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CASES OF VAT EVASION ON THE BASIS OF EUROPEAN COURT JUDGMENTS

Review
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Abstract

In a supply chain, the business entity or entities often “forget(s)” to fulfil their obligation to pay VAT. This is all the more true in the case of transactions within the Community, where many abuse the right to tax exemption. Both NAV (National Tax and Customs Administration) and the government are fighting fraudulent taxpayer behaviour, aiming to whiten the economy by curbing fraud. As VAT evasion is difficult or impossible to catch up with, often an intermediary entity within the chain is held accountable as the entity knew or must have known that its transaction contributed to the realization of VAT fraud within the chain. The topicality of the issue is provided by the application of various new tools continuously introduced in Hungary in order to whiten the economy. One of the reasons for this is that there is a lot of abuse in the field of VAT fraud, which means a significant loss of revenue for the Hungarian central budget. Not only do abuses result in a loss of revenue, but revenue is also lost from the state due to unfounded VAT returns. In such cases, the issue involves billions that the state could have spent on the development of health care, education, or other areas. In the absence of due diligence, anyone might inadvertently get into a fictitious invoice chain, thereby supporting the “work” of legal offenders. In general, participation in VAT fraud can be eliminated with due care and reasonable measures. The main objective of the presented study is to introduce, through the verdicts of the Court of Justice of the European Union, some of the measures that the court can reasonably expect from the taxpayer.

INTRODUCTION

Regulations concerning value added tax have long been provided by the Sixth Council Directive 77/388/EEC of the European Union. The new Directive on the common system of value added tax was adopted by the European Council on 28th November 2006 (EU Council Directive 2006/112/EC on the common system of value added tax, hereinafter referred to as the VAT Directive), which entered into force on 1st January 2007.

Hungary joined the Community of the European Union on 1st May 2004, when, in the scope of legal harmonization, Act LXXIV of 1992 was amended by Act IX of 2004. The currently applicable legislation in Hungary is the Act CXXVII of 2007 on value added tax (hereinafter: VAT Act) (Erdős, Földes & Öry, 2013).

VAT is a full-phase net sales tax that business entities are required to pay based on value added at all stages of production and distribution, and the tax is borne by the final consumer (Erdős et al., 2013). Its general nature suggests that it covers almost the entire scope of the sales of goods and provision of services. Full-phase means that VAT must be charged at all stages of the supply chain after sale (from production to consumption). The only exceptions are tobacco products labelled with a tax stamp that is single phase. It is a net, non-accumulative tax, as the VAT invoiced to the business entity on the purchase can be deducted from the amount of VAT charged on the sale. The difference must be settled financially in the budget. The tax is levied only on the value added by the enterprise. It is a turnover tax, as it is levied not on the taxable person, but on sales turnover. It can be considered sector neutral because it burdens all sectors equally, it does not differentiate among market participants in terms of property type, sectors, business forms or other aspects. It is an indirect tax, as the person paying the tax and the person bearing the tax burden are separated. It is a consumer-type tax, because the VAT charged by all participants in the supply chain is ultimately paid by the consumer. It is a stable budget revenue. It is declared by self-taxation. Imports are an exception, as the customs authorities determine the amount of value added tax by levying it (Fellegi, 2013).

The VAT Act does not include the definition of a chain sale, chain transaction, thus it is an unofficial but well-known term for the transactions described in Section 27 of the Act. Chain sale is meant when the same product is sold several times in a row (i.e. at least twice) so that the delivery of the product in the chain goes directly from the first seller to the final customer. In this case, the path of the product does not follow the individual invoices - as it

shows the direction of the transfer of ownership - but leads from the first seller in the line to the final purchaser (Farkas, 2018).

The amendment to the VAT Directive, which is the basis for the rules on chain transactions, was adopted by the Council of the European Union at the end of 2018; it needs to be applied by Member States as of the 1st January 2020. The European Union has established uniform rules for the case where a Community transaction takes place in a chain sale and the transport is carried by the an intermediary or it is let carried out in its own name. The change is that the buyer cannot overturn a presumption about having transported as a buyer in any way unless it communicates to the seller of the product its appropriate tax number (the Community tax number established by the Member State where the product was dispatched). The law does not prescribe a mandatory form for the method of communication, so it is also acceptable if the invoice issued for the transaction contains it. The change contributes to the elimination of double taxation, so that the member states can determine uniformly which entities participated in the community transaction (Kiss et al., 2019).

