of registration for VAT. In order to eliminate their impact, it is necessary to deduct their sale and, on the contrary, to add inputs which are taxed.

2.1.2 Identification of transactions subject to VAT

The second method of calculation of the theoretical tax base is based on the identification of all transactions subject to VAT. In this case, the starting point is input-output tables showing processes of domestic production and transactions with products in the national economy. This method was used for the VAT gap calculation not only by IFP (2012), but also Reckon (2009).

The theoretical VAT base consists of:

- final consumption of households, non-profit-making institutions and the government, without that part of consumption which belongs to exempt sectors;
- formation of fixed capital of households, the government and all exempt sectors;
- intermediate consumption. Intermediate consumption shows supplies which are provided by non-exempt sectors to exempt sectors. Therefore, VAT is imposed on these supplies as exempt sectors cannot claim the paid VAT in their inputs as deduction.

All data are again provided as the tax base, i.e. excl. VAT. The rates pertaining to individual supplies were used for the adjustment of data from the input-output tables. The average VAT rate in the economy was used for the adjustment of other items which cannot be disaggregated in such a manner in detail.

2.2 Average VAT rate in the economy

The average VAT rate in the economy is used in the analysis both for the adjustment of data from national accounts for the VAT impact and for the determination of the theoretical VAT collection.

There are several ways how to obtain the average rate value. The average rate can be obtained from tax returns filed by VAT payers. These data are at the disposal of the Ministry of Finance of the Czech Republic. Another possibility is to calculate it from statistics of family accounts. Statistics of family accounts (see the annex) include financial expenditures of households for individual commodities and services, while their classification is very detailed. If we assign the applicable VAT rate to each of these items, the average rate can be calculated subsequently which is “paid” by households in their financial expenditure. At the same time, it should approximately mirror the average rate in the whole economy.

Considering the availability of data, the rate from tax returns is used as the average VAT rate in the economy.

2.3 Theoretical VAT collection and the VAT gap in the Czech Republic

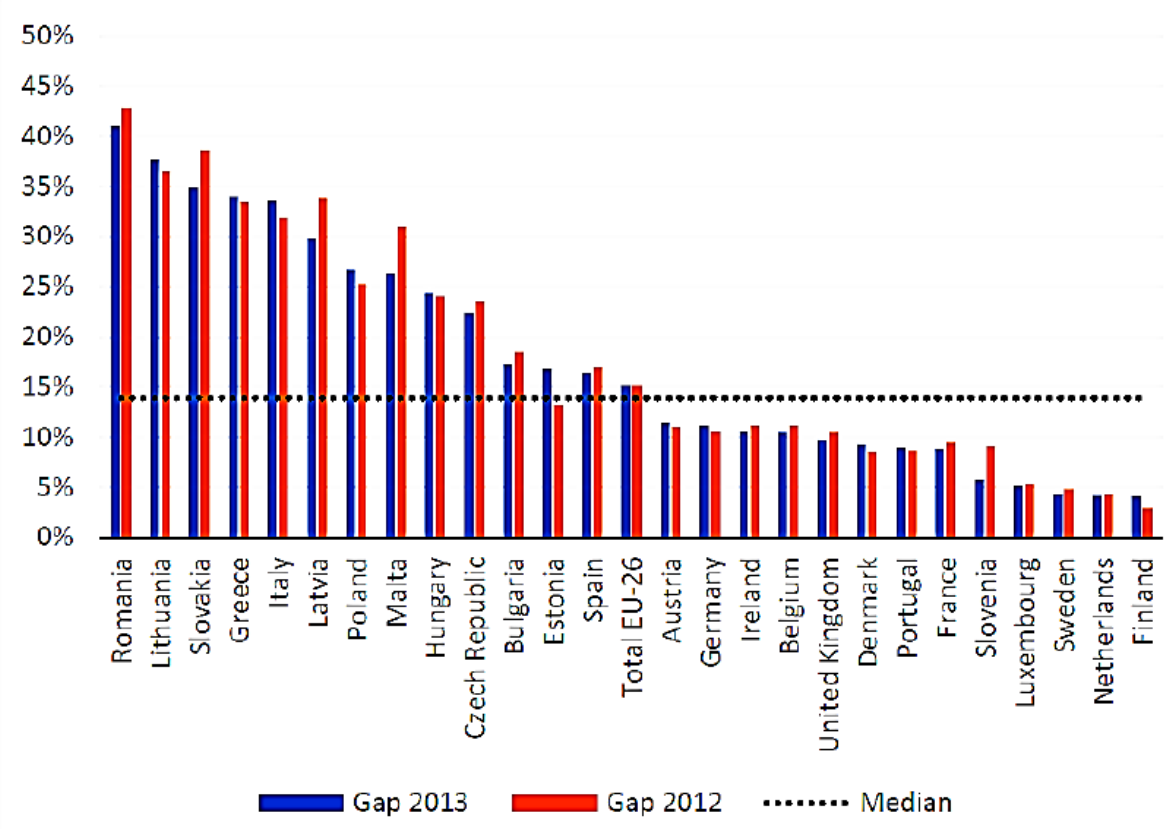
The theoretical tax base is multiplied by the average rate in the economy, whereby we get the theoretical VAT collection. It is subsequently compared with the accrual VAT revenues.

The difference arisen between the calculated theoretical VAT and collected VAT can be caused by errors in statistical reports (or national accounts) or just by the presence of tax fraud (VAT gap) in the economy.

3. Estimates of the VAT gap

On the basis of the aforementioned methodology, the Ministry of Finance carried out several estimates of the VAT gap for the CR. However, these estimates are used at present only for the internal analytical needs of the Ministry of Finance. For communication purposes, such estimates are used exclusively for the reason of international comparability which are published by the EC. The EC estimates are based on a similar methodology as that described above, and they do not differ considerably from our national methodology. It is important that both are moving in the same direction.

Figure 2.1 – VAT Gap in the EU-26 countries, 2012-2013



Source: CASE 2015.

According to the CASE estimates, the VAT gap in the CR has been ranging from CZK 90 to 95 billion in the recent years, and the CR is not among the completely worst EU countries, yet the size of its VAT gap is higher than the EU median. This amount is higher than the current and future planned deficits in the CR. If the VAT gap is completely removed theoretically the CR would safely reach budget surpluses. Also in a more realistic case, as provided by Stavjaňová (Stavjaňová J., 2014), the achieving of the average European size of the VAT gap would mean for the CR obtaining CZK 20-30 billion. As she states further, this income would be able, for example, to cover the abolishment of payments to social insurance premium of both employees and employers of employees with gross income up to CZK 12,000, which is approx. 10% of all employees. Thus, achieving the mere European average would enable the CR to decrease deficits of public finances considerably or support the employment of low-income employees.

Table 1: VAT gap estimates for the CR in 2009-2013 in EUR million

	2009	**2010**	**2011**	**2012**	**2013**
VTTL	12 636	13 991	14 122	14 883	15 070
Liability on Household Consumption	7 509	8 428	8 659	9 304	9 531
Unrecoverable input liability on Intermediate consumption. Government and NPISH	3 246	3 692	3 809	3 869	3 954
Unrecoverable input liability on GFCF of exempt industries	1 654	1 793	1 574	1 632	1 502
Net Adjustments	226	78	79	77	83
VAT Revenues (Eurostat)	9 784	10 420	11 246	11 377	11 694
VAT Gap	**2 852**	**3 571**	**2 876**	**3 506**	**3 375**
VAT Gap as % of liability	**23%**	**26%**	**20%**	**24%**	**22%**

Source: CASE 2015.

In relative terms, the observed points could be interposed with a slightly declining straight line. Nevertheless, these data can also be seen as the fact that the VAT gap size in the past oscillated in the aforementioned range, while there was a certain improvement in 2013 due to anti-fraud measures that were adopted in the previous years – the reverse charge introduction, the obligatory publication of accounts, the institute of unreliable payer, the special method of tax ensuring and guarantee of the recipient of taxable supply. However, it is only a hypothesis that will have to be confirmed in the following years.

However, an increase in the tax gap can be seen in the development which corresponds, more or less, to an increase in the VAT rates in the given period. Since 1 January 2010, both tax rates have been increased. The reduced rate increased to 10% and the basic rate increased from 19% to 20%. In 2012, the reduced tax rate increased from 10% to 14%. Generally, in 2008, 2010 and 2012 the development of theoretical and actual VAT collection varied and the VAT gap was increasing. The VAT gap development in the CR supports, to a certain extent, the assertion of many theorists, i.e. that higher tax rates

lead to higher tax fraud. The higher rates are, the more attractive non-acknowledgement of the income for tax subjects is, and therefore the higher potential "savings" in the tax are.

