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Implementation of a cash accounting scheme for VAT: EU experience

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The goal of this article is to describe the current arrangements for charging VAT upon the collection of receivables under the Croatian and the EU law. In some EU member States, this method of charging VAT has been in use for years now, but no longer than since 1995 (United Kingdom and Ireland). The European countries' experience shows that this scheme has both advantages and drawbacks, which may be useful in formulating a future Croatian VAT Act.

OBLIGATION TO CHARGE VAT AND ORIGIN OF THE RIGHT OF DEDUCTION OF INPUT VAT IN CROATIA

The announced possibility of a continued implementation of a cash accounting scheme for VAT from the beginning of 2015 (Government of RC, 2014) might have a dual effect. On the one hand, it could facilitate the operation of small businesses plagued by insolvency problems and delayed collection of claims. On the other hand, it is questionable whether the national budget can sustain the delayed revenue collection in the next year and/or the years after that.

The VAT Act and Rulebook on VAT regulate the time of occurrence of a chargeable event, the obligation to charge and the origin of the right to deduct input tax. These regulations are in line with the EU Council Directive¹.

Under the effective provisions of the Act, persons subject to personal income tax (craftsmen, self-employed persons and citizens – registered for VAT) may charge VAT on the basis of received or collected consideration for the supplied goods and services and are entitled to deduction of input tax at the moment when an invoice for supplied goods and services is paid to the supplier (Article 139). This does not apply to supplies of goods from the RC to other EU Member States, acquisitions of goods from other EU member States, supplies of goods and services where VAT is payable by the recipient, as well as to certain other supplies or transfers of goods. This scheme is called the collected consideration or cash accounting scheme and it remains in force until 31 December 2014. From 1 January 2015, however, all persons liable for payment of VAT should charge the tax under the accrual accounting scheme, in which the liability to pay VAT occurs when an invoice is issued or received, regardless of whether it has actually been paid.

¹ Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax came into force on 1 January 2007.

Entrepreneurs, currently applying the cash accounting scheme for VAT are required, regardless of the turnover realised in the previous year, to issue R-2 invoices, stating that the cash accounting scheme has been applied.

OBLIGATION TO CHARGE VAT AND ORIGIN OF THE RIGHT OF DEDUCTION OF INPUT VAT UNDER THE COUNCIL DIRECTIVE

In most EU Member States, there is a possibility to apply the cash accounting scheme to certain transactions or categories of taxable person. National VAT legislations are based on the Council Directive 2006/112/EC, while the provisions on invoicing were formulated along the lines of the Council Directive 2010/45/EU² which was incorporated in the consolidated version of the VAT Directive in 2010.

As the importance of SMEs and their contribution to economic development has been recognized in the EU, the Council Directive embodies provisions on not only the application of special tax arrangements, but also on the implementation of the VAT assessment procedure based on collected consideration, which provides certain economic benefits to these taxable persons. The provisions of Article 66 introduce a possibility of VAT assessment based on collected consideration in the part relating to output VAT, whereas Article 167a regulates the time of deduction of input VAT.

Member States applying this accounting scheme set a threshold for taxable persons based on their annual turnover that may not exceed EUR 500,000 or the equivalent in national currency. After consulting the VAT Committee, Member States may raise the threshold to a maximum of EUR 2,000,000 or the equivalent in national currency. However, such consultation with the VAT Committee is not required for Member States which applied a threshold higher than EUR 500,000 or the equivalent in national currency on 31 December 2012.

The turnover taken as a reference for applying the cash accounting scheme for VAT comprises the following amounts (exclusive of VAT):

- the value of supplied goods and services, if they are taxed;
- the value of exempt transactions with deductibility of the VAT paid at the preceding stage;
- the value of exempt transactions (export exemptions, international transport-related exemptions and exemptions on services supplied by intermediaries);
- the value of real estate transactions, financial transactions and insurance services, unless those transactions are ancillary transactions.

The Directive also regulates supplies of goods and services to which the cash accounting scheme is not applicable.