A special, simplified case of chain transactions is triangular transactions among taxpayers registered in three different Member States, where the goods are delivered directly from the consignor to the buyer and the transport takes place between the first seller in the chain and the intermediary (Tóth, 2018).

The chain transaction determines the performance location of the sales of goods, while the triangular transaction settles the goods from the point of view of the destination country, thus the intermediate ('B') does not have to register in the country of the final buyer or charge VAT there. Instead, the last entity in the chain ('C') fulfils its VAT liability and its community acquisition, which will be tax-free. If these conditions of the exemption are met, then company "A" of the place of departure of the product can invoice tax-free to the intermediate company "B" (Csátaljay, 2016).

The revenue of the central subsystem of the Hungarian state comes from multiple sources (payments of business entities, consumption-related taxes, payments of the population, EU revenues, etc.), the most significant of which is the value added tax, which is shown in Figure 1. The exposure of the Hungarian budget to VAT is high, which means it is the largest revenue of the state. Of the HUF 13,593.9 billion revenue received, value added tax alone amounts to HUF 3,928.7 billion, which is 28.9% of total revenue.

Figure 2 illustrates the amount of VAT revenue received and the relative loss due to the above-mentioned taxpayer behaviours. Compared to 2013, there is a clear increase in VAT revenues. Revenue

of the Hungarian budget obtained from VAT increased from € 9,073 million to € 11,725 million in four years, which is an increase of almost 30%. At the same time, the extent of VAT fraud has decreased since 2013. According to the European Commission, it has fallen from € 2,424 million to € 1,893 million, which means that the 21% VAT gap has fallen to 14%, a decrease of seven percentage points. Although the amount of revenue lost due to VAT fraud has already decreased significantly, the government is taking further measures to whiten the economy. The problem of VAT fraud is not only significant in Hungary. According to EU data, Member States lost € 137.5 billion in value added tax in 2017, which is 11.2% of total VAT revenue. It has decreased slightly compared to previous years, but still remains very high (European Commission, 2019).

MATERIAL AND METHOD

In Hungary, the detection of VAT fraud is primarily the task of the National Tax and Customs Administration. The tax authority incorporates its findings in a decision (first instance decision). The taxpayer may appeal against this decision, file an appeal against the decision at second instance, and request a review of the court decision. This is how the case reaches the Curia. The process is illustrated in Figure 3. The Curia is the supreme judicial body of Hungary; its task is to ensure the unity of the application of the law by the courts (Curia, 2019).

The study includes a selection of decisions made by the Curia, based on the court database. The database can be found on the website of the court (Court, 2019), from where are retrieved the anonymized decisions. It is possible to filter by various: the court making the decision, the area of law involved, the date of recording, and it is also possible to search within the text. The criteria applied for the study were the following:

Court of decision: Curia

Decision-making college: administrative-labour

Area of law affected by the decision: administrative law

Date of recording is later than: 01.01.2018.

Free text search: chain sales

The resulting cases were downloaded and the relevant judgments are presented.

Of the judgments given by the Court of Justice of the European Union in the preliminary ruling procedure on which the judgments made by the Curia are based, two of the cases referred submitted by the Curia are presented. In addition, two international cases, which were also answered by the CJEU in a preliminary ruling procedure, are also presented.

APPLIED METHODOLOGY

The research is based on document analyses. Document analysis is the independent analysis of publications created by others (newspaper articles, books, lectures). This type of analysis is a common method in the social sciences. It is suitable to draw conclusions based on the collected data (Falus et al., 2019). The presented cases of the Court of Justice of the European Union are collected from the book of Varga, Vincze & Vira (2015). The document analyses listed so far are considered qualitative procedures. It is based on the examination of documents created by others, as well as the exploration of connections and characteristics found in them. In some cases, its purpose is description, the first acquaintance or presentation of a new phenomenon. Others examine more than that, they also explore its cause and consequences. A certain degree of preparation and expertise is required to understand the connections and relationships in the text (Mayer, 2011).

