

HOW TO AVOID THE USUAL PRICE RULE ON THE FUEL MARKET IN THE CZECH REPUBLIC

Pavel Semerád¹

¹Department of Accounting and Taxation, Faculty of Business and Economics, Mendel University in Brno, Zemědělská 1, 613 00 Brno, Czech Republic

Abstract

SEMERÁD PAVEL. 2016. How to Avoid the Usual Price Rule on the Fuel Market in the Czech Republic. *Acta Universitatis Agriculturae et Silviculturae Mendelianae Brunensis*, 64(1): 351–355.

The paper deals with value added tax evasions on the fuel market in the Czech Republic. This commodity is used in carousel fraud. In the chains of taxpayers there are missing traders who fail to meet their tax obligations. Their business strategy is based on quick sales at unusually low prices which do not allow honest parties to compete. Tax administrators should focus on unusual prices which constitute a higher probability of tax evasions. This paper aims to verify whether or not there are ways to evade the measure, focusing specifically on applying methods which could help achieve lower sales prices while avoiding the possibility to require unpaid tax from the recipients of taxable supply. The weaknesses thus found are described and demonstrated in more detail in the paper. During a research some ways were found which could be used for avoiding this specific measure. Methods of Cash Back and Free Shipping were identified and described.

Keywords: tax evasion, usual price rule, value added tax

INTRODUCTION

Tax fraud is an extremely considerable issue in all states in the long term, affecting not only public budgets, but even the taxpayer conduct: once the person sees the tax authority's inability to reduce fraud by legal means or the legislator adopting burdensome, but ineffective measures, they may give up their inner reluctance against fraudulence. Working out between compliance and non-compliance with tax duties is subject to several factors, such as aversion of the tax entity to risk, the maximum amount of profit from fraud or the maximum sentence for the same; how this behaviour is perceived by the society as such may also be considered (Allport, 1920; Le Bon, 1896; Slemrod and Yitzhaki, 2002; Torgler and Schaltegger, 2005; Zubalová *et al.*, 2012).

As regards value added tax, authorities face "carousel fraud" in particular (Brederode, 2008; FATE, 2007; Fedeli and Forte, 2011; Podlipník, 2012). Sophisticated and generally known techniques, they abuse the basic principles of tax administration that apply to trading with other states. Typical of this behaviour is an occurrence of a "missing trader" in the chain of payers; this refers to a person who is the

first entity (owner) in the state in which the fraud is to happen. The payer is required to declare and pay tax using a means referred to as self-assessment. The fraudulent action is based on the fact that such a trader provides the deliverable to another payer while failing to pay an output tax. Upon receipt of the payment and putting all the liquid assets beyond the reach of the company, the entity – risky in terms of tax – ends up in insolvency or without sufficient funding to pay the tax (Pfeiffer and Semerád, 2013). Consequently, the fact that the other entity is entitled to deduction creates enormous losses at the expense of the state budget. This confirms the finding (Tanzi, 1999) that some frauds are simply committed as part of tax returns rather than being associated with activities in the underground economy.

Every state has a problem with its specific subject matter of taxable supply. Yet the responsibility for fighting tax fraud is left to the individual Member States, although it usually involves fraudulent activities in cross-border trading (Lazăr, 2013). Before the Council Directive 2013/42/EU entered into force, this Commission's approach was complicating any change in the long term with the Member State being unable to take any action

without the consent of the other states. Any change also had to comply with Union's practice, such as the neutrality principle, otherwise it was abolished to the whole or partial extent by the domestic courts or the European Court of Justice. Therefore, any changes rather seek to help improve tax collection and administration.

METHODOLOGY AND DATA

The Czech Republic has implemented a measure into its domestic Value Added Tax Act that relates to the recipient of taxable supply. The recipient is liable for unpaid tax if the payment for such transaction is clearly diverging from a usual price while there are no economical grounds for the same. Although the rule entered in force in April 2011, it has not been applied by tax authorities to a satisfactory extent since there are cases of subject matters of taxable supply for which there is a lack of a sufficient database of transactions that enable comparing the price paid as part of a suspicious-looking trade.

This paper aims to verify whether or not there are ways to evade the measure, focusing specifically on applying methods which could help achieve lower sales prices while avoiding the possibility to require unpaid tax from the recipients of taxable supply. The weaknesses thus found are described and demonstrated in more detail in the paper.

