EUROPEAN TRENDS IN SPLIT VAT

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Abstract: *The paper analyses the methods through which split VAT (split-payment mechanism) has been implemented in Bulgaria and Italy, as well as the intended methods through which Poland and Romania wish to implement the system in 2018, with the goal of examining the similarities, problems, and possible improvement paths. The efficiency of the system is still being contested by the taxpayers, because of its costs and complexity.*

In order to improve tax collection efficiency and fraud prevention, the paper suggests a variety of other methods including a real-time VAT collection system. Generally, there are two main options for reforming the VAT system: keeping voluntary tax compliance with modern enforcement measures in place, or eliminating voluntary compliance in a return-free system, in which taxpayers must comply.

Keywords*: Value added tax, Fraud, split TVA, European Union.*

JEL Classification*:* H25; H26; K34

1. The significance of Value Added Tax

The value added tax (VAT) is a general indirect tax on consumption. It is calculated using the tax credit method: liability is obtained by subtracting VAT on a firm's purchases from VAT due on its sales.

VAT was first introduced in France in 1954 and was later adopted by the countries of the European Union in 1967, making it a major source of income for the national budgets of EU members. Currently VAT is the predominant form of consumption tax around the world.

The taxation system has undergone changes according to the states' financial policies and the fluctuations of the economy.

The recent economic crisis and the longer-term shift towards indirect rather than direct taxation made multiple European countries increase their VAT rates. In the UE, VAT is the most important type of tax on production and imports.

In 2016, in the EU-28, revenue from taxes on products accounted for about 83 % and VAT for around 52 % of the total taxes on production and imports[1].

The highest ratios of taxes on production and imports relative to GDP were recorded in Sweden (22.6 %), Croatia (19.6 %), Serbia (19.8 %), Hungary (18.3 %) and Denmark (16.5 %).

The lowest ratios of these indirect taxes were recorded for Ireland (8.7 %), Slovakia (10.8 %), Germany (10.9 %) and Switzerland (6.0 %).

The taxation system will have to be further adjusted based on a series of factors such as population aging, the evolution of the labor market, the level and structure of public spending, and the changing patterns of savings and consumption. In its 50 years of service, the system has become more complex, difficult to apply to the common market, expensive and inefficient.

The complexity of the current VAT system leads to burdens for businesses and high VAT compliance costs. This has led to the need for special programs that reduce the administrative burden of applying the normal VAT rules for small enterprises (such as exemptions from VAT for businesses with an annual turnover below a certain threshold).

The level and collection costs vary from one country to the other, and the current taxation mechanism is based on the key role of businesses in collecting VAT. Administrative procedures vary and can significantly impact the compliance burden.

VAT system reform, based on the new changes in economy and technology, as well as the reducing the operational cost to taxpayers and tax administrations are necessary in every country but also to the EU as whole.

1 https://ec.europa.eu/taxation_customs/sites/taxation/files/study_and_reports_on_the_vat_gap_2017.pdf

The evolution of the VAT system has been slower than that of the economic and technology mediums. The rapid shift in business models, globalization, and usage of new technologies require a profound rethinking and reformation of the VAT collection system, in order to reduce the burden on businesses and VAT losses. The VAT gap is a major problem for the administrations of European countries

The VAT gap represents the gap between the VAT total tax liability and the amount of VAT actually collected. In nominal terms, in 2015, the VAT Gap in the EU-28 Member States amounted to EUR 151.5 billion (a loss of 12% of the total expected VAT revenue).

However, the VAT gap has been declining in most countries, with the exception of Belgium, Denmark, Ireland, Greece, Luxembourg, Finland, and the UK. In 2015, half of the EU-27 Member States recorded a Gap below 10.8 %. The smallest have been recorded in Sweden (-1.42 %), Spain (3.52 %), and Croatia (3.92 %), while the largest Gaps were registered in Romania (37.18 %), Slovakia (29.39%), and Greece (28.27 %).

A change in VAT rules in 2015 was the expansion of the reverse charge mechanism across several countries such as the Czech Republic, Italy, Hungary, Poland, and Slovenia.