The applied content analyses are considered micro-analysis. The text in this case is processed by studying it sentence by sentence and paragraph by paragraph. The researcher then identifies the topics, concepts, and their categories within the text and assigns them to codes. The codes can be divided into three main categories:

Theoretical codes are codes that are already available beforehand and do not acquire their meaning during research. They are based on the use of definitions and models in the literature.

Open codes are defined by the researcher when reading and interpreting the text. Based on his/her expertise, imagination, experience, terms are used that adequately express the content of the text he/she reads.

In-vivo codes are terms, keywords, noticed by the researcher and generalized as code, that are included in the texts studied and were mentioned by their author (Mayer, 2011).

BASICS OF HUNGARIAN CASE LAW: JUDGMENTS OF THE COURT OF JUSTICE OF THE EUROPEAN UNION

Among the judgments of the Court of Justice of the European Union, the following four cases are presented that had a significant impact on Hungarian law enforcement practices and are often referred to in Hungarian court judgments.

The Optigen case: CJEU decision in joined cases EUB C354/03 C-355/03 C-484/03 on the knowledge of the taxable entity

The present case is of particular importance, as in the scope of this judgment the European Court of Justice defined the principle of examining the

knowledge of a taxable entity wishing to exercise the right to deduct for the first time (Csabai, 2013).

MAIN PROCEEDINGS

The companies Optigen, Fulcrum and Bond House were engaged in the trading of microchips and submitted tax returns including refunds, which were examined by the national tax authority. The companies procured the goods from domestic companies, but in the supply chain preceding these companies, the tax authorities uncovered a false trader or a trader using a false VAT number who failed to pay the VAT on its sales. However, the companies in the chain deducted the previously charged tax after their purchases and resold the purchased product to taxable entities established in another Member State of the Community, thus making a tax-free sale within the Community. Their current tax to be accounted for the period was thus negative, for which they submitted a tax refund.

The tax authorities found that the sales of the companies involved in the case were part of a carousel fraud, but these companies could not and did not know that they were involved in a tax evasion transaction by the parties located before and after them within the chain. The tax authorities did not accept the intra-Community sales as an economic activity and thus disputed the right to deduct, given that these transactions were part of a chain of tax evasion, even though these companies did not know about it or could not have been aware of it. The companies involved in the case contested this finding.

DECISION

The Court of Justice of the European Union has ruled in preliminary ruling proceedings that the supply of goods by traders who do not engage in tax evasion and who are not aware and cannot be aware that other entities in the supply chain are involved in tax evasion is an economic activity. These companies are not liable for the fraudulent activities of the other members of the chain, thus the transactions they carry out must be judged independently of the other entities, therefore the right to deduct tax cannot be disputed from them either.

Joined case (C-255/02., C-419/01. and C-223/03) of Halifax and others – Identification of improper exercise of rights

The Halifax case is an important milestone of - among others - the application of Hungarian law, as the Court of Justice of the European Union has laid down the conditions for determining improper exercise of rights in the scope of this case.

MAIN PROCEEDINGS

Halifax Plc is a company dealing with banking activities, therefore a large proportion of its services are exempt from VAT. The University of Huddersfield also does not charge VAT on the majority of its transactions. The two organizations intended to renovate the buildings in such a way that they could reclaim the input tax charged in advance. With the help of involving various companies and organizations, it became possible for them to reclaim the full amount of VAT on the invoices received in relation with the renovation work.

The British company BUPA, which operates private hospitals, has entered into contracts with companies belonging to its own group of companies for the supply of prostheses and medicines. In order to obtain a tax advantage, it had settled the payment specified in the contract before the entry into force of the legislation amending the transport and VAT rules. Halifax, the University of Huddersfield and BUPA asserted their right to deduct after the services they used and applied for a refund of the tax. The Commissioner of Customs & Excise rejected the applications, arguing that the transactions performed for the sole purpose of evading VAT did not qualify as supply of goods, the provision of services and the pursuit of an economic activity within the scope of the Sixth Directive.

The three companies challenged the decision of the Commissioner decision at English courts. The matter to be clarified has been brought before the Court of Justice of the European Union

DECISION

The Court emphasized that the system established by the Sixth Directive is based on a uniform definition of taxable activity. According to it, the supply of goods, the provision of services and an economic activity are all transactions which fulfil the stipulated objective conditions, irrespective of the purpose and outcome of the transactions concerned, even if their motivation is solely to obtain a tax advantage.

