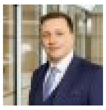
Adjusting input tax on write-offs 3/23/23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Fixed assets, and sometimes inventories too, have to be written off if they no longer meet your company's needs or are obsolete, or if there is no demand for them. The issue of input tax deduction always comes up in such situations, and has been recently heard by the Court of Justice of the European Union (CJEU). This article explores Ruling C-127/22 (*Balgarska telekomunikatsionna kompania*) of 4 May 2023.

Background

Balgarska telekomunikatsionna kompania EAD ("BTK") is a Bulgarian company operating in the telecommunications sector. BTK derecognised (wrote off) goods (plant, equipment and appliances) that were no longer considered fit for use or sale due to wear and tear, defects, obsolescence, unsuitability, or other reasons. Some of the goods were sold as waste, while others were destroyed or buried in a landfill.

BTK adjusted the input tax it had deducted on the write-offs, but later asked the Bulgarian tax authority to return the VAT paid, on the grounds that the adjustment requirement is inconsistent with Article 185(2) of Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax ("Directive"), which says no adjustment is required if destruction, loss or theft of property has been duly proved or confirmed. The dispute landed in the CJEU.

Since some of the goods had been sold as waste, the court examined the obligation to adjust input tax by separating the goods sold from those disposed of or destroyed, and began its assessment by reminding us of the purpose of adjustment.

Obligation to adjust the input tax deduction

Adjustment is an integral part of the input tax deduction system because if the taxable person intends at the time of acquiring goods to use them for taxable supplies, the input tax payable (paid) on the acquisition is deductible. The intended use (intention) dictates the amount of the original input tax deduction. The deduction entitlement remains only if the original intention has been realised. Article 185(1) lays down a principle that requires adjustment in particular if the components used in determining the input tax deduction change after the taxable person files a VAT return. The purpose of adjustment is to determine the amount of deductible input tax accurately and to ensure VAT neutrality in such a way that the right to deduct the input tax on earlier transactions remains only if those were carried out to supply services on which VAT is charged.

Goods sold as waste

Selling goods that are no longer useful for the taxable person does not give grounds for adjusting the input tax deducted on the acquisition because this ends in a subsequent taxable supply of goods. It's irrelevant that the selling of waste is not BTK's core business activity or that the selling price is negligible compared to the acquisition cost, or that the goods were sold as waste (their original nature has changed). Accordingly, where goods are sold as waste, the components used in determining the input tax deduction remain unchanged.

Goods destroyed or disposed of

Destruction clearly leads to the taxable person losing any chance to use the goods for taxable supplies, and the components used in determining the input tax deduction have changed within the meaning of Article 185(1). The CJEU goes on to examine whether Article 185(2), which permits the taxable person to avoid adjusting the input tax deduction in duly proven or confirmed cases of property destruction, loss or theft, is applicable to this situation.

The CJEU points out that the Directive does not define the terms “destruction” and “loss” so their meaning and applicability should be ascertained in everyday language, considering the context of use. “Destruction” denotes an action that substantially changes something, liquidates it, makes it disappear, or makes it non-existent. “Loss” means that someone is denied something they owned or used. It follows that loss of goods does not result from voluntary action by the owner or possessor, yet this is not ruled out in the case of destruction. As regards the context, the CJEU states that this derogation from the general obligation to adjust the input tax deduction was introduced to distinguish between justified and unjustified loss and destruction of goods, so that companies would not suffer any tax loss in addition to the existing loss where destruction, loss or theft has been confirmed.

The CJEU finds that destruction, not loss, is what takes place in these circumstances, and there is no condition that destruction should occur only against the taxable person’s wishes. In certain circumstances this might be voluntary action by the taxable person, such as destruction of goods that have become unfit for use in the company’s ordinary business. Here it’s important to consider the economic and commercial reality. Destruction must be duly proved or confirmed, and for input tax adjustment purposes we should take into account only destruction of goods that have objectively lost any usefulness in the taxable person’s ordinary business. The court finds that being buried in a landfill is equivalent to destruction.

Accordingly, the input tax deduction should not be adjusted for destruction of goods that have objectively lost any usefulness in the taxable person’s business if this has been duly proved.

The CJEU also stated that Article 185(3) permits the member states to require adjustment for transactions that remain wholly or partly unpaid, or in cases of theft, but not for destruction. A member state’s law that differs from the CJEU’s interpretation is contrary to the Directive.

The Latvian legal framework

Section 106 of the VAT Act provides for adjustment if the amount of input tax deduction changes (e.g. cancelled purchases, or discounts received). Input tax should also be adjusted where goods are stolen or destroyed by a natural disaster or in any other forcible manner. However, no adjustment should be made if there is documentary evidence of such theft or destruction. Latvia can be said to have restricted input tax deduction by permitting only a forcible destruction of goods. This is not consistent with the CJEU’s opinion. In practice, to write off obsolete inventories that will not be used in future business, many companies (especially in the retail sector) use wastage rates, which we also find to be inconsistent with the CJEU’s opinion on loss of goods.