

## DIGITALISATION OF THE VALUE ADDED TAX – GREAT CHALLENGES / Peter Rakovský †

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### Obituary Notice

It is with great sadness that we have to announce that the below article by Peter Rakovský will be one of the last ever published. Peter has suddenly passed away on 21 June 2021, aged 28. He was a dear colleague, close friend, a diligent scholar, and a professional with a lot yet to give to the world. He will be greatly missed.

The staff of Department of Financial Law of Comenius University in Bratislava, Faculty of Law.

**Abstract:** *This paper focuses on Value Added Tax (VAT), due to the importance of indirect taxes as one of the most vital tax revenue generators in the EU. VAT is more stable and contributes more to the tax mix than direct taxes. However, the VAT gap is still a serious problem for the national governments, as it reduces the overall tax revenue.<sup>1</sup> Tax authorities are looking for more opportunities to reduce the information asymmetries between them and the taxation subjects. Due to that, collection and analysis of big data seems to be an excellent opportunity to do so in the Slovak Republic as well. One of the biggest sources of big data in VAT in Europe and the world is formed by the so-called “real-time reporting” and electronic filing, since electronic filing is mandatory in the majority of EU countries nowadays. However, policy makers should bear in mind that the mere collection of data is not enough (Bal, 2014). The main subject of this paper is to find, analyse and take into account the most important measures of VAT in the context of digitalisation. In addition, this paper focuses on new trends and challenges for VAT in the Slovak Republic, which may follow the trends within the world.*

**Key words:** *VAT, invoice, transaction, proportionality, information, real-time reporting, tax law, Slovak Law*

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## 1. INTRODUCTION

The main hypothesis of the article is to evaluate the most important measures in the area of VAT in the context of digitalisation, mostly on new trends and challenges for VAT in Slovak Republic, such as real-time reporting and electronic filing and whether they can influence the budget of Slovak Republic. The methods used include abstraction, comparison, analysis, synthesis, induction, deduction, and summarization.

Modern VAT administration can provide almost total state control of the business at the transaction level. The information provided by the VAT administration system, together with the data of payment systems and databases administered by the customs authorities, is a valuable information resource for the state that allows it to monitor, plan, predict the financial and economic indicators of the country as a whole, which confirms the strengthening of the control potential of the value-added tax. Recently, the establishment of interstate control over business in the EU integration association has also been based on the VAT document flow, which demonstrates the new capabilities of the VAT administration system in terms of control over cross-border transactions. It cannot be overlooked that OECD work addresses the problems that arise from national VAT systems being applied as well. For example, the implementation of the OECD standards for the effective collection of VAT on online sales of goods, services and digital products (included in the 2015 BEPS Action 1 report) have continued to influence VAT reform in a growing number of countries worldwide (OECD, 2020, p.4).

The issue of tax compliance has been discussed numerous times in various articles, mainly due to the polarizing nature of the topic. For companies, compliance is often costly and causes a burden, while for tax administrations, compliance of taxable persons is essential for the goal that they want to achieve: obtain tax revenue. According to Barbone, compliance with the rules does not occur effortlessly, but instead, must be overseen by a certain agent (Barbone, Bird and Caro, 2012, p.2). Non-compliance is a serious issue for lawmakers in most of the countries in Europe, and throughout the world as well. Here we are talking about VAT gap again. According to that, one of the most important objectives of the tax administration should therefore be the reduction of the VAT gap (Krajcuská, 2013, p.5).

For VAT purposes, a special document is provided — an invoice. From the legal point of view, VAT Directive already knows the concept of e-invoice, which can be concluded from its article 218 so-called "Concept of invoice."<sup>2</sup> The relevant provision of the VAT Directive has been amended by the Council Directive 2010/45/EU of 13 July 2010 as regards the rules on invoicing (Directive 2010/45/EU). Directive 2010/45/EU introduced three main changes to the EU legal framework for electronic invoices (e-invoices): "(i) a new definition of e-invoice;<sup>3</sup> (ii) the principle of technological neutrality; (iii) the principle of equal treatment among the paper and electronic invoices and iv) the concept of Business Controls that create a reliable Audit Trail (BCAT) as a mean to prove the e-invoice Integrity and Authenticity (I&A)."<sup>4</sup> The changes have been introduced evenly across the EU. Even when the national provisions are slightly different from the text of the Directive, there appear to be no problems of incorrect transposition.<sup>5</sup> Moreover, Directive 2010/45/EU introduced a number of changes in the area of invoice issuance and content and amended three specific invoicing regimes: self-billing, simplified invoices and summary invoices.

<sup>1</sup> From the fiscal point of view, the so-called tax gap represents the difference between the potential revenue from the tax that would have been collected, had all economic entities behaved in accordance with the law, and the tax actually collected, and in 2018, its level was 26.9% in Slovakia.

<sup>2</sup> „For the purposes of this Directive, Member States shall accept documents or messages on paper or in electronic form as invoices if they meet the conditions laid down in this Chapter.”

<sup>3</sup> „For the purposes of this Directive, ‘electronic invoice’ means an invoice that contains the information required in this Directive, and which has been issued and received in any electronic format.”

<sup>4</sup> However, EU concluded the results of this concept as „the lack of clarity” in practice.

<sup>5</sup> E-invoice definition is implemented in Act. No. 222/2004 Coll. on value added tax, as amended, as well as via the following definition: „an electronic invoice is an invoice which contains data pursuant to Section 74 and is issued and received in any electronic format; an electronic invoice may be issued only with the consent of the recipient of the goods or services.”

In the implementation of the offset (invoice) method of calculating VAT, which is widespread in the world, an invoice is a tool for the supplier to present the amount of VAT payable by the buyer (output VAT) as part of the cost of goods sold (services rendered). In turn, for the buyer, the invoice acts as a voucher (certificate) for acceptance of input VAT as a deduction. As we mentioned before, when taking into account that an invoice is a document form in itself, what is actually relevant is the data it contains. Thus, the digital invoice does not necessarily have to be a separate document. Rather, it needs to be a consistent set of data required by the applicable law and provided to the counterparty (and to the tax administrator in the reconciliation statement) (Kačaljak, 2020, p. 28).

*“Circulation of falsified invoices leads to the illegal withdrawal of value-added tax from the budget, which is why tax administration systems for VAT administration are also based on invoices. An invoice draws up each transaction, respectively, the amount of information about invoices, as a source of information for analysing and controlling the movement of budget amounts and taxes from the budget, is enormous, and its processing is possible only using modern big data information technologies.”* (Vishnevskaya, Vishnevskiy and Melnikova, 2019, pp. 471-472). Big data are often being described as the backbone of the successful digital transformation (Sinclair, 2017). Moreover, we agree with the authors’ statement that *“the level of state control depends on the general level of digitalization of economy and the quality of information technologies used by tax authorities. The basis for building a modern VAT administration system is an electronic invoice built into the electronic document management system (EDS) in the B2B sector and in B2G electronic reporting”* (Vishnevskaya et al., 2019, p. 472). Another main idea connected with the e-invoice reporting is the plan to launch a goods **traceability system** as a response to the negative effects of uncontrolled movement of goods within EU countries, as well as “gray” imports. The richness and variety of data enable tax administrations to more effectively cross-check the data. Moreover, **real-time reporting** empowers the tax authorities to cross-check the data with respect to specific transactions in a negligible time distance and therefore more accurately. This is in line with the reasoning of Majdanska and Schoueri, who claim that technology developments and the use of big data can leverage the cross-checking element of control (2017). As a conclusion to big data use, we can conclude that there exist some advantages (preventing VAT fraud, reducing compliance costs and better interaction with taxpayers), but it cannot do without disadvantages (too complex, data privacy can be undermined and demand for the training of staff) (Krajcуска, 2018, p. 26).

## 2. EXCHANGE OF INFORMATION WITHIN EU – WHERE DO WE STAND AND WHERE WE SHOULD GO

As we have stated above, the exchange of information is not necessary only separately in one country, but must work on a broader level to tackle tax frauds. Within EU, most of the legislative activities focus on direct taxes. Council Regulation (EU) No 904/2010 of 7 October 2010 on administrative cooperation and combating fraud in the field of value added tax lays down the conditions under which the competent authorities in the Member States responsible for the application of the laws on VAT are to cooperate with each other. In its article no. 1, it states that *“to that end, it lays down rules and procedures to enable the competent authorities of the Member States to cooperate and to exchange with each other any information that may help to effect a correct assessment of VAT, monitor the correct application of VAT, particularly on intra-Community transactions, and combat VAT fraud. In particular, it lays down rules and procedures for Member States to collect and exchange such information by electronic means.”*

As the European Commission states, “while the tax authorities of Member States already exchange some information on business and cross-border sales on that basis, this cooperation relies heavily on the manual processing of information. At the same time, VAT information and intelligence on organised gangs involved in the most serious cases of VAT fraud are not shared systematically with EU enforcement bodies. Finally, a lack of investigative coordination between tax administrations and law enforcement authorities at national and EU level mean that this fast-moving criminal activity is not currently tracked and tackled quickly enough” (European Commission, 2017).

### 3. E-INVOICE

EU states that the reduction of administrative burdens on businesses by Directive 2010/45/EU was triggered mainly by the following two sets of provisions: (i) e-invoicing requirements and (ii) the issuance and content of invoices, which simplified and harmonised the invoicing requirements (European Commission, 2020b, p. 3). As the biggest impact of Directive 2010/45/EU, EU sees on the reduction of administrative burden is due to the higher uptake of unstructured e-invoicing,<sup>6</sup> because of simplifications, which encouraged companies to switch from paper invoices to PDFs.<sup>7</sup> The financial cost savings generated through the cash accounting scheme that can be attributed to Directive 2010/45/EU have been estimated at about EUR 33 million over the 2014-2017 period across ten Member States (Slovak Republic included) (European Commission, 2020a, p. 26).

Directive 2010/45/EU did not distinguish between structured<sup>8</sup> and unstructured e-invoices. By not differentiating between the two e-invoice formats and enforcing the technology-neutrality principle, the Directive did not directly stimulate the use of automatically processable invoices and thus it did not lead to an increase in the uptake of structured e-invoices (European Commission, 2020). Moreover, EU concluded that there is no evidence of any significant impact of Directive 2010/45/EU on tax control or VAT compliance. The opinions expressed by tax authorities confirm that the effects of Directive 2010/45/EU when it comes to VAT compliance are, if any, rather limited. Commission stated that “tax authorities and stakeholders are of the opinion that not more can be achieved by invoicing rules in the area tax control. Since the information from invoicing is not readily available to tax authorities, their focus is currently on systems assuring real-time reporting allowing better risk analysis and more targeted controls. At the same time, it is reassuring that the simplification and harmonisation of invoicing and e-invoicing requirements did not have any adverse impact on tax control activities” (European Commission, 2020b, p. 5).

Moreover, the fight against tax frauds cannot be handled with just one measure. Nowadays, at the level of the EU, we can see a significant effort in the VAT area to take necessary further steps for the so-called “final regime of VAT”, connected with the so called “general reverse-charge” mechanism. The final regime would in the end require replacing the current system consisting of an exempt supply in the EU Member State of departure of the goods and a taxed intra-Community acquisition of goods in the EU Member State of destination by a system of a single supply taxed in and in accordance

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<sup>6</sup> Unstructured e-invoices refer to invoices transmitted electronically without a prescribed or specific format, e.g. an email with a PDF attachment or a fax received in electronic not paper format.

<sup>7</sup> Portable Document Format, a file format for capturing and sending electronic documents in the intended format.

<sup>8</sup> Structured electronic invoices refer to invoices issued, transmitted and received in a structured electronic format allowing their automatic and electronic processing.

with the VAT rates of the Member State of destination. A "destination-based" VAT system means that goods traded across borders are taxed in the country where they are consumed (the destination country) and at the destination country's tax rate, rather than where they are produced (the origin country). As a rule, the VAT will be charged by the supplier who will be able to verify the applicable VAT rate of any Member State online by means of a web portal (European Commission, 2017). Another condition for the final system of VAT is that the effective electronic notification of transactions involving goods and services delivered and received for all taxable persons, for the purpose of effective functioning and monitoring application of the general reverse-charge. This condition essentially seeks to prevent the transfer of fraud to the last stage of distribution of goods and services, i.e. degree of final consumption, where this mechanism can no longer be applied, i.e. where the supplier is obliged to apply VAT to the price of the goods or services supplied according to the standard rules of the common VAT system (Beno, 2020, p.12).

#### 4. LEGISLATIVE ACTION OF THE MINISTRY OF FINANCE OF THE SLOVAK REPUBLIC

In direct taxation, the electronic filing is being further enhanced through the Open API initiatives (Slovensko.Digital., 2018) where the respective data requirements can be incorporated directly within the ordinary business processes. In other words, the business will no longer be required to separately produce and submit a certain piece of data, if this may be automatically submitted to the tax administrator by its (e.g.) accounting software. Now, as it is anticipated that the data necessary for evaluation of the amount of income or other values relevant for the administration of taxes will be gathered from third parties (ideally through integrated interfaces), forms will become redundant with respect to data collection. In fact, one may reasonably assume that the use of manually filled out forms for data collection presents a significant risk of error (Kačaljak, 2020, p.25). Further steps have been introduced in the VAT area as well.

In a recent period, the Ministry of Finance of Slovak Republic published preliminary information on the draft law on sending data to the financial administration from invoices of tax subjects.<sup>9</sup> According to the preliminary information, the intention of the draft law is to introduce the obligation of all taxpayers to issue an invoice from each business transaction within a specified period, in which case the obligation to record sales with the e-cash register client (Financial Administration, 2020) does not apply. At the same time, the introduction of the obligation to send selected invoicing data to the financial report before the final version of the invoice is prepared is envisaged. The taxpayer will be able to fulfil this obligation either through the accounting software it uses, which will also include a communication component certified by the financial administration, or a free state online application. Also on the part of the taxpayer in the position of the customer, the obligation to send the registered incoming billing data will be introduced in one of the above ways. The aim of this measure is to ensure that the financial report obtains information on the declared services for which the invoice is issued in real time (European Commission, 2017).

From our point of view, the so-called real time reporting of transactions subject to VAT is emerging within EU Member States, as well as outside the EU and that it is (among other things) also a basic condition for the introduction of a general reverse charge regime (see text above). For this reason, *a priori*, we do not see the intention as

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<sup>9</sup> Preliminary information on the draft law on the transmission of financial administration data from invoices of tax subjects.

controversial, and rather assume that its widespread implementation throughout the EU is a matter of time.

However, at this stage (while the Slovak Republic would still be at the forefront) we would like to appeal that the invoicing regime, in addition to obtaining information for the Financial Administration, also pursues the goal of improving "comfort" for entrepreneurs and increasing their own protection against involvement in fraudulent chains (where given the available court rulings, we see that the consequences of participating in fraudulent chains also have a significant impact on small and medium-sized enterprises, who have found themselves against their will - worst of negligence in the chain). We suggest that in the draft stage the concept of real time reporting worked with: (i) the principle "once and enough" - where an already sent "preliminary" invoice issued by the supplier was automatically forwarded/registered on the customer's side through a state-managed system, so the customer would limit himself to simply confirming such an invoice on his side, with the possibility to download it to accounting software, and thus would save administrative burden associated with fulfilling this obligation; (ii) early warning system for customers - where, at the same time as the pre-invoice is delivered, the system administered by the Customer's State would inform about possible red flags on the supplier's side (list registration; low rating; the fact that it is a new company without assets and employees), which would also bring added value to entrepreneurs (some more prudent and solvent entrepreneurs use commercial tools such as *finstat* to control these red flags, but this also means that small and medium-sized enterprises in particular without such mechanisms carry a higher risk of involuntary participation in fraud); and (iii) the function of pre-filling pre-invoice data into tax return forms, recapitulative statements and control reports - this feature can be useful primarily for businesses that do not use sophisticated software (which already process these statements automatically). We believe that the construction of technological infrastructure for the functioning of these elements could also be financed from the development plan, as it fully falls within the framework of digital state administration.

## 5. PRO FUTURO PROPOSALS

Based on our analysis, we can predict the following business problems associated with the introduction of new systems:

- lack of time for introducing changes to the taxpayer accounting systems associated with a change in the format of documents and the accounting methodology in connection with the transition to party accounting;
- delay in the sale of goods at the time of receipt of the batch registration number (the problem is critical for sale on the basis of direct delivery, leads to an increase in storage costs, risks of loss of consumer properties of goods, etc.);
- technical difficulties in the implementation of bundles of goods, including traceable goods (Vishnevskaya et al., 2019, p. 474).

We note the main advantages of such a system of traceability:

- no additional reporting for traceability purposes;
- there is no need for taxpayer buyers to verify the reality of the lot number of the goods;
- information on traceable goods is available to the tax authority in real time (compared with the current system by the 25th day of the month

following the quarter of the transaction) (Vishnevskaya et al. 2019, p. 474).