Finally, the Court of Justice of the European Union has set up a three-step test to determine whether there has been an abuse of the right to deduct; abuse of the right of deduction can be considered only if all of the following conditions are met:

- The Sixth Directive and the conditions laid down in international tax law are formally in place, but there is no real economic activity behind them.
- The purpose of the transactions concerned must be to obtain a tax advantage.
- The tax advantage involved is contradictory to the objectives of the above provisions.

Only in the event of the combined existence of the above three conditions can the improper exercise of the right be established concerning the transaction.

Joined case of Mahagében Ltd. (C-80/11) And Péter Dávid (C-142/11) - Determination of the right to tax deduction

The next pillar of the case law on value added tax is the case of Mahagében Ltd. and Péter Dávid. It is of paramount importance, as the CJEU has established the conditions for the right to deduct in the scope of this case as well as the significance of the knowledge of the taxpayer.

MAIN PROCEEDINGS

Mahagében Ltd. purchased acacia logs from its supplier, and the related invoices were included in their tax return. In the course of the inspection of the supplier, the tax authority found that not all shipments were accompanied by a consignment note or that it did not have enough acacia logs for the shipments in its stock. According to the tax authority, Mahagében Ltd. could not establish the right to deduct the tax related to the transaction, as the invoice issued by the supplier is not authentic. Dávid Péter undertook to carry out construction work for various customers. In the scope of inspections performed by the tax authorities, Dávid Péter stated that he had no employees and all the work was performed by his subcontractor Máté Zoltán. During the tax audit, it was established that Máté Zoltán did not have the material and personal conditions necessary for the construction either, nor did his subcontractor.

DECISION

According to the Court of Justice of the European Union, a taxpayer cannot be punished by denying its right to deduct if it did not know or could not have known that the activities of the other entities within the chain were aimed at evading tax, it acted with due diligence or if the buyer did not participate in tax evasion.

The CJEU has ruled that the possession of an invoice is sufficient to exercise the right to deduct and that the right to deduct cannot be denied on the ground that the entity before or after the taxpayer within the chain has failed to fulfil its tax liability.

The Court has developed a three-step test for establishing deniability of the right to deduct VAT:

- The tax authority must establish that the taxable person knew or should have known that the transaction in question was part of a VAT fraud,
- The range of reasonable measures expectable from a taxpayer depends on the circumstances of the case,
- The tax authority may not oblige the taxable person to carry out an inspection as it is not its task (e.g. to inspect whether there has been such fraud in previous transactions or whether the

business entities of those transactions had the material and personal conditions necessary for performance, etc.)

The case of Mecsek Gabona (C-273/11) – Conditions tax free intra-Community sales

MAIN PROCEEDINGS

The Hungarian company Mecsek Gabona sold cereals to an Italian company and it issued an invoice in connection with transaction. Mecsek Gabona found that the buyer had a VAT identification number at the time of the sale. During the verification of the tax returns, the tax authority sent an international request to the Italian tax authorities to trace the buyer. As a result of the inspection, the foreign authority retrospectively deleted the tax number from the register because the Italian party could not be located, there was a family house at its registered office address and it never fulfilled its tax liabilities. Based on the circumstances, the Hungarian tax authority disputed the tax exemption of the sale, as Mecsek-Gabona could not prove that the product had indeed left the territory of the Member State where the sale took place, i.e. Hungary. In their opinion, the taxpayer was a conscious participant in tax evasion.

DECISION

In its ruling, the Court stated the following:

'The intra-Community supply of goods shall be exempt only if the right to dispose of the product as owner passes to the buyer and the seller proves that the product was dispatched or transported to another Member State and that the product during the dispatch or transport de facto left the territory of the Member State where the supply took place.'

The transfer of the right of disposal took place in the transaction on the basis of the terms of the contract. The tax authority acts lawfully if, after proving that the product has not left the territory of the Member State where the goods are supplied, i.e. Hungary, it also proves that the seller knew or could have known that it was contributing to VAT fraud and had taken the necessary measures to avoid that fraud.

