

The Right for Deducting VAT

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Abstract

Romania must comply with the VAT Directive, the judgments of the Court of Justice of the European Union and the European Court of Human Rights on VAT matter, that includes the matter of VAT deduction. The right to deduct VAT, in principle, cannot be limited for a taxable person and it is an abuse of law made by tax authorities when refusing this right. There are exceptions though, when the substantive and/or formal requirements are not met, the taxable person was involved in a VAT fraud or its supplier incorrectly drawn-up the invoice. The substantive requirements are: the purchases must be from a taxable person and must be used for taxable activities. The formal requirements are the obligations relating to accounting, invoicing and tax declarations. If tax authorities discover a VAT fraud or/and that a VAT liability has not been declared they must take immediate measures, impose compliance and collect the corresponding sums from the responsible person.

Key words: VAT, VAT deduction, VAT fraud, CJEU, ECHR

J.E.L. Classification: H25, H26, K40

1. Introduction

This article will clarify the rules for deducting the value added tax (VAT) according to the Jurisprudence of the Court of Justice of the European Union (CJEU) and the European Court of Human Rights (ECHR). The research is based mainly on the cases that CJEU and ECHR ruled on. From analysing the tax authorities' inspections results in the past few years it was concluded that they tend to become increasingly abusive and they cancel and refuse the right of taxpayers to deduct VAT. Therefore, it is necessary for the rules of deducting VAT and the right of the tax authorities to cancel the right of taxable persons to deduct VAT to be clarified – for the advantage of both the taxpayers and tax authorities.

It is essential for the EU countries to ensure uniform application of the common VAT system. Its' implementing measures are appropriate to realise that aim (VAT Directive 2006/112/EC point 61). Romania must comply with the common system of value added tax (VAT), which includes the VAT Directive 2006/112/EC and also the judgments of the Court of Justice of the European Union (CJEU), and the judgments of the European Court of Human Rights (ECHR). Thus, it is mandatory for Romania to apply and respect the EU common rules of the VAT, including the right of taxable persons to deduct it.

The right of taxable persons to deduct the tax paid or payable for goods or/and services purchased for use to taxable transactions is a fundamental principle of the common VAT system. The VAT essence consists in deducting the tax for upstream purchases from non-consumers (Terra *et al*, 2015, p. 991). The right to deduct VAT is an integral part of the EU VAT mechanism and in principle cannot be limited (CJEU Joined Cases C-110/98 to C-147/98 - Gabalfrisa SL and Others). This right shall arise at the time the deductible tax becomes chargeable (VAT Directive 2006/112/EC Article 167). This right is exercisable immediately in respect of all the VAT charged on transactions relating to inputs (CJEU Case C-437/06 - Securenta point 24, Case C-102/08 - SALIX Grundstücks-Vermietungsgesellschaft point 70). The rules of deduction of the VAT are meant to entirely relieve the trader of the burden of the VAT payable or paid in the course of all its

economic activities. The common system of VAT consequently ensures complete neutrality of taxation of all economic activities, whatever their purpose or results, provided that they are themselves subject in principle to VAT (CJEU Case C-137/02 – Faxworld point 37, Case C-268/83 - Rompelman point 19, Case C-153/11 - Klub point 35, OPINION OF ADVOCATE GENERAL Sharpston delivered on 13 March 2008, Joined Cases C-95/07 and C-96/07, Ecotrade SpA point 49).

A person who has the intention, confirmed by objective evidence, to start independently an economic activity and who starts to incur costs and/or makes the necessary investment to initiate that economic activity must be regarded as a taxable person. That taxable person is entitled to deduct the tax due or paid in respect of expenses and/or investments made for the purposes of the operations which it intends to carry out and which give rise to a right of deduction without having to wait for the start of the actual operation of his business. For this purpose, the Court of Justice of the European Union ruled in the Case C-110/98 - Gabalfrisa.

