

## Management of Tax Security Knowledge in Intra-Community Trade

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**Summary:** This chapter explores the issues of knowledge appreciation and knowledge management in the context of securing VAT in intra-community trade. This knowledge is proven to be necessary to both honest taxpayers carrying out legal economic activity as well as to bodies enforcing the tax law. The VAT to be presented has been deliberately selected owing to the ever-growing number of VAT scams within fraudulent tax “carousel” schemes; they involve multiple exports and imports of the same goods (in many cases exclusively based on fictitious invoices) through a diverse chain of supplies in a variety of EU countries.

**Keywords:** management, knowledge, VAT, trade, fraud

### Introduction

Taxes have a long-standing history as a source of revenue for state budgets. Throughout history, however, taxes due were collected in the form of both tributes (e.g., crops, commodities) as well as in monetary sums. Taxes are an ordinary phenomenon in the functioning of societies and within the society many groups seek legal optimization of tax burdens, whereas others seek quite the opposite, pre determining the performance of unlawful activities which are driven by a desire to make profit and which indirectly reduce the economic security of the state where the malpractice of diminishing mandatory money obligations takes place.

It suffices to mention that in the European Union (EU) itself new opportunities of destabilizing tax security, notably with regard to Value Added Tax (VAT), arose due to the establishment of free movement of persons, goods, services, and capital within the single internal market. Thus, trade transactions from various EU countries since 1993 are no longer subject to control at internal borders, and the VAT rate in the case of intra-Community

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supply of goods is zero percent, with the tax being paid by the purchaser in another country.

VAT governed by normative regulations in specific EU member states is one of the major revenues for the state budget. Though the concept of value added tax was developed already in 1919 by C. F. Siemens, its practical application has only been made possible since 1954. The factors underlying the abuse of the whole system by dishonest tax payers for the purpose of perpetrating tax fraud in relation to VAT are the scarcely precise, fairly liberal and basic structure of the Sixth Council Directive<sup>3</sup> as well as the currently applying Council Directive 2006/112/EC,<sup>4</sup> in combination with a complex mechanism for settlement of this tax. As the scale of fraud in this respect is significant, it is necessary to comprehend that the knowledge and its management within VAT security proves to be one of the more substantial elements in the protection of budget revenue in the EU member states.

### **Towards Knowledge Management**

A distinguished expert in management, P. Drucker (1909–2005) was one of the first to highlight that knowledge and knowledge expert workers constitute the principal assets of the enterprise or organization—depreciating somehow natural resources, capital, or work. Around 1960, he defined the term *knowledge work* and *knowledge worker*.<sup>5</sup> He also asserted that

we know now that the source of wealth is something specifically human: knowledge. If we apply knowledge to tasks we already know how to do, we call it “productivity.” If we apply knowledge to tasks that are new and different we call it “innovation.” Only knowledge allows us to achieve these two goals.<sup>6</sup>

<sup>3</sup> Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment, OJ 1977 L 145, case 09-1–23.

<sup>4</sup> Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ L 347, 11.12.2006.

<sup>5</sup> E. Skrzypek, “Wiedza jako czynnik sukcesu w nowej gospodarce” (Knowledge as a factor for success in the new economy), in E. Skrzypek, A. Sokół, eds., *Zarządzanie kapitałem ludzkim w gospodarce opartej na wiedzy* (Management of human capital in an economy based on knowledge) (Warsaw: Instytut Wiedzy i Innowacji, 2009), p. 145.

<sup>6</sup> P. F. Drucker, *Managing for the Future: The 1990s and Beyond* (Oxford: Butterworth-Heinemann, 1992), p. 23.

Knowledge is created by people due to mutual interactions between them and their environment. Therefore to appreciate the core of knowledge it is necessary to explore and understand the human being and the reaction process which generates knowledge. It is human relations that are a source of creation of knowledge, knowledge is subjective, relational in process, esthetical and generated in practice. For this reason the core of knowledge and process of knowledge creation need to be oriented toward a man and acting in a manner conducive to producing a kind of added value in the form of new knowledge for both a person as well as for an organization.<sup>7</sup>

K. R. Popper argues that knowledge never starts out of nothing; as a starting point it always needs some general background of knowledge which is recognized as prevailing at a definite time alongside its difficulties and problems. In principle it arises out of a contradiction between expectations embedded in our general background of knowledge from one side, and a new outcome such as observations or a certain hypothesis suggested by them on the other hand.<sup>8</sup> Therefore, knowledge is a result of all possible acts of cognitive understanding— where knowledge is a result of cognitive processes and cognition is, to a large extent, conditional on knowledge already possessed (the level of possessed knowledge determines the chance of cognitive choice of the object as well as a manner of cognition).<sup>9</sup>

Knowledge, however, is more difficult to define – one is to see it as using information to make a decision. Knowledge is more on knowing how to interpret information and providing new insights to some problem at hand. It is often using previous experience to interpret the information and use the interpretation to initiate some action. Thus knowing the temperature influences a person's choice of what to

<sup>7</sup> See K. Raczkowski, "Zarządzanie wiedzą w organizacji inteligentnej" (Knowledge management in an intelligent organization), in S. Lachiewicz, A. Zakrzewska-Bielawska, eds., *Zarządzanie wiedzą i innowacjami* (Knowledge and innovations management) (Łódź: Politechnika Łódzka, 2010).