Fuel was selected for the purpose of the paper, as a commodity that is significantly affected by carousel fraud. Annual losses in the Czech Republic are estimated to equal 8 billions CZK (ČAPPO, 2012). The first entity of the chain in the Czech Republic can take this opportunity to make a profit (in the form of tax evasion) of even more than 6 CZK per litre while the usual distributor's margin is 0.20 CZK per litre approximately (Semerád and David, 2014). Fraudulent companies can afford selling fuel much cheaper than their fair competitors. Such an attractive price helps them increase sales and generate more profit. Not infrequently, even a fair operator must desperately resort to purchasing an untaxed tank to survive the tough competition (Petlachová and Ležatka, 2014). Yet there has not been a case of applying the "usual price" principle.

Although the number of sellers is high on the market with some 160 fuel distributors (Customs Administration, 2014) and 6,918 gas stations (Ministry of Trade and Industry, 2014) currently registered, only base prices of ČEPRO Company can be found upon request. This alone significantly complicates applying the "usual price" principle and subsequently any levying of unpaid taxes on recipients of taxable supply since it may expose the taxpayer to arbitrary behaviour of the tax authority that may *ex post* interfere with transactions that already took place which may affect the principle of legal certainty. Attempting to set a usual price of fuel was therefore something in which the author was active earlier in more detail (e.g. Semerád, 2012a; Semerád, 2013).

An overall analysis of the fuel market can be considered one of the key activities in preparing the paper. Data collection and analysis are essential for producing an objective and systematic examination of the current state of the topic in question. Without carrying out the analysis, any identifying and understanding the rules of the market, its differences and components, ways of competitor struggles, opportunities that the market/distribution chain enables would be impossible; the same applies to revealing some of the tax fraud models and the impact they have on sales and conduct of other entities. The scope of the analysis is subject to the availability of data whilst depending on the extent of readiness of each entity to share their knowledge and lessons learned.

The analysis was based on sourcing primary data through surveying. The communication was underway via personal interviews. The respondents were randomly chosen from the community of distributors, operators of gas stations and representatives of tax authorities, e.g. General Financial Directorate, General Directorate of Customs, and Ministry of Finance of the Czech Republic. It was an unstructured survey and enabled directing the interview based on the respondent's feedback (Kotler *et al.*, 2007). There were asked 40 respondents.

Some of them mentioned problems with untaxed mineral oils, which were imported mainly in the period 1993–1996 in the Czech Republic from Germany, Poland, Austria and the Slovak Republic. These mineral oils were sold on petrol stations as fuels. The problem of fuel quality was mentioned as well. Illegal mixing is defined as a process of deliberate modification of chemical composition and physico-technical properties of fuel which does not comply with applicable legal and technical standards (Semerád, 2012b).

Fraudsters in some cases had calculated their tax obligations by an intention mistake. They had not added excise duty to VAT tax base. It was done also in ČEPRO's warehouses. For this reason the ČEPRO a.s. made this kind of business impossible in the year 2010. The next way of fraudsters led to do a tax evasion by purchasing goods from other EU member states. This problem was known also before the year 2010. Respondents gave examples of causes: The Slovak Republic – Case Komarno (2003–2004), Austria – Case Linz (2009), Germany (2010–2011), Slovenia (2012–2013). According to their opinion the Slovenian business was contrary to economic profitability. The distance from Slovenian refinery is up 300 km.

While the analysis was used for dissecting the issue to form rather simple and better-to-understand segments, synthesis was subsequently employed to produce a complex through integrating the sub-parts, which ensured clarity and a greater extent of objective knowledge.

General conclusions were drawn from partial findings by means of induction, the conclusions

being probabilistic in nature. Some sort of uncertainty is stemming from the limits of human understanding and limited availability of certain knowledge and facts, e.g. the lacking background data on pricing. The conclusions are therefore based only on those resources available that can be gathered. Prediction was giving rise to estimates of expected scenarios, impacts and results when using the proposed solutions.

RESULTS

While surveying the respondents, fundamental processes were found that are underway on the fuel market. The entities can be split into groups that involve tax warehouses and refineries, fuel distributors and gas stations. Placing orders for fuel takes place under agreed rules between businesses; terms of payment are also not uniform with every entity allowed to use their own methods of payment. Although elements applicable for defining risk factors may include these (e.g. Semerád and David, 2014), the facts were not utilised for the purposes of the paper.

