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Israel Tax Authority

The Tax Authority's Handling of the Fictitious Invoice Phenomenon

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Background

A tax invoice is used to deduct the input tax[1] included in it, resulting in a decrease in the companies' and entities's VAT liability. Furthermore, the invoice amount, net of VAT, serves as documentation allowing the recognition of an expense and, consequently, a reduction of a taxpayer's taxable income for income tax purposes.

A fictitious invoice is issued illegally, presenting a transaction that was not carried out, parties to the transaction that are not the parties involved therein, or an amount, sale, or service that does not reflect the actual transaction. This decreases the VAT liability and the taxable income.

The Israel Tax Authority tries to combat the phenomenon of fictitious invoices for over two decades. In the Tax Authority's risk survey for 2022, the phenomenon of fictitious invoices was included in the "business/strategic" risk category and ranked among the ten highest-level risks the Authority is required to address.

The phenomenon of fictitious invoices has been expanding over the years due to the ease of committing fraudulent acts, among other things, through the deduction of VAT included in fictitious invoices, the reduction of the taxable income reported to the Income Tax and the National Insurance Institute and the tax paid thereon; The decrease of appreciation in real estate taxation; And refunds on fuel taxes. The use and trade of fictitious invoices cause damage to the State Treasury, estimated at billions of shekels per year.

Apart from the financial aspect, an inequitable allocation of the tax burden due to tax evasion, including the reduction of tax liability through fictitious invoices, results in frustration and undermines the tax payment ethic of taxpayers in Israel. Moreover, the issue and deduction of fictitious invoices is a central component of serious crimes committed by crime families and criminal organizations in Israel. These organizations use fictitious invoices to camouflage their illicit criminal activity and disguise the capital obtained as part of a 'legitimate' activity listed on the invoice. In addition to reducing tax liability, fictitious invoices are a tool for laundering capital from illegal undertakings.

1 The value-added tax imposed on the sale of assets to a dealer on the import of assets by a dealer or the provision of services to the dealer.

Key Figures

NIS 2.51 billion annually

the minimum estimated annual damage to the state treasury due to fictitious invoices[2]

1,814

fictitious invoice assessments by the VAT authorities in 2019–2022[3]

about NIS 7 billion

the total VAT[4] charged in the fictitious invoice's assessments 2019–2022

only 3% (NIS 180 million)

the collection rate from fictitious invoice assessments in 2019–2022

71%

assessments rates out of all fictitious invoices assessments in 2022–2019 with no double taxation charge, under the VAT Law regarding distributors and those who deduct fictitious invoices

59%

fictitious invoices cases rates in 2019–2022 with no Ransom fine and no indictments out of all the fictitious invoice cases submitted to the Authority's legal examination

66%

System A[5] rate alerts on suspicion of tax deduction from fictitious invoices not processed at the VAT offices and the tax assessment offices in 2017–2022

only 309

"Critical" alerts in System B[6] in the Authority were checked and entered into System A out of thousands of "critical" alerts[7]

2 According to an estimate carried out by the Tax Authority, which relates to the years 2017–2019. The estimate of the minimum amount of damage relates only to damage caused in VAT terms, to which must be added the financial damages caused in relation to income tax, to the National Insurance Institute for capital gains tax and excise tax refund on diesel fuel.

3 Until October 2022

4 The total VAT charges that were added due to the assessments conducted net of interest, linkage differentials and fines. The charges consist of NIS 1.5 billion tax charges and NIS 5.5 billion double taxation under Sections 50(a) and 50(a1) of the VAT Law.

5 A risk management system capable of alerting suspicious against companies and entities to the field units.

6 A dedicated intelligence system at the Tax Authority, whose products are supposed to be used by VAT offices and tax officials in their fight against the phenomenon of fictitious invoices.

7 Alerts in the system since its establishment in 2018.

Audit Actions

From November 2022 to February 2023, the State Comptroller's Office examined the Tax Authority's handling of fictitious invoices. The audit was conducted at the Tax Authority, and completion examinations were performed at the Registrar of Companies, the Israel Police, and the State Attorney's Office. The audit examined the Tax Authority actions to prevent and thwart the phenomenon of fictitious invoices and the assessment treatment of this phenomenon, as well as the future designated programs available in the Authority to combat the phenomenon.