<sup>8</sup> K. R. Popper, *Objective Knowledge: An Evolutionary Approach* (Wiedza obiektywna. Ewolucyjna teoria epistemologiczna) (Warsaw: PWN, 2002), p. 93.

<sup>9</sup> A. G. Noweś, "Stan zasobów wiedzy w polskich przedsiębiorstwach w świetle badań empirycznych" (State of knowledge resources in Polish enterprises in the light of empirical research), in J. Bogdanienko, M. Kuzela, I. Sobczak, eds., *Zarządzanie wiedzą w warunkach globalnej współpracy przedsiębiorstw* (Knowledge management in circumstances of global cooperation among enterprises) (Toruń: Wydawnictwo Adam Marszałek, 2008), p. 42.

wear based on their earlier experience in similar weather. Knowledge arrives in many forms.<sup>10</sup>

Relying on the realistic theory of knowledge it is possible to present a clock-like structure of the author's knowledge; likewise the knowledge structure by A. Jashapara contains previous experiences forming extensive networks of social, political, economic, and organizational relations.

A time-related arrangement of knowledge refers to the metaphor of a clock—to 24 hours within a day; the reference to hours, determining successive needs or possibilities for application of knowledge and passing time, being a synonym of passing knowledge if it fails to be preserved and codified. Also a clock represents the future which we have to confront using experiences acquired in the past; the past to which we cannot return physically but only metaphysically. A clock like structure of knowledge placed on a knowledge axis involves three major components:

a) **Experience radar (seconds)**, assessing each situation systematically and straightaway, making use of afterthought, retrospective, and experiences analogously to an active radar, with a pointer counting seconds symbolizing a radiating beam that explores a specific area within which all signals are caught, received, and processed. Depending on the time pressure, the meaning of data, information, and consequently knowledge may take on a standardized shape in the form of quick reaction (as in single loop learning, without use of afterthought) or long impulses—a longer time for searching (as in double loop learning and extensive deployment of creative and reflective thinking).

b) **Explicit knowledge (minutes)**—as overall knowledge being within a prevailing circulation. It may be gleaned from books, newspapers, radio, and television broadcasting, verbally, via the Internet, and other message types, it is a type of external knowledge regarding an individual and is codified.

c) **Tacit knowledge (hours)** is a type of specific personal knowledge. It includes all conditional circumstances, habits and culture, religious, social and other assumptions. It is the most precious knowledge as only its user is aware of what knowledge he possesses and only he may apply a specific

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<sup>10</sup> I. Hawryszkiewicz, *Knowledge Management: Organizing Knowledge Based Enterprises* (Basingstoke: Palgrave Macmillan, 2010), p. 72.

scope of knowledge to a specific place and time. Successful use of tacit knowledge may be achieved by dynamic interaction and teamwork which deploys explicit knowledge (hour hand) as well as operational-strategic radar of experiences (second hand).<sup>11</sup>

The foregoing assumptions indicate that a man faced with a new situation and new problems frequently refers to the previously gained knowledge and intuition he possesses. He determines a response by transforming possessed knowledge into actions. The foundations of the knowledge structure are previous experiences which further both knowledge types: "I know how" as well as "I know what" (tacit and explicit knowledge). It is suggested that usage of the experience radar is a specific example of double loop, deepened learning. It means that the radar every time refers to both reflective thinking as well as to experiences of the man, thus opening up new thinking perspectives in a specific case. Thus, it leads to the restriction of routine and generation of new ideas which may improve or destabilize functioning of a given organization.<sup>12</sup>

So what does knowledge management mean? According to R. von Spek and G. Carter, knowledge management in numerous cases is synonymous with a concept of an organization being in a process of learning, sharing with good practices, competence management, business excellence, management of innovations or intellectual capital.<sup>13</sup> Knowledge management is inextricably linked with a man who stores the resource of knowledge and a man has the capability of adding possessed knowledge to this repository. Above all he decides whether, when, and to what extent to avail himself of collected data and information and convert them into knowledge and then use it in a proper place and time through wisdom with the purpose of materializing knowledge.

