

Accounting and Fiscal Aspects Concerning Value Added Tax Adjustment

MARIANA GURĂU

Department of Economic Sciences
„Nicolae Titulescu” University, Bucharest
ROMANIA
marianagurau @univnt.ro

ANCA BRATU

Department of Economic and Administrative Sciences
University of Bucharest,
ROMANIA
anca.bratu@faa.unibuc.ro

Abstract: *When considering value added tax, economic activities can be taxable or tax exempt from the payment of value added taxes, with or without a deduction right. Our research has shown that these last types of operations are prone to creating confusion, among economic entities and fiscal authorities, with regard to their VAT. The problem becomes even more acute when considering adjusting and recovering VAT. We believe that an analytical paper, dealing with adjustments of value added tax, is necessary in light of the fact that the legislation on this matter is very fluid, often being the subject of change. The largest of these took place at the end of last year and it was followed up by a seemingly never ending series of modifications. The purpose of this paper is to analyze different aspects of VAT, to present the manner in which one should act when a value added tax adjustment is required and to differentiate between the situations when a company may or may not have the obligation to perform and adjustment. Over the course of the paper we will present a few examples which require a VAT adjustment, as well as the resolution used for them. Legally obtaining fiscal advantages presupposes an excellent knowledge of fiscal legislation. For this reason, in the first part of the paper, we will identify the most important characteristics of VAT and we will present a series of special VAT schemes. This will be followed up by the solution for a few problems in the area of VAT adjustment. This paper will also encompass certain accounting aspects relating to VAT adjustment, as seen through the relationship between accounting and fiscality.*

Keywords: *deductible, deduction right, pro rata, VAT adjustment, capital goods, neutral relationships, integrated relationships.*

1. Introduction

TMF Group Romania, an outsourcing company present in the country for 17 years, has released a report identifying frequent changes in legislation as one of the major challenges faced by companies in Romania.

Starting from this observation, we can say that, for many economic entities, the relationship with the tax administration is difficult to handle and, from a value added tax, it can create a lot of confusion.

The fiscal objectives of any economic entity, regardless of financing source, are represented by ensuring fiscal security and efficiency.

Fiscal security is guaranteed by respecting rules and terms imposed by tax law, therefore avoiding tax penalties and sanctions, therefore leading to improved resource allocation.

Fiscal efficacy requires minimizing the tax burden of the company, while respecting tax law. This objective can be achieved directly or indirectly.

Value added tax, including VAT adjustments, are regulated by Law 227/2015 concerning the Fiscal Code.

The literature on value added tax adjustment is limited. Therefore, in order to present as many of the possible situations of interest for our study, we will refer to a series of normative acts, as follows:

- Law 227 / 2015 concerning the Fiscal Code with modifications and completions;

- HG 1/2016 – Governmental decision concerned with the methodological implementation of the New Fiscal Code;
- OPANAF 3840/2015 – concerned with establishing company registration criteria for VAT purposes;
- Law 207 / 2015 concerning the Procedural Fiscal Code with modifications and completions.

2. Theoretical background for value added tax

As mentioned in the introduction, the value added tax literature is very poor on the topic discussed by this paper in particular. We will identify, for starters, what is the area of interest for VAT and we will attempt to describe the necessary conditions for an operation to fall under VAT legislation in Romania.

Because economic activities performed by economic entities can be either taxable or tax exempt from value added taxes, with or without a deduction right, this can lead to questions, among economic entities and fiscal authorities, with regard to their VAT, especially when considering adjusting and recovering VAT.

Before going any further, one must be establish what the conditions for being considered a taxable person are.