Key Findings

Collection of Fictitious Invoices Taxes Debts – the total collection of fictitious invoices taxes in 2019–2022 was only at about NIS 180 million; this compared to an estimated minimal financial damage to the state treasury in VAT of about NIS 2.51 billion annually compared to the tax principal to be charged in fictitious invoices assessments examined, net of interest and linkage differentials and fines in 2019–2022, at about NIS 7 billion; And compared to the charges from the audited assessments, which include interest, linkage and fines, in NIS 7.9 billion. The total payments for these assessments were minimal (about NIS 180 million), about 3% of the tax principal charged in these assessments, and about 2% of the total tax principal charged in assessments, together with interest charges, linkage, and fines. The lack of enforcement of tax charges on fictitious invoice assessments affects deterrence and encourages criminals, who know that even after investigating this issue and conducting assessments, the Tax Authority will not collect the amounts of charges in their assessment. This results in real financial damage to the state treasury.

The Estimated Financial Damage from the Fictitious Invoice Phenomenon – the audit found that although the total minimum financial damage due to the fictitious invoice phenomenon in VAT terms is NIS 2.51 billion, the Tax Authority made a partial estimate of the average financial damage to the state treasury in VAT terms only, and no estimate was made of the financial damage caused to income tax, the National Insurance Institute, appreciation tax and the refund of excise duty on diesel fuel. Furthermore, this estimate referred to 2017–2019. The Tax Authority did not reassess after 2019 to update the total financial damage due to fictitious invoices in all tax systems. Therefore, it is impossible to estimate the overall financial damage to the state's tax revenues due to using fictitious invoices.

VAT's Addressing the Fictitious Invoices Phenomenon Through Tax Assessments – it was raised that 1,367 assessments were prepared by the VAT offices on fictitious invoices in 2019–2022[8], which are 75% of all assessments on this subject[9]. The charge for these assessments was NIS 1.5 billion, 22% of all assessments. In the Major Crimes Unit, 447 assessments were prepared, 25% of all fictitious invoices assessments. The charge for these assessments was NIS 5.4 billion, 78% of all assessments. Although most of the fictitious invoice assessments (75%) were prepared in the VAT offices, the rate of tax charged in these assessments out of the tax charged in all fictitious invoices assessments (in the VAT offices and the Major Crimes Unit) is meager (22%).

Filing of Indictments in Fictitious Invoices – in cases where investigative actions were carried out or in cases involved in a criminal offense and the amount of the offense is over NIS 150,000, an offense discovery report (ODR) must be opened, which means that the case is referred to the Tax Authority's legal department for examination in the criminal procedure. It was found that in 59% (598) of the 1,019 assessment fictitious invoices cases for which an ODR was opened, no indictments were filed, and no ransom fine was imposed. The total assessment charges in these cases were about NIS 3.2 billion. It was also raised that the Tax Authority's legal department did not file indictments in 450 cases opened in 2009–2018, and these were closed without the imposition of a criminal sanction in the form of filing an indictment or charging a Ransom fine[10]. The Legal Department estimates that most cases are of fictitious invoice offenses. The total tax for the criminal offenses included in the closed cases was over NIS 796 million. The continuing handling of the fictitious invoice cases and the failure to submit indictments ultimately led to the closing of the cases in which many resources were invested to examine and investigate to establish the assessments. The Tax Authority stated in its response that the failure to submit indictments in the 450 closed cases resulted from a severe shortage of personnel in the Legal Department.

Transfer of Fictitious Invoices Cases from the VAT Offices to the Investigation Units – it was found that at the audit end, out of the 91 cases that were transferred in 2018–2022 according to the procedure on "Manner of handling of criminal cases in the regional VAT offices," only ten cases were received for handling by the Tax Authority Investigations Division, at about NIS 112 million of VAT in these cases. The remaining 81 cases were not handled by the investigation unit, even though the estimated VAT therein was NIS 582 million, and the estimated financial damage on average per case

8 Up to October 2022.

9 The remaining assessments were prepared at the Major Crimes Unit which prepared the civil assessments with respect to cases handled by the VAT investigation units.