An integrated approach towards defining the core of knowledge management is demonstrated by A. Jashapara. An author that while depicting strategic, systemic, and social perspectives, specifies knowledge

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<sup>11</sup> K. Raczkowski, *Zarządzanie wiedzą administracji celnej w systemie bezpieczeństwa ekonomiczno-społecznego* (Management of customs administration knowledge in a system of economic-social security; ms.) (Warsaw: 2010).

<sup>12</sup> Ibid., p. 71.

<sup>13</sup> R. Spek, G. Carter, "A survey on good practices in knowledge management in European companies," in K. Martins, P. Heisig, J. Vorbeck, eds., *Knowledge Management: Concepts and Best Practices* (Berlin: Springer, 2003), p. 196.

management as the “effective processes of learning related to discovering, applying and sharing human knowledge (both codified as well as non-codified); they deploy appropriate technologies and organizational culture for the purpose of expanding the intellectual capital of the organization and enhancing the efficiency of its operations.”<sup>14</sup>

It seems that currently in many cases the term knowledge management is incorrectly associated with transfer of documents or accessibility and application of computer networks. In fact knowledge management constitutes the whole system of methods, forms, and means designed to guarantee effective economic and social functioning in an organization. An organization or rather its management is tasked to create such an organizational culture in which members of the organization will be aware of the necessity to cooperate appropriately both in an internal (intra-organizational) environment as well as an external one by means of localization as well as gaining, developing, sharing, applying, and storing the knowledge.

### **Value Added Tax in EU Countries**

Value Added Tax is a turnover of indirect tax—which is assumed to affect to the least degree the final prices of goods and services that are subject to taxation due to so-called transferability on subsequent phases of the economic trade. It is the multi-phase tax that is really offloaded on to the consumer; the recipient of goods and services.

Maurice Lauré, a former French minister of economy, is considered one of the creators of VAT, which came into effect for the first time in 1954. In 1993, standard VAT rates were established; they could not be lower than 15 percent or higher than 25 percent, with the reservation that states could apply a single reduced rate as well as transitional rate in subsequent years. In recent years VAT rates have been subject to numerous changes; the current standard percentage ratio ranges from 15 percent for Cyprus and Luxembourg, to 25 percent for Hungary, Denmark, and Sweden (see Table 1).

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<sup>14</sup> A. Jashapara, *Knowledge Management: An Integrated Approach* (Harlow: Pearson Education, 2004), p. 12.

**Table 1. VAT rates in 27 EU Member States, 2010**

No.	State	Standard rate (%)	Reduced rate (%)
1.	Cyprus	15	5; 8
2.	Luxemburg	15	6; 12; 3
3.	Great Britain	20	5
4.	Spain	18	8; 4
5.	Malta	18	5
6.	Germany	19	7
7.	Holland	19	6
8.	Romania	24	9
9.	Slovakia	19	6; 10
10.	France	19.6	5.5; 2.1
11.	Estonia	20	9
12.	Czech Republic	20	10
13.	Bulgaria	20	7
14.	Italy	20	10; 4
15.	Portugal	21	5; 12
16.	Austria	20	10
17.	Slovenia	20	8.5
18.	Latvia	21	10
19.	Belgium	21	6; 12
20.	Ireland	21	13.5; 4.8
21.	Lithuania	21	5; 9
22.	Poland	22	7; 3
23.	Greece	23	11; 4.5
24.	Finland	23	9; 13
25.	Hungary	25	5; 18
26.	Denmark	25	-
27.	Sweden	25	6; 12
EU 27 Average		20.5	

Source: Based on *Taxation trends in the European Union* (Luxembourg: Publication Office of the European Union, 2010), p. 100.

At the beginning of the twenty-first century, VAT was applied in 118 countries. The United States was an exception. As a strong global economic power, it was the only country within the OECD which did not have VAT in its structure of tax contributions.<sup>15</sup>

<sup>15</sup> See *Combating VAT fraud in the EU: The way forward* (Brussels: International VAT Association, 2007), p. 11; and *Consumption Tax Trends* (Paris: OECD, 2004).

Currently all enterprises that desire to conduct business within the European Union need to have a VAT number.<sup>16</sup> The structure of identification numbers in the EU states mostly comprises of about 8–12 numbers, preceded by a descriptor comprising one or two letters, e.g., ATU1111111<sup>17</sup> (Austria, 9 characters; the first position following the prefix is always “U”), BE011111111 (Belgium, 10 digits; the first character following the prefix is always zero “0”), PL111111111 (Poland, 10 digits), SE1111111111 (Sweden, 12 digits). But the most heterogeneous structure of VAT identification numbers can be identified in Great Britain where four formats operate: blocks of 3, 4, and 2 digits: GB111 1111 11 or GB111 1111 11 111, GBGD111 (in relation to government departments), or GBHA111 (in relation to health authorities).<sup>18</sup>

**Fig. 1. Characterization of possibilities for use of VAT Information Exchange System (VIES)**

Source: Taxation and Customs Union Database

<sup>16</sup> EU VAT registered taxpayers are obligated to lodge an application and confirm registration of economic activity in the EU in order to avoid double taxation in member states.