Fuel distributors buy fuel from either tax warehouses or other distributors. As a rule, market prices are not to differ to a significant extent. However, as respondents said, they stand face to face to unfair price competitors who set their prices in the long term following the “ČEPRO base price: CZK 1” model. Since however the tax authority still has not made use of the liability for unpaid tax due to the sale for unusual prices, no reduction of such sales occurs. To this end, the distributor's deposit amounting to CZK 20 millions introduced in 2013 is considered a major breakthrough. Without giving the amount or securing it in the form of a bank guarantee, trading in fuel outside gas stations is not permitted. Even this action, however, based on respondents' experience, failed to help remove at least suspect traders from the market; the deposit even considerably reduced the total number of distributors of whose just under 10% remained against the former number of 1950 operators.

The issue covered by this paper is thus based on an alternative way of fighting tax fraud. But even if there was any methodology for experts and the tax authority to accept, the ways of doing business that enable circumventing the “usual price” principle will be necessary to cope with. Two alternatives were studied: the “Cash Back” method and the “Free Shipping” method. The advantage of these is in that they can be applied to any subject matter of taxable supply.

The “Cash Back” Method

A service used for holders of certain payment cards, it allows cash collection at cash desks/checkouts in selected shops. Merchants alter the ATM provided the shopper makes a purchase for a minimum amount and pays for it by card. A similar principle can be applied to evade the proposed methodology.

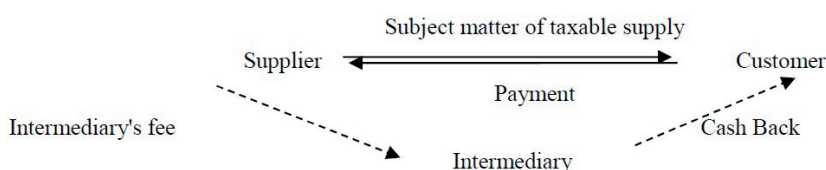
If a price is set at which there is still no risk of recourse under Value Added Tax Act, this very amount forms the minimum price at which the carousel fraud is carried out. A question arise about how can those committing fraud be discerned from a competitor that sells for the same price?

Assumed is the participation of another entity to be pulled directly into the fraudulent action, such as a gas station operator. It is required to receive and pay for taxable supply. After the receipt of the payment, the fraudulent seller makes use of the “Cash Back” method, paying a proportion of the price back to the Customer. At that moment, the Customer gets fuel below the set minimum price although the tax document has been issued for a legally accepted usual price. Such existence of two separate transactions is reducing the clarity and the ability to inspect. As part of this step, the money can be transferred via another entity (labelled as “Intermediary” on Fig. 1). The entity releases an invoice for the Supplier which covers brokering a deal or a service, paying the money to the Customer as a separate supply. While the financial & analysis department might be able to trace back the transactions via cash flow of all the entities mentioned above, revealing the entity of the Intermediary will be difficult or even impossible.

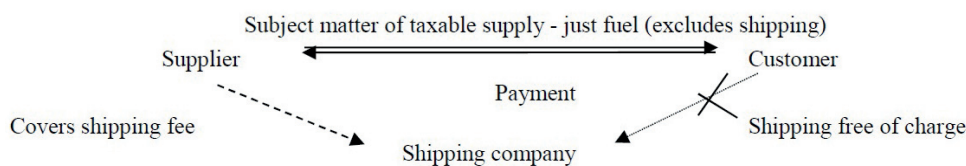
The money may even not be paid through any third party. The Supplier may pay it in cash to the Customer without any proof. Such steps are impossible to detect if none of the entities notifies law enforcement authorities; doing so might result in the entity convicting itself of tax fraud, money laundering or legalisation of proceeds from crime.

The “Free Shipping” Method

Shipping costs form a relatively insignificant part of the total selling price of fuel. Shipping, however, can be a very important tool for circumventing this methodology in context of fixed minimum usual price. Fig. 2 shows “Free Shipping”, a method that takes normal business operations involved in mail-order trading as a model. The operating principle of these is the situation when the Customer is not charged the shipping fee from a certain amount of



1: The “Cash Back” method when used in tax fraud



2: The method of "Free Shipping" when used in tax fraud

purchase; instead, the fee is covered by the Supplier in full from Supplier's margin/profit.

In fuel, the usual range of margin is 0.01 to 0.20 CZK per litre approximately. Depending on the shipping distance, transport costs may even be higher than the distributor's margin. The "win scenario" will thus be the total margin covering at least transport costs while the worst case will involve a loss-making business. At first glance, the method of "Free Shipping" does not seem to be one that can be used reasonably.