10 414 of the cases were closed according to the State Attorney's Office's criteria or because it was impossibile to obtain approvals from the relevant authorities stipulated in the directive. The other 36 cases were closed because they did not receive the required approval or it was found that under the circumstances, there was no justifiable basis for filing an indictment.

was over NIS 7 million. It was also raised that in 81 of the 147 cases that were entered into a designated portal for their transfer to the handling of the investigations units, five years have passed from the submission date of the report until the examination date by the Investigations Division, resulting in the Tax Authority being unable to conduct audits and prepare assessments in these cases, under the VAT Law.

Income Tax's Handling of VAT Files with Fictitious Invoices – it was found that the Income Tax Headquarters does not monitor and control the fictitious invoice assessments by the assessment officers from the list of headquarters files. In the absence of monitoring and supervision, it is impossible to learn of the scope of the Income Tax system's handling of fictitious invoices, including the actions carried out other than the assessment itself, such as the filing of indictments, approval of forfeits, and debt collection from the assessments. In addition, it is impossible to know whether assessments prepared by the VAT authorities regarding fictitious invoices were handled as part of the income tax assessment, and in any case, it is impossible to monitor the quality of the handling.

System A

- In 2016, the Tax Authority began developing a risk management system capable of alerting suspicious companies and entities to the field units. It was found that the system is not connected to relevant Tax Authority information systems and other relevant systems outside the Authority. Therefore, System A is incapable of alerting on suspicious indicators or improving the alert data in the system. Unit A employees are compelled to manually enter these systems to gather all the information required to locate and verify the data of the suspicious companies and entities according to the predefined suspicious indicators and transfer them to the field units.

- As of the audit end, system A has not been updated manually for over six months, and it is impossible to verify which of the data in it is updated; therefore, any use of the system data requires checking and verifying the existing information. Moreover, new data about 2,000 suspects were not checked or entered into the system.

- Actions against companies and entities suspected of deducting input tax through fictitious invoices – The VAT offices and tax assessors did not process 1,992 alerts on suspicion of "deductors" (alerts on dealers suspected of deducting input tax from fictitious invoices), which constitute 66% of the alerts on suspicion of "deductors" that were entered into System A. (3,021), even though the financial damage to the state treasury can be mitigated if the deduction of the input tax included in these invoices as part of an assessment will not be recognized.

System B – a dedicated intelligence system in the Tax Authority that makes accessible the information from the Computerized Processing System (SHAAM) database for investigation and verification of suspicions, and whose outputs were supposed to be used by the VAT offices and the tax assessors in their fight against the phenomenon of fictitious invoices.

- Although the development of the system began in 2018, the system is still not in use. As a result, except for the 309 alerts that were checked and entered into System A, Unit A did not check thousands of alerts in System B, of which thousands are critical alerts, and did not alert in System A.

- Although the continued development of System B is included in the VAT Computerized Processing System work plan for 2022, by the end of 2022, no Computerized Processing System employee was assigned for this purpose, and the development of the system was not completed. Hence, at the audit end, the Tax Authority is not preventing fictitious invoices, and the financial damage to the state treasury from the phenomenon of fictitious invoices has increased, even though it could have been partially prevented.

The Registrar of Companies – retroactive reporting on the transfer of shares is used to disguise fictitious invoices so that the issuer of fictitious invoices, recognized as such in the Tax Authority's systems, is incorporated into an existing company, while the transfer of shares is not reported. The absence of enforceable obligations to notify the Registrar of Companies of a change in the shareholders registry of a company enables those suspected of issuing fictitious invoices to be incorporated into existing companies without updating the Registrar of Companies of the shift for disguising the fictitious invoices. Furthermore, the Registrar of Companies might be updated retroactively after the fictitious invoices, notwithstanding the potential imposition of a financial sanction by the Registrar of Companies. This is because the financial sanction is insignificant compared to the remuneration a company owner can receive for transferring his shares to another person who intends to issue fictitious invoices through the same company. Consequently, the Tax Authority cannot prevent fictitious invoices in real-time

Promotion of Project A (a real-time transverse data analysis system) – the Tax Authority did not promote Project A for over a year and a half, from July 2019 to March 2021, even though the system could have prevented the deduction of fictitious invoices at billions of NIS.

