

# PROBLEMS RELATING TO TAX AVOIDANCE AND POSSIBLE SOLUTIONS IN THE EUROPEAN UNION'S AND HUNGARIAN'S REGULATION<sup>1</sup>

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**ABSTRACT:** *This study examines the Value Added Tax regulation both in Hungary and in the European Union. The VAT income is a very important and significant revenue of the state budget. This is the reason why it is very important to reduce the amount of losses caused by tax frauds, tax evasion and tax avoidance. The study introduces the different types of tax frauds, the characteristics of the tax fraud based on chain transactions. One of the main parts of our study highlights the new legal instruments and measures applied by the Hungarian tax authority.*

**KEYWORDS:** Value Added Tax; tax avoidance; tax fraud; missing trader fraud; carousel fraud; online cash register; Road transportation control system; tax payers classification  
**JEL CODE:** K32

## 1. INTRODUCTION

The revenue from the Value Added Tax (hereinafter VAT) is one of the most important income of the Hungarian budget, during the last years 30 % of the total revenue came from the VAT, mainly in last eight years, in the new macro-policy. Connecting to this the tax avoidance is becoming increasingly widespread in Hungary, one reason of that is the extremely high tax rate (27%). Because of the tax evasion and avoidance the Government's room for budgetary manoeuvre is decreasing. The loss of revenues raises the deficit and debt levels of the State, and reduces the funds available to foster public investment, growth and employment (Duta 2015).

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<sup>1</sup> "The described article/presentation/study was carried out as part of the EFOP-3.6.1-16-00011 "Younger and Renewing University – Innovative Knowledge City – institutional development of the University of Miskolc aiming at intelligent specialisation" project implemented in the framework of the Szechenyi 2020 program. The realization of this project is supported by the European Union, co-financed by the European Social Fund."

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The loss from tax avoidance, the amount of not paid VAT, the unduly deducted and recovered VAT causes hundreds of billions loss to the Hungarian budget. According to the available data provided by the European Commission in 2014 2,1 billion euro VAT income (651 billion Forint) failed to collect in Hungary.

The tax fraud distorts the social and social justice aims, laid down by the tax system. According to the Spicer's viewpoint the tax fraud reallocates the income and gives the tax income collected from the honest taxpayers to the unfair taxpayers (Spicer 1986).

Moreover the tax fraud has distortive effect on the market, and increases the burdens of the fair tax payers. The fraudsters reduce their expenses through the unfair competitive advantage and therefore they can increase their incomes. So the allocation of resources (Szilovics 2013) distorts within the national economy. The study introduces the problematic areas in the European Union's and in the Hungarian regulation. The main focuspoints of our study are the Act CXXVII. of 2007 on value added tax, the Act XCII. of 2003 on the Rules of Taxation and lower levels acts on other specific subjects. The study analyzes such economic areas, which are the most affected by the tax fraud. It highlights the characteristics and problems of the EU's and Hungarian tax system and the factors encourage tax fraud and the different types of tax fraud. According to the EU's data the Member States fail to collect 200 billion euro VAT income. The smallest loss, 5 % are in Luxembourg, Finland and the Netherlands and the largest are in Romania, Slovakia and Lithuania, 40 %. On a comparison with other Member States Hungary is in the mid-range, every four Forint from VAT income are failed to collect by the State. These differences indicate how deep the state is affected by tax fraud. (Kúria 2016)

## 2. SCHEMES ON TAX AVOIDANCE AND TAX FRAUD.

According to the scientific literature there are two types of tax fraud. As a general method it mentions the concealment of the revenue. This kind of abuse is committed by the lack of providing invoice. It is very common that the consumers do not receive invoice for example in a club and the consumers do not even care about, because they do not have cost accounting intent. It is also very often that the consumers do not ask for invoice because if they do so, they receive discount from the price. According to this it is important to note that the final consumers have interest in the system of VAT concealing. According to the viewpoint of some authors it is also general tax fraud when someone does not submit its tax statement. In this case the taxpayers carry out real economic activity, they have revenue from it (Deák 2015), but they do not submit their tax statement and do not pay VAT (Kormos 2001, Deák 2016). This is the case also, when the taxable person submit its tax statement, but it contains incorrect data, so it deceives the tax authority.

