Chapter 7

The Usual Price Rule as a Tool to Detect a VAT Fraud

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7.1. Introduction

Tax fraud has a long-term negative impact on public budgets and primarily target the abuse of taxes for one's own enrichment. At the meeting of the Economic Committee in the Chamber of Deputies of the Parliament of the Czech Republic (2013), it was even said that some fraudsters consider themselves entrepreneurs in VAT (Value Added Tax). They basically do not care whether they trade in fuel, scrap iron, plastic cards, electronics, fish, or wood (Ministry of Finance of the Czech Republic, 2014).

According to European Commission statistics (2017), Member States lose about EUR 100 billion a year to fraud. This is a huge loss that significantly deepens the public budget deficit, and it is clear that the efforts are made to fight fraud. An example may be the introduction of a reverse charge for risky commodities and services, and in the event of sudden misuse of other subject-matter transactions, a rapid reaction mechanism may be used. Individual states are trying to fight fraud even in domestic adjustments. In addition to the mandatory submission of the recapitulative report, the control report is also used (Semerád & Bartůňková, 2016), which is intended to notify the tax administrator in the event of a suspicious report to initiate inspection activities of the identified entity.

Value-added tax is claimed to be resistant to tax fraud[1], and it is one of the best-harmonized taxes within the European Union. It is also popular because it allows cross-border trade, even

[1] The claimed resistance to tax evasion is based on the fact that the recipient of the taxable supply needs a tax document issued by the seller to claim the deduction. Although there are machinations where end customers (consumers) can agree with the supplier on delivery without a tax document, which does not include value-added tax in the final price, most supplies do indeed include VAT (Semerád et al., 2021).

though it is becoming the riskiest part of the entire chain. Not only in the context of intra-Community supplies, the tax administrator relies on the honesty of taxpayers. If they do not want to pay the tax, the state in which the recipient of the taxable supply operates will lose the entire output value-added tax (Pfeiffer & Semerád, 2013).

The model of these so-called carousel frauds[2] is based on the principle that the entity responsible for self-assessment of tax intentionally fails to meet its tax obligation. In addition, the real organizers hide from the tax administration behind disadvantaged people who either do not understand the consequences of their behaviour at all or do not have enough information about it. The problem is also that business entities abused for tax fraud do not have a long life, usually a few days or weeks, but no longer than a few months (not counting the time during which this empty shell hibernates). Subsequently, they end up as non-contact, and their place is taken by another pre-prepared entity.

Thus, it is clear that the mere reporting of taxable supplies is not sufficient to combat tax fraud as it is usually too late to remove them. Countries thus shift their attention to the recipients of taxable supplies and try to prove to them at least their awareness that their supplier may have been involved in tax fraud. This effort is linked to the judgments of the European Court of Justice (2006a, 2006b) which allow the tax administrator to refuse the right to deduct tax payments from an entity that should and could have known that its supplier was part of a fraud.

However, this proof is very lengthy and complicated because these types of fraud are very well organized and involve several hundred entities cooperating with each other. An example is the Moby Dick case, in which more than 400 companies were involved, in what was supposed to be a fraud of EUR 520 million (Europol, 2024). Legislators must therefore come up with additional conditions that, in the event of a violation, increase the likelihood that it will be possible to deny the right to deduct and claim a liability for unpaid tax.

Since each country can adjust the conditions in accordance with Council Directive 2006/112/EC according to individual needs, the authors focus in this chapter on the conditions that are effective in the Czech Republic, mostly on the Liability for Unpaid Tax in the event that the subject of performance was provided for an unusually low price, also sharing the possibility of avoiding liability.

7.2. Liability for Unpaid Tax in the Czech Republic

Carousel fraud is based on the principle (Fig. 7.1) that the exemption from value-added tax is abused when goods or services are supplied to another Member State. The supplier can claim its inputs but invoices without value-added tax.

