

# Reverse Charge as a Mandatory or Optional Tool to Fight Tax Evasion

VERONIKA ĎURIŠOVÁ, JITKA ZBORKOVÁ

Department of Finance and Accounting

University of West Bohemia

Univerzitní 8, Pilsen

CZECH REPUBLIC

ver.dur@centrum.cz, <http://www.fek.zcu.cz>

prochaz2@kfu.zcu.cz, <http://www.fek.zcu.cz>

*Abstract:* This contribution deals with the value added tax problematic with the emphasis on the reverse charge. The main characteristics of the VAT are defined and analyzed and the reverse charge regime is defined from the point of view of the EU Council Directive 2006/112/ES as well as the Czech VAT law. This article introduces reverse charge as one of the possibilities to prevent or even eliminate tax elusions. It explains the duty and possibility to apply reverse charge from the point of view of each member of the EU. The variability of approaches is discussed and illustrated on the example of gold trade to apply the reverse charge. As a conclusion a case study from the Czech Republic is presented where the reverse charge is applied in larger extend, mostly for building and assembling services. This fact influenced a huge number of the subject that weren't experienced with this way of taxation and brought them many complications at the beginning. The reverse charge is applied here to pursuit a prevention of the tax elusion as the amount of the building contracts are usually very high. Despite the fact that it would be naive to expect total disappearance of the tax elusions, the reverse charge is supposed to be effective and advantageous and its expansion is anticipated.

*Key-Words:* Value Added Tax, Reverse Charge, Tax Evasion, Construction and Installation Works, Council Directive 2006/112/EC

## 1 Introduction

Since the first human communities, we can find different examples of the different amounts paid by the members of the community to secure the common needs. Character, structure and the way of collection the taxes changed a lot throughout the history, mostly in connection with the development of the different taxation theories. These days, the principles of the optimal taxation system formulated by Adam Smith as Canons of Taxation, are still valid. The first principle says that every person should pay to the government depending upon his ability to pay. The mode and timing of tax payment should be as far as possible, convenient to the tax payers. Finally, the cost of collection must be low and the government should put an effort into making it economical [1].

Even though the principles applied in the current taxation systems are mostly coincident with the Smith's Canons of Taxation above, they lack their simplicity due to the throughout the year development. The value added tax is the part of the taxation system in most of the developed economies and represents one of the fundamental incomes of

the state's budget. The VAT widely spread in the 80s when implemented in most of the European countries and became one of the conditions to become a member of the EU [2].

It is possible to identify several advantages that caused the replacement of the cascade cumulative turnover tax with the value added tax system. One of the basic advantages is the possibility to impose a tax on the services that prevail in the market economies nowadays. Furthermore the tax neutrality is another advantage, as an external tax neutrality that guarantees the equality between the domestic goods and the import, and as an inside tax neutrality when the tax can't jeopardize the market competition. As the VAT is closely linked to the consumption, the revenue of such tax is relatively reliable and predictable [2].

## 2 Problem Formulation

*„The journey of the civilization is paved with the tax assessments.“*

Spiro Theodore Agnew

## 2.1 Advantages of Reverse Charge

The reverse charge system is based on the transfer of the tax calculation and its payment from the supplier to the recipient. The recipient can therefore claim the tax deduction but at the same time must bear the cost of the tax. If there is no disproportion, there is no actual finance movement and the recipient only reports the acceptance of the reverse charge at the relevant authority.

Primarily, this mode represents the tool to guarantee the external tax neutrality in the VAT system. It is used to impose a tax on the international transactions among the states of the EU, where the VAT rate is different and the distortions may arise. For example, when exporting from one EU country to the other, where the place of the tax is the other country, the purchaser is required to pay the tax in the country and only pay the price without VAT to the supplier. Therefore, the supplier is not disadvantaged when compared to the domestic suppliers.

Secondary, the mode combats with the tax elusions which become frequent in the system where the reverse charge is not used.

According to the information taken from the website of the European Committee, the difference between the real VAT income and the VAT income that could have been received, reaches 12% (20% in some countries) [4]. As the most common way of the tax elusion is issuance of the invoice by the economic subject that subsequently disappears without paying the tax while the valid invoice is left in the tax system, the reverse charge mode seems to be the most effective. The services and goods prone to tax evasion were identified by the analysis in different EU countries and the opportunity to apply the reverse charge mode was given to these countries to combat the tax elusion [5].