From the point of view of VAT, **persons are classified** as follows:

Taxable persons	Normal (mandated to record themselves, for VAT purposes, from the start of their activity.)		VAT payers
	Tax exempt	Taxable, similar to small economic enterprises	The ones exempt from paying VAT: They are not mandated to register for VAT purposes, when they start their activities, but they have to register if their intra-community purchases are in excess of 10.000 euro/year or if their revenues are greater than 65.000 euro/year.
		Companies performing activities which are VAT exempt and without a deduction right.	
Non-taxable persons	Juridical non-taxable persons	Public institutions, NGOs	
	Natural non-taxable persons	Natural persons who are not involved in any independent economic activities	

Prerequisites for an economic operation to fall under Romanian VAT laws are:

- The operation must be for pay or equivalent;
- It must be performed by a taxable person, meaning any person, regardless of juridical nature, performing an independent economic activity;
- It must be the result of an economic activity;
- It must be performed in Romania.

Economic activities falling under the VAT laws can be classified in accordance with a multitude of criteria, in this manner:

Classification criteria	Types of operations falling under VAT laws	
Type of operation	A)	Delivery of goods;
	B)	Services;
	C)	Intra-community acquisitions (ICA);
	D)	Imports.
Taxation	A)	Tax a) delivery of goods and services: give the company the

regime	able operations (VAT applicable);	right to deduce VAT for goods and services bought and used in order to accomplish the aforementioned taxable operations; b) Intra-community acquisitions and imports.
	B) Tax exempt operations (VAT is not applicable).	a) delivery of goods and services with a VAT deduction allowance : the VAT deduction is permitted for goods and services bought and used in order to accomplish the aforementioned taxable operations; b) delivery of goods and services without a VAT deduction allowance : the VAT deduction is <u>not</u> permitted for goods and services bought and used in order to accomplish the aforementioned taxable operations; c) Tax exempt intra-community acquisitions and imports.
VAT classes	A) Normal tax regime; B) Special tax regime with exemptions for small companies (with an annual revenue of less than 65.000 euro); C) Special tax regime for tourist agencies; D) Special tax regime for second-hand goods, art objects, collectors' items and antiques; E) Special tax regime for investments in gold; F) Special tax regime for taxable non-residents who offer electronic services to non-taxable persons.	

A VAT deduction is the subtraction of VAT paid to suppliers of goods and services (Output VAT) from the VAT received from clients in exchange for good and/or services (Input VAT).

The VAT owed to the state budget is determined on a monthly basis with the use of the VAT account, therefore:

- If Output VAT is greater than Input VAT, the difference is the VAT payable.
- If Output VAT is smaller than Input VAT, the difference is the VAT receivable.

VAT receivable and VAT payable can be compensated from one period to another or the value can be recovered.

VAT recoverable is to be reimbursed by the tax authority, in accordance with a procedure approved by the Ministry of Public Finance. The tax authority will decide, in accordance with the Order of the Minister, and based on a risk analysis, whether it will commence a fiscal inspection before or after the reimbursement is approved. For negative VAT accounts payable with an option to be paid and the amount smaller than 50.000 RON, the fiscal authority will reimburse the amount and will follow up with a fiscal inspection at a later date, except for the following situations:

- a. If the tax payer has, on his fiscal record, acts which are sanctioned as infractions;
- b. If the tax authority based on its own prior knowledge, has reason to believe that there is a risk for the reimbursement to be wrongly paid.

Any time the reimbursement is allowed with a fiscal inspection at a later date, it will be performed based on a risk analysis.

3. Practical aspects concerning VAT pro-rata

The fiscal code provides for a series of VAT operations which are classified into two categories, from the perspective of VAT deduction: tax exempt operations which allow for a deduction and tax exempt operations which do **not** allow for a deduction.

In certain situations, when an economic entity is partially tax exempt but cannot differentiate, in its records, between taxable and tax exempt operations, the person will be considered to be a mixed regime taxable person and, in order to determine the deduction value, it can apply a pro rata.

When is a pro rata used and how is it determined?

Pro rata taxation is applied for a tax deduction when a **person has a mixed regime or when a person is partially taxable.**

The deduction right, for a person with a mixed taxable regime, is determined as follows:

- If the VAT is for the acquisition of goods and services destined for operations which give an allowance for deduction, then the VAT is entirely deductible;
- If the VAT is for the acquisition of goods and services destined for operations which do not give an allowance for deduction, then the VAT is not deductible;
- If the destination of the goods and services is not known or impossible to determine, the VAT is deductible based on the pro rata.

Taxable persons with a mixed regime can opt-out from a deduction, in which case, the tax, for the acquisition of goods and services to be used in operations with or without an allowance for deduction, will not be reduced.

Rules for determining and applying pro rata

Pro rata is the result of the total sum, without VAT, but including subsidies which directly influence the price, for operations which permit a deduction (D), divided by the total sum, without VAT, of the aforementioned operations (D) and the operations which do not permit a deduction (ND)¹.

The pro rata does not include the following:

- a. The value of any delivery of capital goods which have been used by the taxable person in its economic activity, with the exception of operations mentioned at c);
- b. The value of any delivery of capital goods or of services done by the taxable person and mentioned under art. 270 p. (4) and art. 271 p. (4) of the Fiscal Code, as well as the transfer mentioned at art. 270 p (10);
- c. The value of operations mentioned under art. 292 p. (2) letter a) of the Fiscal Code, as well as fixed assets operations², as long as they are accessories to the main activity.

Therefore, the pro rata is determined with the formula: $D / (D + ND) \times 100$

Example: If D is equal to 300.000 and ND is 50.000, the value will be:

$$300.000 / (300.000 + 50.000) \times 100 = 86\%$$

Pro rata particularities:

- The definitive pro rata value is determined annually as a percentage value and is rounded to the closest next whole value;
- The method for determining the pro rata value must be annexed to the tax discount form;
- The provisional pro rata value, to be applied, is the value for the previous year, or the pro rata value estimated for the current year, in the case of taxable persons with a deduction right for whom the weight of deductible operations changes, when compared to the previous year;

¹ Includes money received from the state or local budget, granted as financing for exempted operations without a deduction right or operations beyond the scope of the law.

² Fixed assets operations include delivery, rental, lease, land rental, operational leasing and other similar operations, done in relation to fixed assets.

An operations is accessory to the main activity if it cumulatively observes the following conditions:

- the realization of the operation requires only limited man and material resources;
- the operation is not directly related to the main activity of the taxable person;
- the expenses for the realization of the operation and the value of the tax deductible is not significant.

- Taxable persons must communicate to the tax authority, at the beginning of each year, on the 25th of January at the latest, the provisional pro rata value to be applied for that year, as well as the manner in which it was determined;
- The tax deductible for a year is determined, on a provisional basis, by multiplying the value of the tax deductible for each fiscal period of the calendar year with the provisional pro rata value of that year;
- The definitive value of the tax deductible, for a calendar year, is determined by multiplying the total deductible value for the calendar year with the definitive pro rata value.

4. Fiscal and accounting aspects concerning VAT adjustments

An important, but cumbersome, rule resulting from the pro rata particularities is given by the obligations for mixed regime persons to adjust their provisional tax deductment:

- a. the deducted value, determined based on the provisional pro rata value, is subtracted from the definitive value of the tax deductible for the year;
- b. the difference obtained at a), be it a plus or a minus, will be marked down in the corresponding row for regularizations in the tax adjustment form for the final fiscal period of the year, or the tax adjustment form for the final fiscal period of the person, assuming it is being annulled.

The tax adjustment represents the correction of the tax deduction right, either by the annulment of the right exercised at the moment of acquisition/construction/improvement of goods, or by exercising this right after the acquisition/construction/improvement of goods, if it was not exercised initially.

The adjustment is required for **capital goods as well**³ because one must take into account that these goods are, by definition, used by the taxable person for a number of years and that the VAT tax deductment for these goods is allowed only on the condition that they are used for operations which give a deduction right.

To this effect, adjustment periods are differentiated depending on the type of capital goods, thus:

- 1) 5 years for capital goods, other than fixed assets;
- 2) 20 years for fixed assets, including transformation or improvement of fixed assets, should the costs exceed 20% of the value.