The recipient of the taxable supply becomes the Missing Trader, whose obligation is to self-assess the tax (reverse charge mechanism). The subject of performance is supplied by Buffer Trader 1 with local value-added tax. The problem is that the Missing Trader only collects the payment but does not pay the value-added tax to the state within the legal deadline. This is the weakest point in tax administration. The subject of performance is further resold to other entities, e.g. Buffer Trader 2 and a Broker. From there, the subject of supply goes to another Member State, and the carousel of sales continues.

[2] Missing Trader Intra Community Fraud (MTIC).

The basic prerequisite for successful trading in carousel fraud is time. The faster individual trades can be executed, the greater the return on each turnover. To make it harder to monitor transactions, fraudsters use, for example, foreign collection agencies, and the money does not pass through the accounts of fraudulent companies at all. By the time fraud is detected, it may be too late for the tax administrator to intervene.

In order to make deliveries as quickly as possible, fraudsters use a very accommodating pricing policy, selling the subject-matter of performance at a lower price than the price for which honest competitors sell their products, goods, and services. If these price wars last for a long time, it can cause irreversible market distortions. In order for honest entities to survive, they have to adapt and can themselves participate in some carousel frauds (Semerád, 2014). It therefore depends only on the speed of legislators how quickly they can implement tools into domestic case law that will help tax administrators in taking evidence.

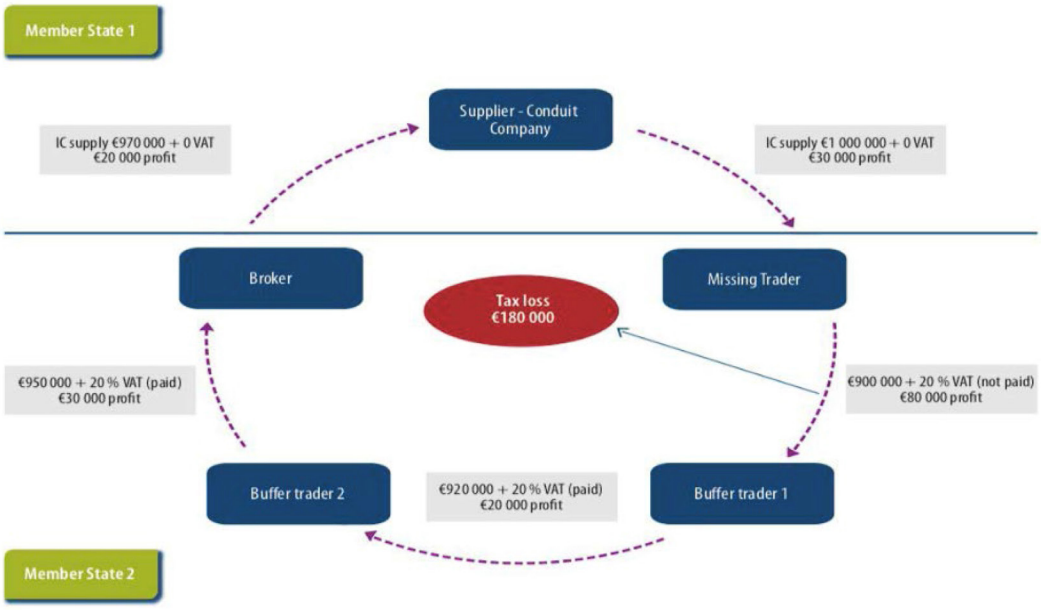

Fig. 7.1. Example of carousel fraud including real amounts

Source: (European Parliament, 2021).

In the Czech Republic, several conditions have been gradually introduced that expose the recipient of taxable supply to a Liability for Unpaid Tax. In addition to the obligatory condition, based on the assumption that the recipient of the supply should have known and could have known, the law gradually introduced (i) the obligation to pay to registered bank accounts, (ii) trading only with registered entities, (iii) the institute of an unreliable payer, and (iv) trading at market unusual prices.