## 2.2 Reverse Charge and Tax Evasion

The value added tax is considered to be very significant for the state budget revenue as it is not only the most profitable tax but it's paid throughout the whole fiscal year as well. It is the neutral tax that enables to tax services and goods at the final consumer. However, the current situation is a natural reluctance of taxpayers to pay taxes and everything with the similar character. It may be done in a lawful way such as tax optimization or in an unlawful way such as tax evasion. Of course, the tax administrator hence the state (through its legal representatives) reacts to this situation by gradual changes and amendments of tax laws. In the VAT

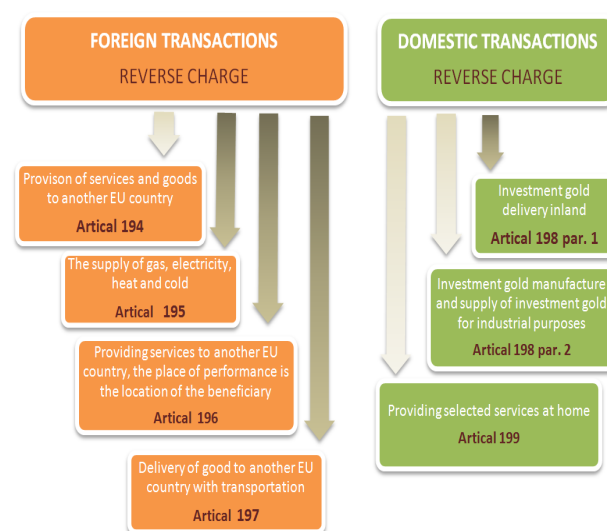
area, currently widely used method appears to be just the reverse charge mechanism. The primary purpose of this paper is to describe and interpret the reverse charge procedure and discuss its use to combat tax evasion.

## 3 Problem Solution

A Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax plays the leading role in the VAT adjustment. It is possible to identify two basic areas for the reverse charge application in this Directive, specifically in Articles 194 to 199. The areas have been outlined above - the area of foreign transactions among the EU member states, and the area of domestic transactions.

In both of these areas, there are two possible approaches in terms of eligibility that the European Union uses towards the member states. The first approach is the mandatory application of the reverse charge by all Member States in selected transactions. These transactions are mainly foreign transactions and it is necessary to achieve integrity in them throughout the European Union, Figure 1 shows them as the dark arrows. On the contrary, the light arrows indicate the transactions where the Member States are given choice. The application of the reverse charge is optional in these cases. The above mentioned selected services identified as prone to tax evasion fall into this category.

**Fig. 1: Reverse charge breakdown in Council Directive 2006/112/EC**



Source: own, 2013

### 3.1 Application of Combined Approach

Illustratively, the variability of the approach to the application of the reverse charge can be shown on the gold trading example. Transactions related to gold, from the perspective of VAT, are complicated mainly because gold is not only used as an input to the production process but also for investment purposes. The normal mode of VAT may cause a major obstacle to the use of gold in financial investments and thereby reduce the international competitiveness of the gold market within the European Union. Additionally, the investment gold operation do not differ much from the other financial activities which are exempt from tax.<sup>6</sup> For these reasons, the application of VAT to the supply of gold diverse a lot. The starting point for determining the taxation of gold transactions is Article 198 of Directive 2006/112/EC. The three different situations are distinguished as shown in the Fig.2

The first option is to allocate the exemption to the Member State (given by the Member State Committee for VAT) to specific transactions relating to investment gold which would otherwise be exempt under financing activities. In this case, Member States are obliged to apply the reverse charge for such taxable transactions, as given in paragraph 1 or Article 198.

The second option is defined in paragraph 2 of Article 198 and does not define the reverse charge as mandatory but only optionally. The Member State has a right to decide whether to apply the reverse charge or the standard method of taxation for the supply of:

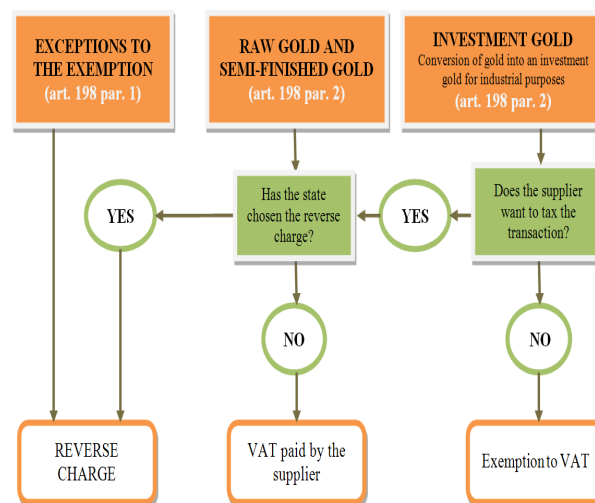
- unrefined gold,
- semi-finished gold of purity of 325 thousands or higher.

The last option is covered in paragraph 2 of Article 198 as well, combining not only the right of choice on the side of a Member State, but also on the supplier side. The supplier has a possibility to choose whether to waive the exemption of tax which he would otherwise be entitled to. The option to waive the exemption is for those taxable subjects who:

- produce investment gold, transform gold into investment gold,
- normally supply gold for industrial purposes.

If the taxable subject supplying any of these kinds of gold decides for taxation, it is up to the Member State to make a decision on who is going to pay the VAT, the supplier or the purchaser, and therefore whether the reverse charge will be applied.

**Fig. 2: The reverse charge application in the gold supplies**



Source: own, 2013

For example, only two possibilities for the application of the reverse charge are used in the Czech Republic, because VAT Committee agreed no exception to the exemption under Article 198 par1.

Firstly, the supply of raw gold and other semi-finished gold materials are subjects to reverse charge. Secondly, when the payer producing investment gold and supplying gold for industry waives the exemption to VAT, it becomes the subject to the reverse charge, according to the choice of the Czech Republic.