However, VAT collection, and thus also the relative VAT gap size, are not influenced only by the VAT rate amount. VAT development also influences them, in particular the development of expenditure on the final consumption. If household consumption increases, VAT collection also rises. Consumers' preferences are also important. It means whether they purchase more goods and services subject to reduced or increased VAT rates. All these factors have an impact on VAT collection development, the theoretical VAT amount, and thus on the relative VAT gap size under otherwise unchanged circumstances.

Another negative factor which has an impact on VAT gap growth from the empiric perspective is the economic recession. The econometrical analysis of the impact of various aspects on the VAT gap development is included, for example, in the study of CASE (2013).

Such a conclusion arises from the aforementioned, among others, that the VAT gap cannot be automatically taken as the indicator of tax administration performance, but it is also necessary to take into account both tax and political influences and generally economic impacts.

VAT gap structure

The sector concept to the VAT gap is a tool for the identification of sectors with the biggest volume of tax fraud. The methodology of the VAT gap structure is dealt with by the IMF in its programmes. This methodology was published in the case of Estonia. However, the paper of the Slovak Financial Policy Institute has crucial importance which modified and applied this methodology to the conditions of the Slovak Republic. At the same time, it can be expected that with the similar characteristics of the Czech and Slovak economies, the given methodology and, after all, also expectable findings, the results will also be valid for the CR, except for the construction industry.

VAT gap structure in the SR

Potenciálna DPH	Potential VAT
Priznaná DPH	Acknowledged VAT
Zaplatená DPH	Paid VAT
Rizikové sektory	Risky sectors

A Agriculture, forestry industry, fishing
B Mining and extraction
C Industrial production
D Supplies of electricity, gas, steam
E Supplies of water; waste water cleaning and drainage
F Construction industry
G Wholesale and retail trade; motor car repairing
H Transport and storage
I Accommodation and catering services
J Information and communication
K Financial and insuring activities
L Activities related to real estate
M Professional, scientific and technical activities
N Administrative and supporting services
O Public administration and defence; mandatory social security
P Education
Q Health care and social work
R Art, entertainment and recreation
S Other activities
T Activities of households and/or employers
U Activities of extraterritorial organisations and associations

Source: Tax report of the Slovak Republic, 2015, IFP.

Wholesale and retail trade, motor car repairing, the construction industry, accommodation and catering services, agriculture and professional services appear as the most risky sectors in the case of the SR. According to expectations, the largest VAT gap in absolute terms is in the retail trade and wholesale sectors where both carousel fraud and – to a considerably lower extent – also the non-reporting of sales manifest themselves. The relatively largest gap is in the sectors of agriculture and accommodation and catering services. We can also provide evidence of a large gap in accommodation and catering sectors directly in respect of the CR, and this is also the main reason why the EET focuses on this sector as the first one. The gap related to professional services is also relatively large, both in absolute and relative terms. Here there is probably a mix of non-reporting of sales and carousel fraud. In the Czech Republic, for example, in the case of advertising.

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Reverse charge method in the environment of harmonized VAT

Milena Hrdinková

Legal framework

VAT as a general indirect tax with a wide basis and high degree of neutrality has been harmonized in the EU since 1977. The currently valid regime has been of a transitional character until now, and the preparation of the definite solution outlined in the Green paper of the European Commission of 2010[22] is under progress or it has rather been sometimes discussed for several years. If I should personify the definitive solution of VAT in the EU, I can imagine it best as Mrs Colombo from the well-known TV series. We all know that its existence is logical as the transitional regime lasting for nearly forty years does not make much sense, and so we speak of it as something self-evident. At the same time, not only that nobody has ever seen the definitive regime and hardly anybody has a vague idea of what it could look like, but most participating persons are more and more feeling that it does not exist in fact.

VAT is of crucial importance not only for the EU Member States, but also for the functioning of the EU, as the EU institutions are financed from a portion of its revenues. Although VAT is a harmonized tax, it includes a number of variations in individual Member States and its application is fragmented. The negotiations on legislation regulating VAT in the 1970s were long and difficult, and the result had to reflect a number of concessions and compromises. Yet, in my opinion, one of the best functioning taxes in the history was developed, realistically imposed on consumption with a high rate of neutrality, both regarding the type of tax subjects and taxable supplies.

The particular tendencies of the Member States also influenced strongly the system after 1977. By the accessing of other Member States to the EC and later to the EU, most of them brought "derogations" to the system which were negotiated before their joining. The reason was mainly using regulatory effects of the tax (e.g. reduced rates, exemption). This all resulted in a considerable fragmentation of the harmonized legislation that includes a number of variations from the VAT system, while these variations do not often have a system rational reason, but they exist due to purely political causes.

It is interesting to remember that the original proposal of the Commission on how the VAT system should have looked like in the EEC was based on the principle of taxation according to the origin. It would probably lead to a system which is much simpler and less susceptible to massive fraud, but it turned out to be absolutely impassable among Member States. The agreement was reached regarding taxation according to the destination which corresponds better with the principle of the tax imposed on "consumption", but it is very demanding in terms of fraud detection and prevention and in the environment of the continuously developing internal and single market it requires very close cooperation among tax administrations. Probably also for this reason, there was a rather radical diversification of

[22] COM (2010) 695 final of 1 December 2010 Green paper on the future of VAT "Towards a simpler, more robust and efficient VAT system"

the VAT collection method for intra-Community supplies and supplies inside a Member State (the so-called domestic supplies). While in the case of the first group, the tax is collected in the manner that is finally similar to the reverse charge method as it relies on the tax subject receiving the taxable supply, in the case of domestic supplies the effect of tax collection in fragments remains fully preserved, also at the payment level. Although this system may seem to be complicated, it turned out to be the only realistic and adequate system for the instruments that the tax administrations had at their disposal at the given time. The harmonized VAT in the EU is administered by 28 completely independent tax administrations. The harmonized tax in such an environment does not mean by far the unified procedure in its selection. Moreover, the method in what VAT and taxes are generally collected has changed considerably compared to 1977. While 35 years ago not even a telephone line was a matter of course at each financial authority, today data can be shared basically in real time not only at any tax administration workplace basically in all Member States, but often also at any place in the field. With the high involvement of modern technologies, the current status is completely incomparable not only with the period at the beginning of VAT harmonization, but also with the period when the legislation in question was generally amended for the last time (2006). It is not by chance that today the Member States are standing before the decision on what solution is the most appropriate for the definitive regime. If we make the situation simpler and disregard a lot of particular details, the problem is basically how to unify the regime for domestic and cross-border supplies inside the EU. Is the reverse charge mechanism appropriate in the given situation for the whole EU or is it realistic that 28 different tax administrations will cooperate so much that they will be able, without problem, to collect VAT in fragments regardless of the fact in what Member State the transaction in question is taking place?

The legal basis for the joint harmonized VAT system in the EU is Article 113 of the Treaty on the Functioning of the EU (TFEU) the content of which has remained basically unchanged for many years. This provision speaks of the fact that the Council will take measures for harmonization of legal regulations concerning turnover taxes, excise duties and other indirect taxes to an extent necessary for the functioning of the internal market. TFEU does not foresee what type of measures they should be, and it does not even indicate what type of tax (turnover tax or VAT) it should be. It leaves the decision fully in hands of the authority which has the legislative initiative (the Commission), of course, when respecting the fact that the measures according to Article 113 of TFEU are always accepted with a special legislative procedure, i.e. unanimously. The role of the European Parliament which is limited in these cases to the so-called consultation procedure is rather negligible from the perspective of the potential to influence the form of the legislative regulation. It arises from this that the form and outlines of the indirect tax systems in the EU are formed fundamentally by the European Commission, which corresponds very well with its primary role of the guardian and promoter of the internal market functioning. It can be validly objected that the Commission is largely hindered with the necessity of obtaining the support of all Member States for its proposals which has turned out many times just in the tax area in the past as (nearly) insurmountable. On the other hand, it is evident that the Commission has the exclusive legislative initiative in the tax area at the EU level, although in the area of tax collection and administration it is, if we ignore the comitology procedure, completely without competences. A paradoxical situation occurs where the authority which creates and proposes the indirect tax system in the EU, the main purpose of which is to obtain the income of public budgets of the Member

States as well as funds for functioning of the EU institutions, does it without any responsibility for whether these taxes are in fact properly collected. From the perspective of the total tax revenues of the Member States, VAT is a completely critical item and in many Member States it is a tax bringing the most funds to their budgets.

