

## **STUDY AND ANALYSIS OF VAT EVASION AND ILLEGAL RECOVERY IN LEBANON**

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### **—Abstract —**

In order to combat VAT evasion and illegal recovery, it is necessary to conduct a thorough analysis of the potential loopholes in tax legislation and regulations, and discuss the procedures in the operations of the VAT and Customs Administrations, to come out with proposals aimed at combating this phenomenon and reducing its negative consequences on the state revenues.

Therefore, we will study the indicators revealed in the field study we already conducted in terms of cases of VAT evasion and illegal recovery, in light of reconsidering the legal texts that regulate Value Added Tax, as well as administrative, structural and legislative loopholes. Field and structural measures are suggested, along with reconsideration of tax legislation related to this issue.

**Key words:** *VAT Evasion, illegal recovery, legislative loopholes, tax legislation.*

**JEL Classification:** H26.

## **1. INTRODUCTION**

Nowadays, VAT evasion and illegal recovery is an issue of growing concern in Lebanon. Unfortunately, studies related to it are still quite rare. Our previous paper revealed about the most significant VAT evasion cases and the way tax payers evade paying their required VAT or try to have an illegal refund. From these VAT evasion cases, we pinpointed the main causes of such evasions and proposed solutions to limit as much as possible VAT evasion in Lebanon. This study was initiated to deal with a problematic issue that lies between malpractice and the sense of patriotism between the non-righteous means of some citizens to evade tax payment and their illegal gain of money; it is a study that is associated with ethics and social understandings, aiming to protect public funds. The issue of tax evasion and illegal recovery of VAT is an example of these problematic issues despite the positive development of this tax throughout the past ten years.

In spite of the overlap of tax legislation and practices adopted in the procedures of its implementation and the actual attitudes of many taxpayers, this study is not a specialized analysis on the financial law, and the discussions and legal interpretations are not possible in this respect. That is why we will only be putting forth a concluded number of problems related to cases of tax evasion and illegal recovery as gleaned from the data gathered in our previous study.

## **2. LITERATURE REVIEW**

Although many studies have been made on tax compliance, very few have examined compliance, or rather noncompliance, primarily from the perspective of ethics. Most studies on tax evasion look at the issue from a public finance or economics perspective, although ethical issues may be mentioned briefly, in passing.

(Brederode, 2008:31) published a study which dealt with tax evasion in some EU countries and he stressed and explained the issue of what is called “Carousel Fraud” that affects negatively EU revenues. VAT fraud is an issue of growing concern for the tax authorities in EU countries, because of its size and frequency, the increased sophistication of the fraud schemes and inherent difficulty of combating it, and its financial significance. The value added tax is a significant part of the total revenue for the EU member states, accumulating to 13 to 22 % of

the total annual revenue and is charged at standard rates varying between 15 and 25 % on most goods and services across the EU.

(Gebauer et al.,2007:1) published a study in Germany about tax evasion and methods to control it. In his study, they stressed that the German State Treasury sustained significant losses due to VAT evasion. They also discussed the newly established reform models, and their ability to reduce the VAT evasion and prevent the decrease in revenues in the European Union. In the course of his discussion of the three models of reform, they mentioned that, apart from the usual types of VAT evasion caused by transactions without invoices, input-tax reimbursements based on forged invoices, the so-called Carousel fraud appears to have recently been playing an important role for the tax revenues. Carousel fraud works in such a way that intra-Community EU companies supply and purchase goods and services and this leads at the end to a fraudulent retention of VAT revenue. (Gebauer et al., 2007:1.)

A study carried out in Nigeria (Fagbemi et al., 2010:1) on tax compliance, including VAT, shows that the level of tax evasion is clearly affected by the low ability of tax administration officials to enforce tax liabilities and by corruption. 90% of the surveyed taxpayers believe that tax evasion is an ethical matter. A study carried out in Portugal by Iglesias and Tavares (Tavares et al., 2010) suggested that attributions of tax evasion had two independent dimensions the confidence in the Fiscal Justice and confidence in the efficiency of tax evasion control. This study (Tavares et al., 2010) reports on a research conducted in initially in Spain using the same causal attributions used in the Portuguese research.

Another study conducted in Turkey (McGee et al., 2011:1), regarding ethical attitudes to tax evasion, showed similar results to the studies conducted in Nigeria and Portugal. The aforementioned McGee et al. study found that tax evasion is more likely to be viewed as justifiable if: the tax administration officials are corrupt, tax funds wind up in the pockets of corrupt politicians, or the tax system is perceived as being unfair.

### **3. ANALYSIS AND SUGGESTIONS FOR EVASION CASES**

In this paragraph, we discuss the most significant cases dealt within our previous study, noting that many practices in many evasion cases might be common; thus,

there are many common suggestions that are put forth in an attempt to deal with such cases.