The reduction of VAT fraud necessitates complex and costly actions by each state's administration.

The way VAT is collected has changed over time, but it is based on a preliminary self-assessment by the taxpayer followed later by audits by the tax administration.

2. VAT split payment mechanism

The idea of a blocked VAT account was introduced in 2003 and was called a "VAT trust account" (Sinn et al., 2004). A blocked VAT account can only be used for incoming and outgoing VAT payments, as well as settlement of net VAT liabilities at the end of the reporting period.

A VAT account yields additional transaction costs in the form of payment orders, account-keeping fees, transaction fees, etc.

VAT compliance costs for small businesses are relatively higher than for big companies, particularly when they conduct business across the EU.

Split payment mechanisms, sometimes referred to internationally as 'tax withholding' mechanisms, have been implemented in Bulgaria and Italy.

2a. Bulgaria VAT split payments

Between 2003 and 2007, Bulgaria has implemented a split VAT payment system in order to increase its collection efficiency.

The VAT amount had to be paid to a supplier's VAT account. Once the accounts were launched, however, a firm that paid at least 80% of the VAT on its transactions through the VAT accounts could obtain a refund within 45 days, irrespective of whether or not it was undergoing an audit (Pashev, 2007).

The abandonment of split VAT in 2017 proves that its benefits have been low, with VAT fraud still occurring and numerous compliant taxpayers filing legal cases against the tax administration for refund denial.

According to Pashev (2007), using cash in the economy leads to fraud, and split VAT is not efficient in this case. Additionally, the most affected by this mechanism were the small and medium sized businesses, due to the high costs of implementation and the reduction of cash flow.

The Bulgarian experience shows that audit and monitoring remain of prime importance even if firms' access to VAT is removed.

2b. Italy VAT split payments

Italy introduced split VAT in 2014 after a complex analysis uncovered a mechanism through which firms that supplied goods and services to the state were committing VAT fraud. This led to a system in which VAT due to firms that supplied public authorities no longer being paid to the supplier, but to a separate and blocked bank account of the tax authorities.

The split VAT system was implemented with the approval of the European Commission through a waiver from Article 206 of the VAT Directive regarding VAT payment, and from Article 226 of the VAT Directive regarding the invoicing rules, which will last until 2017.

The waiver was requested in order to implement a control system that could take advantage of data available via electronic invoicing for supplies to public authorities. The usage of electronic invoicing for supplies to public authorities grants tax authorities access to the information needed for an efficient control of transactions and corresponding VAT amounts.

As of January 1st 2017, in order to increase the rate of compliance, all invoiced issued and received must be communicated to the tax authorities.

In June 2016, Italy presented a report in accordance with Article 3(2) of the Council Implementing Decision (EU) 2015/1401.

According to the report, an estimated €2.2 billion has been recovered annually as a result of the measure. The result was higher than the estimates made at the time of the introduction of the measure, VAT refunds of the suppliers have not been affected, and VAT evasion resulting from the non-payment of the VAT by suppliers to public authorities has been stopped. However, as suppliers under this system do not receive the VAT from their clients, they will more often have to ask for an effective refund of the VAT, in case they cannot offset this VAT with other taxes due in Italy. To avoid a negative impact on these taxable persons, even more so if the suppliers are not established in Italy, it is essential that the refund procedure is functioning properly and timely.

In order to avoid the negative impact, suppliers to public authorities have been given access to a priority procedure in case the period of refund was even shorter than 3 months.

The Italian government wishes to extend the duration of the split VAT mechanism until the end of 2020 and to extend its application in order to combat tax evasion by invoicing transactions with the state and other public bodies. The state wants to extend the mechanism in the next 3 years to companies controlled by central and by local authorities, and to a list of around 40 companies listed on the stock exchange, a total of around 2.400 companies.

2c. Poland's split payment system

The introduction of the split payment mechanism in Poland has been under discussion for the last three years and the law will come into effect on the 1st of April 2018.