When to conduct a VAT adjustment?

a. **The deduction adjustment is performed for capital goods when they are used, by the taxable person, for:**

- Either partially or entirely for purposes other than their economic activity;
 - Operations which do not give a tax deduction right;
 - Operations for which the tax deduction is different than the initial deduction.
- b. In situations when elements included in the calculation for the tax deduction are changed;
 - c. In situations when the deduction right for a capital good was limited, partially or in totality, and is used in an operation which allows for a deduction. For deliveries of goods, the additional value of the tax deduction is limited to the value received for the delivery.

A tax adjustment is not required in the case of damaged, lost or stolen goods, assuming that this has been proven and confirmed in an appropriate manner, similarly, but not limited, to the following situations:

- Natural calamities and force majeure, proven and confirmed in an appropriate manner;
- Stolen goods, confirmed with the aid of papers issued by the appropriate authorities;
- Leasing contracts with a capital good as an object which is not returned within the stipulated terms, when the contract is cancelled. The financier does not have the obligation to adjust the tax deduction if it can prove that it has initiated and gone through the necessary steps to recover the good, regardless of whether they have or have not been recovered by the leasing company.

Recording VAT operations is considered a neutral relationship between the two domains because VAT is an indirect tax which does not influence the performance of the economic entity.

³**Capital goods** include all fixed capital goods, as well as transformation and improvements of fixed assets/ parts of fixed assets, should they exceed 20% of the value, excluding maintenance and repairs. Fixed assets are considered fixed assets regardless of whether they are recorded as inventory or fixed assets.

However, by exception, when an economic entity has other activities, which do not give a deduction right, and it has to apply a pro rata VAT deduction, the operations which are the result of the VAT deduction are fall under the integrated relationship between accounting and fiscality. The statement is also true for other situations concerning VAT adjustment because, as a result of adjustment operations, the economic entity will record increases or decreases in expenses which will affect performance, specifically profits or losses, for a given accounting period.

We can observe that VAT adjustments have an impact on the Financial Statements, the Profit and Loss account and the Cash Flow Statement, by increasing outward cash flows.

How is the VAT adjustment performed?

The adjustment is done only once, or once per time period:

- 1) The adjustment is performed **only once** for the entire remaining adjustment period, including the year during which the destination of the good is changed, when:
 - a. The destination of the capital good is changed;
 - b. A capital good, whose deduction right was limited, partially or in totality, is the object of a delivery which allows for a tax deduction;
 - c. The capital good no longer exists, unless:
 - It can be proved that the capital good was the object of a delivery which allows for a tax deduction, or
 - The capital good has been destroyed.

Example: A taxable person (a pharmacy working alongside a medical practice) buys furniture at the end of December, year N, for the price of 10.021 RON, VAT included (19% = 1600 RON). Its activity allows for a full deduction of the VAT, specifically 1600 RON.

In March N+2, the furniture is moved in the medical practice, which does not have a deduction right. The accounting record of the acquisition is:

%	=	404 Suppliers of non-current assets	<u>11.621</u> RON
214		Fixtures and fittings	10.021 RON
4426		Input VAT	1.600 RON

The adjustment is performed as follows:

As previously mentioned, the adjustment period of capital goods, other than fixed assets, is 5 years. In our example:

- Year N is taken into consideration for the deduction right;
- Year N+1 is taken into consideration for the deduction right;
- The loss of the deduction right is in the year N+2 (the right is not taken into consideration).

The adjustment in the favor of the state (taking into consideration that, for the next 3 years, it will be used as furniture for the medical practice) is 1.600 RON x 3/5 = 960 RON.

From a fiscal perspective, the VAT adjustment will be declared by using the VAT expense account form, code 300, with a minus sign at row 31, called “Pro rata adjustments/Adjustments for capital goods”. Furthermore, it will be recorded in the capital goods register, which must be kept for a period starting from the moment when the tax, for the acquisition of the capital good, is eligible and ending 5 years after the end of the period during which a deduction adjustment right could be exercised. This is to permit the control of VAT deductible and adjustments. Any other records, documents and journals concerning the capital goods must be kept as well, for the same period.

