

## Chapter 12

# Circular VAT Fraud by Transfer of Tax Liability: The Case of the EU

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### ABSTRACT

*Tax frauds with fake traders have existed since the 1980s and are certainly not a new phenomenon. Likewise, ways to fight against these frauds have existed since the moment they first appeared. Just as the frauds have evolved over time, so have the proposals for solving them becoming more sophisticated and comprehensive. With the development of the VAT system in the European Union, the methods of fraud are also developing, and over time the EU member states realize that they cannot fight against these frauds alone. The directive on the common system of VAT in 2006 represents the unification and the beginning of the joint fight of the member states of the European Union against these frauds. The EU member states systematically reinforced the measures of the common fraud prevention strategy. One such measure is the transfer of tax liability between the member states of the European Union.*

### INTRODUCTION

The issue of tax fraud is complex for several reasons, but the first thing that needs to be clarified is the very definition of tax fraud, as well as the definition of what this term is not. When referring to any activities that result in the reduction of government revenue from taxation, it is possible to group them into three main groups: tax avoidance, tax evasion and tax fraud. The concept of tax evasion in its simplest definition represents any attempt to reduce the taxpayer's tax payments in a legal way, for example through the exploitation of loopholes in the law (Kirchler *et al.*, 2003). This definition is very broad in nature and includes a large number of possible tax liability reduction activities. Devereux *et al.* (2012) therefore point out that it is neither possible nor helpful to try to find a single definition of tax evasion and further conclude that it is necessary to break down all evasion activities with the aim

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### ***Circular VAT Fraud by Transfer of Tax Liability***

of finding appropriate ways to limit such undesirable activities, through the appropriate legislature. It is possible to conclude that although tax evasion activities are of a legal nature, they are also subject to social undesirability because they result in a decrease in state tax revenues. Jelčić *et al.* (2008) define tax avoidance or tax evasion as resistance to paying taxes and a conscious effort to remove or reduce the unwanted effects of taxation. This resistance can be active (intentional) and passive (unintentional), for example by an honest mistake when getting used to a new system. Furthermore, the same author draws a distinction between legal and illegal tax evasion and equates illegal forms with the concept of tax evasion (Rafay & Ajmal, 2014).

Analysis of available statistical data on foreign trade confirms the existence of significant impacts of foreign trade on economic growth and income. A study by Frankel and Romer (1999) identified channels through which trade affects economic growth: a) specialization based on comparative advantages and b) diffusion of technologies through investment activity. As a rule, growth rates are higher in countries with a diversified export structure or that improve the quality of their exports regardless of the level of added value (Henn *et al.*, 2017), or in countries that are deeply integrated into global production and trade processes (Didier & Pinat, 2017). Factor analysis explains numerous components that influence the contemporary restructuring of the export system. This refers to the system of benefits and privileges for exports, which are offered by both exporting and contracting states (Abshari *et al.*, 2021).

For example, VAT tax benefits are an incentive for foreign trade participants to increase their export activity (Ainsworth & Alwohaibi, 2016; Zu *et al.*, 2020). The burden of VAT is borne by the end consumer, the key here is the interaction between the state (represented by its supervisory authorities) and business entities in the tax administration process (de la Feria & Schoeman, 2019). On the one hand, exporters receive state support, while customs formalities are simplified and computerized to the greatest extent possible. On the other hand, the number of disputes related to VAT refunds is increasing every year, the most important of which are disputes that fail to be resolved in pre-criminal proceedings. The European Union is actively discussing different models of combating fraudulent actions of entities that lead to differences in VAT (Van Doesum & Nellen, 2021) three key categories of actors are defined: end consumers, sellers and the tax administration must ensure the bona fide fulfillment of their duties (Poniatowski *et al.*, 2020). The negative impact of VAT fraud, as an illegal activity, creates some of the most dangerous consequences for economies (Fjeldstad *et al.*, 2020; Pouwels, 2021), and such activities could be directly or indirectly involved in the financing of terrorism. The most important instrument to combat VAT fraud is the development of international cooperation (Ding *et al.*, 2021) and the use of modern technologies (Kowal & Przekota, 2021). In recent years, research in the field of VAT application has been more focused on improving the effectiveness of tax control (Mitusova 2021), improving the quality and efficiency of tax administration (Zhirova, 2017) and minimizing the risk of tax fraud and developing methods to reduce the scope of shadow business (Gurdgiev, 2019).

Tax evasion is closely related to the gray economy and such activities have significant economic and social consequences because they directly reduce budget revenues, and thus the quality and availability of public services (Šimurina *et al.*, 2018; Walker-Munro, 2021). It is important to conclude that the result of tax avoidance as form 4 of legal tax evasion is the same as that resulting from illegal tax evasion, which is the reduction of state revenues from taxation, and as such it represents a major problem for the state. Tax frauds with fake traders have existed since the 1980s, and are certainly not a new phenomenon. Likewise, ways to fight against these frauds have existed since the moment they first appeared, and just as the frauds have evolved over time, so have the proposals for solving them becoming more sophisticated and comprehensive. With the development of the VAT system in the European Union, the methods of

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