

How subsidies affect transactions for VAT purposes

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We have read conflicting opinions from the State Revenue Service (SRS) on how financing from the State or EU funds affects value added tax (VAT). Persons receiving such funding should consider this issue carefully and may have to seek SRS approval for VAT treatment. To help you navigate this complexity, we will offer some guidelines based on the assessment made by the Court of Justice of the European Union (CJEU) in its ruling C-87/23 of 4 July 2024. The case involves a dispute between the Latvian Information and Communications Technology Association (LICTA) and the SRS.

When thinking about whether a payment is subject to VAT, we need to remember that VAT is basically charged on supplies of goods and services for a consideration performed by a person taking part in the transaction as a taxable person.

The 'taxable person' is a term that helps us primarily distinguish an economic activity in the nature of business from a non-economic one. For example, if an individual sells their private property for a consideration, the sale will not attract VAT unless the regularity of transactions or other circumstances point to the hallmarks of an economic activity.

Also, only a registered taxable person is eligible to deduct input tax if goods and services are acquired to make taxable supplies.

The Associations and Foundations Act states that an association is a voluntary union of persons formed to achieve the goal prescribed by its articles of association, which is not in the nature of making a profit. An association is permitted to carry on a business as an ancillary activity for achieving its goals. An association is allowed to use its income only for achieving the goal prescribed by its articles of association. None of the profit an association or a foundation makes from its economic activity can be divided between the members of an association or the founders of a foundation.

LICTA, a registered taxable person, organised and carried out training services cofinanced by the European Regional Development Fund (ERDF). On average 30% of the service value was paid by customers and 70% came from the ERDF. LICTA's own resources were insufficient to provide the services, so it engaged third parties to provide services on its behalf to customers with whom LICTA had signed an agreement. The actual suppliers invoiced LICTA and charged VAT on their services, which LICTA deducted as input tax. LICTA believed the training was a taxable supply and charged VAT on the supply when invoicing the customers.

The SRS disallowed the deduction of input tax on the grounds that LICTA was not conducting an economic activity. The SRS claimed that since these projects could only be carried out by associations or government agencies, not businesses, the projects did not provide for profit-making opportunities and organising the projects per se cannot be an economic activity.

The dispute landed in court and the Regional Administrative Court decided to refer the following preliminary questions to the CJEU:

- For VAT purposes, is LICTA considered to have supplied the services it acquired from the actual suppliers for this project?
- Is the association a taxable person in this situation?
- What is the taxable amount if the customer only pays 30% of the service value and the rest comes from the ERDF?

Let us now explore the aspects the CJEU scrutinised when hearing the dispute and what conclusions we can draw when analysing our own situations.

Are the services supplied for a consideration?

According to CJEU case law, a supply of services is for a consideration and therefore taxable only if there is a direct link between the supply and the consideration actually received. A direct link can be established if there is a legal relationship between the supplier and the customer involving mutual performance, and the fee the supplier receives is the actual consideration for the services supplied to the customer. Also, to treat a supply of services as one for a consideration:

- It's not mandatory to receive the consideration directly from the customer – it can be received from a third party.
- It's not relevant whether the service fee is higher or lower than cost or market.

The association issues tax invoices for the training in its name to the customers under their agreement. The company that actually carried out the training was acting on behalf of the association and invoiced the association for its services. So there is no doubt that the association qualifies as a training service provider in relation to the customer, and it does not matter that the association engaged a subcontractor instead of hiring employees. The training services being financed by the ERDF does not prevent the supply from qualifying as one for a consideration because the consideration can come from a third party. The association making no profit from the project does not change the CJEU assessment, either.

Is the association, whose activity involves carrying out ERDF-funded state aid programmes, considered a taxable person that carries on a business?

Since the provision of training services meets the criteria allowing it to qualify as a supply of services for a consideration, we need to assess whether the association was acting as a taxable person. Under the VAT directive, a taxable person is any person that independently carries on any economic activity at any place regardless of its goal or result. Any manufacturing, trading or service activity, including mining, agricultural activity and the free professions, is considered an economic activity. The use of any tangible or intangible property for the purpose of generating long-term income in particular is considered an economic activity.

The CJEU points out that an economic activity is examined per se, regardless of its goals or results. So the fact that because of its corporate form an association is a non-profit organisation that is only permitted to carry on a business as a revenue-generating ancillary activity, does not prevent it from being considered a taxable person. Also, the training being mostly financed by the ERDF does not affect the economic nature of the association's activity because the term 'economic activity' is applicable regardless of what type of funding the entity has chosen, including state subsidies.

What is the taxable amount?

Based on the finding that to treat the supply of services as one for a consideration it does not matter that the supplier only receives a partial consideration for the services from the customer and the rest comes from the ERDF, the taxable amount is the entire total amount received by the service provider (30% from the customer plus 70% from the ERDF).

Accordingly, the CJEU found that the association was right to charge VAT on the full amount comprising the customer payment and the ERDF money, and to deduct the input tax on the services acquired from subcontractors involved in providing the services.

If the customer/ERDF payments were treated as cost recharges, they would not be subject to VAT and the input tax on the acquired services could not be deducted.