<sup>17</sup> A digit 1 in a presented sequence of characters is only an example of illustrating the number of digits in a sequence of characters in a specific structure of the tax identification number.

<sup>18</sup> See Taxation and Customs Union, “VAT identification number structure,” Brussels 2008, <https://www.verisign.com/partners/vsvatformat.pdf>



The VAT Information Exchange System (VIES)— see Fig. 1 —constitutes an efficient tool used to exchange information regarding VAT (especially in relation to intra-Community supplies) among EU tax administrations as well as to confirm the VAT number.

The system does not enable collective examination of VAT numbers of the economic entities; neither does it provide full access to the type of economic activity conducted by the registered taxpayer. Yet, although it facilitates verification of whether a given entity is registered and currently active or not (response 0–1), it implies that it is impossible to check the previous activity of the given entity, for example, that of a few months ago.

### **Tax Fraud—Challenges to Security with Regard to VAT**

As a result of the evolution of crime mechanisms which frequently involve hundreds of people, there are many cases of tax scams, notably involving VAT. An annual scale of scam VAT in the EU states—fraudsters assisted by high-priced tax consultants and consulting agencies are increasingly improving their knowledge of the European VAT system—is estimated at a level close to €100 billion. Such a huge scale of scams poses a danger not only to the budgets of single countries but also to that of the entire EU budget.

However, a key issue is the reason for such behavior, which historically has tended to be the same, namely the desire to make profits quickly. It also transpires that dishonest taxpayers may also quite easily exploit regulations of single laws on VAT, which correspond in principle with the structure of directives.

First, following the implementation of the EU directive into the legal system of specific states, new regulations became noticeable; they regard among others taxation of transactions among the EU states including intra-Community supply of goods and intra-Community acquisition of goods. In this context a tax rate at zero percent for the intra-Community supplies is of major importance.

Such a rate is exceptionally beneficial for a taxpayer as all possible VAT from such supply (from the previous phase of trade/turnover) may be practically subject to refund to the bank account of the taxpayer. Yet, to achieve such preferential tax assessment/settlement there are formal requirements that have to be fulfilled with regard to, among others, documents certify-

ing such supply between VAT-registered taxpayers from two various EU countries.

Second, in a majority of member states taxable persons may, as a rule, deduct from the tax due purchases insofar as the goods and services used for their taxable business activities. In practice each invoice with a deductible tax, even from a dishonest trader, is extremely beneficial to a taxpayer; after taking into account that he is entitled to reduce his tax paid to a tax office or apply for a refund of the excess between the calculated tax and due tax.

Third, the issue of the refund of VAT (if there is an excess between tax due and calculated tax). The tax refund shall be transferred to a bank account indicated by a taxpayer within statutory time limits (e.g., 60 days). It must be manifestly underlined that financial funds obtained as VAT refund on the bank account are exempt from any extra tax burdens, specifically they are not taxable income subject to the law on personal income tax (and similarly exempt from corporate income tax).<sup>19</sup>

Fourth, after the European Union has been joined by a given country the check-in (clearance) proceedings cease to be carried out. Consequently, no officer can confirm the movement of goods across the border. Such a practice is the result of the EU principle of free trade among the member states. The procedure continues to apply in relation to the export of goods, that is, their transportation across EU borders. What is interesting is that the scale of fraud is far smaller, since at the moment the only proof evidencing that a trader from an EU state has received goods are the documents prepared in accordance with the requirements of the tax on goods and services law. It is clearly a vulnerability of the VAT system, which may be used to facilitate scams.

Fifth, tax bodies never assume that a taxpayer acts in bad faith, and if he is a VAT-registered taxpayer who lodged a tax return VAT-7 or VAT-7K within the time limit and claimed a refund from tax on goods and services, he has a good chance of receiving the refund within the statutory time limits.<sup>20</sup> As a rule, such a refund will certainly be verified, yet if all documents appear correct, the tax body is obliged to refund the difference of the tax.

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<sup>19</sup> Law on personal income tax of July 26, 1991, uniform text from 2000, Dz. U. No. 14, item 176 as amended.

<sup>20</sup> Characterized numeration of the tax return may be differently numbered in various EU states.

The interesting aspect is that the above construction is totally separated from payment for goods; which would be extremely helpful while conducting an investigation and may prove that the transaction has taken place.