7.2.1. Registered Bank Accounts

In the past, it was the case that the provider of taxable supply could write any bank account on the invoice. The recipient of the taxable supply thus paid invoices not only to the provider's account but also to the accounts of various collection agents in the Czech Republic and abroad.

The reason was to prevent the tax administrator from freezing the accounts of entities that it suspected may be part of a fraudulent group.

Therefore, the tax administrator introduced the obligation for all taxpayers to register their bank accounts with the tax administrator. The tax administrator has thus collected all bank accounts, the list of which is listed for each taxpayer on a publicly accessible website (Fig. 7.2).

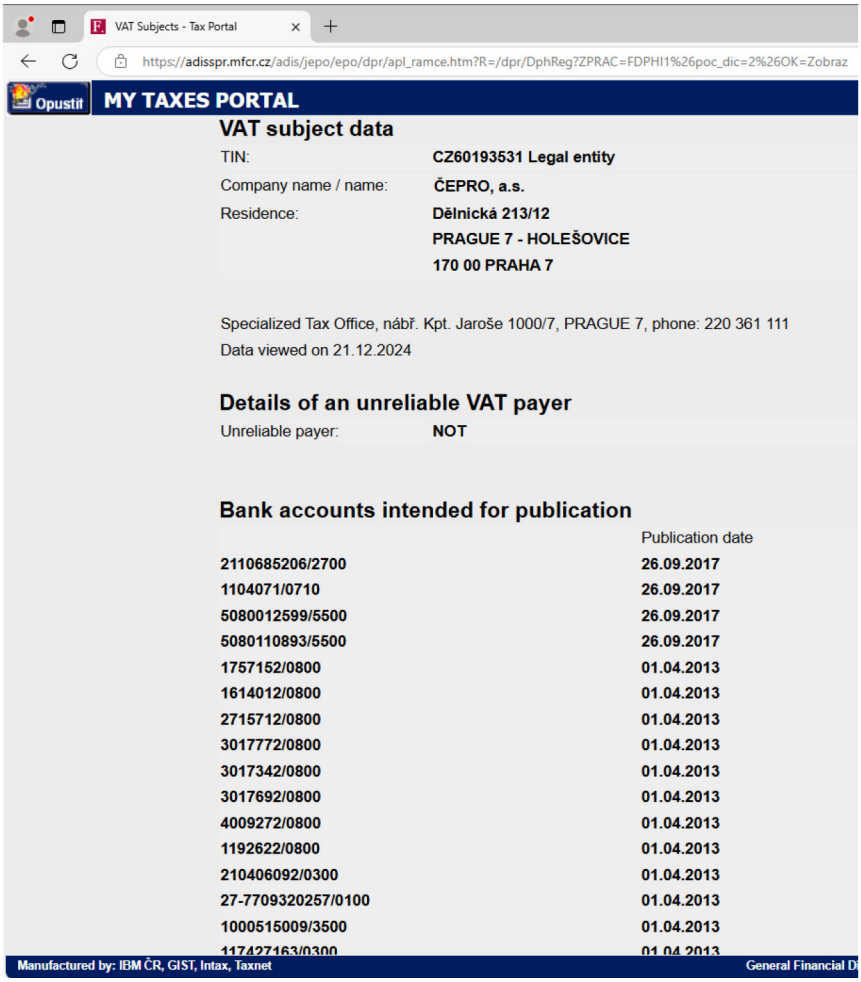

Fig. 7.2. Verification of information on VAT payers

Source: (General Financial Directorate, 2024b).

All customers can verify:

- whether the entity is a payer of value-added tax,
- what is the legal name of the entity,
- where it is based,
- whether it has been identified as an unreliable payer, and
- what are its bank accounts registered with the tax administrator.

This provides several benefits, the main one being that it is possible to automatically check any changes on the part of the taxable supply provider using, e.g. accounting software and to ensure that the payment is made to the correct account (Semerádová & Semerád, 2022).