The adjustment of the VAT is recorded in accounting using the following formula:

$$635 \text{ Other taxes, duties and similar expenses} = 4426 \text{ Input VAT} - 960 \text{ RON}$$

- 2) When the pro rata changes, the adjustment is performed **for more than one financial period**. The steps for this are the following:
 - a. The initial tax deductible is divided by 5 or 20;
 - b. The result from pt. 1 is multiplied with the definitive pro rata for each one of the subsequent 4 or 19 years;

- c. The tax deducted initially, according to the definitive pro rata, is divided by 5 or 20.
- d. The results from pts. 2 and 3 are compared. Any difference between them represents the adjustments which need to be made and which will be recorded in the regularization of the tax expense account of the last period of the fiscal year.

Example: A taxable person, with a mixed regime buys, on the 20th of October of year N, a piece of technological equipment, classified under fixed assets (with the purpose of using it for operations which give a deduction right as well as for operations which do not give a deduction right). The acquisition cost is 10.526,12 RON, VAT 19%, 2000 RON. In the year N – 1 they have determined a pro rata value of 40%. This has become the provisional pro rata for year N.

	=	404 Suppliers of non-current assets	<u>12.526 RON</u>
213 Plant and machinery			10.526 RON
4426 Input VAT			2.000 RON

Therefore, the amount of 2000 RON is the input VAT for this acquisition. For year N the deductible will be 800 RON (2.000 RON x 40%).

The VAT without a deduction right will be recorded using the following accounting formula:

635 Other taxes, duties and similar expenses = 4426 Input VAT 1.200 RON

For five years, the VAT will be adjusted by taking into consideration the modifications of the pro rata value.

In year N:

At the end of year N, the calculated pro rata is 35%. The VAT deductible is adjusted to 700 RON (2.000 RON x 35%). The economic entity will owe to the state budget the sum of 100 RON (800 RON – 700 RON).

The following procedure will be applied for years N+1, N+2, N+3, and N+ 4:

- a. The Input VAT is divided by 5: 2.000 RON/5=400 RON;
- b. The result obtained at pt.1 is multiplied by the definitive pro rata value corresponding to each one of the subsequent 4 years;
- c. The VAT that was initially deducted, according to the definitive pro rata, is divided by 5: 800RON/5=160 RON;
- d. The result from a. (400 RON) is compared with the result from c. (160 RON). The difference between them, a plus or a minus, represents the adjustment that needs to be made.

At the end of year N+1 a definitive pro rata value is determined to be 32%.

The VAT will be:

- The VAT to be deducted is 400 RON x 32% = 128 RON
- The result is compared with the deducted VAT: 160 RON – 128 RON = 32 RON (to be paid to the state budget)

The pro rata for year N + 2 = 48 %:

- TVA to be deducted: 400 RON x 48 % = 192 RON
- The result is compared with the deducted VAT: 160 RON – 192 RON = 32 RON (to be paid from the state budget).

Depending on whether the VAT calculation, using the pro rata, shows that there is VAT to be recovered, the accounting formula to record this will be:

635 Other taxes, duties and similar expenses= 4426 Input VAT the value written in red

The person has to maintain a record of the capital goods which are the object of the VAT adjustment, which would allow for a control of the deductible value and any adjustments made. This record needs to be kept for a period starting from the moment when the tax on the acquisition of the capital good becomes demandable and it ends after 5, or respectively 20 years after the end of the period during which the deduction adjustment can be solicited.

5. Conclusions

We can conclude that careful attention needs to be given to the way in which the deduction is made, as well as to the adjustment of the VAT deduction for capital goods bought or manufactured by a company. This is especially significant for cases when there is a change in the destination of the goods during the adjustment period. This is especially important because events which can lead to an adjustment of the value of the tax will also substantially impact the cash flow of the company.

Another observation is related to the fact that operations, involving the adjustment of the value added tax, are cumbersome, and, sometimes, avoiding a deduction altogether being the preferred option. This is a problem for the business environment, in general, in the same way as the frequent changes in fiscal legislation can be significant time consumers among professional accountants.

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