### 3.2 Reverse charge case study in a large extent - Czech Republic

In the cases described above it is a situation which affects a very small number of businesses and therefore can not be assumed that there could be greater organizational problems when applying the reverse charge. The opposite situation occurred in the Czech Republic on 1 January 2012, when the construction and installation works were included in the reverse charge.

This step made many VAT payers to get in touch with the reverse charge that had very little or no previous experience with it. Because of that, it was necessary to clearly define the range of construction and installation works, provide control options of reverse charge application and set rules for the transition between 2011 and 2012.

The first problem was solved using the European classification CPA and the construction and

installation works were defined by the code 41-43. Even though it seems as a very effective solution from the legislative point of view, the disadvantage of this classification is that it is relatively new and many companies did not get in touch with it before 2012. The classification without professional help is therefore often difficult and a variety of consulting services is often used. However, the consulting companies can provide only a non-binding classification. Binding classification is provided by the Czech Statistical Office, which, however, provides the information to the private subjects for statistical purposes only. Due to the large number of inquiries to the Ministry of Finance, in 2013, the compromise was agreed that in the cases of doubt, the reverse charge can be applied when both parties agree.

The subsequent checks of the correct application of the reverse charge lies in the submitting the listing of records for tax purposes which is inspired by the methodology of the overall report used in the European Union to control reverse charge in foreign transactions. The main and very important difference is that the overall report is carried out by the supplier that transfers the liability to the recipient or the purchaser.

The overall report is then closely inspected and the checks, whether the recipients actually paid the tax they were transferred to. However, not only provider or supplier of the goods is obliged to report the list of records for tax purposes, it's also the recipients or purchasers. Thus every transaction which is subject to reverse charge is noted in two records, e.g. in a provider's report and in the recipient's report. The purpose of this duplicity lies in the use of cross-checks at financial authorities so that they can detect any inconsistencies in the reports. To ensure the feasibility of such checks, it is compulsory to submit the records in the given electronic format.

However, this results in an increase of technical knowledge that are difficult especially for small businesses operation in the field of construction and installation works. These difficulties are partly reduced with the help of the freely available website of the General Tax Directorate, which offers an interactive tax return forms and other reports in the given electronic format.

The last, but very problematic issue was to determine the ways of transition between 2011 and 2012, when there were very diverse junctions of tax policy, such as taxed advances or issuing the corrective tax documents that were partially subject to the reverse charge. Although a large part of the solution was pre-announced, the variability of the

construction and installation works in the business practice is so wide that a large numbers of unknown situations emerged. Therefore the beginning of the year 2012 was very challenging due to the availability of relevant information.

## 4 Conclusion

The fundamental characteristics of the VAT brought a wide expansion of the tax in most of the European countries in the second half of the 20<sup>th</sup> century and its implementation has become one of the conditions for entry into the European Union. These are primarily the possibility to taxation services, tax neutrality, convenience for international trade and reliability of revenue for the state. The tax evasion resistance is also often considered as an advantage however the theory and practice diverge. The newly enacted arrangements, the introduction of the reverse charge and its expansion declare that tax evasion is the major problem of the current system and the fight with it is at the forefront not only in the Czech Republic, but throughout the European Union as well.

The starting point for the analysis of reverse charge for domestic and foreign transactions is the relevant Articles of Council Directive 2006/112/EC. Due to the fact that the provisions in this Directive are often complicated, the certain degree of generalization is used to highlight the main principle. The decision-making process for compulsory and voluntary application of the reverse charge is depicted on the example of supply and trading with gold and the comparison with the Czech legislation is mentioned. The topic is later specified for the domestic transactions in the Czech legislation which were chosen from the options given by the European Union. The partial aspects are examined and analyzed for the construction and installation works and that concerns a large group of businesses.

Given that the reverse charge has been used for few years already to combat tax evasion and recently the number of work involved in this system expands, the cancellation of the system can not be expected in the near future.

### References:

- [1] KOHOUT, Pavel. Optimální daňový systém. Revue politika [online]. 2003 [cit. 2013-04-10]. available from: <http://www.revuepolitika.cz/clanky/757/optimalni-danovy-system>

- [2] KUBÁTOVÁ, Květa. Daňová teorie a politika. ASPI, 2006
- [3] MAGSUMOVÁ, Gabriela. Evropská unie vyzvala veřejnost k diskusi ohledně systému daně z přidané hodnoty. Bude se systém DPH měnit? Epravo.cz [online]. [cit. 2013-02-15]. available from: <http://www.epravo.cz/top/clanky/evropska-unie-vyzvala-verejnost-k-diskuzi-ohledne-systemu-dane-z-pridane-hodnoty-bude-se-system-dph-menit-70145.html>
- [4] Proposal for a Council Directive amending Directive 2006/112/EC as regards an optional and temporary application of the reverse charge mechanism in relation to supplies of certain goods and services susceptible to fraud.
- [5] Council Directive 98/80/EC of 12 October 1998 supplementing the common system of value added tax and amending Directive 77/388/EEC - Special scheme for investment gold.
- [6] Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax.