

The regulations limited the right to the partial recovery of input VAT do not comply with the VAT Directive (2006/112/EC)

Introduction

In the judgment of 18 December 2008 (no. III SA/Wa 2337/08), the District Administrative Court in Warsaw has questioned the provisions of the VAT Act relating to the partial VAT recovery through the turnover split (the so called "pro rata recovery").

In this judgment, the Court considered the current provisions regarding the percentage limits and the annual VAT correction of input VAT as violating Article 176 and Article 173(2)(e) of the VAT Directive (2006/112/EC).

Background of the case

The motion for the binding tax ruling filed by the taxpayer concerned the interpretation of Article 90 and Article 91 of the VAT Act and the possibility to apply the final VAT correction in case the initial pro rata differs by less than 2 per cent from the final pro rata.

The Minister of Finance assumed that due to the wording of the second sentence of Article 91(1), the taxpayer is not entitled to apply the annual VAT correction with the use of the increased pro rata, since the difference between the initial pro rata and the final pro rata did not exceed 2 percentage points.

In consequence, even though in the given case the final pro rata was equal to 3 per cent (i.e. it was higher than the initial pro rata by less than 2 per cent but exceeded the 2 per cent ratio required by Article 90(1) of the VAT Act), the taxpayer was completely deprived of the right to recover VAT.

The Court overturned the interpretation, stating that the provisions quoted by the taxpayer violate with the European regulations.

Recovery limitation with the pro rata not exceeding 2 per cent

According to the Court, Article 90(10)(2) of the VAT Act is in breach of Article 173(2)(e) of the VAT Directive as far as it deprives the taxpayer whose pro rata did not exceed 2 per cent, the right to recover input VAT.

This provision of the Directive entitles the Member States to introduce regulations, in which they "*provide that, where the VAT which is not deductible by the taxable person is insignificant, it is to be treated as nil*". In the same time, the European regulations do not provide for a possibility to introduce analogous regulations that are detrimental for the taxpayer. In consequence, according to the Court, upon the introduction of the pro rata mechanism, the Polish legislator had been entitled to provide for the 98 per

cent ratio allowing for the full input VAT recovery.

In the same time, he had not been entitled to introduce the 2 per cent ratio that deprives the taxpayer of the recovery right in total.

Annual correction in case the turnover split is changed

According to the Court, sentence 2 of Article 91(1) introduces further limitations to the recovery right which are not grounded by the wording of the VAT Directive. According to the Court, the prohibition to apply the correction in case the final pro rata changes by less than 2 percentage points, violates the neutrality of VAT.

Practical implications of the judgment

The quoted judgment may crucially influence the practical approach for the preparation of VAT settlements by banks, insurance companies and other entities that carry out mainly VAT exempt activity with a pro rata not exceeding 2 per cent or pro rata changing by less than 2 per cent over the year.

KPMG assumes that the questioning of the regulations depriving the taxpayers with a low pro rata of the right to recover VAT, together with the questioning of the further

limitations connected with the applicability of the annual correction of the input VAT, causes that due to the current wording of the VAT

Directive, all entities carrying out activity that is mostly VAT exempt, will be entitled to the VAT recovery according to the calculated turnover split.

We would also like to note that according to the approach taken by the jurisprudence in the past, the right to recover VAT may impact the possibility to treat the non-recovered input VAT as tax deductible for CIT purposes.

Our Assistance

In connection to the abovementioned judgment and the potential changes in the methodology of VAT settlements, we would like to offer you our services covering:

- verification of the previous and future pro rata calculations;
- analysis of the necessity to prepare corrections of the CIT declarations in connection with the existence of the VAT recovery;
- evaluation of the efficiency of the application of VAT recovery in the light of the corrections of CIT and payment of default interest;
- preparation of motion for binding tax rulings regarding CIT and VAT together with on-going contacts with the tax authorities;
- preparation of VAT overpayment motions and carrying out of the proceedings in this respect;
- assistance with the preparation of the corrections of VAT declarations, potential corrections of CIT declaration and necessary explanations.

If you are interested in more detailed information, please feel free to contact us.

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