## 6. REAL-TIME REPORTING V. PRINCIPLE OF PROPORTIONALITY

EU law system, especially in the meaning of CJEU case-law,<sup>10</sup> understands the principle of proportionality, together with the principles of legal certainty, equality, etc. constitute the general principles of EU law (Hartley, 2007, pp. 131-157), based on which interactions and interference by the state authorities to the taxpayer's rights must be met. Four tests can be performed in order to establish whether the measure is proportionate: i) the measure must be appropriate, ii) the measure must pursue legitimate objective, iii) least restrictive effective means test and iv) so-called balance test - the measure cannot be disproportionate (costs v. benefits test). However, Sauter mentions that the latter two tests are often "applied as alternatives rather than complements". Based on the reasoning of Sauter, the least restrictive means test is applied most frequently (2013, pp. 447-448). Almost identical tests are highlighted by Ellis (1999) and Maliszewska-Nienartowicz (2008, p. 91). Therefore, *stricto sensu*, we can identify the following criteria in testing proportionality: suitability, necessity and proportionality in narrower sense. These sub-principles (referred further to as "criteria/factors") do not need to be fulfilled as a whole to declare a measure disproportionate. However, the order of the tests is crucial and must be followed (Rosenfeld and Sajó, 2012, p. 725). We can say that the reasoning of the interactions and interference to the taxpayer's rights in the tax area, bearing in mind the principle of proportionality with the words "*should not go further than necessary*." Instead, in the proportionality evaluation, the focus should lie on the specific aspects of these digitalization initiatives. Moreover, the design of certain projects should be re-evaluated due to the particular design flaws, which can be deemed disproportionate under the national laws of individual states. The problems are concentrated within the lack of data privacy (Daňko and Žárská, 2018, p. 183), unfeasible system of penalties and excessive compliance costs. It is now of great importance to integrate these two areas and to establish a minimum benchmark for the lawmakers and the judges. Currently, the framework of the proportionality principle is rather vague. It can be only abstractly assumed, how it can be applied on the digitalization projects (Krajcuska, 2018, p. 24).

## 7. CONCLUSION

After our analysis, we believe that we have proved the importance of the above-mentioned measures in the area of VAT in the context of digitalisation, mostly real-time reporting and electronic filling. Based on that, we can confirm our main hypothesis stipulated in the introduction. The effectiveness of the VAT administration system depends on the simplification and harmonization of invoicing and e-invoicing rules not just in Slovakia, but across the EU as well. Future regulation should have an overall positive contribution to its general policy objectives, namely i) the reduction of the administrative burdens on businesses, ii) the reduction of VAT frauds, iii) the proper functioning of the internal market, and iv) SMEs promotion.

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<sup>10</sup> CJEU, judgement of 29 July 2010, *Dyrektor Izby Skarbowej w Białymstoku v Profaktor Kulesza, Frankowski, Józwiak, Orłowski sp. j.*, C-188/09, ECLI:EU:C:2010:454; CJEU, judgement of 19 September 2000, *Ampafrance SA v Directeur des services fiscaux de Maine-et-Loire* (C-177/99) and *Sanofi Synthelabo v Directeur des services fiscaux du Val-de-Marne* (C-181/99), ECLI:EU:C:2000:470; CJEU, judgement of 18 December 1997, *Garage Molenheide BVBA* (C-286/94), *Peter Schepens* (C-340/95), *Bureau Rik Decan-Business Research & Development NV (BRD)* (C-401/95) and *Sanders BVBA* (C-47/96) v Belgian State, ECLI:EU:C:1997:623.

As a conclusion, in our point of view, these two factors and their combination are determinative for the type of system: 1) obligatory e-invoice 2) e-invoice release through a single state resource. The maximum possibilities from the point of view of control are provided by the e-invoice system, based on the obligation to issue electronic invoices on a continuous basis (for all categories of transactions through a single state resource, which gives the state an information database in electronic form on transactions in the country in real time, i.e. delayed by the statutory deadline for the release of e-invoice. The next step, which could optimize the data collection and VAT digitalisation, is the centralization of transaction data from disparate the electronic document management system providers in Slovakia governed by the state. Such measures will provide a reliable control system that operates in real time. On the other hand, the absence of the obligation of the e-invoice for all types of taxable transactions or the absence of a single state resource would predict tax frauds connected with VAT. Finally, building an effective traceability system without the obligation and centralization of e-invoice production is not, in our opinion, possible. In addition, the building of a strong e-invoice system is a necessary condition for the introduction of the final regime and general reverse-charge mechanism within EU.

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