Reverse charge method as a tool for VAT collection

The difference between the total VAT liability and the actually collected tax in the EU, in other words VAT fraud, equals approx. 15% of the total tax duty. It is the amount of approx. EUR 170 billion per year. This tendency has been stable for a number of years, while the results of individual Member States are very different and oscillate approx. between 4 and 41%. The largest part of VAT fraud is fraud in the chain when the provider of the respective supply (the so-called missing trader) does not pay output tax, while the recipient of this supply claims its entitlement to input tax deduction. Two Member States are usually involved in this chain (carousel) fraud and fraud is carried out only in one of them.

Carousel fraud can be avoided using the reverse charge method. The duty to acknowledge VAT is transferred from the provider of the supply to its recipient. In the chain, business transactions are carried out without the tax payment as the same person is obliged to pay tax who claims this tax as deduction. Thereby any misuse of VAT deduction is prevented. VAT incurred in fragments, but only in the tax administration system, and it is collected in reality only at the end of the trade chain. The structural elements of tax, such as the tax base, rates, exemption etc. remain the same. The tax is the same, it is only collected in another, more effective way. Considerable optimisation occurs, collection is more effective and tax administration has at disposal more sources for control of this link in the chain where there is the duty to pay tax and where there is also logically an increased risk of fraud. The risk of fraud at the end of the chain can be decreased considerably with the increasing ability of tax administrations to intervene against the grey economy. The measures of the control and repressive characters are aimed against these types of fraud, e.g. different forms of registration cash desks and fiscalisation of cash payments and the systems for automated cross control of invoices (electronic reporting). At the time when the EU Member States made the decision to have the harmonized VAT system and started developing this system, the effectiveness of similar measures was generally very low. With high involvement of modern technologies, however, the situation is developing quickly and the current situation is also completely incomparable with the situation ten years ago.

Current framework of the reverse charge method

It is possible to summarize that according to the effective EU legislation, the reverse charge method is considered to be a non-conventional tool the use of which is admitted only for some commodities for domestic supplies and only in the following cases:

1. For certain categories of goods and services explicitly specified in the VAT Directive (Articles 198, 199, 199a). During implementation, the Member States may decide what items they wish to apply the reverse charge method to and what items not. The possibility of the application of measures for certain categories is time-limited, for some (in particular those newly being introduced) it is limited, for the time being, until the end of 2018.
2. On the basis of an individual derogation granted by the Council (following the procedure according to Article 395 of the VAT Directive). The licence is granted for a limited period of time, usually 2-3 years, and exclusively as part of the prescribed procedure on the basis of the application of the Member State. If the Commission finds the application to be justified, it shall prepare the proposal of the implementing decision which has to be approved by the Council unanimously. The submission of the respective legislative proposal falls completely within the discretionary power of the Commission which has a very reserved attitude to the applications of this type, and refuses a number of applications. It justifies this in particular by a potential negative impact on neighbouring Member States and the internal market and by fears about violating the existing VAT system, if the reverse charge method would start to be used with higher frequency, and suggests a threatening collision with the TFEU. In what exactly the Commission sees incompliance with the TFEU which leaves, as already mentioned above, a very wide space as regards the method used for the indirect tax area, is not specified by the Commission in its notifications by which it refuses the applications for derogations. If the Commission agrees with allowing a derogation, the legislative process, from filing an application of the Member State until the final approval by the Council, lasts for a minimum of eight months. The Council does not comment on applications refused by the Commission. Some decisions of the Commission from the past show that in areas where conventional measures were introduced upon its recommendation instead of the reverse charge method, afterwards there was also massive tax fraud and not negligible budgetary losses.
3. By the procedure according to the so-called Quick Reaction Mechanism (Article 199b of the VAT Directive, since 2013). This procedure is only possible in the event of sudden (newly originated) and extensive frauds and for a temporary time of nine months. This period is intended for bridging a period of the drawing up of the proposal for an individual derogation (see Point 2). The speeded up procedure for allowing the procedure will be used, while assessment falls within the discretionary power of the Commission. The Quick Reaction Mechanism should be a procedurally quicker variant of the standard allowance process of individual derogations, but the practice has not testified to it in any of the cases yet.

The development in the last years shows that the reverse charge method is an increasingly popular instrument for tax administrations, and its negative effects on the internal market to

which the Commission is often pointing out, have not yet been proven to be true in practice. The group of sectors to which the reverse charge method is used, is constantly increasing in spite of a very reserved attitude of the European Commission.

Future regime

The introduction of the reverse charge method to a considerably wider group of supplies for domestic transactions than at present and potentially for all taxable supplies (sometimes it is also called the general reverse charge) would be possible either provided that there would be a total conceptual change and reworking of the EU legislation, for example as part of the so-called definitive regime, or on the basis of an individual derogation granted by the implementing decision of the Council. A certain variant of the second possibility could be a pilot project for a specific Member State (States). While the measure proposed and adopted as part of the definitive regime should have effects on the tax collection system in all Member States, the other would influence only individual Member States.

In 2005 and 2006, Germany and Austria asked for aderogation. Specifically, they were interested in introducing the reverse charge method to all supplies of goods or provision of services among traders where the value of taxable supply exceeds EUR 5,000 or 10,000, similarly as the Czech Republic together with Austria, Bulgaria and Slovakia in June 2015. The Commission did not find these requests to be justified as they represent, from its perspective, a considerable change in the VAT system, and therefore they are non-compatible with the provisions of the VAT Directive. The Commission also argued that tax fraud can be prevented in another way, i.e. with increased controls based on risk analyses. In 2006 and 2007, however, Germany and especially Austria developed considerable political pressure on the Commission and other Member States the result of which was adopting the conclusions of the Council in 2007 that suggested a pilot project as a possible procedure that would enable testing of this system. Subsequently, the Commission issued a notification in which it defined parameters for such a pilot regime of the global application of the reverse charge method, intended for Austria at that time. For political reasons, however, Austria did not accede to its implementation in the end.

The reverse charge method for domestic transactions is one of five possibilities proposed by the Green paper of the Commission for the definitive regime. All alternatives must be subject to an analysis before it is decided which is the “correct” one. Reviving of the idea of the pilot project which, for example, the Czech Republic and Austria would join, is also logical in this context. The experience obtained in such a project would be absolutely invaluable in deciding on the future regime. It could be confirmed, for example, that using the reverse charge method will not result in the destruction of the harmonized VAT system and will not violate the internal market functioning in any way. The advantage could also be the fact that if the solution will be tested by one or two smaller states in the region, the probability that such a step will considerably influence other Member States is very low. The introduction of massive conventional measures aimed against VAT fraud has a comparable effect against pushing fraud behind the frontiers of the state that is introducing them.

Conclusion

Arguments against the reverse charge method are generally known and are heard often. In 2014 and 2015, the Commission rejected a large number of applications of the Member States for application of the reverse charge method for the aforementioned reasons. Everything without offering any alternative solution for a short-term horizon. As far as the future regime is concerned, the Commission indicates a certain liking for extending the one-stop-shop system which requires the strong intervention of just the Commission in the environment of 28 different and fully autonomous tax administrations for its functioning. The question then is whether it is not this that is the reason for its liking.

It is obvious that considerably more attention will have to be paid to the VAT area than so far, as it is not possible to require from the Member States to improve VAT collection on one side which is their responsibility, and insist on refusing available measures on the other side. The VAT collection gap has remained very high for a number of years. The solution for the short-term horizon and the VAT definitive regime in the EU must not only consider the change in the conditions for tax administration against the period when the transitional regime was introduced, but also the fact that for this whole period nothing has suggested that VAT administration would be integrated in a substantial way inside the EU in the near future. It is more than probable that in the following twenty years, if the EU Member States are in a political mood comparable with the situation today, their tax systems will be administered by 28 various and mutually fully independent tax administrations. In such an environment, the application of the reverse charge method is very logical for domestic supplies as well as for intra-Community supplies.

Implementation of the reverse charge regime

Blanka Mattauschová

In the standard VAT system, tax is applied in an exact ratio to the price of goods and services regardless of the number of supplies carried out in the production and distribution process before the degree in which the tax is applied.[23] The provider of a taxable supply will include VAT in the price of its supply and will pay this tax. The recipient of a taxable supply will pay this VAT in the price of goods or services and at the same time it can, when the defined conditions are met, claim the entitlement to deduction. Thereby there is the system of divided payments which divides tax collection among the individual links in the chain. Unlike the standard VAT system, in the reverse charge the duty to pay VAT and claim the entitlement to deduction is transferred only to one person – the end payer. Given the fact that the reverse charge is a derogation of the standard VAT system, such a derogation can be applied according to the VAT basic principles in a very limited way, only to the extent determined by the VAT Directive.[24] It includes several variants on the basis of which the Member State can introduce this regime. These variants are described above.