- The practice of a trading company of hiding a part of its activities or declares that its activity is 'general trade' makes it difficult to detect whether the actual activity matches the one declared of and, therefore, increase the possibility of evading taxes. The institution must be obliged to accurately specify the kind of trade or other activity it will practice when registering the institution in the Ministry of Finance and Trade Register and hence, institutions must be obliged regardless of their number of operations, to register for VAT; institutional operations must be restricted to the declared activity of each operation.

- Some suppliers conceal trade operations from which they collected VAT; this is a crime of stealing public funds. During the procedures of approving deduction requests presented by institutions, the inspectors must verify that the trade operation is real, and they are to check the source of purchasing invoices that belong to the institution that requested the deduction, to verify that the source of supply that collected the VAT value had really paid it to the Treasury. To control these cases of VAT evasion and to facilitate control and file study, we suggest that each institution or trader should have banking domestication account for the benefit of the Ministry of Finance, through which he pays all the state's VAT dues. The mechanism of including these dues in this account will be studied. This is a form of domesticating VAT account.

- Some well-known evasions occur when many institutions in tourism services collect VAT from the consumer and do not pay part of it to the Treasury, and make double invoices ( so there exist hidden and disclosed invoices). This practice represents a well-known theft of the treasury fund and corruption in the institution's accounting department.

Tax administration must control these cases of evasion, employ detection programs, field inspection on institutions that offer touristic services, and compare its results in each institution with the data related to its income tax. The suggestion concerning domestication of the VAT account of the institutions concerned applies to these cases.

#### **4. ANALYSIS AND SUGGESTIONS IN CASES OF ILLEGAL RECOVERY**

Cases of the right for deduction and recovery overlapped when interpreting the text which did not serve the benefit of the Treasury, probably contrary to the intentions of the tax legislator. In this context, we mention the following cases:

- The following statement is mentioned in recovery request (Article 30): “The administration has to reach a decision concerning the recovery request in a period that does not exceed three months from the receipt of the request”.

The deadline mentioned in the article was interpreted as a confirmation of the taxpayer’s and a drop of the administration’s right. In fact, a lot of law makers interpret the deadline as a way to urge the administration to study the recovery request file, especially that the statement that comes directly after mentions another deadline (four months). This statement includes the obligations of the administration, after its approval of the recovery requests, to pay 9% interest to the concerned taxpayer from the date of submitting the application.

This loophole in legislation, allows collusion and gives excuses to delay the study of the file beyond the deadline, and pushes the administration to pay the request amount. This actually had happened, the consequences of which were catastrophic on the public funds.

- Illegal recovery resulting from interpretations of texts contrary to the intentions of the tax legislator.

One of the most important cases is the recovery of used car dealers of part of the VAT at importation. This phenomenon resulted in apparent overlap between Article 2 and Article 24 of the Value Added Tax Law and the tax administration did not amend or give exceptions in the text of Article 2 to eliminate any apparent contradiction with Article 24 in relation to adopting customs value at importation (mentioned in the first section of this chapter), but instead decided to adopt a solution that caused doubts about the credibility of customs value by approving a minimum local price of 80% of the Customs value of the car, which created a lasting margin of the recovery. These measures triggered experts’ discussions around the legality of this percentage, especially that it is not based on any legal text. The actual practice of these operations does not ensure that the results of this

measure will be positive for the consumer, but instead it is a way that allows the importer to have additional profits. From this perspective, and in light of the absence of the text that allows recovery on the basis of the difference between the customs value and the value at purchase, the criteria that determine the customs value must be realistic so that no recovery occurs in this kind of cases, in addition to verifying the correctness and accuracy of invoices at rates and purchases. There is a need for a special text that deals with such special cases.

On the other hand, there are cases of recovery or deductions by dealers of used cars on total tax; a number of dealers declare that a big number of cars remain unsold. Some employees in the tax administration complain that comprehensive inspection is not possible due to the big number of importers and cars exhibited for sale. Hence, it is not possible to detect recovery operations or deductions. In fact, dealing with such a phenomenon must not be dealt with lightly, since we live in a country that imports big numbers of cars, and the taxes and duties collected from them constitute an important percentage of revenue fund. For this reason, the best solution is to make use of “NAR” and “NAJM” systems to detect and match the data of imported cars (number, type, body structure number,...) with the data related to the value of cars in the local market (number, type, body structure number,...) and verify this in the Division of Car Vehicle Registration in the Ministry of Interior.

- Illegal recovery resulting from manipulating invoices and declaring internal trade operations are usually fictitious.

One of the most important cases is the scrap and construction trades, as well as fictitious companies.

- a- The case of scrap trade shows obvious collusion between two companies, one bought from small non-taxable suppliers, and another sold to final consumers, who do not recover tax. The latter hides collecting VAT from a third company and does not pay the due to the Treasury; this is done through a fake sale made with the first company to create fake balance in the carried over budget of the first company. This practice is considered forgery or double theft of public fund, because in this trade, where scrap is not used in Lebanon but is exported, VAT is recovered from the Ministry of Finance, although the first company did not pay to the Treasury.

