

# Applying ratio to VAT margin scheme for second-hand goods 3/30/24

In this article, we will explore how the courts ruled on a tax audit where the State Revenue Service (SRS) claimed the company under audit had wrongly deducted input VAT and misapplied a ratio. Although the SRS did not approve the company's adjustments to its VAT returns and did not refund the VAT it had overpaid, the courts found the penalty and interest charged by the SRS to be justified. This case highlights important lessons for companies to avoid similar problems in the future.

## Background

The audit found the company had wrongly calculated the deductible portion of input VAT and applied the wrong ratio in providing hire-purchase services for the acquisition of second-hand vehicles. The company wrongly included the values of transactions governed by section 138 of the VAT Act even if the difference between the acquisition cost and the selling price was zero or a negative number. The SRS ended up charging interest on arrears plus a penalty and refusing to approve the overpaid amount of VAT for the period being audited.

## The audit results and the court ruling

The company challenged the audit results and took the SRS to court. The Regional Administrative Court upheld the audit decision and stated that the margin scheme for second-hand goods where the difference between the cost and the selling price is zero or negative does not give the right to deduct input VAT. The Regional Court found the interest had been charged correctly because prior to the audit the company had understated the output VAT after including expenses that did not give the right to deduct VAT and using a ratio.

## The appeal

The company filed an appeal stating that section 138(21) of the VAT Act provides for deducting input VAT on a particular acquisition and supply of second-hand goods but does not provide for deducting input VAT on administrative expenses where no output VAT arises on goods supplied under this section.

## The court motives

The main question in court was whether a ratio should be applied to the value of transactions covered by the margin scheme when it comes to deducting input VAT. The company stated that its hire-purchase transactions involved taxable supplies (second-hand vehicles) and exempt supplies (crediting services). The company used most of the acquired goods and services to make taxable and exempt supplies. Accordingly, the company deemed it reasonable to apply section 98(2) of the VAT Act and use a ratio.

The court pointed out that the margin scheme derogates from the general VAT principles and input VAT can be deducted only if transactions result in a positive difference. If the taxable person has made transactions under section 138 of the VAT Act, 'the ex-VAT value of transactions giving the right to deduct input VAT' in the numerator and denominator of a ratio calculated under section 98(2) should generally include the ex-VAT value (margin) computed under section 138(10), i.e. the positive difference between

the cost and the selling price from which input VAT has been deducted at the same time.

The margin scheme allows the trader to deduct an amount of input VAT that does not exceed the amount of output VAT. If the difference between the cost and the selling price is zero or negative, i.e. there is no margin, then there is no amount chargeable to VAT either. This transaction does not allow the taxable person to deduct input VAT because it produced no value added.

The SRS did not approve the VAT returns and did not refund VAT to the company, but the penalty and interest on arrears were deemed reasonable nevertheless. This shows that a company's errors can have serious consequences whether or not the SRS decides to approve its tax returns.

What can we learn from cases like this? Accurate, high-quality accounting and statutory compliance are critical to avoid litigation, legal issues and financial losses. This lawsuit highlights the need for accuracy in tax calculations and reports. Companies are advised to stay compliant and calculate taxes correctly to avoid unpleasant surprises on a tax audit. This case also shows that SRS audits and findings can be robust and resilient if they are based on the law being applied accurately.