If, as a result of Tax Authority inquiries, there is a VAT liability that has not been declared, it is obvious that the Authority can - and indeed must - impose compliance and collect the corresponding sum. The discovery of liability cannot impinge the potential right to deduct the input tax, which does not depend on the liability. The right to deduct the VAT cannot be refused if the verification results in a VAT liability which has not been declared and which, if it had been correctly declared, would have entailed a concomitant right to deduct but, in the absence of such liability, no right to deduct could exist. In such cases, the failure to exercise the right to deduct is indissociable from the failure to declare the tax liability which the authority now seeks to enforce. The Tax Authority must take into account that to enforce the liability and at the same time to refuse the right to deduct VAT would, moreover, run completely counter to the principle of neutrality which is fundamental to the whole VAT system. If the taxable person would not be allowed to deduct the VAT for inputs, then it will double the amount of VAT that the Tax Authority would cash in the sense that the VAT would be collected both from the supplier and from the taxable person (OPINION OF ADVOCATE GENERAL Sharpston delivered on 13 March 2008, CJEU Joined Cases C-95/07 and C-96/07, Ecotrade SpA points 45-50).

Regarding all these aspects the CJEU ruled that there are two main requirements categories that govern the right to deduct the VAT, the substantive requirements and the formal requirements. The tax authorities cannot pass over these two requirements categories.

2. Substantive requirements for VAT deduction

In order to have the right to deduct VAT, first the substantive requirements must be first met. The taxpayer must be a taxable person and the goods and/or services (inputs) must be purchased from another taxable person. The purchased goods and/or services (inputs) must be used for taxable economic activities. So, the substantive requirements consist in the fact that it must be a connection between the purchasing of goods and/or services (inputs) and the taxable economic activities of the taxpayer.

The substantive requirements for the right to deduct the VAT are those which govern the actual substance and scope of that right, such as those provided for in Chapter 1 of Title 10 of the VAT Directive 2006/112/EC, entitled 'Origin and scope of the right to deduct' (CJEU Case C-590/13 - Idexx Laboratories Italia points 41 and 42, Case C-332/15 – Astone point 47).

About the substantive requirements of the right to deduct VAT, the CJEU has also ruled on other CJEU Cases - Case C-338/98 - Commission v Netherlands point 71, Case C-438/09 - Dankowski, points 26 and 33, Case C-274/10 - Commission v Hungary point 44, Case C-280/10 - Polski Trawertyn points 43 and 44.

If the Tax Authority has the information necessary to establish that the substantive requirements are met, in respect of the right of the taxable person to deduct that tax, it may not require additional conditions which may have the effect of extinguishing the exercise of that right (CJEU Case C-284/11 – EMS -Bulgaria Transport point 62).

If the purchased goods and/or services (inputs) are used for taxable economic activities of a taxable person, that taxable person has the right to deduct the VAT from the liability. Tax authorities cannot refuse or cancel the right to deduct VAT if the goods and/or services (inputs) are used for taxable economic activities by a taxable person.

3. Formal requirements for VAT deduction

In order to have the right to deduct VAT the formal requirements must also be met. The formal requirements for the right to deduct the VAT regulate the rules governing its exercise and monitoring thereof and the smooth functioning of the EU VAT system, such as the obligations relating to accounting, invoicing and tax declarations (CJEU Case C-590/13 - Idexx Laboratories Italy points 41 and 42, Case C-332/15 – Astone point 47).

With regard to the formal requirements of the right to deduct VAT, the CJEU has also ruled on other CJEU Cases - Case C-338/98 - Commission v Netherlands point 71; Case C-146/05 – Collée points 25 and 26, Joined Cases C-95/07 and C-96/07 Ecotrade SpA points 60-65, Case C-385/09 - Nidera Handelscompagnie points 47 to 51, Case C-280/10 - Polski Trawertyn points 41 and 48, Case C-324/11 - Tóth point 33.

The CJEU ruled that (CJEU Joint Cases C-80/11 and C-142/11 - Mahagében and Dávid) the right to deduct VAT cannot be cancelled or refused because the taxable person doesn't have other documents, than invoices, to prove that the transactions really took place. The issuing of the invoice by the supplier of the goods and the receipt thereof by the beneficiary consents and demonstrates that the delivery has taken place. For this purpose, not further documents are necessary in order to prove the delivery.

