

VALUE ADDED TAX EVASION AND EXCISE DUTY FRAUD ON FUEL MARKET IN THE CZECH REPUBLIC

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Received: November 30, 2011

Abstract

SEMERÁD, P.: *Value added tax evasion and excise duty fraud on fuel market in the Czech Republic*. Acta univ. agric. et silvic. Mendel. Brun., 2012, LX, No. 2, pp. 335–340

This paper deals with analysis of current problems in the motor fuel market. It analyzes bottlenecks in setting the legislative changes in value added tax, excise tax and the legislation concerning fuels. The biggest problem is tax evasions that favor one group of business entities at the expense of another, and also cause that the state loses revenues mainly from indirect taxes. Therefore, attention is directed to quality control of fuels as a means of consumer protection and prevention of tax evasion and ways to combat tax evasion in import, distribution and storage of mineral oils. The examples are the most common errors found in fraudulent companies. Based on the data collected the possible ultimate evasion was estimated. Therefore, I propose that value added tax law should be amended and some other measures to improve supervision by public authorities like tax authorities and customs administration offices should be taken.

carousel frauds, excise duty on mineral oils, quality control, untaxed fuel, value-added tax

Motor fuel market in the Czech Republic is rather specific from the point of view of taxation. Breakdown of fuel prices is unique compared to breakdown of prices of most other commodities. Besides income tax, personal and corporate, taxpayers have to pay excise tax on mineral oils set at a fixed rate and value added tax which varies depending on the sales price. Even in the past, this element of the Czech market was affected by tax evasions when the names of light fuel oils were confused and then they were sold at petrol stations as diesel fuel. The Czech Republic and also other member states of the European Union are looking for effective tools to combat tax evasions or at least to reduce them as much as possible.

After the Czech Republic joined the European Union intra-community trade expanded, giving rise to carousel frauds. These frauds involve selling goods through a series of companies and one of the entities which are part of the supply chain fails to pay VAT (*Financial Action Task Force, 2007*). As these sales are broad and complex, it is very difficult to find the evader. The consequence of the failure to collect taxes, not only indirect taxes, is the loss of revenue

for the governments. Removing border checks means insufficient tracking of vehicles (fuel tanker trucks) that import fuel from other member states of the European Union or third world countries. Although the toll system which allows keeping track of these fuel tanker trucks was implemented in a greater part of the country, it cannot be entirely relied on because it has its drawbacks (e.g. bypassing toll highways using toll-free stretches).

As a result of setting a fixed rate of excise tax on gasoline (12,840 CZK/ 1,000 liters) and diesel fuel (10,950 CZK/ 1,000 liters) tax evasion can be for some companies a highly profitable business (*Danielová, 2011*). Illegal fuel blending (“cocktailing”) of petroleum products is among traditional tax evasion activities (*MV ČR, 2011*). Cocktailing of motor vehicle fuel refers to an illegal blending operation in which non-motor vehicle fuel components are being added to motor vehicle fuel. These are, for example, mineral oils that are used in many industries or for heating. As excise tax imposed on these oils is lower, a tax evasion occurs (*Krajša, 2011*).

As this problem is much bigger, I suggest the following definition of the term: illegal mixing of fuel (“cocktailing”) is a process of deliberate modification of chemical composition and physico-technical properties of fuel which does not comply with applicable legal and technical standards. This is done without knowledge and approval of authorized government departments and government institutions with the intention of trading and selling to the ultimate customer. The aim is collecting taxes from the consumer but not declaring them and paying them. Motor vehicle fuel is blended with chemical substances, compounds and mixtures that have similar technical characteristics but a lower rate of excise tax or are exempt from taxation entirely or partially (these components are destined for off-road use or for disposal). The fuel blend can endanger life and health of consumers, cause property damage and environmental pollution.

The second, no less important area of tax evasion is illegal reducing of tax liability. This can relate to almost any tax. The principle is the unwillingness to pay the assessed tax and the efforts to minimize the tax liability by illegal means. Some retailers do not include excise tax in the tax base of value added tax or participate in carousel frauds (Kulková, 2011).

A special case of tax evasion not only in the fuel business is non-payment of taxes either due to accidental or intentional over-indebtedness of a business or just unintentional failure to pay. Business ethics and company's solvency also play an important role in paying taxes. If it is a case of intentional over-indebtedness, then such a company can be called a “three-month company” (Semerád, 2009).