A National Action Plan for Processing Invoices – in 2021, the Director of the Tax Authority appointed an integrated task force to develop an outline addressing the phenomenon of fictitious invoices using the existing resources available at the Tax Authority until a computerized solution is found. In July-September 2021, the integrated task force carried out a pilot against companies, entities, and taxpayers, of which alerts were raised in System A regarding the issue and deduction of fictitious invoices by increasing the withholding tax rate or revoking the exemption from withholding tax by the assessor. In December 2022, the integrated task force presented the Director of the Tax Authority with a proposal for a coordinated action plan with the nationwide VAT offices and tax officials.

- It was found that, contrary to the Director of the Tax Authority's decision, according to which the national operation will begin in January 2023 under the outline proposed by the integrated task force, until March 29, 2023, the Authority did not launch the national operation as determined, and did not start holding training on the subject for VAT offices and tax officials.

- It further emerged that the above pilot relied on the data from System A, which was updated then and thus contributed to its success. On the other hand, at the time set for the start of the national operation, System A had not been updated for over six months, about 2,000 suspects from the past months had not been entered into it, nor alerts had been raised in System B. Expanding the pilot based on an outdated system requires resources for verifying the data and may delay receiving the pilot results or receiving incorrect results.

Israel Invoice Allocation Project – this project will enable the operation of a control system for tax invoices at over NIS 5,000 through the allocation of a confirmation number for online tax invoices already at the stage of issuing the tax invoices from the companies and entities to their customers. On May 14, 2023, the Knesset Finance Committee approved for second and third readings the economic plan to reduce the use of fictitious invoices as part of the economic plan for 2023–2024, and the project was approved as part of their budget. As part of the plan approved for second and third readings, starting on January 1, 2024, the Tax Authority will assign online a unique number to a tax invoice at over NIS 25,000, and the amount will be incrementally reduced over five years so that on January 1, 2028, the value of the invoice will be NIS 5,000. A tax invoice without allocation approval will not be recognized for an input tax deduction. However:

- It was raised that there is no cooperation between the Investigations Division, the Assessment Headquarters, and the Economic Unit concerning unifying the suspicious indicators developed in the Investigations Division, which are currently used to prevent and thwart fictitious invoices, to develop the Israel Invoice Allocation Project optimally.

- It was found that in January 2016, the Committee for the Implementation of the Chilean Model recommended that a procedure for approving a tax invoice by the Tax Authority be anchored in the VAT Law and that the Authority had begun developing the preventive model and planned for the Israel Invoice Allocation Project to go live in 2020. However, as of the audit's end, the project that was supposed to be a vital tool in the Tax Authority's war against fictitious invoices had not been completed.