Legal framework of the reverse charge in the Czech Republic

The domestic reverse charge was introduced gradually in the Czech Republic, not only in connection with extending selected commodities for its application at the level of the European Union, but mainly in relation to the identification of extensive fraud in the trading of selected commodities.

The first case of the application of the reverse charge regime in the Czech Act on VAT[25] that was already introduced in 2006 concerned supplies of specifically defined gold. The Czech Republic acceded to a considerable extension of the reverse charge subsequently as late as in 2011 when other selected commodities from Article 199 of the VAT Directive were also included in the domestic law. On 1 April 2011, Act No. 47/2011 Coll. came into effect, amending the Act on VAT, on the basis of which there was an extension of the reverse charge for supplies of some types of waste and scrap (defined in the annex No. 5 of the Act on VAT). This amendment further introduced the reverse charge in the supply of construction or assembly works defined in the numerical code of the production classification CZ-CPA 41 to 43. With regard to the fact that construction or assembly works concerned a great quantity of subjects, the effective date was postponed to 1 January 2012.

[23] Article 1 of the Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax.
[24] Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax.
[25] Act No. 235/2004 Coll., on value added tax, as amended.

As in 2010, considerable tax fraud occurred in the trading of greenhouse gas emission allowances that expanded massively within a short period of time in the whole EU, based on an unambiguous approval by all Member States there was a very quick including of greenhouse gas emission allowances in the list of commodities in Article 199a of the VAT Directive. On the basis of this fact, the reverse charge regime was introduced with the effective date from 1 April 2011 to this commodity also in the local Act on VAT.

During 2009, extensive tax fraud was identified in the Czech Republic in fuel trading. On the basis of these findings, on 12 February 2010 the Czech Republic asked for granting an individual derogation according to Article 395 of the VAT Directive for the introduction of the reverse charge regime in fuel trading. Unfortunately, this request was rejected by the European Commission due to fears of violating the internal market and stating that the volume of tax fraud in fuels in relation to the so-called VAT gap is not of such an extent so that an individual derogation would have to be granted. The Czech Republic also failed with its proposals to extend Article 199 of the VAT Directive with fuels when negotiating the amendment to the VAT Directive in working groups of the EU Council. On the basis of these facts, therefore, it was not possible to introduce the reverse charge regime in the local legislation for fuel supplies, and some other solutions have to be chosen for tax fraud elimination.

The Czech Republic made other important reverse charge modifications in 2015, in connection with the implementation of Directive 2013/42/EU and Directive 2013/43/EU. On their basis, the reverse charge regime was divided in the Act on VAT into permanent and temporary regimes.

The permanent use of the reverse charge regime continues to apply to supplies of gold (section 92b), used materials and waste defined in annex No. 5 to the Act on VAT (section 92c) and the provision of construction or assembly works (section 92e).

The temporary reverse charge regime (section 92f) applies to the supplies of commodities referred to in annex No. 6 to the Act on VAT if so stipulated by the government with its regulation. The extent of commodities results from the dispositive provision of Article 199a of the VAT Directive defining the list of supplies to which the reverse charge regime can be applied until the end of 2018, and further from Article 395 of the Directive enabling the EU Council to allow, at the proposal of the Commission, a special measure deviating from Article 193 of the Directive (the so-called individual derogation). In addition to newly defined commodities, the transfer of greenhouse gas emission allowances was also transferred to annex No. 6 the legal regulation of which was embodied until that time in section 92d of the Act on VAT.

The possibility to introduce the reverse charge regime on the basis of the so-called Quick Reaction Mechanism for a period not exceeding 9 months, resulting from Article 199b of the VAT Directive, was reflected in the domestic act in a separate section 92g. The government is again empowered to determine the extent of commodities in its regulation.

On the basis of the authorisation embodied in section 92f of the Act on VAT, the government issued Regulation No. 361/2014 Coll. (the "Government Regulation") in which selected commodities were included from annex No. 6. In addition to the transfer of greenhouse gas emission allowances where the reverse charge regime was already applied (it concerned only the legislative transfer to annex No. 6), the reverse charge regime has also been applied to the following selected goods with effect from 1 April 2015:

- listed cereals and technical crops (except for sugar beet where the effect date was from 1 September 2015),
- metals, including precious metals,
- mobile phones,
- integrated circuits,
- portable equipment for automated data processing and video game consoles.

Section 2, para 2 of the Government Regulation, defines that for the aforementioned commodities the reverse charge regime will apply only if the total amount of the tax base of all supplied selected goods exceeds the amount of CZK 100,000.

Within a short time interval, after the reverse charge extension since 1 April 2015, it turned out that selected cereals and technical crops were defined in the Czech Republic a little bit wider than in the Slovak Republic. On the basis of this fact, the real threat of the quick transfer of a large portion of fraud related to cereals and technical crops was identified which were not included in the reverse charge regime, in the Czech Republic. For this reason, it was necessary to extend the application of the reverse charge regime as soon as possible to all cereals and technical crops specified under the nomenclature codes of Chapters 10 and 12 of the customs tariff. This modification was reflected in the domestic legal order with effect from 1 July 2015 on the basis of Government Regulation No. 155/2015 Coll.

At present, the application of the reverse charge regime is also under preparation for some other commodities from annex No. 6 of the Act on VAT, specifically for gas and electricity supplies to a trader and for supplies of gas and electricity certificates. This modification should occur with effect from 1 February 2016.

Practical aspects of the reverse charge regime implementation

The key factor for the effective application of the reverse charge regime for selected commodities is a sufficient time for its implementation, not only in relation to taxpayers, but also to tax administration. Here there are two opposing views, the requirement of the state for the quick prevention of tax fraud within the given commodity on the one hand and the requirement of taxpayers for a sufficient time to modify accounting and record-keeping systems and a change in the trade terms and conditions on the other.

The reverse charge regime can only be applied in the case of supplies of specific commodities defined in the applicable provisions of the VAT Directive. Considering the fact that the text of the VAT Directive is a result of a compromise agreement of all EU Member States and represents the basic legal framework that is subsequently implemented in the internal regulations, selected commodities in the VAT Directives are defined generally. For practical implementation, it is therefore necessary to seek an appropriate equivalent or definition of the given notions in the domestic legal order.

As in the case of the definition of commodities for the application of the applicable tax rates, for the purposes of defining goods being subjected to the reverse charge, the nomenclature codes of the customs tariff are also used. The definition of services is set in relation to numerical codes of the CZ-CPA production classification. Even if it concerns regulations which have been dealt with as part of the Act on VAT since the beginning of its functioning, all practical situations cannot be included within this specific definition. It is obvious that there will always be a certain quantity of transactions the classification of which can be at least disputable. Therefore, in order to eliminate the legal uncertainty of tax payers, the legal fiction was embodied in the Act on VAT defining that in the case of any doubts regarding commodity classification it is possible, based on the agreement between the contracting parties, to use the reverse charge regime. Another possibility is to ask the General Financial Directorate for a binding assessment for the use of the reverse charge regime.

The biggest boom of the reverse charge regime which influenced a large number of tax subjects was the extension to construction and assembly works with effect from 1 January 2012. Even if the legislation regulation included a sufficient period of time between the dates when the Act came into force and into effect, doubts and problems related to the practical application were still occurring a year after the effective date of the Act. Problems on the side of taxpayers concerned mainly the exact definition of commodities falling within the reverse charge regime and the related correct application of the applicable VAT regime. Such an extensive definition of commodities was also a big burden for tax administration, mainly in relation to the internal system regulation and the evaluation of the discrepancy between reported transactions on the side of both the supplier and buyer. On the basis of this experience, it is possible to state that each measure introduced to combat tax fraud requires a certain time before it starts fully functioning. At the same time, it turned out in the given case that the introduction of the reverse charge regime can influence for taxpayers not only the setting of accounting and other information systems, but for construction and assembly works, the necessity to regulate rules for drawing subsidy programmes was also its secondary aspect for subjects drawing funds for the construction

activity as part of public budgets. Last but not least, there was the situation that even in spite of all the efforts for the timely detecting and solving of the weaknesses of this regulation, some key problems were identified as late as during the actual practical application.