MATERIALS AND METHODS

Confidential information was obtained at the PETROLsummit 11 from fuel experts. Speakers at the summit were tax and customs officials, representatives of the Directorate General of Finance and the Directorate General of Customs, and also business people running fuel companies for a long time – wholesalers and petrol stations.

To get an idea of criminal offences, information was extracted from the official websites of the Police of the Czech Republic and Customs Administration of the Czech Republic. There is a lot of information about closed criminal cases and current investigations.

Unofficial information was obtained from fuel retailers. It is necessary to add that it was really difficult to give them confidence in answering questions. For this reason, identity of these respondents is kept secret.

The most important part of the research was the collection of really sensitive data. This was not the collection of information on a specific case but it was a comprehensive and detailed analysis of market problems. After the data was processed the method of reasoning was used to generalize conclusions

about the problems. Then they were described and explained.

The legal measures that were proposed or came into force were subject to analysis of effectiveness in solving these problems.

RESULTS

Two major problems occurring in the motor fuel market are adulterated fuel through cocktailing or illegal blending and illegal reduction of tax liability. This was known before this research and it was independently confirmed by respondents. For this research it was important not only to identify the problem but also on the basis of the data collected to analyze processes that lead to this problem.

Cocktailing of motor vehicle fuel can take place in different parts of the distribution chain. Some tax warehouses are privately owned so that there is no direct government control over these premises. Some unknown owners of tax warehouses take advantage of this situation in order to enrich themselves. According to the information the fraud works like this: Fuel fraudsters purchase great quantities of substances that are similar in composition to motor vehicle fuel. They fraudulently report that the fuel was used for burning in the boiler house or was exported (delivered) to another country. In fictitious exports the government loses VAT revenue, as these activities are claimed as exempt and eligible for deduction. These components are added to large tanks which are located in the warehouses. The total tank capacity can be more than one million liters. Adding other components can be hardly recognized. Small vendors who have their own fuel tanker trucks can mix these substances in the tank. The truck's tank that was improperly cleaned after delivering another petroleum product (there is still some residue left from the previous delivery) is impossible to get into the tax warehouse.

Therefore, it is most likely that the problem of illegal blending occurs during the transportation of fuel from the source (depot) to the place of discharging (petrol station). When leaving the depot the tank is sealed so obviously the seal must be broken and replaced with another one. A speculative answer was received from one vendor who said that two tanker trucks come to the petrol station, one with regular fuel and the other with adulterated fuel. At first adulterated fuel is siphoned and only then regular fuel. What happens to what remains in the tank? It is allegedly sold in the black market without any tax receipt to fill trucks or cars.

It has been proved that adulterated fuel is imported from Poland. In Poland some components are conditionally exempt from tax. These are, for example, the following trade names: Oil Rust Cleaner, Biosepar, Technisches Formöl, Oil OM-10, Olej smarowy bioform, Formenöl, Olej ceramiczny, Lubricating oil, Smierol, Topclean 10, Universal technisches öl, Ecosolv L. During July and August 2011 some 32 million liters were delivered to the

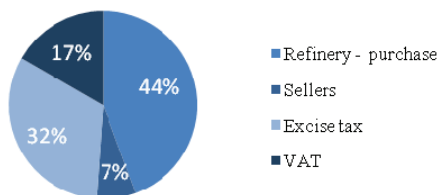
Czech Republic, Slovak Republic and Hungary (Danielová, 2011). This trade goes beyond the national borders and spreads across the whole of Europe.

Gasoline frauds may also occur at petrol stations. Some could intentionally mix biodiesel with diesel fuel and E85 with petrol Natural 95. If this really happens is uncertain.

Much easier seems to be illegal reduction of tax liability. It is the value added tax that is often the subject of tax evasion. As can be seen in the table I. (*Diesel price breakdown*) and in the chart 1 (*Percentage analysis of diesel price*), VAT on fuel is approximately 17%. If the sales price is 34.00 CZK, the calculated VAT is 5.67 CZK/liter. The wholesale price is lower (minus a retail markup). Nevertheless, there seem to be groups for which VAT fraud is a good source of profit.

I: *Diesel price breakdown*

Price ČEPRO*	Diesel fuel
Refinery – purchase	15.09
Sellers	2.29
Excise tax	10.95
VAT	5.67
Sales price	34.00



1: *Percentage analysis of diesel price*

Source: Own research based on information of ČEPRO, a. s.