Given the foregoing defects of the tax on goods and services system we may identify the prevailing types of tax fraud:

- Understating or not disclosing receipts due to counterfeiting and concealing invoices
- Extortion scam of the calculated VAT
- Theft of tax identification numbers, registration of fake companies (fraud type: missing trader)
- Carousel frauds including frauds with the participation of numerous groups of entities from at least a few member states, also called Olympic rings

Missing trader fraud has not yet been defined in legal terms but may be characterized as an entity's activity involving VAT registration of a fictitious enterpriser in order to avoid tax payment. In the whole structure it is the tax authorities that suffer losses.<sup>21</sup> In most cases a trader that registers for VAT uses data which are inconsistent with the actual circumstances (e.g., indication of a private apartment as an office for business or indication of false address). Another rule that applies in the procedure is that registration is made by a person who does not actually run the business (e.g., unemployed or foreigner). Registration is repeatedly made on the basis of stolen documents. A distinctive feature of the trader that tends to avoid tax in this way also involves an imprecisely defined scope of his activities (i.e., a trader deals with production and trade as well as services). Further the above described trader frequently changes bank accounts and usually possesses many accounts.

One of the simplest mechanisms of *missing trader fraud* refers to a transaction where goods are transferred between two EU states. An intra-Community transaction is performed between trader A (a member of state X) and trader B (a member of state Y) in such a way that trader A, in dispatching goods to trader B, makes intra-Community supply of goods and trader

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<sup>21</sup> P. Rochowicz, "Don't let yourself get involved into the carousel," *Rzeczpospolita*, March 24, 2005.

B makes intra-Community acquisition of goods. Then trader B will make domestic delivery of the previously acquired goods to another trader C (also a member of state Y).

In this scheme traders A and C may be legally operating enterprisers, yet B may not report intra-Community acquisition of goods and, above all, makes a domestic transaction at the price including VAT but fails to pay this tax. Missing traders often submit tax returns including the VAT but they fail to pay it. Usually the business of such traders ceases to continue when the tax authorities discover the fraud. However, due to lack of property and assets, further actions by these authorities appear unsuccessful. In addition trader B is aware that without paying the VAT, he will be able to sell goods at dumping prices.

A more complicated scheme refers to the situation in which a *missing trader*, B, will acquire goods from a legally operating trader, A, and then he will make domestic delivery of the previously acquired goods to another trader, C. Traders A and C are legally operating enterprisers. At the same time trader B makes a fictitious intra-Community supply of goods to the benefit of another trader D in another member state, thus evading payment of VAT. In this specific event trader D may be a VAT taxpayer and unaware of the fraud when his VAT number was utilized used by a missing trader. However, it may arise that this trader will be a partner of enterprisers perpetrating the fraud.

In both cases a decisive element in terminating this malpractice is prompt reaction on the part of the tax authorities.<sup>22</sup> Taxpayers carrying out intra-Community transactions are obligated to disclose them in summing up information on VAT returns. In most EU states, taxpayers are only required to disclose the intra-Community supply of goods. This information is further transferred to all EU states within the VAT Information Exchange System.<sup>23</sup> Therefore, the tax administration of a given country possesses information whether its taxpayer performed the intra-Community acquisition

<sup>22</sup> It should be noticed that one of the main problems is that the system which was put in place in 1993 for the exchange of information between member states on intra-Community supplies of goods does not provide relevant and timely information for tackling VAT fraud efficiently. See Communication from the Commission to the Council concerning some key elements contributing to the establishment of the VAT anti fraud strategy within the EU, SEC (2007) 1584.

<sup>23</sup> VIES is an integrated IT system enabling exchange of information on transactions among VAT registered taxpayers within the European Union.

of goods and is capable of taking measures to verify legality and proper procedures of such a transaction. It may then transpire that the VAT number<sup>24</sup> (e.g., in Poland it is a NIP, the TAX Information Number is preceded by a code PL) used in the transaction was only borrowed for the purpose of the fraud. In connection with this, an obligation to disclose not only the intra-Community supply but also intra-Community acquisition in summary information brings a greater probability that tax authorities will detect all the irregularities in transactions more quickly. Tax administrations in the EU states collect information not only about supplies from the EU (within VIES), but also about supplies that are disclosed in summary information of the VAT return submitted quarterly. In this manner a simple comparison of information will provide a full picture of possible inconsistency, which then may be analyzed thoroughly.

The other type of fraud is the so-called carousel which may be briefly described as the movement of goods between two (or more) member states, arranged in such a manner that the goods return to the state of origin. Such carousel circulation of goods is facilitated by the lack of border checks within the EU. In numerous cases of this type of fraud there is only a simulation of the circulation of goods, so no charges such as transportation costs are incurred.