VAT cannot be deducted by a taxable person if an invoice was incorrectly drawn-up by the supplier because the VAT fiscal regime wasn't correctly applied. CJEU ruled that in a transaction subject to the reverse charge regime the VAT Directive 2006/112/EC and the principle of fiscal neutrality do not preclude the recipient of the services from being deprived of the right to deduct the VAT which he paid when that tax was not due to the services or/and goods supplier on the basis of an incorrectly drawn-up invoice (CJEU Case C-424/12 – Fatorie point 44).

If the substantive and formal requirements, for the right to deduct VAT, mentioned by the VAT Directive 2006/112/EC are met, the right to deduct VAT cannot be refused because the taxable person has not ensured that the issuer of the invoice, relating to the goods for which the right to deduct VAT is claimed, is a taxable person, that it really owned the goods and could deliver them. Also, this right cannot be denied for the reason that the taxable person didn't make sure that the supplier declared and paid the VAT or because the taxable person doesn't have other documents than invoices to prove that the goods were delivered or because the taxable person does not have evidence to justify the assumption of irregularities or fraud made by the issuer of the invoice (CJEU Joint Cases C-80/11 and C-142/11 - Mahagében and Dávid).

4. VAT fraud

VAT fraud is a major problem for the EU Member States' budget revenues and for the proper functioning of the internal market. Every year, VAT fraud brings damages of billions of euros to the EU finances. This is often organized on a large scale, sometimes by criminal organizations (Deliman *et al*, 2014, p. 244). The fraud in deducting the VAT means that the right is fraudulently or abusively invoked.

According to the Court of Justice of the European Union (CJEU) rulings, tax authorities can refuse the right to deduct VAT if, in the light of objective evidence, that right is fraudulently or abusively invoked – matter which is for the Romanian referring court to ascertain (CJEU Case C-285/11 - Bonik, Case C-107/13 - FIRIN, Case C-277/14 – PPUH and Case C-332/15 - Astone).

Tax authorities must prove with robust evidence the existence of a fraud or the participation of a taxable person to a possible fraud between supplier and buyer. The right to deduct the VAT that was paid by the taxable person to the supplier cannot be refused by tax authorities if such evidence does not exist.

If an invoice for purchasing goods was issued by an 'non-existent trader' or it is impossible to establish the real supplier of the goods, the right to deduct the VAT cannot be refused and the taxable person cannot be asked to make inquiries it shouldn't (CJEU Case C-277/14 – PPUH). An Exception is the situation in which it can be proved that the taxable person knew or it should have known that the delivery of the goods was implicated in VAT fraud, matter which is for the Romanian referring court to ascertain (CJEU Case C-277/14 – PPUH).

Constantly the CJEU ruled that, since the refusal of the right of deduction is an exception to the application of the fundamental principle constituted by that right, it is incumbent upon the competent tax authorities to establish, to the requisite legal standard, the objective evidence needed to substantiate the conclusion that the taxable person knew, or should have known, that the transaction relied on as a basis for the right of deduction was connected with VAT fraud committed by the supplier or by another trader acting upstream or downstream in the chain of supply (CJEU Case C-285/11- Bonik point 41, Case C-107/13 - FIRIN point 42).

Romanian courts also ruled on this matter. We retain the judgement of the High Court of Cassation and Justice (Decision No. 7405/22.11.2013 of the HCCJ - Administrative and Tax Litigation Chamber), which concluded that the granting of the right to deduct value added tax is conditional on the fulfillment of both the substantive and formal requirements, the former referring to the very existence of the right to deduct, and the other conditions for exercising it. The right to deduct VAT can no longer be refused, once all the formal and substantive requirements imposed by the law have been met, unless the tax authority has established, based on objective evidence, that the taxable person knew, or ought to have known, that the transaction relied on to justify the right to deduct was involved in fraud committed by the issuer of the invoice or another upstream operator.

In VAT matter, it was concluded that measures to prevent tax evasion or avoidance may not, in principle, derogate from the basis for charging VAT except within the limits strictly necessary for achieving that specific aim. They must have as little effect as possible on the objectives and principles of the VAT Directive 2006/112/EC and may not therefore be used in such a way that they would have the effect of undermining VAT neutrality (CJEU Case C-588/10 - Kraft Foods Polska point 28 and Case C-271/12 Petroma Transports and Others point 28).