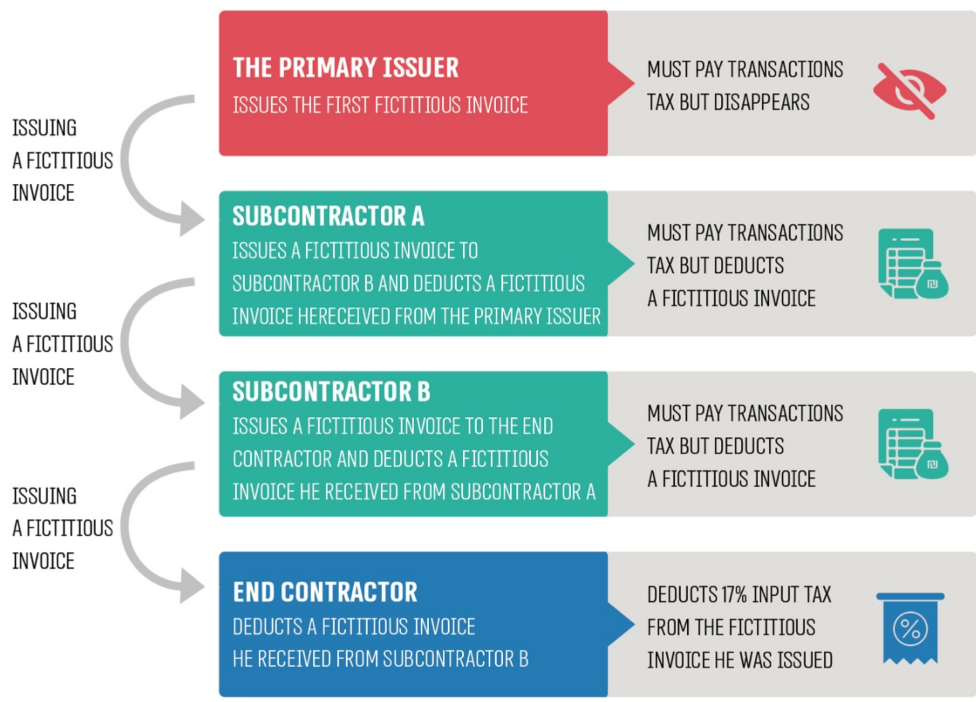
Key Recommendations

- It is recommended that the Tax Authority collect fictitious invoices assessed debts and assess in active cases, as close as possible to the date of the offense.
- It is recommended that the Tax Authority technologically improve System A and, among other things, create automatic links to the existing databases and digitize the forms in the system since these improvements may increase the scope of thwarting[11], improve their quality, and distribute them in "real-time" directly to the end units. It is further recommended that VAT offices and tax officials increase the processing of the relevant cases of companies and entities suspected of deducting fictitious invoices while addressing the issuers of fictitious invoices.
- It is recommended that the Tax Authority identify organizations for the issue and deduction of fictitious invoices as early as possible. For this purpose, it is recommended that the Authority complete the development of System B, which allows alerts that may prevent tax loss, to derive the full benefit inherent therein.
- Given the use of new companies and existing companies to commit significant tax offenses through fictitious invoices, it is recommended that the Tax Authority, the Registrar of Companies, and the Economic Law Department in the Legal Counsel and Legislative Affairs Division at the Ministry of Justice examine ways to prevent the establishment of new companies and the changing of shareholders in existing companies intended for the issue of fictitious invoices.
- The Tax Authority should pool the extensive knowledge accumulated in its various units concerning fictitious invoices to unify the suspicious indicators and find the balance between the existing systems and the systems under development. This is to solve the phenomenon of fictitious invoices that will combine prevention, thwarting, and control actions.
- It is recommended that the Tax Authority promote the Israel Invoice Allocation Project, considering the need to integrate it with System A and System B or with Project B. Thus, enabling comprehensive handling of the phenomenon of fictitious invoices, including preventing criminal elements from entering the tax network or their integration in existing companies; Preventing the issue and deduction of fictitious invoices in active companies, by not providing an allocation number and addressing the issue and deduction of fictitious

11 Various actions for the purpose of stopping or preventing the issue or deduction of the fictitious invoices.

invoices that were not prevented during the invoice allocation phase; And preventing the diversion of the financial damage caused to the state treasury from input tax deductions in VAT to offsetting income tax expenses.

The Route of Issuance and Deduction of Fictitious Invoices and Financial Damage to the State Treasury



Summary

The phenomenon of fictitious invoices has been expanding over the years. The use and trade in fictitious invoices cause financial damage to the state treasury, in VAT terms, estimated at a minimum of about NIS 2.51 billion annually. Furthermore, the issue and deduction of fictitious invoices is a critical component of serious crime committed by crime families and criminal organizations in Israel and is a means of financing terrorist organizations.

Over the last decade, the Authority has worked in several ways to find a computerized solution to this wide-ranging phenomenon. For this purpose, a unit was established to eradicate the crime committed through fictitious invoices and improve alerting capabilities against the issuers of fictitious invoices. Furthermore, committees were established to find technological tools, and the characterization and development of systems to prevent and thwart the issue and deduction of fictitious invoices has begun. In none of the routes taken have the initiatives taken by the Authority been completed, and there is no holistic solution that combines prevention as early as possible and quick detection and effective enforcement after discovering the issue and deduction of fictitious invoices.

The delay that has been ongoing for years in the establishment of computerized systems for prevention, thwarting, and control based on the information supposed to be received through them, and the partial addressing of the issuers and deductors of fictitious invoices, have over the years caused financial damage to the state treasury, in VAT terms, estimated at a minimum of about NIS 2.51 billion annually, as well as the loss of deterrence on tax offenders and the establishment of criminal organizations that use fictitious invoices for laundering capital and camouflaging their criminal activity.

The Tax Authority should rectify the deficiencies noted in this report and recruit the prosecutor's office and the police to join forces to address the phenomenon of fictitious invoices. All this is to eradicate the phenomenon and prevent further harm to the public purse, the state governance, and the necessary battle against money laundering and criminal organizations.