The most relevant cases are the followings: One form of the general tax fraud, when the taxable persons reduce the amount of the payable tax with the costs of supplies satisfying personal needs. This kind of tax fraud is based on real, small amounts of money invoices. The company owns trucks and it deducts the VAT on gas oil, it would not be tax fraud, but the company asks for invoice after filling up the tank of personal car with gas oil and deducts the VAT from that kind of invoice. Because of the relatively small amount and complex evidentiary procedure the tax authority does not place great emphasis on checking this kind of situations. But in accordance with the principle „little

streams make great rivers”, in this cases the budget fails to collect a significant amount of taxes. Cases in connection with not submitting tax statement of intra-Community acquisition Cases when the tax payers mark in their tax statement their domestic, taxable supplies of goods as intra-Community supply or as exports of products Unlawfully using of fake domestic or Community’s VAT identification number.

In our study we would like to highlight in deeper sense from the general tax fraud forms the cross-invoicing. The point of this scheme is the following: there is a real intra-Community supply transaction and after this transaction the tax payer reduces the payable VAT with fictional invoices on domestic supplies of goods and with Community sales. But instead of Community sales the goods will be sold at the black market. All these lead us to cross-border trade and to missing traders VAT fraud. But before the detailed analysis of them we introduce in our study the basic characteristics of tax fraud based on chain transactions.

### **3. CHARACTERISTICS OF TAX FRAUD BASED ON CHAIN TRANSACTIONS**

According to the scientific literature the chain transactions are such transactions where the same goods are sold successively several times (Magony 2015), but the goods are transported only one time, from the first supplier to the last. It is typical that at the starting point of the chain there is an operator without real economic activity, who does not declare the tax based on the transaction and so it does not pay it, but the last person of the chain will deduct the tax. This kind of misuse has more and more foreign suppliers. The participating parties feel safe because of the difficulty of the proof and the weakness of cooperation between the tax authorities. The essential part of this method is the following: the person on the starting point of the chain carries out intra-Community purchases and the last person of the chain carries out untaxed intra-Community supply. From the beginning of the chain the goods will be sold below the market price and the other persons of the chain will progressively increase the basis of the tax and the tax, the last person of the chain reduces the amount of the payable tax with a huge amount of the tax on the supply (Antal 2010) and therefore it has opportunity to tax recovery. It is very difficult to reach the real organizers of these transactions because they manage the processes from the background. These processes are often helped by professionals (lawyers, tax advisers), who are aware and have knowledge about the countries’ tax systems (Németh 2007), tax authorities processes. In the following section our study introduces two more main construction: the missing trader fraud and the carousel fraud.

### **3. MISSING TRADER FRAUD**

The different types of fraud are as old as the VAT system of the EU. According to a study in connection with missing trade fraud, this kind of fraud is often related to illegal activities and crimes, like illegal employment or money laundering. Missing trader fraud (Sólyom 2014), also known as Missing Trader Intra-Community (hereinafter MTIC) fraud, is the abuse of the VAT rules on cross-border transactions within the EU. It relies on the fact that no VAT is chargeable on these transactions. In a typical VAT supply chain where there is no fraud a VAT-registered business which *buys and sells goods charges*

VAT to customers (called *output tax*) and is charged VAT by suppliers (called input tax). The business can reclaim the VAT it has paid and so it passes to State budget *the net VAT it collects* (*output tax less input tax*) or reclaims from State budget any excess input tax. MTIC fraud was originally prevalent in sectors such as IT and mobile phones. However, the criminals have moved onto other asset classes such as precious metals, power, gas and carbon emissions allowances and telecoms.