*) A basic weekly price of the company ČEPRO, a. s. for the week from 23 August to 29 August 2011 – 25.74 CZK/liter was used. The price is divided into the following components „Purchase - refinery“ and „Excise tax“ plus distribution costs 0.30 CZK/liter.

There are a few ways of achieving this. The common practice is as follows: VAT fraudsters set up a limited liability company and register as VAT payers with quarterly VAT liability and as fuel sellers with the Customs Office. They do business for the entire quarter of the year as any other business company. The difference is that the prices they are selling goods at are lower than the prices of other wholesalers. This company attracts customers and the business is booming. At the end of the quarter they file a tax return and continue their business operations. Before the day the VAT return is due they pay some company a fee for consultancy or a penalty. The company thus goes bankrupt because it is unable to pay its liabilities. It cannot pay the tax to the government because it does not have enough

money. At that moment, it is however, too late for state institutions to seize its property because it already belongs to a new owner, who can be, for example, a poor person. Transactions are carried out with a minimum maturity or in cash because if the suspect is found, the criminals' accounts will be frozen (Kulková, 2011).

According to the information obtained, newly set up companies are suspicious in the market. To obtain history, the companies are set up much earlier. Sometimes they are simply bought by another company and renamed to some good-sounding name.

DISCUSSION

April 2011 was a month of big changes in this area. On 1 April 2011 an amendment to the VAT Act came into force. It contains a concept of customer liability for a tax payment to be made by a supplier. In practice, this means that if the tax is not paid by the supplier tax authorities have the right to collect the tax from the customer. Tax authorities can claim the tax arrears from the customer provided that they knew or should have known and could have known that the tax on goods would not be paid by the seller. This is very difficult to prove and maybe that is why no customer has so far been held liable for unpaid taxes of the supplier. The question of *awareness* was brought before the European Court of Justice in the case *Optigen (C-440/04)* whose ruling poses a big problem for tax authorities. The European Court of Justice in its justification stated that if a person did not know or could not have known about being part of fraud its right to deduct VAT cannot be affected by law. According to another case, *Halifax (C-439/04)*, it is impossible to issue demand for payment to a person who knew that he was part of the fraud but did not profit. Maybe for this reason such taxes have not been demanded yet (Kulková, 2011).

If the purchaser does not want to run the risk of receiving demand for payment at a later date, there is a chance of avoiding it. A special case of tax settlement is the right of the purchaser to pay the tax directly to the deposit account of tax authorities of the seller. The only disadvantage is that when the next order is placed the goods will not be sold to him. Fraudsters do themselves out of VAT which is his profit.

On 21 April 2011 an amendment to Fuel Act 91/2011 of the Collection of Laws came into force. It introduced compulsory registration of motor fuel retailers with the aim of exercising better supervision over collection of indirect taxes – VAT and excise tax on mineral oils (*Semerád, PETROL, 2011*).

The outcome should be supervision over all entities. The purchaser cannot buy goods from anyone other than those who are on the list which is kept by the Customs Office. A threat of sanctions has forced all entities to register. There is a discrepancy between information from public administration

and retailers. Public administration claims that it has helped reduce tax evasions; retailers say that nothing has changed. However, it is too early to judge.

Fuel illegal blending ("cocktailing") is being fought by the Czech Trade Inspectorate (CTI). However, it has a limited budget which allowed taking 2,200 samples in the year 2011 (Pěkný, 2011) at 6,666 public and private petrol stations and stations with restricted access (Beran, 2011). Some entities are checked only after 3 years have elapsed. According to this policy the numbers of inspections should increase annually. Sellers welcome the decision of the Czech Trade Inspectorate to conduct inspections of distributors and suppliers. At present only fuel sellers are subject to inspection. A list of bad sellers is publicly available on the website of the Czech Trade Inspectorate. An association of petrol stations has also been asking the CTI to make a comment on the published results of inspections. This comment would be useful both for professionals and the general public. The association suggests rating and tagging petrol stations using the traffic light system (Indráček, discussion following the lecture by Pěkný, 2011).

Color marking should be as follows:

- Almost good, only little deviation (green),
- Serious deviation (orange),
- Dangerous, consumer- threatening exceeding of standards (red).