THE IMPLEMENTATION OF THE CASH ACCOUNTING SCHEME FOR VAT IN SOME EU MEMBER STATES

A total of 19 EU Member States, including Croatia, implement the cash accounting scheme for VAT with different VAT registration requirements. In most of the countries, a primary requirement is the threshold level, which ranges from EUR 45,000 in Poland to EUR 2,000,000 in Spain, Ireland, Italy and Malta. The next criterion is the performance of certain business activities, mainly those involving the supply of goods or services to persons who are not registered VAT payers: retail traders, free-lancers, craftsmen and entrepreneurs registered as SMEs.

Since the Directive provides a framework for exemptions from the application of the scheme, these exemptions are more or less the same in all the countries. The scheme cannot be applied to import and export supplies, when the customer is liable for payment of VAT (if the so-called reverse charge

² Council Directive 2010/45/EU of 13 July 2010 amending Directive 2006/112/EC on the common system of value added tax as regards the rules on invoicing.

mechanism is used), to supplies between connected persons, supplies subject to special VAT schemes, exempt supplies and supplies related to leasing, credit and renting. Exempt supplies are subject to the accrual accounting scheme for VAT.

In order to apply that scheme, certain tax conditions must be met. These most frequently include the settlement of any debts for public levies or VAT, occurred in the period preceding the entry into the scheme, or the conclusion of an agreement on the manner and period in which this will be accomplished. An entrepreneur must not be recorded as a violator of regulations or sentenced for any VAT-related offences.

An entrepreneur who meets the VAT registration conditions can opt for the use of the scheme.

The implementation period, including exit from the scheme (under some country-specific conditions) lasts from 4 months to 4 years. However, it is a common obligation of taxpayers leaving the scheme in all the countries to settle any tax liabilities within a specified period, except when the regulations governing winding-up or bankruptcy proceedings are applied.

Table 1 in the Annex shows the regulation of the cash accounting scheme for VAT in some EU Member States.

ADVANTAGES AND LIMITATIONS OF IMPLEMENTING THE CASH ACCOUNTING SCHEME FOR VAT : EU EXPERIENCE

The VAT assessment based on collected invoices helps small businesses facing problems with irregular, delayed or unsuccessful collection of receivables. They can use the amount of tax payable on invoices issued for their supplies in their business operations until the invoices are paid. Thus, the scheme facilitates cash flow, especially in economies with typically long average collection periods. Since the application of the scheme is optional in all the observed countries, each entrepreneur can, depending on the specificities of his/her business activity, financial condition and operations, as well as the stage of the business (a start-up or a mature company), assess whether it brings any benefits to him/her. The scheme is beneficial, for example, for businesses which allow longer payment periods to customers and in which the periods of invoice payment to vendors differ markedly from the periods of receivables collection from customers. It is, however, less beneficial for entrepreneurs whose supplies are payable on sale (e.g. retail traders and caterers, where output VAT is charged immediately after the sale, and there is no right of deduction of input tax until the invoices are paid to vendors), entrepreneurs whose input VAT is higher than the output VAT, as well as those with a continuous supply flow.

The implementation of the scheme also involves some limitations and difficulties. The accounting procedures are complex, because cash-based calculations must be separated from the accrual-based ones (with respect to exempt transactions); the payment method must be specified in the records; transactions subject to cash-accounting scheme are recorded on special forms, and special records are kept in a book of received invoices for deferred VAT. A list of all invoices received and outstanding invoices issued should be enclosed with the annual tax return. All this not only increases the average invoice processing time but also requires the development of new accounting programmes. Similarly, this increases the tax compliance costs borne by VAT-registered businesses (new forms, more time-consuming VAT compliance, etc.). An additional problem for the entrepreneur occurs when he/she exits the scheme, because he/she must calculate and pay, by a specified deadline, the entire amount of VAT accrued during the implementation of the scheme.

CONCLUSIONS

VAT is an important fiscal policy instrument, which is why even seemingly minor changes in the system affect tax revenues. This article was not aimed at assessing the effects the changes caused by the continuation, and even expansion of the right of implementation of the cash accounting scheme for VAT have on tax revenues. Its purpose was rather to present the EU Member States' experience in the implementation of the scheme which shows that, besides the benefits offered to small businesses, the scheme also has certain limitations.