#### 4. CAROUSEL FRAUD

In our study we would like to highlight the main elements of one other type of fraud, the so called carousel fraud and of course this problem did not come out of the blue.

It has been apperaed since the 90's years in the Community. The carousel fraud is linked to the intra-Community supply and currently it is the most common type of the VAT fraud.

Carousel fraud differs from the type of purchase in the sense that at the end of the chain the broker ("D") sells its products not domestically but sells intra-Community sales to the initial channel company ("A"), thus closing the circle. In this design, the same goods may turn up several times. It is typical of carousel fraud that one or more legally operating "buffer companies" enter the gap between the missing trader and the broker, making it difficult for the tax authorities to work.

The practice of tax-exterminating players is that they already linked exports outside the Community to chain transactions. In such a case, there is a carousel fraud scheme in a Member State which, at the end of the chain, a brokerage company performs a tax-free export valuation in a third country while deducting the tax on its purchases. Exports of fraudulent businesses are, in practice, aimed at importing countries with low tax burden. A taxpayer resident in a third country buys the goods from the broker and then re-exports them to a Member State of the European Union by assigning another EU Member State as the destination of the valuation. As a consequence, the import VAT payment obligation will only be due in the final Member State of the valuation. In order to conceal the true origin of the goods, the shipments are scattered and sold to companies in different states. Then, from one Member State, another company resident in different Member States buys the product and sells it back to the first business in the chain, so the circle will resume. This circle revolves until it is overlaid before the tax authority.

#### 5. TAX ABUSES IN CONNECTION WITH DEDUCTION

One of the most common type of tax avoidance when a company exercises its right to deduct trough illegal or fictional activites. According to the EU practice the right to deduct is based on invoices. In respect of the principal of trueness the accounting system of the companies have to represent the economic transactions. In cases when a company, registered for VAT takes goods and services, which are connected to the company main activity, the company has the right to deduct the VAT. It is important to notice that the basis of the right to deduct are the followings: to have a proper VAT invoice or relevant Customs receipt, to be registered for VAT, to have purchases which are for the purposes of a taxable business. If the company has such VAT invoices, which are not connected to

real economic transactions or are not proper and the taxable person should know about this, the tax authority is entitled to refuse the right to the deduct.

According to the provisions of the VAT regulation, the taxable persons fulfill their VAT obligations due self tax payment. The taxable persons submit an application for refund the tax, but they do not have to present the invoices. A solution of this kind of problem could be the online invoicing and the system for classification of the taxable persons.

## **6. TAKEN MEASURES AGAINST TAX AVOIDANCE AND EVASION IN THE HUNGARIAN REGULATION**

One of the main of the EU is to discourage the VAT fraud, but the EU does not define what kind of particular instruments have to be taken by the Member States. According to the provisions of the Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax the Member States can measure other obligations besides of reporting obligations in order to prevent tax avoidance. There is only one condition: these obligations have to fulfill the principle of equal treatment.

In Hungary there were two possible solutions in order to hinder the tax avoidance. One of them is to reduce the 27 % VAT tax rate. The other one was to obligate more and more taxable persons to supply data and to have regular monitoring. Since 2012 several different measures were introduced by the Hungarian tax authority, like tax registration, enumerated VAT declaration, limitation of cash payment, reverse charge, online cash register, the new road transportation control system (EKÁER), classification of the taxable persons, reduced VAT rates, compulsory electronic invoicing.

## **7. ONLINE CASH REGISTER**

Since 1 January 2004 it is obligatory for certain businesses to apply online cash register (Báté 2011). According to the the Ministry for National Economy since then 420 billion Forint flowed to the State budget. With respect to a study of the European Commission the tax wedge was reduced from 22,24 % to 17,95 % between 2013 and 2014. From 2017 numbers for obligatory online cash register will increase. According to an analytical report the extension of usage of online cash register will result 30 billion Forint revenue surplus. It is important to notice that the casinos are not subject of the online cash register' regulation and in our viewpoint it would be better to extend the regulation on the casinos. The reason is quite simple, the casinos deal with huge amount of cash flows and misuse can easily occur on the gambling market. But of course misuses can happen all the time, if someone does not want to pay taxes it will find a way to do so. Online cash register alone is not much, it is important to check the obligation of giving receipt or invoice.