In the opinion of the Court, the awareness of the company cannot be proved on the basis of the circumstances and data set out in the decision of the Hungarian tax authority. However, it emphasized that if the taxpayer knew or should have known that the transaction carried out was part of a VAT fraud and did not take all reasonable steps to prevent it, the tax exemption could be disputed in a similar situation.

Furthermore, the Court explained that the tax exemption could not be refused on the grounds that the tax authority of the other Member State retroactively deleted tax identification of the customer number after the.

CONCLUSIONS

On the basis of various legal cases, it can be concluded that participation in a transaction aimed at VAT fraud and cooperation with companies whose operation is aimed at tax evasion should be avoided. However, this requires the collection of preliminary control information on the potential business partner(s). Not only is it worth checking the other party before concluding the contract, but during multiple phases of the transaction. The following might be a solution:

- Information available about the partner company online might be helpful. As a first step, it should be checked whether the communication takes place with the person authorized to represent the company. The best place to do this is to browse the online register of business entities. From the data of the balance sheet data of the company conclusions can be drawn about the value of assets and the number of employees. Its receivables and liabilities can also be observed. The size of its sales revenue can also be a starting point for investigation. If it shows an unbalanced or suddenly rising volume, more research might be necessary to become more convinced about the motivations of the partner.
- Reference data can also be requested.
- It is recommended to examine the background and commercial past of the company. In the case of recently established companies even more care is required.
- It is worthwhile to make sure that the potential seller has the personal and material conditions necessary for the performance of the activities and tasks included in the contract, and it is expedient to find out about the planned schedule of the performance and the method of implementation. In the opinion of the authors, there is also a tendency for tax evasion if a potential partner refuses to respond to such enquiries, or gives general, meaningless answers, or tries to avoid it; in such cases additional investigative measure should be considered.
- It is worth visiting the registered company seat, office of the seller. It is suspicious if the company seat is an apartment of a block of flats or an empty plot in and it has no other official address. The question may arise as to whether this company carries out any real economic activity at all.
- The willingness of a potential business partner to evade taxes can be recognized by the fact that the seller and the buyer emerge at almost the same time and sell or search for the same goods.
- The ratio of the purchase price to the market price can also be an important factor. If there is a considerable difference, the reasons should be definitely looked for.

- The consignment note also reveals a great deal of information. If the buyer does not request the delivery of the goods to its own address, but to the premises of a third party, it has to be considered that there is a chain sale, so the relevant legislation shall be applied.
- If products are sold under EXW, it must be checked whether the goods were transported into another Member State as a direct consequence of the sale or did they switch owner before leaving the country.
- For intra-Community sales, it is important to make sure that the buyer is engaged in a real economic activity so that the product is not sold to a conduit company.
- Once the transaction has been completed, it must be verified that the other partner has provided data about online invoicing, which can be tracked from the own database.

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LIST OF FIGURES

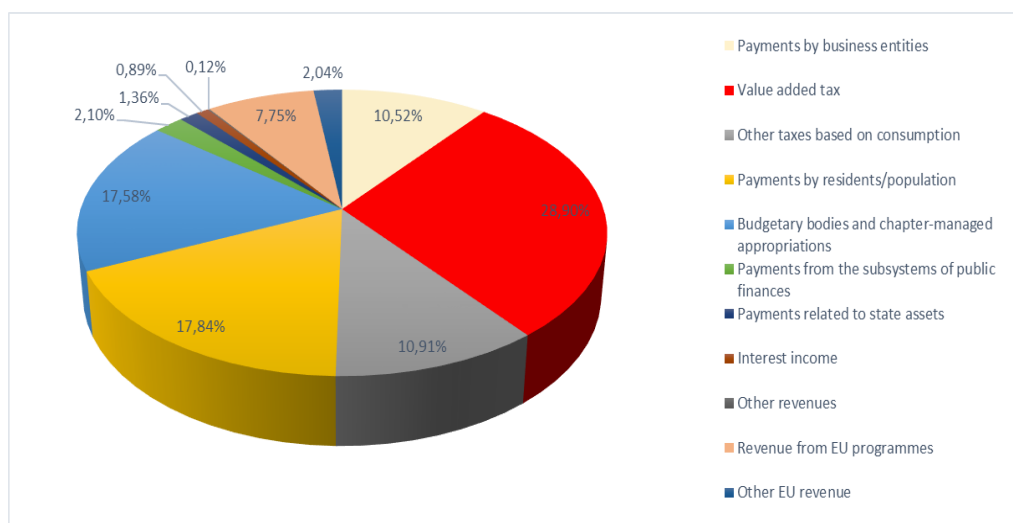


Figure 1
Distribution of revenues in the state budget based on the data of the CSO (2019)

