Deducting input VAT on preparations for making taxable supplies (2/15/19)

One of the conditions for deducting input VAT on goods or services is that they must be acquired for making taxable supplies, but there is no requirement for such taxable supplies to have been made; the intention to make them will suffice. This article explores a few aspects to consider when it comes to deducting input VAT on activities carried out in preparation for taxable supplies.

VAT neutrality principle

The Court of Justice of the European Union (CJEU) and the Supreme Court of Latvia have found that the system of input VAT deduction aims to exempt a trader from VAT he has to pay or has paid in relation to his entire economic activity. So the common system of VAT provides complete neutrality in charging VAT on all economic activities regardless of their objectives or results, as long as those activities are generally chargeable to VAT. In other words, government cannot generally intervene in the VAT system by denying its use, unless there is reasonable suspicion that a taxable person has been abusing that system. After detecting an abuse of the VAT system with respect to activities carried out in preparation for taxable supplies, the tax authority may either deny the right to deduct input VAT (refuse to approve the amount of VAT appearing on the VAT return) or demand a refund of any amounts of input VAT deducted earlier.

Preparatory activities for making taxable supplies

Preparations are part of the concept of economic activity. The CJEU has explained that economic activity may comprise multiple consecutive activities, including preparations. So the person that carries out preparatory activities is considered a taxable person and permitted to deduct input VAT. That person has the right to immediately deduct the VAT payable or paid in relation to any investment transactions he intends to carry out which give him the right to a VAT deduction, without having to wait until those activities actually begin. But the taxable person has to observe the following conditions.

Firstly, there must be a real, credible, good-faith intention to carry out economic activity, which may be demonstrated by preparations completed earlier and other evidence. In general, such an intention might be demonstrated by drawing up a business plan, the trader’s internal documentation and/or activities done consecutively to carry out the intention (e.g. for the intention of construction – various blueprints, road reconstruction, commissioning and preparing technical drawings for electricity supply, taking out a construction permit, obtaining permits from relevant government agencies etc). There is no exhaustive list of such activities, and everything should be evaluated in conjunction with other circumstances of the case. The taxable person should be ready to explain the economic substance of the proposed activity and provide appropriate evidence to the tax authority. Great significance is attached to such explanations being consistent. This matters because the case law recognises that where there is merely an abstract desire to do something sometime, carrying out some activity beforehand per se does not suggest that the preparatory activity is really linked to the proposed economic activity which provides the right of deduction. Such an abstract desire might point to the taxable person’s intention of obtaining a tax advantage.

Secondly, the cost of goods or services acquired earlier must go into the price of transactions chargeable to VAT in the future. The case law recognises that the taxable person should make sure the acquired goods or services are linked to making taxable supplies, since the same preparations might just as well be aimed at making an exempt supply. So the taxable person is expected to provide evidence before exercising the right of deduction.

Thirdly, there must be a direct and immediate link between the input VAT and the taxable supplies. The taxable person’s intention and its implementation should be objectively compatible and should not be very remote or impossible, with each case being assessed on its own merits.

Meeting these conditions means that even if the proposed taxable supplies fail to materialise after the preparations, the taxable person will retain the right of deduction. If he is unable to control the course of events, then denying him the right of deduction would be unreasonable and incompatible with the principle of neutrality.