Further in practice, the introduction of the limit of CZK 100,000 for the application of the reverse charge regime for selected goods with effect from 1 April 2015 turned out to be a problematic point. It is obvious that in the event of the delivery of certain commodities (e.g. mobile phones, etc.) payers can also commonly purchase in retail stores, the determination of the financial limit for the reverse charge application can be appropriate. Nevertheless, in the cases of commodities traded as part of wholesales (e.g. delivery of metals), the determination of the limit can result in an increase in administrative burden resulting from the application of two types of regimes (both standard and reverse charge) for the identical commodity. Values for the limit determination can also be misleading, either in relation to the amount on the tax document or in relation to the value of the tax base of all supplied goods. Already in the first months of the limit application, there was a requirement from practice to introduce a similar fiction of the application of the contractual reverse charge regime between suppliers and buyers and also in the event of supplies of selected goods below the limit of CZK 100,000. Considering the fact that there is already a similar regulation in the Czech Act on VAT and the reverse charge application results in a decrease in tax fraud, it can be expected that this requirement will be added in the subsequent amendment to the government regulation or the Act on VAT.

The introduction of the reverse charge regime also has, of course, an impact on the cash flow of the state budget that is losing the advantage of continuous financing at the given moment as the tax will be collected as late as at the end of the distribution chain.

Interaction of domestic reverse charge implementation with other member states

In connection with the implementation of reverse charge for selected commodities separately, in terms of one member state, there is a question, whether such a fact can also influence other member states. This question is also legitimate in connection with the fact that one of the reasons why the application of the Czech Republic for the possibility to use reverse charge for fuels was denied was a concern of the European Commission about the "transfer" of such fraud to the neighbouring member states, and therefore about the violation of the internal market.

Although the experience with using reverse charge in the Czech Republic isn´t long-term in the context of the operation of harmonized VAT regulations, it is possible to say that the threat of the massive transfer of fraud to other member states needn´t be justifiable. Apart from the legislative and non-legislative tools used in terms of the fight against tax fraud also the economic and business environment of the given state have a great impact on whether there is any risk of transfer of tax fraud for the selected commodity after the introduction of reverse charge in the neighbouring country. It is easier to transfer the tax fraud in an environment where similar ways of trading with the selected commodity are set and also in an environment where other barriers are minimized, such as the language barrier or restrictions on market entry. The Czech Republic gained valuable experience related to the risk of the transfer of tax fraud in the past, namely in terms of the supply of used materials and scrap. In the Czech Republic, the reverse charge has been introduced for this commodity since 1 April 2011, which was one year later than in Slovakia and in Hungary. In view of the fact that mainly the traders from all three countries together participated in the fraud transactions with this commodity, when the reverse charge was introduced in other countries the fraudulent activities were transferred to the Czech Republic. Based on this experience it is important, that the neighbouring member states which have a similar economic and business environment mutually coordinate the introduction of reverse charge for selected commodities. Every member state should have the possibility to consider, during a sufficient time period, whether any risk of the transfer of tax fraud exists, based on their experience, and if it does, the regime of reverse charge should be introduced in the same time period.

Based on the gained experience it is possible to state that, while evaluating the risk of the transfer of fraud after the introduction of isolated reverse charge, not only the given commodity and economic and business conditions of each member state matter, but also other introduced tools for the fight against tax fraud. In case of commodities which are traded globally under the same economic and business conditions where there is a higher risk of fast and massive transfers throughout the whole EU, as it happened e.g. with emission allowances for greenhouse gases, it is necessary to enable the introduction of reverse charge in all member states in the same range and time, the best way is through the extension of a directive on VAT.

Currently, it is obvious that the efforts to gain individual reverse charge for a specific commodity (whether in the form of a quick reaction mechanism or based on individual derogation) within the existence of rigid approval procedures on the level of EU are very time-consuming and they don´t always lead to reaching the expected target.

Alternative possibilities of VAT fraud for the commodities subject to the regime of reverse charge

In connection with the introduction of the reverse charge regime, whether in the individual or global form, there is a question if any space for the realisation of tax fraud will still exist. You can´t expect that it is possible to avoid tax fraud with only one, albeit effective, tool. Even in case of reverse charge the tax fraud can be transferred to the last tax payer in the chain who will not pay VAT from the sales to final customers using currently existing schemes (e.g. entry into insolvency or immediate termination of contact). Therefore it is also necessary to analyze and introduce other tools which will together support the stable work of VAT.

Parallel tools for the fight against tax fraud

Even though the reverse charge can be considered an effective tool for the fight against tax fraud, its wide use is currently limited by the range of commodities approved on the EU level. For this reason it is also necessary to work with other tools in terms of the fight against tax fraud, which can be chosen within the scope set by the directive on VAT and the CJEU case law.

For these reasons, together with the gradual expansion of the reverse charge regime other legislative measures used for the fight against tax fraud were also introduced in the Czech Republic. These measures were chosen based on the analysis and evaluation of the character and principles of individual tax fraud which were available to the financial administration.

The amendment of the VAT Act effective on 1 April 2011 introduced a new institute of liability of the customer – tax-payer for the tax from the taxable supply in the country which wasn´t paid by the supplier who provided the taxable supply. The institute of liability is applied based on the evaluation of the following criteria: did the recipient of a taxable supply know or was he supposed to know and could know that one of the situations embodied in the provisions of section 109 par. 1 of VAT Act occurred? The liability is further

applied in cases where the tax wasn´t paid and at the same time one of the situations listed in section 109 par. 2 of VAT Act occurred. The situations are as follows:

- The price of supply is obviously divergent from the usual price,
- Payment is provided fully or partly cashless to the bank account held by a provider of payment services out of the country,
- Payment is provided to a different account than published (in cases where the payment exceeds the amount of CZK 540 000).

It is also possible to apply the liability for tax within the supply of fuels inside the country which is carried out by a person other than a distributor of fuels stated in terms of the law regulating fuels. Furthermore, the justified recipient can also be liable, which means the person who receives the selected products subject to the excise tax based on the authorisation issued by the customs office in the regime of conditional exemption from excise duty from another member state. This person is liable for VAT related to the sale of selected products in the territory of the Czech Republic.

The liability for tax can also be applied in cases where the taxable supply from the tax-payer who is labelled as a so called unreliable payer occurs. The payer can become unreliable when he seriously violates the obligations related to the administration of value added tax. The definition of what is considered a serious violation of obligations is set in the Information of GFŘ.

With effect from 1 January 2016, a control report is going to be introduced which will be submitted by the VAT payers together with the tax return. In the control report there should be detailed lists of selected transactions which will consequently be analyzed (paired). Based on the comparison of such details between the customers and suppliers it will be possible to identify organized connections of payers unjustifiably drawing the financial resources in real time.

Reverse charge in VAT – possibilities and limitations

Petr Toman

The core of the reverse charge system in VAT lies in the change of the person liable to report and pay VAT to the state budget. While in the standard regime the person providing a taxable supply (supplier) is liable for the payment of VAT, in the reverse charge regime it is the person receiving the taxable supply (customer). The use of this system is possible only in cases where two persons liable for the tax are involved in the transaction. Only these persons can become VAT payers or another type of person to which may arise liabilities in accordance with the principles of VAT (the Czech tax system knows such persons who are not tax-payers under the name "identified persons" – in the following text such a person is always identified as VAT payer, for clarity).

The reverse charge regime represents a possible tool for VAT collection, especially in two basic situations:

1) The supplier is not a VAT payer in the state where the place of supply is located, but the transaction is not extracted from the VAT regime.
2) There is a risk of tax fraud of the type "missing trader", for this transaction.

Non-resident persons

In the first case it concerns the situations where the supplier is located in a different state than where the place of supply of the transaction in question is. This type of reverse charge is normally used for the cross-border provision of services, in the Czech Republic also for the supply of goods with installation. In 2016, this type of reverse charge in general should be extended to any supply of goods when the supplier is a person non-resident in the country, which is not registered here for VAT and where the customer is a Czech VAT payer.

The situation when the customer reports and pays VAT instead of a non-resident supplier, because the customer is already registered for VAT in the state of the place of supply, leads to significant savings especially in the area of the costs of the tax administration, both on the side of the entity alone and also on the side of the tax administrator.

The supplier saves significant costs related mainly to registration for VAT and to fulfilment of tax duties in a state different from his home country. At the same time he does not bear any costs related to possible tax checks in the state of the place of supply. With regard to the fact that the supplier is not obliged to register for VAT in the state of the place of supply, possible costs related to the language barrier are also eliminated.