## **8. ROAD TRANSPORTATION CONTROL SYSTEM (EKÁER)**

Because of the the increased trade and the establishment of international chains the transporting of goods became more and more complex. That is the reason why the traceability of goods is emphasized nowadays. From 1 January 2015 the road

transportation control system (Höflinger 2015) was introduced in order to prevent VAT fraud. The reporting obligation applies to acquisitions of goods from another EU Member State to the territory of Hungary or acquisitions for other purposes, supplies of goods from the territory of Hungary to another EU Member State or supplies for other purposes, and first supplies of goods subject to taxation in domestic trade, to other than end users, involving road transportation, if performed by using vehicles subject to road toll payment. The reasons of the introduction were the insurance of transparent goods' transportation, to filter foodstuffs containing ingredients unfit for human consumption and to reduce VAT fraud. Some products (sugar, oil) were successfully filtered out by the road transportation system and as the results of the supervision it was obvious whether there was transportation between states or not. But it is important to mention that there are still remaining products like UHT milk and popular IT-tools, where the fraudsters have chance to try to avoid taxes. According to the scientific literature the road transportation control system is a success. Since the setting of the system together with roadside checks and permanent investigation 100 thousands of controls were carried out and an amount HUF 16 billion have been flown into the State budget. Good sign of success of the online cash register and EKÁR besides of the economic growth that last year an amount HUF 400 billion plus realised in the State budget.

However there are some gaps in the system and the tax authority has to be up to date in order to prevent fraud. The scope of the notification has been increased. Not only does it have to announce the carriage of goods carrying a cargo of over 3.5 tons with a tolled vehicle, but the requirement for any vehicle, such as commercial vehicles, to reach 3.5 tons. This was necessary because the carriers shifted to the practice of overcharging the 3.5 tonnes of motor vehicles and thus delivering more goods, without the cargo would have been obligatory to EKÁER. It is also irregularity if they do not report a cargo and also report more than they actually deliver.

Another problem is if the carrier carries a risky product with a weight of less than 500 kg or less than 1 million forints, it is not obliged to apply for an EKÁER number. A similar problem can be mentioned even among non-risky products that the vehicle does not cover vehicles up to 3.5 tons. So, whoever wants to avoid the system, it delivers the goods abroad by this method, because it does not count as illegal.

According to the opinion of the authors it would not be a good solution to wider the scope of the notification because of the burden of administration, it would be better to increase the number of roadside checks in the near of border crossing points.

Significant changes have taken place with regard to official closure, and we may already find concerns before the implementation of the regulation. If the carrier fails to comply with its reporting obligation or other risk factors justify the application of the fiscal lock. Authority abolition was abusive; therefore decision-makers placed responsibility on the carriers to retain the official lock in an unharmed state from attachment to lock. If the carrier removes an official seal without the permission of the authority, the tax authority may fine it.

Another major innovation is that the vehicle can now be held back by the inspectors until the payment of the fines imposed if the punished carrier does not have a Hungarian tax identification number and has his seat, residence, habitual residence in Hungary and no guarantee of payment of the fine. It follows that, the lock down is not cover equally all

cases. Transport vehicles of the Hungarian carriers can not be hold back, but the transport vehicles of foreign carriers can.

It appears that the regulation benefits the domestic carriers, so the regulation is contrary to the principles of the EU.

## **9. CLASSIFICATION OF TAX PAYERS**

The Hungarian tax authority put more and more emphasize on risk analysis nowadays. In 2009 the risk analysis of the newly-approved undertakings was introduced and in 2012 the tax registration procedure (Jakab 2013). Since April of 2016 the classification of tax payers came into operation and it classifies the tax payers into 3 categories, like reliable, average and risky tax payers.