Similarly, the European Court of Human Rights (ECHR Case *Bulves AD v. Bulgaria* App no.3991/03 22 January 2009, points 69 to 71) ruled that is a violation of Article 1 of Protocol No. 1 if the right to deduct the VAT paid upstream is refused by the tax authorities in case the taxpayer didn't know that there was an upstream VAT fraud.

ECHR accepts that when tax authorities possess information of VAT fraud by a taxpayer, they may take appropriate measures to prevent, stop or punish it. However, it considers that in the absence of any proof of direct involvement by a taxpayer in VAT fraud in chain of supply, or knowledge thereof, the tax authorities cannot hold a taxpayer responsible for the supplier's fraudulently behavior over which it has no control and in relation to which it has no means of monitoring or securing compliance. ECHR notes that if the taxpayer has absolutely no power to monitor, control or secure compliance by its supplier with its VAT reporting, filing and payment obligations then it cannot be held liable.

Using the same reasoning ECHR resumed that (ECHR Case *Business Support Centre v Bulgaria* App no.6689/03 18 June 2010 points 23 to 27) once tax authorities discover the supplier's failure to fully and timely discharge its VAT reporting and payment obligations, they can initiate a tax inspection and start the procedure against it in order to recover any such late payments together with interest. A practical application of that jurisprudence can be the case where the right to deduct VAT is refused to a taxpayer who has purchased goods from a supplier and the latter has no warehouses and tax authorities cannot establish the chain of supply and the places of loading and unloading of the goods.

The Court of Justice of the European Union (CJEU) ruled that an abusive practice can be found to exist only if, first, the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the VAT Directive 2006/112/EC and Title VII from the Romanian Tax Code, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of the relevant provisions of the VAT Directive 2006/112/EC and, second,

it is apparent from a number of objective factors that the essential aim of the transactions concerned is solely to obtain that tax advantage (CJEU Case C-277/09 - RBS Deutschland Holdings point 49).

From this perspective, it must be kept in mind that the substantive of transactions must take precedence over the form in commercial contracts. It must be determined on a case-by-case basis if the manner, in which those transactions were structured and the persons involved, was exclusively pursued to obtaining a tax advantage represented by the VAT deduction of payment to the state budget.

So, if it cannot be objectively established that transactions are not subject to economic content, since the tax advantage obtained is merely a subsidiary effect of the transaction, and not its purpose, then tax authorities cannot reconsider a transaction from an economic point of view so as to accurately reflect the fiscal burden of VAT. To refuse the right to deduct VAT is an abuse of law made by the tax authorities, which must be penalized by applying the principle of substantive prevalence over the form - without being a tax fraud.

5. Conclusions

Both taxpayers and tax authorities in Romania must comply with the VAT Directive 2006/112/EC, the judgments of the Court of Justice of the European Union (CJEU) and the European Court of Human Rights (ECHR) regarding the deduction of the VAT.

The right to deduct VAT in principle cannot be limited but there are exceptions regarding the substantive and formal requirements, tax fraud and the VAT rules applied by suppliers when drawing-up the invoices.

The substantive requirements for VAT deduction are: the taxpayer must be a taxable person, the goods and/or services must be purchased from another taxable person and must be used for taxable economic activities. The formal requirements for the right to deduct the VAT are the obligations related to accounting, invoicing and tax declarations. These are the only requirements and tax authorities cannot ask for more. But if the VAT rules aren't correctly applied by the supplier and the invoice is incorrectly drawn-up then the VAT cannot be deducted by the taxable person.

Tax authorities can refuse the right to deduct VAT if they prove that the taxable person was involved in a VAT fraud - matter which is for the Romanian court to ascertain. However, the taxable person cannot be held responsible for the conduct of the supplier if it didn't know or it couldn't have known about the VAT fraud. Tax authorities must start the procedure against the fraudulent supplier in order to recover any VAT late payments together with interest.

The tax authority may determine whether the taxpayer's transactions have an economic content and therefore there is an identity between the substantive and the form, based on objective elements.

Without being implicated in tax fraud, a taxpayer can conceive its business so it can lower its VAT.

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