In relation to the payment terms there might exist some savings with respect to cash-flow and also on the side of the customer – recipient of supply (see below).

Such savings also arise on the side of the tax administrator who fully avoids the liability to certify application of VAT for distant entities which are often difficult to contact, thanks to the use of reverse charge in this case. It is possible to expect that especially for the entities located outside European Union even the delivery of documents themselves or the effort to perform the tax check can be quite an important problem, particularly if these entities do not have a local agent for tax matters. We also can´t ignore the language barriers, where the legal regulations essentially usually require communication in the local language.

Missing trader

However, the use of the reverse charge system brings significant advantages in the area of tax fraud in situations described as "missing trader". Those are such situations where the tax fraud occurs when the supplier in the standard regime states VAT in the tax document, but does not report this VAT in his tax return and does not pay it to the state budget. The supplier then follows the standard procedure when he claims the VAT deduction from the received taxable supply stated in the tax document in his tax return. In accordance with the VAT principles also certified by the case law of the EU Court of Justice the right of supplier for the VAT deduction claim cannot be shortened, unless the customer knows or could and must know that the VAT will not be properly paid by the supplier. In such situations significant tax fraud in the VAT collection occurs on the side of the state budget.

In many cases the tax administration is not able to identify such avoidances because the fraudulent supplier does not report the tax liability in his tax return. Even in cases where such a transaction is then identified – especially during the checking of the claim of deduction on the side of the customer and related cross-check of supplier – in such moments it is already not possible to contact the supplier and eventually chargeable tax on the side of supplier is not collected into the state budget.

Possibilities of the subsequent reduction of claims of VAT deduction on the side of the customer are then reduced by the case law of the EU Court of Justice only for situations where it is clearly shown that the supplier knew or could/had to know about the tax fraud on the side of the customer.

The application of the reverse charge regime successfully prevents the possibilities of tax fraud of this type. In case of the application of the reverse charge regime the supplier does not report VAT on the tax document for such a transaction (and does not have this liability), logically it also cannot happen that he collects the VAT from his customer, but does not pay

it into the state budget. The reverse charge regime therefore definitely and completely effectively leads to the avoidance of the possibility of VAT fraud of this type.

In a common chain when the customer is a VAT payer (B2B type transaction) and has the full right to deduction, the VAT represents only an accounting entry also on the side of the customer and the liability to pay VAT for the supplier is fully covered by the exercise of the deduction claim for the purchase transaction. In such a chain, VAT tax fraud cannot occur by its nature because VAT represents only an accounting entry and eventual deviations, e.g. by virtue of the use of an incorrect VAT rate, they are directly compensated also on the side of deduction.

The effectiveness of the reverse charge system in selected areas was certified both by local practise and also on the level of the European Union. Classical example of the suitable and very effective use of the reverse charge regime in terms of the European Union is the use of this system in the area of emission allowances. The way of trading the emission allowances where these allowances are traded almost exclusively by the entities liable for the taxes which have the full right for the deduction, is another example of the situation when any restrictions of the reverse charge regime use discussed below didn´t occur and couldn´t occur.

But also in cases of other commodities where the reverse charge regime was applied the investigations on the side of the financial administration available from the generally provided information confirm the prevention of tax fraud of the missing trader type for the relevant commodity and their transfer to the states which did not apply such a measure. It is possible to trace this fact in the Czech Republic to the trade with scrap or some crops.

Limitations of the reverse charge regime

Apart from absolutely unambiguous positives which the reverse charge regime brings, it is not possible to also ignore some limitations.

New types of tax fraud

Application of reverse charge regime creates conditions for other types of tax fraud. In this regime the VAT is basically paid always by the “last” entity in the chain, which delivers the goods or services to the person which is not liable to pay VAT (normally it will be a person which is not liable to pay tax, but it can also be a person which is liable to pay tax

which didn´t exceed the registration turnover). This point is then crucial for the proper VAT payment.

If an incorrect assessment of the type of customer occurs on the side of this "last" entity, there is a VAT fraud from the full amount of supplied goods or services. This can be caused both by the incorrect setting of the supplier´s system and by intentional fraud on the side of customer, when the customer provides incorrect identification data for the supply, including the tax identification number. The customer can then fraudulently realize the profit through further sale of these goods obtained without the tax.

That´s why it is possible to expect that the tax fraud in this system be concentrated mainly to such types of goods which are easy to sell further on the market and which usually don´t require certification of the way of obtaining or other evidence of ownership.

This type of tax avoidances can be traced today even for goods where delivery to another member state is declared, however the real delivery is performed in the home country. Although it is possible to partially limit this type of tax fraud via proper records and the reporting of transactions in terms of special recording obligations, the current systems of collective reporting used for the cross-border supplies represent a rather clumsy system which is difficult to use flexibly to practice. The evidence used in terms of domestic reverse charge is then probably a more suitable tool. The question, however, is if the flexibility of this controlling tool would not decrease in case of expansion of the reverse charge regime to other kinds of supplies because of the system being overloaded with tracing back the differences caused mainly by time shifts. The planned control report and its effectiveness can then give us many clues in this regard.

On the other hand, it should be noted that from the perspective of new tax fraud as described above, suitable candidates for reverse charge are for sure the commodities which are not usually traded by persons who are not registered for VAT. Unambiguous examples of this are the emission allowances mentioned above, a suitable candidate can then also be different semi-finished products intended for further industrial processing or energetic commodities in terms of trading among registered traders.

New entities responsible for VAT payment

In terms of the standard regime the supplier is the entity responsible for VAT payment. With respect to the application of VAT the responsibility is limited "only" to the correct VAT payment for the portfolio of provided services or supplied goods. For the majority of tax-payers it means only a limited group of similar types of products. The application of VAT,

especially the different rates, shouldn´t cause any significant difficulties to the responsible payer in such a system in standard situations.

In the reverse charge regime, however, this situation differs significantly. The customer, who used to rely on the information stated in the invoice, becomes the entity responsible for VAT payment. The range of different types of goods and services for which the supplier would be responsible for the correct calculation of VAT will usually be significantly larger and more diverse than in the standard situation.

In cases where the customer has the full right to deduct not even this situation should bring greater risks. Especially in cases where the tax administrator would use such procedure that the possible correction of VAT deduction would be fully compensated also with the modification of the relevant deduction. Any possible inaccuracies would then have only accounting impacts.

A totally different situation would occur for the entities which don´t have the full right to deduct VAT or are obliged to shorten the deduction. Many of these entities would actually become the person responsible for VAT payment for the first time. This situation may concern particularly the financial institutions, different educational facilities, non-profit entities, etc. In cases when such entities provide only exempt supplies without the right to deduct or when the range of their taxable supplies is minimal, they don´t apply the right to deduct VAT in the standard regime. In the area of VAT, no direct obligations arise for them in terms of domestic supplies and they therefore don´t have any practical experience with the payment and application of VAT. However, in the reverse charge regime these entities become responsible for correct VAT payment from all purchased supplies, using the correct VAT rate and the calculation of the correct amount of tax. There won´t be any limitation in the application of VAT only on the selected portfolio of provided services or delivered goods where these entities could be considered “specialists” in the given area, but it will be a matter of all purchased supplies from office supplies to materials, different types of services for businesses, to lunches in an employee cafeteria. The range of these supplies in combination with the limited experience of such entities with the practical application of VAT or the imperfection of their accounting systems which didn´t have to be faced with the issues of VAT so far might represent a significant limitation of the introduction of the reverse charge system. For these entities there would be a significant increase of costs related to tax administration, trainings and the checking of the relevant staff at the moment of transfer.

Reverse charge regime for selected commodities (specific reverse charge)

Currently the reverse charge regime is used only for selected supplies. Even this method, however, faces some restrictions.

Probably the most important restriction is especially the limited influence on the basic reason for the application of this regime, namely the prevention of tax fraud of the missing trader type. Practise shows that the introduction of a reverse charge regime for selected commodities does not prevent the transfer of fraudulent trading to other commodities or to different jurisdictions where the reverse charge regime wasn´t introduced for specific commodities. The coordination of procedures in terms of the European Union is therefore one of the prerequisites of the effective suppression of these structures.

Another important limitation is also the way of defining specific supplies on which this regime is applied. In terms of practice, especially the definition through different statistic codes or even nomenclature of customs tariff in combination with verbal definition might not be fully clear. This problem also occurs within the current definition of the reverse charge regime for construction works because of the definition through not always unambiguous statistic classifications or for the delivery of scrap and waste.