The system has several advantages: the authority can supervise the risky companies and can warn the companies about the risky companies. This warning has a huge meaning, because in case of a tax audit, the company can not submit good faith if the audit of the tax authority reveals problems. The companies have to check the tax number of their business partners before and during the transaction and have to weight the factors because it can be serious consequences in case of business with a risky company.

The tax authority classifies the business undertakings in every quarter. The Companies with compliance behaviour will be benefitted and the risky companies will be sanctioned. The reliable companies have to meet strict condition.

As mentioned the reliable tax payers will be benefitted, for example in case of a tax penalty they will get payment in instalment. The average tax payers are regulated by the normal rules.

From the regulation it is obvious that the risky companies have to expect continued audits in order to promote their legitim operation.

## **10. ONLINE REPORTING OF BILLING PROGRAMS**

The next „weapon” of the Hungarian tax authority besides of the online cash register and the EKÁER is the online billing. From the 1 January 2016. every online billing programs have to have data service function. In case of an audit the billing program provides data about a defined period or defined invoices. It is important that in case of amount of 100.000. Ft VAT it is obligatory to report about the invoices to the tax authority. The system is under testing from 1 January 2017. and sooner or later every VAT payers will be obligated to use such programmes. The aim of the tax authority is to introduce the automatic data services. From 2017 only such billing programmes can be legally used, which are able to provide data online to the tax authority.

Similar systems are used in Turkish and Brazil with the exception that in those countries only the tax authority is entitled to issue online invoices. From 1 January 2017 the invoice shall contain the tax number of the buyer if the amount of VAT is or over 100.000 Ft. After the testing period the system will enter into force, according to the expectations the VAT income will be grown with around 10 billion Ft.

Advantage of the system that the data service is full and clear. Together with the EKÁER it could be a great tool to filter out fictional invoicing and of course it contributes to environmental protection because it can decrease the amount of the paper invoicing.

The disadvantage of the system is that cause huge administrative burdens and costs to the companies. In order to reduce the costs the government enhance to issue free billing programmes to the companies.

## 11. CONCLUSION

Nowadays the criminal organisations for the purpose of tax fraud mean and cause a lot of problems as well as in Hungary and in every Member States of the European Union. Their activities cause significant financial losses to the State budget and because of the foregone revenue the room for budgetary manoeuvre decreases, the budget deficit grows, therefore the opportunity for public investment, for economic growth and employment incentives will decrease. The new methods of tax frauds present the tax authorities of the Member States with major and complex challenge, therefore it is very important to endeavour to cooperate in this field, because stopping tax fraud is a common interest of the Member States. The tax avoidance influences the competition between the market participants, because the undertakings with evasive behaviour are able to sell their products on a lower price than the others. It is clear that the tax avoidance distorts the competition because the undertakings with law-abiding behaviour could not be able to operate effectively on the market.

According to the opinion of the authors the Hungarian tax authority introduces more and more legal instruments in order to prevent tax fraud and in order to protect the sustainability of the highest VAT tax rate in Europe. As we mentioned in our article the Hungarian tax authority is trying to step up with the development of the digital technology and introduced numerous different instruments like online cash register, EKÁER or the risk analysis systems, but they can still only serve as partial solutions.

In order to prevent the shadow market we propose to concentrate on reducing of use of cash, because these form of payments are almost invisible in front of the tax authorities and it is notable that cash is the engine of shadow economic. According to the estimations of the National Bank of Hungary the transportation, production, treatment of cash causes 100 billion Ft for the State budget, so the repression of cash would mean hitting two targets with one shot. In one hand it would cause more income from visible credit card payments and on the other hand it would reduce the costs of maintaining cash.

According to the opinion of the authors the tax authority should pay particular attention to the risky tax payers and to personal controls and seek to close longterm cooperation with reliable tax payers. The aim of the study was to highlight the problematic sides of the tax regulation and to emphasize the legal-vacuum in the systems.

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