The Polish Government hopes that this mechanism will increase the state revenue and have a major impact towards the reduction of the VAT gap.

Split payment will be applied on a voluntary basis, for B2B transactions and only for bank transfers.

The split payment mechanism in Poland requires the VAT payer to establish two separate bank accounts for invoice payments: a company bank account and a VAT account.

Payment for purchased goods or services may be split between these two accounts if the purchaser decides to opt-in to the split payment mechanism; the purchaser would thus pay the value added tax into the VAT account with the remainder net sales value paid to the supplier's company bank account. The supplier would have very limited access to the VAT account and thus, generally, would be unable to dispose of those funds freely.

Those who use the system receive stimulents such as exemptions from sanctions and from joint and several liability, as well as an accelerated (within 25 days) input tax surplus refund deadline.

While the funds accumulated on the VAT account will always be the property belonging to the VAT taxpayer, such taxpayers will have very limited access to the funds collected on their VAT account(s).

VAT taxpayers in Poland will only be able to use their VAT account to make transfers to other VAT accounts and to make VAT liability payments to the tax office.it will not be possible to pay off other taxes using the VAT account.

2d. Romania VAT split payments

The current VAT system is vulnerable to fraud and VAT compliance costs are a major administrative burden for Romanian businesses.

In 2015, Romania's VAT Gap of 37 % remains one of the highest in the EU, although it has been declining in comparison with previous years.

In 2014, the reverse charge mechanism was introduced by the Romanian government for the supply of energy, for green certificates, and in the wood industry.

Split VAT has been in effect since the 1st of October on an optional basis and will become mandatory for all VAT registered traders starting with the 1st of January 2018.

Unlike Poland where the system is automated, Romania has a manual payment system. The manual system requires that payments are divided into two payment orders. This requirement of separating the payments falls to the taxpayers, along with the implementation costs. The split payment VAT system will force all VAT registered businesses to open up a distinct bank account for receiving VAT from clients and paying VAT to suppliers.

The law has been contested by Romanian taxpayers due to the numerous negative effects of blocking off the VAT account:

- cash flow problems and administrative issues,
- additional bank charges,
- increased compliance time
- additional IT costs for adapting the accounting and payment software.

Meanwhile, the Romanian taxpayers are unhappy with ANAF's current practices that have repeatedly led to delayed VAT reimbursements.

The efficiency of the mechanism is being contested due to the form under which it will be put into practice, the lack of preparation time and its mandatory nature for all tax payers.

According to tax payers' reactions, the government is taking into account the introduction of split VAT only for insolvent firms and firms with large VAT debts.

Conclusion

Although the principles of the tax are broadly the same everywhere, the compliance burden on business varies considerably.

The mechanism for split VAT has been applied in different ways with different results.

In Bulgaria it did not provide the desired results, whereas in the first 3 years in Italy it has been considered a success and it will be continued and expanded.

Starting with 2015, VAT evasion in Romania has diminished due to the reduction in VAT rates for food products and collateral measures, such as reverse taxation and the reduction of cash payments. Manual split payments and blocked VAT bank accounts at the level of the taxable person's bank will have to prove their efficiency in 2018. The fight against VAT fraud must continue and will have to be based on the way the ANAF IT infrastructure obtains fiscal information, on obligatory certified software for billing, and on Standard Audit File for Tax.

Numerous measures to tackle different forms of VAT tax evasion are discussed, debated, and implemented by EU Member States and the EC, such as the extension of the reverse charge mechanism, the recapitulative statement of intra EU supplies, and the quick VAT fraud reaction mechanism (QRM), among others.

Other alternative mechanisms have been proposed, such as: Automated split payment in the case of credit card payments; and Credit card VAT payment monitoring.

The introduction of split VAT to B2C online sales made by foreign businesses to UK individuals is being discussed in Great Britain, due to increased VAT fraud. Another option is the application of the mechanism only on sales made by foreign non-EU companies selling their goods in the UK.

Given the high level of VAT fraud, new methods of improving and simplifying the collection of VAT, by means of modern technologies or via financial intermediaries, are required.

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