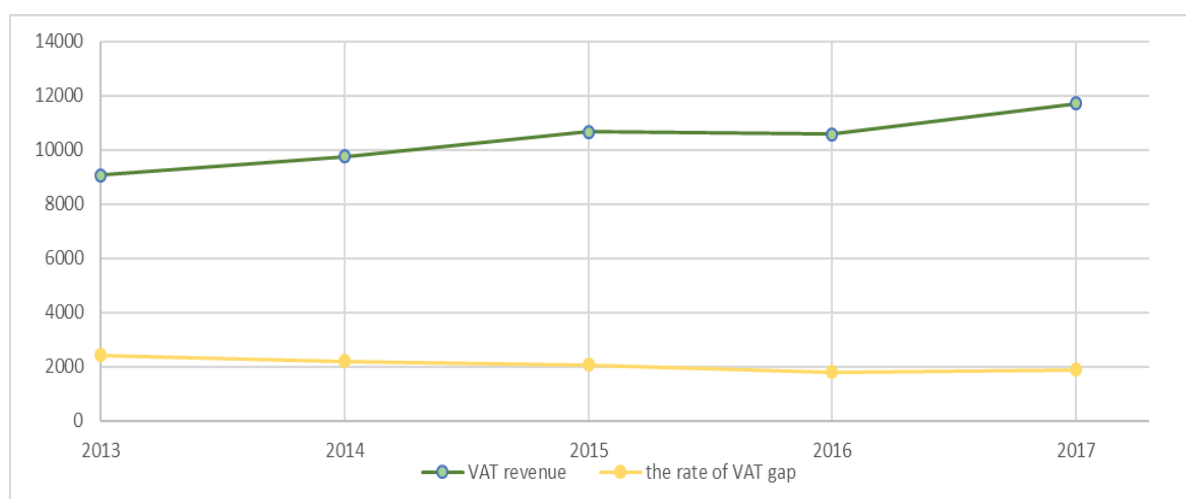


Figure 2
VAT revenue of Hungary and the rate of VAT gap in 2013-2017 based on a study by the European Commission

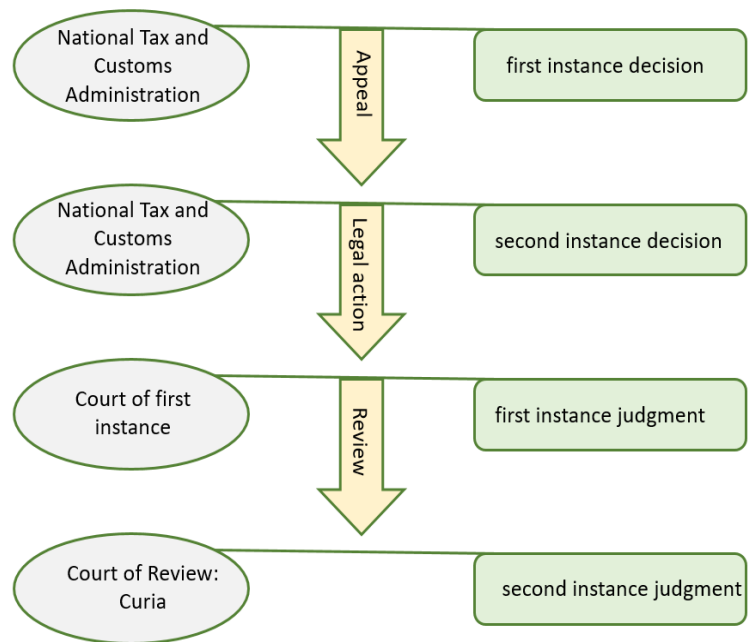


Figure 3
Options of legal remedy