The logical 'disadvantage' is that if the recipient of the taxable supply pays into an unregistered account, they run the risk of guaranteeing the unpaid tax. In practice, this works in such a way

that if the provider of the taxable supply fails to meet its tax obligations, they can be recovered from other entities in the chain.

7.2.2. Trading with Registered Entities

Since the 1990s, fuel has been the subject of huge tax fraud in the Czech Republic. It started with imports of light fuel oils, which were sold as diesel fuel at Czech filling stations. This led to excise tax fraud, as light fuel oils had a lower tax burden than diesel fuel.

After the Czech Republic joined the European Union in May 2004, fraudsters created space for 'standard' carousel fraud. Their greatest expansion was around 2010, when fuel fraud was estimated to amount to EUR 160-320 million (David & Semerád, 2014; Office for the Protection of Competition, 2012-2013).

For this reason, a register of fuel distributors was first created, and then a condition was set that distributors must pay a deposit of EUR 800 000 to the bank account[3] of the customs administration (e.g. Semerád, 2014). This circumstance has been implemented into the Value Added Tax Act:

"The recipient of a taxable supply, which consists in the supply of fuel by a fuel distributor under the Fuel Act, is liable for the unpaid tax on this supply, unless at the time of its performance or provision of consideration for the taxable supply the fact that the provider of the taxable supply is registered as a fuel distributor under the Fuel Act is not disclosed in a manner allowing remote access" (Section 109, paragraph 4, of the Value Added Tax Act).

As follows from the statutory provision, the recipient of the taxable supply must purchase only from entities that are registered as fuel distributors.

7.2.3. Unreliable Payer

Trading with unreliable payers is another situation where the recipient of the taxable supply is exposed to a Liability for Unpaid Tax. An unreliable payer is a taxpayer who is listed in a public database of VAT payers (Fig. 7.1) and who has had or has tax arrears towards the tax administrator (Semerádová & Semerád, 2022).

"The recipient of the taxable supply is liable for the unpaid tax on this supply if, at the time of its realization or the provision of payment to him, the fact that the provider of the taxable supply is disclosed in a manner allowing remote access that he is an unreliable payer" (Section 109 (3) of the Value Added Tax Act).

The only way to avoid a guarantee is to use special tax security (Section 109a, par. 1 of the Value Added Tax Act), which allows the taxpayer to pay value-added tax directly to the tax administrator's account (only the tax base is paid to the provider)[4].

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[3] After the ruling of the Constitutional Court of the Czech Republic (2014), this obligation was reduced to EUR 400 000 for smaller distributors.

[4] "If the recipient of the taxable supply pays tax on such taxable supply on behalf of the provider of the taxable supply without being called upon as a guarantor, this payment will only be used to pay the tax of the provider of the taxable supply on this taxable supply".

7.2.4. Usual Price for Taxable Supply

However, the main topic of this chapter is the Liability for Unpaid Tax for taxable supplies that are not realized at usual prices[5] (Section 109 (2) (a) of the Act on Value Added Tax):"The recipient of the taxable supply is also liable for the unpaid tax on this supply if the consideration for this supply is clearly different from the usual price without economic justification."

Yet, this provision is very problematic since for registered accounts, unreliable payers, and fuel distributor registration, there is a publicly available database that can be used before the business transaction is carried out. In the case of normal prices, there is no publicly available resource and it is up to the recipient to make a price comparison of multiple sellers according to their possibilities. Even so, the cheapest of them does not have to be a scam – it is just the cheapest. The question is rather how the price was created, and this is not always easy to determine.