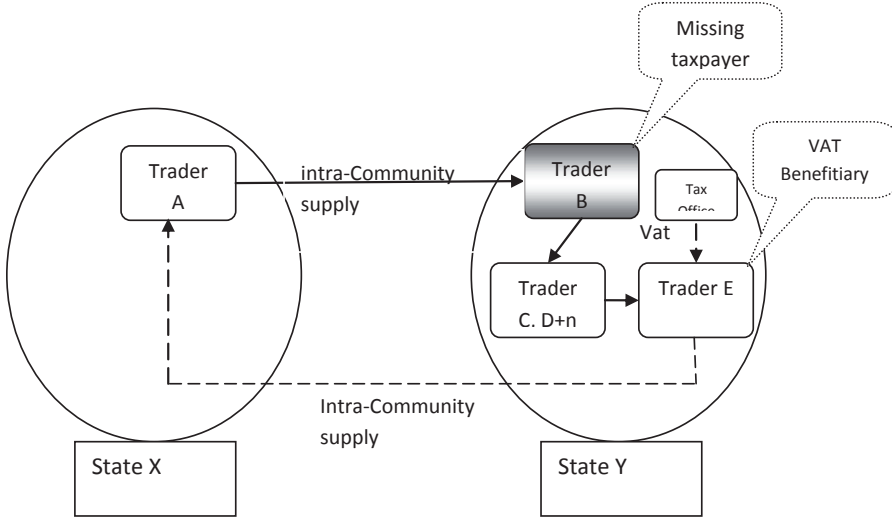
A common trait of carousel frauds is the lack of collateral in the form of trade loans as they are predominantly cash transactions, despite the high value of the goods, or transfers to accounts owned by enterprises of legal entities which hampers identification of the person in charge of the business. Frequently the payments are disguised as supplies which are followed by money transfers. However, most often the same amount of funds is in circulation throughout the carousel which, after calculation of payments made by one trader, create multiplied amounts far exceeding the real one.

The simplest mechanism of the carousel fraud is built in the following way (see Fig. 2):

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<sup>24</sup> A name for the VAT number may be different in various states, e.g., in Poland there applies a number NIP preceded with a code PL.

**Fig. 2. Basic scheme of carousel fraud in the EU states**



Source: The author

1. Trader A having its registered office in a member state X sells goods on to trader B with the registered office in a state Y (due to intra-Community supply of goods trader X has a zero rate and possible VAT refund) at a total price of €100,000.
2. Trader B which is most often a missing taxpayer<sup>25</sup> resells the goods on to buffer trader C with a loss of €80,000 + VAT (e.g., at a rate of 20 percent it is €16,000). Trader C has a registered office in a state Y (certainly issuing a proper VAT invoice—yet it fails to pay VAT to a relevant tax authority). Thus, trader B acts to the detriment of tax authority and goes missing (or ceases to exist) without paying the tax for domestic supply of goods.
3. Subsequently, sale of the goods by trader C may be made with a negligible profit (e.g., selling the goods for €85,000 + VAT) and further traders, e.g., D and E (brokers), will settle VAT properly.

<sup>25</sup> Importers (being purchasers) may receive goods without paying VAT for intra-Community acquisition and at the same time they have to pay VAT from their sale.

4. The last element in the chain, trader E will make an intra-Community supply of goods to a trader which began the carousel, i.e., to trader A. Since the intra-Community supply is zero rated (?) trader E will be entitled to claim back the VAT on the bank account (trader E sells the goods on to trader A for, e.g., €95,000 and recovers the whole calculated VAT, that is €17,000, from the tax office). Traders D and E are labeled buffer traders and trade with missing tax payers. However, unlike missing traders they duly discharge their tax obligations.<sup>26</sup>

The scheme presented above may be repeated until the tax administration of a given state interrupts this malpractice. It needs to be highlighted that supply of goods is made on the basis of invoices issued at proper intervals. A more complicated structure of the carousel fraud will involve numerous missing tax payers in its chain, thus rendering the whole situation increasingly blurred. Further, it makes the cracking of this mechanism of fraud extremely labor-intensive and time consuming. Additionally such carousels may encompass many member states creating so-called Olympic rings.

A report by the European Commission regarding carousel frauds and offenses while acquiring goods (SCAC 364 document) collected and described a total of 151 fraud cases.<sup>27</sup> Key conclusions refer to, excepting scam mechanisms, the types of goods that are frequently the objects of the transaction. To achieve the best financial outcome fraudsters mostly prefer to transfer mobile phones and their accessories, computers, and IT components, expensive electronic equipment, and even luxury cars. Extraordinary situations arise when some models of mobile phones become an object of transactions even before their release on the market. Recently the assortment of goods has expanded with xenon car bulbs and engine injection systems. The demand for these goods measured by issued invoices exceeds its real yearly demand twofold.<sup>28</sup>

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<sup>26</sup> Mechanism of tax frauds making use of chain transactions, supplement to VAT Guide (Poradnik VAT), No. 6, May 10, 2007, Wydawnictwo GOFIN.