If the chart shown on Fig. 2 is to be used to evade Value Added Tax Act, then the Supplier will invoice only fuel consumption while not charging its Customer for shipping costs. This will result in the

taxable supply to be seemingly carried out at a usual rate; after a more detailed investigation it is not the case. The Supplier gains a competitive advantage as it is offering a lower price of the fuel delivered. Consequently, the Customer has a lower cost of ownership in addition to other benefits it may get, in different forms. Respondents indicated that they received offers for a vacation free of any charge, gratuitous provision of technical equipment/electronics, etc. This may however cause serious inconvenience to the tax authority. While detecting the missing transport will be possible through checks at taxpayers, proving other benefits and relations of these to trading is at least an issue.

DISCUSSION AND CONCLUSION

Any legal action that has the potential to reduce tax fraud is of great importance. In preparing it, however, testing its robustness in a comprehensive manner is essential. Tax entities are nowadays very well prepared and able, either alone or through consulting companies, to hide their illegal activity. The factor of inadvertent error in meeting tax obligations due to e.g. incorrect interpretation (misunderstanding) of the act can be ignored to some extent, although even this may produce difficulties. Much more dangerous and serious are however fraudulent activities committed by organised groups that form compound structures which are difficult to uncover for the tax authority. Although the measure to transfer the liability for unpaid tax onto the recipient of the supply is a fully legal instrument (Council Directive 2006/112/EC), it is difficult to apply, especially where a sufficient basis for objective comparison is missing. Overall, this measure is not fully resistant to an innovative entity. Mainly carousel frauds are sophisticated and generally known techniques. They abuse the basic principles of tax administration that apply to trading with other states. Czech fuel market has not been resistant to them. As evidence the problem unusual prices can be used. The fair traders are not able to compare fraudster's sell methods. In spite of having possibility the liability for unpaid tax the tax authority has not used this measures against tax evasion.

This paper aimed to verify whether or not there are ways to evade the measure, focusing specifically on applying methods which could help achieve lower sales prices while avoiding the possibility to require unpaid tax from the recipients of taxable supply. The weaknesses were found. The paper presents two models of fraud which could be used for evading usual prices. These involve the methods of "Cash Back" and "Free Shipping". Using the "Cash Back" approach, the recipient of taxable supply obtains the deliverable for a legally accepted usual price. The providing entity, however, gives some extent of the funds back, either in cash without any receipt, or through an intermediary. With "Free Shipping", the recipient is not charged for shipping. Although both cases comply with the requirement for "usual price" in terms of documents, the reality is different. This way the entity committing fraud gains a competitive advantage.

In addition, there is still the possibility of challenging the data *ex post*. While tax entities trade in real time, the tax authority can use data that it receives and processes with delay. Unlike the merchants, it has enough information on market prices. A state of uncertainty arises on the part of taxpayers in that they are going to be exposed to liability for unpaid tax although they had taken all the measures that can be realistically required from them. It should be noted here that legal certainty is an important principle of EU law system.

Acknowledgement

This paper was supported by Internal Grant Agency of the Faculty of Business and Economics, Mendel University in Brno [No. 13/2014].