Returning to the issue of wholesale sales of fuels[6], it is necessary to know the market habits:

1. Fuel is supplied from tax warehouses.
2. Road freight transport is used for distribution to petrol stations. Tanks have a capacity of more than 30,000 l.
3. There may also be several registered distributors among tax warehouses and petrol stations who resell the goods.
4. If the goods come from the Czech Republic, there is not much room for tax evasion (with the exception of excise duty fraud), as the margins are in the order of a maximum of EUR 0.02 per litre (Semerád, 2014).
5. On the other hand, supplies from other Member States are risky and opens up space for carousel fraud (approx. 0.25 CZK/EUR).
6. Standard items (1) must be included in the calculation of the usual selling price (PS).

$$P_S = (P_P + E + M + C_{TR}) \times VAT_R, \tag{1}$$

where: P_P – acquisition price in the tax warehouse, E – excise duty on mineral oils, M – the fuel distributor's margin, C_{TR} – transport costs, VAT_R – value added tax rate.

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[5] "When determining the price, the usual tax administrator bases its decision on the provisions of Section 2 (1) of Act No. 151/1997 Coll., on Property Valuation and on Amendments to Certain Acts (the Property Valuation Act), as amended. This provision considers the usual price to be the price that would have been achieved in the sale of the same or similar property or in the provision of the same or similar service in the usual course of business in the Czech Republic on the date of the performance. In doing so, it is necessary to take into account the individual circumstances of the case, which may have an impact on the price. However, the amount of the usual price does not reflect the effects of extraordinary market circumstances (e.g. the seller's or buyer's distress, the consequences of natural or other calamities, restrictions on competition in the given sector), the influence of the personal circumstances of the seller and the buyer (e.g. property relations – economic or capital dependence, family or other personal relationships – personal dependence) or the influence of special popularity (i.e. special value attached to property or services resulting from a personal relationship to them, e.g. emotional relationship to the subject of performance). The usual price can be determined by analysing the agreed prices in the market segment of comparable property or service at a given place and time" (General Financial Directorate, 2021).

[6] The fact that fuel fraud is a serious criminal activity in the Czech Republic is evidenced by the statistics of the General Financial Directorate, where the total extent of additional tax administration assessments amounted to CZK 20 billion (2008-2012), of which 27% was fuel (Chamber of Deputies of the Parliament of the Czech Republic, 2013).

Since prices in tax warehouses change on a daily basis, it is necessary to assess whether the price is available on the market (it could have been created without tax fraud) before each order. The problem, however, is that the sale prices are not publicly available, therefore, if the customer does not buy from other entities, they usually do not provide such information. An exception in the Czech Republic is ČEPRO a.s., whose 100% shareholder is the Ministry of Finance of the Czech Republic. However, publicly available price information is only basic and does not take into account individual price offers from other customers.

Let us assume that the taxpayer will use the basic price of ČEPRO a.s. Then he/she should know that there is a possibility of temporary stocking in tax warehouses, which works on the principle of speculating on price growth. If the distributor believes that there will be an increase in prices, they can buy the goods before the price increases, leave them in the tax warehouse, and sell them later. This allows it to generate more profit while offering its customer a lower price, yet this was not created by tax fraud. Tax warehouses charge a fee for this stocking. It is therefore necessary to take into account the cost of this transaction, namely the price of P_p acquisition plus storage fees. Note that, their amount is known only to the provider of taxable supply (seller).

A certain alternative to obtaining information is the General Directorate of Customs, which has information on the purchase and sale prices of distributors. The problem is that even this information is not publicly available, and it can only be obtained on the basis of a request under the Act on Free Access to Information, which the office has 14 days to evaluate. Given such a delay, it can only be guessed what the current usual selling prices are. Even obtaining data from the General Directorate of Customs may not mean successful. As the results of Semerád (2014) showed, they contain errors. Distributors also entered prices without excise tax in the database, which created differences of almost CZK 10 per litre.

7.2.5. Liability for Unpaid Tax – Application by the Tax Administrator

As this is a relatively complex issue, the authors asked the General Financial Directorate (2024) how many times the liability for unpaid tax on fuel was applied. The answer was that the tax administrator could not provide analytical information on how many times the guarantee was applied to fuel due to unusual prices.