<sup>27</sup> SCAC 364 – The second report on carousel and acquisition crimes – result of reports prepared by the member states, March 31, 2003, TAXUD/2327/03.

<sup>28</sup> See M. Duda, *Dziennik*, March 31, 2010, p. A4.

In order to combat the above described fraudulent tax schemes, in spite of actions at a national level, there are attempts to introduce systemic solutions through furthering cooperation among the member states' administration within the system VIES or SCAC forms as well as multilateral checks.

To enhance all-embracing cooperation among tax authorities of the member states in respect of fighting against tax frauds, the Council of the European Union adopted in October 2003 a new Council Regulations (EC) No. 1798/2003 on administrative cooperation in the field of value added tax, which came into force on January 1, 2004.<sup>29</sup> The fundamental postulates of this document, apart from strengthening the role of VIES, included formalizing the thorough exchange of information on intra-Community transactions in a specific EU member state by, among other means, a standard form SCAC 2004 which combines a request for information exchange as well as a request for administrative proceedings—Articles 5 and 19 of the regulation. However, the most significant from the perspective of fighting tax fraud is the standard form SCAC 383, intended specifically to counteract missing tax payer fraud.

It should be underlined that the above findings may be subject to criminal responsibility for crimes or tax offences pursuant to national regulations of criminal and penal laws.<sup>30</sup> As described above, a missing tax payer under this law may be liable for the following: failing to declare tax or delinquent default on payment of a tax. In the case of counterfeiting documents (e.g., forging invoices or bills of lading) the sanctions envisaged in the Criminal Code of the given country may be applied.<sup>31</sup>

Apart from structures set out above and methods for preventing VAT scams, the jurisdiction of the European Court of Justice has had a substantial impact on determining the approach of tax administrations to this problem. In regard to this issue, the first judicial decision was made on January 12, 2006 (combined cases *Optigen, Falcrum, Bond House*).<sup>32</sup> The fact findings certainly dealt with a carousel chain of supplies where British traders made

<sup>29</sup> Council Regulations (EC) No. 1798/2003 on administrative cooperation in the field of value added tax, OJ L 264, October 15, 2003, p. 1.

<sup>30</sup> See e.g. Law of September 10, 1999, Criminal-penal Code, Dz. U. No. 111, item 765 as amended.

<sup>31</sup> E.g. Art. 270 or 271 of the law of June 6, 1997, Criminal Code, Dz. U. No. 88, item 553 as amended.

<sup>32</sup> Judgment of the European Court of Justice of January 12, 2006 (joint cases No. C-354/03, C-355/03, C-484/03; *Optigen, Falcrum, Bond House*).



an intra-Community supply of goods to traders in various EU states, having previously purchased them from missing traders. One of the major findings was that traders had acted in good faith and did not know and were unable to know that they were involved in the carousel. Tax bodies denied their right to make tax deductions from transactions performed with missing traders. The Court of Justice in its deliberations, based on the objective approach towards supply of goods, argued that examining intentions stimulating other participants of the supply chain would be in contradiction with the objectives of the common VAT system. Also the Court asserted that the right to deduct VAT is a basic constructive element of the value added tax and as a rule it cannot be restricted.

The Court, in its decision, manifestly supported traders acting in good faith. It deprived the member states of the right to compensate their losses suffered from unpaid VAT on other participants of the carousel fraud.

In another judgment of July 6, 2006 (combined cases C-439/04 and C-440/04 *Kittel i Rewolta*),<sup>33</sup> the findings were similar, with the exception that one of the traders consciously participated in a circulation of supplies that constituted tax fraud. In this case, the Court decided that a taxpayer who was or should have been aware of involvement in a fraudulent chain of supply should be, under the 6th Directive, treated as an active fraudster regardless of any benefits derived from the malpractice. He cannot be regarded as an entity acting in the capacity of the taxpayer and conducting business. Therefore, this group is not entitled to exercise its right to deduct the tax calculated in accordance with regulations of the 6th Directive.

The European Court of Justice therefore, gave a vague green light to refuse the entities consciously engaged in tax fraud the right to reduce the tax due by a tax calculated in the previous phase of the trade. Yet in this event it is exceptionally difficult to show proof evidencing such conscious activity of the trader.