REFERENCES

- ALLPORT, F. H. 1920. The influence of the group upon association and thought. *Journal of Experimental Psychology*, 3(3): 159–182.
- BREDERODE, R. F. van. 2008. Third-Party Risks and Liabilities in Case of VAT Fraud in the EU. *International Tax Journal*, 34(1): 43–50.
- EUROPEAN COUNCIL. 2006. Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax.
- EUROPEAN COUNCIL. 2013. Council Directive 2013/42/EU of 22 July 2013 amending Directive 2006/112/EC on the common system of value added tax, as regards a Quick Reaction Mechanism against VAT fraud.
- CUSTOMS ADMINISTRATION OF THE CZECH REPUBLIC. 2014. Spotřební daň: Seznam držitelů povolení. [Online]. Available at: <http://www.celnisprava.cz/cz/aplikace/Stranky/SpdInternet.aspx?act=findphm>. [Accessed: 18 January 2015].
- ČESKÁ ASOCIACE PETROLEJÁŘSKÉHO PRŮMYSLU A OBCHODU. 2012. Krácení DPH na trhu s pohonnými hmotami. Daňové úniky při výběru spotřební daně a daně z přidané hodnoty při obchodu s minerálními palivy. Rozpočtový a zemědělský výbor Poslanecké sněmovny Parlamentu České republiky. [Online]. Available at: http://afim.cz/files/dokumenty/29_CAPPO-kraceni-SpD.pdf. [Accessed 1 February 2015].
- FINANCIAL ACTION TASK FORCE. 2007. Laundering the proceeds of VAT carousel fraud. [Online]. Available at: <http://www.fatf-gafi.org/media/fatf/documents/reports/Laundering%20the%20Proceeds%20of%20VAT%20Caroussel%20Fraud.pdf>. [Accessed: 5 January 2015].
- FEDALI, S. and FORTE, F. 2011. International VAT Fraud: The Carousel Game. *Journal of Modern Accounting and Auditing*, 7(3): 211–226.
- KOTLER, P., WONG, V., SAUNDERS, J. et al. 2007. *Moderní marketing*. Praha: Grada.
- LAZÁR, R.-E. 2013. Tax Evasion between Legality and Criminal Offense. *Elsevier: Procedia – Social and Behavioral Sciences*, 92, 462–466.
- LE BON, G. 1896. *The crowd a study of the popular mind*. New York: The Macmillan Co.
- MINISTRY OF INDUSTRY AND TRADE OF THE CZECH REPUBLIC. 2014. Evidence čerpacích stanic pohonných hmot: Zpráva o aktualizaci a stavu Evidence čerpacích stanic pohonných hmot v ČR k 31. 12. 2013. [Online]. Available at: <http://www.mpo.cz/dokument147600.html>. [Accessed: 18 January 2015].
- PETLACHOVÁ, P. and LEŽATKA, R. 2014. *Průlom v přístupu k přípravě nového zákona – státní správa spolupracuje na přípravě zákona o elektronické evidenci tržeb s odbornou veřejností*. [Online]. Available at: <http://media.mfcr.cz/accordent/2014-07-09/main.htm>. [Accessed: 12 January 2015].
- PFEIFFER, S. and SEMERÁD, P. 2013. Missing Trader Fraud in European VAT. In: MENDELU Working Papers in Business and Economics. [Online]. Available at: <http://ideas.repec.org/s/men/wpaper.html>. [Accessed: 1 February 2015].
- PODLIPNIK, J. 2012. Missing Trader Intra-Community and Carousel VAT Frauds – ECJ and ECtHR Case Law. In: *Croatian Yearbook of European Law & Policy*.
- SEMERÁD, P. 2012a. Liability for Unpaid Tax – is it Possible to Determine the Usual Price of Fuel? [in Czech: Ručení za nezaplacenou daň – je možné stanovit cenu obvyklou u pohonných hmot?]. *Soudní inženýrství*, 23(2): 133–139.
- SEMERÁD, P. 2012b. Value added tax evasion and excise duty fraud on fuel market in the Czech Republic. *Acta Universitatis Agriculturae et Silviculturae Mendelianae Brunensis*, 60(2): 335–340.
- SEMERÁD, P. 2013. (Determination of the usual price for fuel in the Czech Republic) [in Czech: Stanovení ceny obvyklé u pohonných hmot v podmínkách České republiky]. *Odhadce a oceňování majetku*, 19(3–4): 46–57.
- SEMERÁD, P. and DAVID, P. 2014. Possibilities of Identification of Tax Fraudsters on Fuel Market. In: *Proceedings of the 19th International Conference Theoretical and Practical Aspects of Public Finance*. University of Economics Prague. 11–12 April, Prague, University of Economics. Prague: Wolters Kluwer.
- SLEMMOD, J. and YITZHAKI, S. 2002. Tax Avoidance, Evasion, and Administration. In: AUERBACH, A. J. and FELDSTEIN, M. (eds.), *Handbook of Public Economics*. Amsterdam: Elsevier.
- TANZI, V. 1999. Uses and Abuses of Estimates of the Underground Economy. *The Economic Journal*, 106(456): 338–347.
- THE CZECH REPUBLIC. *On value added tax, as amended*. Act No. 235/2004 Coll.
- TORGLER, B. and SCHALTEGGER, C. A. 2005. *Tax Morale and Fiscal Policy*. CREMA Working Paper Series. [Online]. Available at: <http://www.crema-research.ch/papers/2005-30.pdf>. [Accessed: 1 February 2015].
- ZUBALOVÁ, A. et al. 2012. *Daňové teórie a ich využitie v praxi: daňová teória a politika II*. Bratislava: Iura Edition.

Contact information

Pavel Semerád: pavel.semerad@atlas.cz