The only information subsequently received was the sum of all liabilities for unpaid tax without distinguishing the reasons (Tab. 7.1). A total of 3,656 guarantor notices were issued during the period under review. With regard to the number of transactions between payers, this is an almost negligible amount; the largest number of calls (3,428) were sent between 2016 and 2020.

Table 7.1. Number of calls for liability for unpaid tax in the period 1.1.2011-15.11.2024

Year of publication	Number of challenges	Year of publication	Number of challenges
2011	1	2018	963
2012	1	2019	923
2013	2	2020	305
2014	14	2021	52
2015	46	2022	30
2016	284	2023	61
2017	953	2024	21

Source: (General Financial Directorate, 2024a).

The year 2016 was specific in that two instruments against tax evasion began to be applied. In the case of invoices, it was the control report (Semerád & Bartůňková, 2016) and Electronic Records of Sales (Semerád et al., 2024).

7.2.6. How to Circumvent the Arm's Length Clause

The low number of calls for liability for unpaid tax may also be due to the fact that although sales take place at usual prices, they are associated with other harmless-looking accompanying activities that additionally reduce the price – e.g. the Cash Back and Free Shipping method (Semerád, 2016). Their detection requires very detailed analysis, which is not humanly possible outside of targeted inspections. However, artificial intelligence in combination with ViDA (VAT in the Digital Age), a concept involving the online exchange of information in cross-border transactions within the European Union, could be of help.

The Cash Back method is also known from offers for common consumer. The customer buys the subject-matter, pays for it, and fills in a form, on the basis of which the seller or manufacturer will refund part of the purchase price. In the event of a fraudulent transaction, the payment is likely to be mediated through a third party. This will break the direct ties between the seller and the buyer, making it more difficult for the tax administrator's analytical unit to supervise and match the transaction.

The Free Shipping method is based on the principle that goods are delivered at a seemingly usual price but already include shipping, which will no longer be invoiced. Transport costs for fuel are based on the kilometric zones between the tax warehouse and the petrol station. Distributors with their own fleet of tankers can incur these costs at the expense of their margin, and if external carriers are used, the transport will not be re-invoiced to the customer. This supply may again be difficult for the tax administrator's analytical unit to trace.

7.3. Conclusions

Tax fraud, especially carousel fraud, significantly distorts the market environment. It also causes huge losses on the revenue side of the state budget, as value-added tax, which should be properly paid to the benefit of the states, ends up with the organizers of the tax fraud. It is estimated that EU countries lose about EUR 100 billion in VAT fraud. The common tax calculation mechanism – in the case of intra-Community supplies under the reverse charge regime – may not be sufficiently robust.

A turning point in this area was brought the judgments of the European Court of Justice, which made it possible to refuse the right to deduct supplies for which the recipient should and could have known that they were affected by tax fraud. Gradually, it also came to the point that the tax administrator could require a Liability for Unpaid Tax in the case of such supplies if the provider of the taxable supply did not meet its tax obligation.

In the Czech Republic, the performance for which guarantees can be applied has been clarified. This includes (i) the provision of a payment to a bank account of the beneficiary other than the one registered with the administrator, (ii) the payment recipients who are identified as unreliable payers, (iii) trading with entities other than those authorized (e.g. fuel distributors), and (iv) trading at prices other than usual.

In this chapter, the authors focused mainly on the problem of identifying the usual price for fuel. It is practically impossible to set such a price, as there is no real-time price information (with the exception of ČEPRO a.s.). It is also problematic to identify unusual prices when fraudsters use, for example, the Cash Back or Free Shipping method. In this way, it is possible to additionally reduce the prices of goods that otherwise appear to be normal prices through inconspicuous transactions.

Perhaps for this reason, the tax administrator does not apply the liability for unpaid tax more often. Between 2011 and 2024, there were a total of 3,656 guarantor calls, which is almost negligible in the total number of transactions carried out by Czech VAT payers. However, it is still a tool that has great potential and can be used in other (not only) Member States of the European Union.

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