An important problem, especially of entities trading the same commodity on different markets, might also be a different definition of commodities where the reverse charge is applied in individual member states. The unambiguousness of definition, definition through local classifications or the non-coordinated use in terms of member states further greatly increases the administrative costs of the tax-payers and significantly increases the risk of the incorrect application of the VAT legal regime.

Value limits

It is undisputed that the application of value limits can help eliminate the basic deficiency of the reverse charge regime, namely the space for development of a new type of tax fraud – see above. It is possible to expect that individual transactions with entities which aren´t VAT payers will be lower in value than with entities which are tax-payers and where the reverse charge regime is expected. Introduction of the value limit eliminates the possibility of not applying VAT for smaller transactions where there is the highest risk that the counterparty is not registered for VAT.

At the same time, application of the value limit decreases the administrative burden for entities which supply goods in smaller volumes to a large number of customers, both payers and non-payers. The seller primarily doesn´t have to certify the type of purchasing entity for

supplies which don´t reach the value limit and in situations where the law enables it he can issue the same type of simplified documents to all entities.

The value limit, however, represents another complication of the reverse charge regime. Especially in cases where there are more documents issued for one supply (e.g. because of advance payments) or when some price adjustments occur after the realisation of taxable supply (Credit and Debit Notes) or there are more supplies shown on one document (whether it is a common document with more types of delivered goods or services or it is a summary tax document), the completion of value criteria might be unambiguous. Both transaction parties are then uncertain whether the chosen regime was applied in accordance with the valid regulations.

As for the entities trading in multiple states, the different amount of the value limit and its definition in local currency will also cause other administrative complications.

Impacts on the financial positions

Implementation of the reverse charge regime neutralizes the impacts of value added tax on the financial position of tax-payers. In situations where the VAT is paid by the entities with a full right to deduction from the purchased supplies at the same time when the right to deduction is applied, VAT becomes an irrelevant item in terms of financial flows.

On the contrary the standard regime brings a significantly larger playing field to the tax-payers in the area of financial flows. It is possible to reach interesting financial effects through requesting a longer maturity period for the purchased supplies or contrarily a shorter maturity period on the side of the provided supplies or speculation about the day of realisation of taxable supply at the end of the taxable period.

Equally on the side of the state budget, the application of the VAT payment system with a particular date and returning excessive deduction within a 30-day period enables the state budget to obtain interest-free financing. This effect gets stronger in cases of ongoing tax proceedings because of excessive deductions (leaving aside the question of a possible interest rate on such retained excessive deductions in accordance with the current practice of the courts). Implementation of the reverse charge system considerably eliminates this “interesting” side effect for the state budget.

Risk of financial instability of tax-payers responsible for payment of VAT

Last but not least, the reverse charge regime transfers the responsibility for correct payment of VAT in the full amount onto the entities which either don´t have any right to deduction or provide taxable supplies to entities which aren´t tax-payers. After the introduction of the reverse charge regime such entities would face significant tax liabilities corresponding to the relevant VAT from the whole realized turnover. In comparison with the standard situation where VAT is paid in each segment of the chain "only" from the value added by such an individual segment, in this case a significant payment liability cumulates in the last segment.

In case this segment of the supply chain faces financial difficulties, the collection of VAT from the whole value of the supply is threatened. There is another cumulating of risks arising from the correct collection of a significant part of tax revenues from a limited group of tax-payers.

Conclusion

In my opinion it is certainly possible to say that the application of the reverse charge regime is an important and effective tool for the prevention of tax fraud of the missing trader type. However, the same as with other measures, this one also has some limits which are necessary to monitor in the case of its implementation.

In terms of the efficiency of this tool in the area of tax fraud it seems appropriate to rather use the general reverse charge system and not its restriction only to selected supplies which enables the transfer of tax fraud to the commodities which are not subject to the reverse charge system. Such a procedure can, especially in the case of coordination among the member states, at least partly eliminate the administrative burden related to this system.

It is particularly possible to trace the limits of the reverse charge system in the concentration of VAT collection into the hands of a limited number of entities which can, in case of their financial instability, significantly threaten the payment of VAT. Also an effective system of checking the application of the reverse charge regime only in the relationships among the entities liable to tax (B2B) is crucial for the elimination of other types of tax fraud. From the current practice it is obvious that the use of tools such as summary reports isn't necessarily sufficiently effective for these purposes. Also a significant administrative burden, especially when transferring onto the reverse charge system, and the relocation of responsibility onto the entities which have in many cases never faced VAT issues before (entities providing exempt transactions without the right to deduction), can be another important argument against the introduction of this system.

A variant solution can of course be using VAT only for the supplies traded exclusively among the business entities. In these cases, however, there is a risk of transfer into other commodities and an urgency to use different tools in these areas.

Can the reverse charge of VAT be a way to the introduction of the flat tax?

Ladislav Minčič

When researching possible variants of the further development of the tax system in the Czech Republic, European Union and in the world itself a lot of different solutions are discussed. One of the possible ways was indicated more than 30 years ago by professors from Stanford, Robert Hall and Alvin Rabushka, elaborating a so-called flat tax. In the Czech Republic there was a discussion about the possible application of this concept in the late 1990s. It might give an impression to the general public and part of professional public that the flat tax was already introduced, with better results here and worse results there, because the term flat tax was and is used almost exclusively as a marketing abbreviation for income tax of physical persons with one percentage rate. In fact the flat tax is a term which should replace existing income taxes and value added tax. In the language of the terms commonly used today it is possible to describe the flat tax in many ways (Minčič, 2000, 2001 and 2002; Basham and Clemens, 2001), from the business view it is suitable to define it as the modification of VAT with a single rate accompanied by the complete cancellation of the direct taxation of profits. The application of the flat tax concept is more real in the view of increasing problems with the taxation of profits which is too mobile in today´s digital world. A large challenge for serious actual thought about the reform is the current unsatisfactory yield of VAT.

I continue to hold the hypothesis that the benefit of the application of the flat tax would be maximized if the transfer to it was a coordinated action of developed economies. The isolated introduction of the flat tax in one small open economy, such as the Czech one, would require us to enshrine such a volume of special regulations treating the compatibility with EU law into our legal order (if it is even possible to guarantee such compatibility) that the greatest advantage of flat tax, namely its simplicity and transparency, would be totally destroyed.

I have already stressed in the past that with regard to the stability of public finance and legitimate expectations of economic entities it would be a great hazard to follow the way of the so-called big bang and reform the current tax system overnight. A rational tax policy must divide the global targets into sub-steps alone with regard to the time limitations of election periods. A meaningful introduction of the flat tax in the environment of the Czech Republic must be based on sequential convergent steps in the area of both direct and indirect taxation. It would be useful to keep for a certain transitional period, respectively fluently reduce, some distortions to which the tax-payer got used to. Sequential implementation also enables an assessment of effectiveness of the realized sub-steps and alternatively correction of them based on practical experience.

In the stated context it is possible to consider the single percentage rate of the personal income tax introduced eight years ago as a step forward. Rather mixed is the assessment of the institute of the so-called super gross wage. It seems that from the two ways discussed in connection with the treatment of social security contributions which are deducted and paid by the employer as if "for himself", the more promising could be positioning these contributions as fringe benefits taxable on the level of the employer (Minčič, 2001).

Because the flat tax is in its deepest essence a direct taxation of consumption, for its implementation it is crucial to gradually reform VAT as the general indirect consumption tax. A suitable tool for VAT reform could be the introduction of a general reverse charge mechanism. In this sense it is necessary to clarify some especially historical ambiguities.

When the European Commission came up with the so-called Green Paper on the future of VAT at the end of 2010 and indicated variants of possible further development of this symbol of harmonized tax policy, it focused on the problems of the intra-community supplying of goods and services. With this emphasis, the way of tax collection while providing supplies from one member state of the EU to another, resp. the choice between taxation in the place of the origin of supply provided cross-border and taxation in the place of the target destination of the provided supply, goes along with deciding between the system of not using the reverse charge regime and the system based on the reverse charge. It is necessary to take note of the fact that the initial authentic vision of an all-Europe VAT expects the principle of consistent taxation in the place of origin. It is necessary to perceive this view in the context with other original ideas of the proper functioning of not only VAT in terms of the European Community. I mean the legendary idea of VAT with one low rate, a rate of the unified all-Europe value, the revenue of which would be a source of a common budget of an integrated Europe. Such a perception of VAT collection goes well together with the natural view on VAT administration organization inside the national state. Nobody is surprised that the company trading meat products with its seat in Olomouc declares and pays tax to the locally competent Financial Office based in Olomouc and not to the Financial Office in Ostrava, where the company puts the products onto the shelves, where the consumer chooses and buys the sausages, to eat them there with beer.