Estimation of tax evasion is not easy. The following example illustrates what damage can be done by a company reducing its tax base:

VAT on 1 liter of diesel is about 5 CZK. Fuel is not shipped in liters but in bulk quantities in tanks whose capacity can be above 30,000 liters.

Government's loss per 1 tank	150,000 CZK
	(30,000 liters × 5.- CZK/liter).
Loss in 1 month (30 days)	4,500,000 CZK
	(150,000 CZK × 30 days)
Loss in 3 months (90 days)	13,500,000 CZK
	(150,000 CZK × 90 days)

If the seller sells at low prices, he could sell not only one, but for example ten, twenty or even more tanks every day – and this is just one company. What if there were more of these companies? As for illegally blended fuel, the markup is even higher (fixed rate of excise tax) and so tax evasion is higher, too. According to the sellers, VAT revenue losses through fuel tax evasion could annually reach billions of crowns. The exact amount is beyond any estimate.

It is difficult to propose solutions that could change the situation in the motor fuel market. One

solution is not enough because it can always be circumvented. As this is a big problem within the whole of the European Union, proposing solutions for the Czech Republic is meaningless.

Change to excise taxes – **To harmonize rates of taxes on mineral oils and to abolish exceptions** (Semerád, STING, 2011). The objective of this solution is to find some conformity with EU directives – oils should not be distinguished only by nomenclature codes but also by their properties and potential uses. This could restrict illegal fuel blending and increase the profitability of excise tax.

VAT change – **Each entity is obliged to register as a monthly taxpayer on the first day of starting their business which is assumed by its nature and scope to exceed turnover of 10 million CZK but no later than twelve months after starting the business** (Semerád, STING, 2011).

Fuel selling is an activity in which the limit for registration is exceeded if you have sold the second tank. There are very few companies that are not able to sell two tanks in three months. It is practically inconceivable that the limit of 10 million CZK would not be exceeded in a year. Therefore, taxpayers would be relieved of their obligation to monitor the limit and would have to file VAT returns every month. If nothing else, these companies would be for three months under the supervision of tax authorities.

CONCLUSIONS

Combating tax evasion is almost endless. Even the best measures can be circumvented – renaming a product or blending products at different mixing ratio. The proposed solutions are related to the principle of tax laws (excise tax and value added tax). Even though the European Union strives to harmonize taxes, there are still a lot of exceptions for individual countries which withhold approval. The changes, however, are not substantial in scope and after a considerable discussion general agreement could be reached. Social aspects of tough measures could be offset by means-tested benefits. However, where exceptions are made, there is always room for abuse. What cannot be supervised should be repealed; otherwise, it is a vicious circle. The result can then be much worse than the original situation.

Motor fuel market cannot be excluded from the entire market. On the other hand, it is essential in its scope both for drivers – consumers and government budgets. Predominantly national budgets should be motivation of positive changes which would bring money and reduce tax evasions. If this happens depends entirely on approval procedures.

SUMMARY

The paper to be presented at the conference Enterprise and the Competitive Environment 2012 deals with the present situation in the fuel market in the Czech Republic. The aim was to obtain as much information as possible about the market and to identify current problems. It also presents the main

changes of the year 2011 – value added tax, Fuel Act. The solutions proposed by the author can be a stimulus for discussion. The aim is to enforce proposals within the European Union. However, these proposals cannot be pushed through by an individual.

Collecting information was quite complicated because some respondents refused to answer the questions. The reason was either the fear of data misuse or the fear of competition. As the data is really sensitive, total anonymity is assured. Then the problems were generalized. They were analyzed with the aim of understanding the nature of fraud.

Fuel markets in the Czech Republic and neighboring countries are affected by exceptions which allow some goods to be exempt from taxation. As a result of this imported goods either mysteriously disappear or are renamed on paper – the names and the nomenclature codes are changed. Then they are sold in the home country or another member state as gasoline or diesel. For companies committing tax evasion a fixed rate of excise tax on mineral oils is very interesting as it becomes their profit.

A similar situation is in VAT evasions. Companies doing business like any others suddenly do not meet their tax liabilities and end up being insolvent. They owe tax for at least three months. They also cause distortion on the market because their sales prices are always lower than usual prices.

Acknowledgements

I would like to thank everyone for valuable advice and experience with the operation of fuel market not only in the Czech Republic.

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