Field inspection of the goods in the mentioned operation, the invoices and the activities of each of the concerned companies and its price value reveal forgery in invoices. Selling big amounts of scarp is not related whatsoever to the sale of other types of industrial or construction materials...

Field inspection also helps in referring to data of the income tax in revealing the real individual activity of each company, and hence uncovering the fictitious operations.

- b- In the case of fictitious companies, some of which were immediately discovered while others after it has been too late, theft of public funds occurred through illegal recovery of huge amounts of money. From what has appeared to us in this file, no investigation of the reality of the existence of such companies were done, especially that they were established recently and have premises, addresses and phone numbers. In addition, the amounts of money requested for recovery are noticeable due to their huge value. Is it logical, based on what is discussed earlier, that these companies are not given priority in examination and investigation, instead of being neglected until the tax administration is pressured by deadlines that were exploited for the benefit of these companies, intentionally or unintentionally?

That's why it is important to reconsider the procedures and mechanism of studying recovery files and put forth clear legislations that organize these operations according to the following suggestions:

- Categorizing cases of recovery according to many factors, like date of establishment and initiation of work, then matching this with the data given by the company (business number, income tax, and the money requested for recovery,..)
- Determining the procedures of studying the file and verifying its documents in the office and in the field (work practice, actual address, employees, insurance,..)
- Forbidding recovery without file study if the amounts requested for recovery that exceeds specific amounts (e.g. L.P 100 million) and,

therefore, obliging the administration to study the file within reasonable periods.

- Committing companies to break up recovery applications in case the requested amount to be recovered exceeds a specific number (e.g. L.P 500 million) for first-time applicants (not studied previously), and a higher specified amount (e.g. L.P 1 billion) for companies whose files were previously studied.
  - Linking information network and data related to concerned companies with those of the tax administration in the Revenue Directorate of the Ministry of Finance.
- c- Illegal recovery resulting from collusion between scrap and construction traders where the trader buys scrap from small non-taxable traders and then sells them to a taxable exporting company from whom he collects VAT, whose value equals sales for non-taxable users. He covers the collected VAT amount with a fictitious invoice from another construction company, the value of which equals the value at sales to non-taxable users.
- Illegal recovery resulting from hiding internal trade operations so that paid VAT is higher than collected VAT.

Some institutions and traders, through performing sales with invoices, declare sales operations on whose VAT is less than the amount collected for the VAT administration, and present documents that do not reflect their real activity; that is, requests recovery in the framework of brought forward balance. In the same context, some institutions and traders register less value of sales than that of the real value.

Studying the file to decide on the recovery request must include, in addition to the office inspection of document, field inspection of the records around the status of goods in the store and the records' compatibility with that of the accounting records (the necessity to adopt information system for store management), with income tax data; in addition, to comparing the value of sales of goods with the current prices or their equivalence in the local market.

- Illegal recovery resulting from false declaration of transportation or re-exportation operations that are usually fictitious or exaggerated (customs

declaration EX3); some institutions or traders manipulate the declaration on the value of sales and their number between importation and exportation for the purpose of recovering huge amounts of money from VAT. Re-exportation might not have actually occurred, but only confined to declaring exportation on “NAR” system. Studying the file of recovery related to these cases must be done by the Ministry of Finance in close coordination with the Customs Administration.

## **5. LIMITATIONS**

It is clear that this study faced many obstacles; the major ones are the following:  
-Difficulties in accessing information from the official sources due to the sensitivity of this subject, that might raise the reservations and skepticism of a number of employees as to the objectives, purpose and results of the study. In this context, the staffs' response was not equal, being positive or negative. The noncooperation or limited cooperation was under the pretext of the sensitivity of the topic chosen, and therefore employees claimed to respect the professional confidentiality and the procedures that forbid them from discussing the content of the files the official directorate has.

In addition, a number of VAT evasion and illegal recovery files are in the Financial Court of Justice and responsibilities cannot be declared before the sentence is pronounced.

-Through analysis of the cases, several loopholes appeared, but discussing such legal jurisprudence and articles of the law are out of this field of study, which are the specialty of financial and administrative laws.

## **6. CONCLUSION**

This research is a step in a corrective, administrative, financial and organizational stage. It is required to reconsider and delve into a number of legislative texts concerning VAT. In addition, this study must be continued in a quantitative and qualitative context in order to discover the lost and wasted money, and therefore, figure out the possible real contribution of this tax in the Lebanese treasury.

We consider these proposals part of the preliminary work for sustainable future reforms that should be carried out by the concerned departments. We hope that this study, in the context of ethical practice, may have partly contributed to our

national duty. It must be complemented by additional studies, where academic research in the service of human development, national economy and the true spirit of citizenship on one hand, and enhancing the capabilities and financial means of the state to save public money, on the other hand must be undertaken.

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