Contribution in kind and VAT (2) 2/41/22

Manager, Tax, PwC Latvia
Matiss Auzins

This article picks up where we left off last week.

Adjusting input VAT on a contribution in kind

The VAT Act has a section that lays down an obligation to adjust the input VAT deducted on contributed assets and implies that the lawmaker intended to treat the contribution in kind as a transaction outside the scope of VAT (or perhaps an exempt supply).

Section 103(1) of the VAT Act states that contributions in kind to a company's capital, including fixed assets or real estate (RE), in exchange for securities and share certificates, require an input VAT adjustment unless this section provides otherwise. So the main rule provides for adjusting the input VAT deducted on the contributed assets, and the other cases mentioned in the law where no adjustment is necessary can be treated as an exception to the general rule.

When the deducted input VAT may be adjusted

An adjustment is required if the taxable person has deducted more (or less) input VAT than he is entitled to. Apart from discounts, cancelled purchases and bad debts, the deducted input VAT must be adjusted if the originally intended use of the underlying goods (or services) has changed. Goods are understood to include fixed assets or RE. A change of use that requires an adjustment to the deducted input VAT would occur if, say, some RE intended for taxable supplies (sales of new apartments) is used for exempt supplies (some of the apartments are rented).

So, if section 103 of the VAT Act lays down the need to adjust input VAT on a contribution in kind, this is considered a transaction that does not give the right to deduct input VAT, i.e. an exempt supply or rather a transaction outside the scope of VAT. If the contribution in kind were considered taxable, then the rule requiring an input VAT adjustment would be contrary to the fundamental principles of the VAT system. Since the VAT Act is silent on the concept of a contribution in kind, we will look at this in the light of the Commerce Act. Under section 153 of the Commerce Act, a tangible or intangible asset that can be assigned a monetary value and used in a company's business may be the subject matter of a contribution in kind, with the exception of any assets that cannot be legally subject to legal action for debt recovery. An obligation to supply services or carry out work, expected profits or expected operations within the company, expected remuneration, fees, dividends or similar payments which the founder or shareholder may receive from the company cannot be the subject matter of a contribution in kind.

Section 103(2.1) of the VAT Act lists cases where the input VAT deducted on a contribution in kind does not need adjusting. No adjustment is required if a contribution in kind is made to the capital of a VAT-registered taxable person for making taxable supplies or to the share capital of a newly formed company that duly registers for VAT. While this section does not mention the condition that the newly formed company should use the contribution in kind for making taxable supplies, that would be self-evident.

Separately, yet by analogy with this section, section 103(3–4) of the VAT Act prescribes the right not to

adjust the input VAT deducted on an RE contribution. It also states that the acquiring company must continue adjusting the deducted input VAT. The acquiring company must file part A of the statement of RE usage together with its VAT return for the month in which documents confirming the RE delivery were signed. From this date, part B of the statement will have to be filed together with the annual VAT return each year until the adjustment period ends (if adjustment is required).

The question of input VAT adjustment is relevant only if we contribute some RE in the middle of the adjustment period, that is, within ten years after it was acquired or delivered for occupancy following construction, alteration, renovation or restoration. The contributor must file part C of the statement of RE usage and adjust the input VAT for the period up to the month in which documents confirming the RE delivery were signed (this applies if the RE had a mixed use for taxable and exempt supplies before being contributed). The contributor retains the entire risk of the deducted input VAT if the acquiring company fails to meet any of the conditions (failure to duly register for VAT, to submit statements of RE usage, or to make the required input VAT adjustment). If the acquiring company is already registered for VAT, it should remember to notify the SRS of changes to the make-up of the contribution in kind.

Section 103(2) and (5) of the VAT Act (relating to RE) lays down the procedure for determining the amount of VAT payable to the government if an adjustment is required, for example if the contribution is made to a company that supplies exempt services only.

The VAT Act is silent on whether and how input VAT should be adjusted where construction in progress is contributed.

The right to deduct input VAT on services acquired for contributions to capital

When making a contribution in kind, the contributor may incur a number of expenses associated with this process (valuation services, legal services etc). The main principle for deducting input VAT is found in section 92 of the VAT Act: the input VAT on acquired goods and services is deductible if those are acquired for making taxable supplies (or for supplies made abroad that would be taxable if they were made in Latvia).

So, to deduct input VAT, we have to find a direct and immediate link between the acquired goods (services) and one or more subsequent transactions giving the right to deduct input VAT.

If based on the above, the contribution is a transaction outside the scope of VAT, then we should examine the purpose of the contribution. We need to understand whether the contribution is made only with a view to receiving dividends or in order to interfere in the acquiring company’s business by supplying taxable services (e.g. management services) to it. In assessing whether the services acquired for the sale of shares should be treated as directly related to this transaction only or to the company’s overall business, the Court of Justice of the European Union has paid attention to how costs are allocated in the company’s accounts. If the cost of acquired services forms part of the price of the supply of shares, then the acquired services have a direct and immediate link with an exempt sale of shares. However, if the cost of acquired services forms part of the company’s overall costs, the acquired services are related to the company’s overall business. In that case they form part of the price of services the company supplies. If the company has a taxable business, the input VAT on the acquired services is deductible.