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<sup>33</sup> Judgment of the European Court of Justice of July 6, 2006 (joined cases C-439/04 and C-440/04 *Kittel i Recolta*).

## Concluding Remarks

The foregoing considerations provide an overview of the value added tax system which in principle facilitates scams. The approach of the Court of Justice in many cases proves to be excessively liberal, which is conducive to huge losses in budgets of specific EU member states. To prevent such a situation, new solutions affecting the whole system of VAT are being proposed including the idea to pay VAT at the end of the chain (*reverse-charge*)<sup>34</sup> and that the whole system of VAT should be completely unified by eliminating diverse reduced special rates which apply exclusively in certain countries and to selected groups of goods or services.

The other method capable of combating VAT fraud in a systemic way (irrespective of any amendments to the VAT system) would be the establishment of a European Union fiscal police—one that is fully task-oriented, flexible, and operative (as practice shows OLAF<sup>35</sup> in this structure and system of operations is unable to guarantee a minimal degree of security in this respect).

Such a body should not only be afforded with physical capability to operate in real time in any EU member state, but also would have opportunities of transmitting or verifying information *just in time*, presupposing a proper organizational culture of the integrated system of employees in the EU member states combined with efficient and effective application of information and communication technology. As practice shows, information processed from EUROCANET (European Carousel Network),<sup>36</sup> with the use of SCAC forms, and multilateral cooperation under the Council Regulation (EC) No.1798/2003 of October 7, 2003, on administration cooperation in the

<sup>34</sup> "Union aims counteraction against tax fraudsters," *Gazeta prawna*, February 26, 2008.

<sup>35</sup> OLAF, the European Anti-Fraud Office established on the basis of the Commission Decision 1999/352/EC. The key task of OLAF is combating frauds and corruption as well as protection of European Union interests. Even though the Office is independent as regards investigations, the scope of proceedings is considered negligible as compared with reported irregularities in the areas of abuse and frauds, notably VAT. A good move would be to expand the powers of OLAF in respect to conducting proceedings and penalizing controlled prohibited actions and establishment of so-called OLAF cooperation centers located in each EU member state and directly subject to OLAF rather than to a particular financial department (as currently in operation).

<sup>36</sup> EUROCANET, project initiated by the Belgian administration on January 1, 2005, with a view to enhancing cooperation among EU member states due to the quicker transmission of information, and oriented towards counteracting carousel frauds.

field of value added tax, are not fully exploited, or their usage should be regarded scarcely effective.

Possibly the human contribution to this institution should be constituted by representatives of police forces, customs services, and the tax administration (including tax control) from a given country delegated to discharge of specific functions for a term of office, e.g., of 4–5 years. Having completed the functional tasks within the national unit of the OLAF they would be able to apply for a subsequent term of office or return to their previous organizational units.

Nonetheless, in order to bring about such a revolution entailing changes to tax law across all EU member states, as well as establishment of organizational and integrated institutions intended to counteract tax frauds, it is necessary to gain broad endorsement and undertake many time consuming discussions and settlements. Proof of this can be seen in the attempts to implement the Eurofisc scheme<sup>37</sup>—construed as EU common operational structures aimed at a very fast exchange of targeted information in the area of tax frauds through strengthening administrative cooperation.

Beyond doubt, in this regard, it will be a challenge to set up an appropriate framework for collaboration a model and concept of management knowledge which enables conversion of data into information, information into knowledge, and then knowledge through human wisdom expressed as practical application. Yet, it is unlikely to happen without intervention, but only when an administration from each state will be capable of obtaining and making use of human resources, or rather intellectual capital—which is currently possessed but not used (usually because of personal motives of a particular decision-maker) as well as that which is lacking and ought to be gained. Knowledge is a key for establishment as well as reinforcing permanent competitive advantages of a given organization or society, and man

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<sup>37</sup> An attempt to establish Eurofisc is a very good solution given that all EU states will obligatorily participate in the Project (it is also recommended for an entity to have legal status—autonomous or within OLAF structures). Original guidelines of Eurofisc provide for four principles of functioning: each state will individually decide on participation in specific activities of the network, confidentiality and active cooperation in exchange of information, and lack of additional encumbrances for the trader. See Eurofisc project 11714/08 FISC 91 as well as Communication from the Commission to the Council, The European Parliament, The European Economic and Social Committee, COM (2008) 807 final, Brussels, December 1, 2008, and Press Release of the Council of the European Union 13784/08 (Press 279), Luxembourg, October 7, 2008.

is its carrier. Until specific organizations integrated within a single community apprehend these correlations in a practical manner, all deliberations on optimization of activities in the field of fighting threats to economic security though the viewpoint of tax will be solely diversions burdened with a smaller or larger error of success in practical application, giving ground to the black economy and illegal organized activities.