It is, however, a fact that already in the late 1960s when VAT was being introduced in the individual countries of the Community, the local politicians came up with higher and variously differentiated rates. During the implementation of VAT, its advantages over the retail sales tax were stressed. It is interesting that among the advantages there were such characteristics as its robustness lying in the spreading of tax collection to all industries and trades and the greater possibility to penalize dishonest payers, because in the production-distribution chain every issued invoice is a public declaration (Cnossen, 1987 and 1992). Academics advocating VAT proceed from the premise that the payers are a priori honest and if some of them aren't, high above them there is a sword of Damocles in the form of checked invoices, and he is under constant pressure from consumers and business partners. The gaps

in VAT collection in the Union countries revitalize the basis of VAT pioneers in tens of percent of the actual collection.

As for other advantages of VAT when compared with the retail sales tax , they are challenged by the existing practice, even though only at a lower extent – VAT should have been a significantly more effective tool for the taxation of services provided by small businesses. The existence of registration thresholds and special regimes is not only a well-sold thesis about the reasonable attitude of governments towards the excessive administration burden of small businesses, it is also an implicit admission of the incompetence of the state to collect taxes in the situation where the consumer and seller agree on a deal without tax. It seems that there isn´t and won´t be any fundamental difference between VAT and retail sales tax . Or the original expectations are still effective. As for the VAT the need of the payer to always distinguish whether the goods or services sold represent the final consumption or intermediate consumption is really eliminated. And for the same reason also another risk of the retail sales tax is eliminated, namely the one that in some cases it leads to multiple taxation of final consumption. It is interesting that in terms of cash flows and the ongoing payment burden of entrepreneurs even the VAT pioneers never claimed that this tax should bring any substantial improvement over the system of retail sales tax .

Another interesting thing is reminding about the past discussions on the comparison of VAT and retail sales tax in relation to the principles of taxation in the place of origin and in the place of the intended destination. While the VAT was granted the variability depending on the VAT type (consumption, income, or the gross product VAT) and the chosen method of the calculation of tax liability (so-called indirect subtraction, i.e. the tax credit method, the so-called direct subtraction or so- called addition method), as for the retail sales tax it was clearly noted that it represents taxation at the place of the intended destination. In the EU and also in other places in the world the VAT is almost universally applied in the consumption version, where the liability is calculated by the so-called indirect subtraction, which is meant as the usual difference between tax on the supplies provided and the tax on the supplies received. Such VAT is a tax collected in the place of the intended destination. I have already mentioned that the original vision of Union VAT expected the application of taxation in the place of origin in connection with the intended elimination of border controls, however it was managed to set up such procedures in intra-community business that even after the elimination of border controls the VAT works based on the principle of collection in the place of the intended destination.

In light of the above mentioned, it is possible to classify the general reverse charge regime for VAT as such a modification of VAT which connects both advantages of VAT as a universal consumption tax and the retail sales tax . In terms of taxable supplies realised domestically, VAT becomes the tax on retail sales which is paid by the payer who provides supplies to the final consumers, more specifically to the non-payers of VAT. In terms of the production-distribution chain, VAT is administered on the level of non-payment, the tax administrator

has an overview of the provided supplies in terms of the production and intermediate consumption based on the tax returns filed, however the entrepreneurs who don´t sell goods to non-payers don´t have the obligation on the payment level. As for the intra-community trade the reverse charge regime would correspond with today´s practice of VAT collection. The exports beyond the EU borders would still remain exempt from tax (the refund wouldn´t be returned, because the exporter would buy his/her inputs without the tax). The elimination of the gradual payment of VAT in the production-distribution chains would eliminate the opportunities of carousel fraud.

The regime of general reverse charge is neutral to the used VAT rates structure. Should the EU aim for a federal group of states, then the traditionally mentioned advantage of retail sales tax (Cnossen, 1987; Shoup, 1990) would be preserved in the reverse charge regime, namely its suitability for federal structure of countries, where every entity of federation administers its own version of VAT. In the context of EU law we understand the application of own, national tax rates.

There is an important fact that from the microeconomic view the general reverse charge reduces the double taxation of profit, resp. multiple taxation of added value, namely parallel payment of income tax (regular advance payments and annual offsets) and VAT (quarterly, monthly). Only the VAT payers who will provide the supplies to non-payers will therefore subjectively feel the double taxation, only in a volume corresponding to the value of such supplies.

In case the VAT reform led to the application of one rate after the generalization of reverse charge regime (comparison between the system with one basic rate and system comprising multiple rates is a topic for independent discussion), it would then be possible to transfer to the method of computation with the so-called direct subtraction technique, without decreasing the existing clarity of VAT. In the conditions of one rate there would be just the formal factoring out the factor before the bracket in case the amount of tax liability is computed as a product of tax rate and tax base, where the tax base would be calculated as the difference between the price of the provided supplies (tax exclusive) and the price of the received supplies (tax exclusive). For the entrepreneurs who wouldn´t provide their goods or services to tax non-payers, it would just be a formal change in reporting in the relationship with the Financial Office.

Ensuing steps would, in connection with the VAT harmonization in terms of the EU, require much greater courage from politicians and tax experts. The turning point of changes would be that the price of received supplies (tax exclusive) would also include the price of “services” received from the own employees, namely through the wage. At the beginning, it could be an adoption of services exempt from tax, similar to the situation when the payer purchases goods or services from a VAT non-payer, so on the payment level it wouldn´t change the liability of VAT payers. In the meantime there would have to be a reform of the

personal income tax – in the Czech Republic we have already gone through it – which consists of the introduction of one single percentage rate.

The decisive moment would be the step eliminating existing corporate income tax which would mean replacement of the parallel taxation of income, resp. added value, which occurs with the parallel application of income tax of legal persons and the value added tax. The replacement would consist of a significantly modified VAT called the tax on business (Minčič, 2001). At the same time, a narrowing of the linear tax subject for personal income tax would occur, which would become the so-called tax on employment (Minčič, 2001). The core of the significant modification of VAT would be the full inclusion of paid wages into the received supplies, not only as exempt transactions. The rate of tax on business and tax on employment would by set at a single percentage level. It would of course be different both from the original VAT rate and from the rate of corporate income tax, but in general also from the original rate of personal income tax and it would be set with regard to fiscal needs probably so that it keeps the existing revenue of the public budgets.

For the existing VAT payers who didn´t pay this tax in the reverse charge regime and paid only the income tax there would again be only one continuous payment liability, namely the tax on business. The VAT payers who provided goods and services to consumers and therefore they had payment liabilities of VAT and also in general of income tax, would also have only one liability of tax on business instead. The entrepreneurs using the services of their employees would withhold from wages and pay the tax on employment. The entrepreneurs (physical persons) who pay the personal income tax today would automatically become the payers of tax on business; modified VAT would change into the real general tax this way. Such physical persons would also become payers of tax on employment the subject of which would be such a part of financial income which they would use for personal (family) consumption. In spite of the unified rate of both taxes, namely of the tax on employment and tax on business, the entrepreneurs would probably decide for the declaration of "salary" paid to themselves only because they could use the personal deductible allowances, resp. credits for the tax on employment, for which there isn´t any right within the tax on business the same as within any other impersonal variant of VAT.

If the European Union kept the principle of taxation in the place of intended destination, the introduced reverse charge regime would be kept in case of intra-community trade. The value of supply provided by the entrepreneur into the other member country would be excluded from the supplies entering into the tax base of the tax on business. If Europe returned to the concept of taxation in the place of origin, the mentioned exemption from the provided supplies would not be applied – in the conditions of VAT as a tax on business with the absence of special taxation of profit, the final leaving of the reverse charge regime wouldn´t mean any significant increase of the risk of not collecting the tax. And as regards the treatment of effects of tax on business onto the international trade with third countries, it would be up to the European Commission, to negotiate international treaties solving

possible tax crediting in relation to the export, resp. import, depending on the chosen paradigm (origin versus destination principle) for the harmonized new VAT, even with possible different rates in individual member states.

In the end I would like to note that the purpose of this text is not to describe the system of flat tax, it is possible to find the description with many details in several different publications. The aim of the author was to show that the reverse charge regime can be used as a useful step towards the gradual introduction of flat tax. Such a view, however, does not fully cover the usefulness of the reverse charge regime. The reverse charge is rational even on its own, which means even without any connection with the flat tax.

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