As announced, the „deferred budget revenues“ should range between HRK 529 million and HRK 1.1 billion over the next three years, with the largest budget deficit to be recorded in the first implementation year³. When it comes to the „deferred revenues“, it is assumed that tax revenues will be collected, but with a delay. Moreover, it is difficult to predict whether all the revenues will be raised, given that even the expected VAT revenues have not been collected according to schedule during 2014. In the first six months of the current year, collected VAT revenues declined by HRK 1.4 billion from last year⁴.

About 50,000 small businesses apply the current cash accounting scheme for VAT. Given the announced new turnover threshold (of up to HRK 3 million), another 70,000 businesses might join the scheme. However, their actual number will, for now, depend on two uncertainties. First, the way the scheme will be regulated in the VAT Act. Will the realised turnover in the preceding year be the only criterion for the implementation of the scheme, or will there be other criteria as well? In some EU Member States, registration with the scheme is strictly subject to certain tax conditions (e.g. all VAT liabilities settled, no tax offences committed and no tax arrears recorded from the previous period). Will all entrepreneurs who meet the turnover threshold be able to satisfy this condition, if imposed? Since 2012, the Tax Administration⁵ has published at its website a list of tax debtors who meet the debt disclosure criteria. According to the data published on 31 July 2014, VAT accounts for one fourth (HRK 5.5bn) of total tax debt (HRK 21bn). The VAT arrears of legal entities, citizens and natural persons engaged in a business activity amount to HRK 3.4bn, HRK 1.3bn and nearly HRK 0.5bn respectively.

The second uncertainty is whether the settlement of the incurred VAT debt will be a precondition for the use of the cash accounting scheme for VAT.

Even with deferred payment of VAT, most small enterprises are still facing problems with the collection of receivables and uncertain invoice collection periods. The statutory payment periods are 30 or 60 days, and those who do not comply with the deadlines can be fined from HRK 10 thousand to HRK 1 million⁶. According to the 2013 annual financial statements held by the FINA, the period of receivables collection from customers lasts 66.6 days, but the collection period for short-term receivables from all participants in the business chain continues to be 98.5 days⁷. A survey conducted by EOS Matrix among two hundred financial experts shows that, in most cases, entrepreneurs collect their receivables in four months (this period includes the maturity period and average delay). The key problem is that a certain number of past due invoices are never collected. The untimely settlement of liabilities is mainly caused by liquidity problems and uncollected receivables from customers.

However, the question remains whether the deferred payment of VAT will be an incentive for more successful operation of entrepreneurs, or whether it will just remain what it is - a tax payment deferral. Unduly long payment periods, or even failure to pay invoices, represent a crucial problem

³ For more information (in Croatian only), see Šunjerga (2014).

⁴ For more information (in Croatian only), see Dozan (2014).

⁵ Available (in Croatian) at: <http://duznici.porezna-uprava.hr/index.html>.

⁶ Act on Financial Transactions and Pre-bankruptcy Settlement (Croatian version), OG 108/12, 144/12, 81/13 and 112/13.

⁷ For more information (in Croatian only), see Gatarić (2014).

which has to be resolved, and such behaviour should be sanctioned. This would give small enterprises a much stronger impetus for business success.

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ANNEX

Table 1.

Implementation of the cash accounting scheme for VAT

Country	Entrepreneurs entitled to use the cash accounting scheme for VAT	Implementati on threshold (amount of supplies in the previous year, in EUR) up to	Exemptions (supplies to which the scheme does not apply)
Austria	<p>freelancers (doctors, accountants, lawyers, architects, tax advisers, journalists, translators and consultants);</p> <p>farmers and entrepreneurs engaged in an economic activity without the obligation to keep accounts;</p> <p>entrepreneurs (excluding farmers and those engaged in certain economic activities who are subject to personal income tax) with a turnover up to EUR 110,000;</p> <p>some public companies (providing gas, water and electricity supply or waste disposal services).</p>	110,000	transactions involving the reverse charge procedure
Bulgaria	<p>entrepreneurs with no debts for public levies;</p> <p>entrepreneurs who have not been sentenced for any tax offences.</p>	500,000	<p>imports and exports of goods;</p> <p>supplies for no consideration;</p> <p>supplies to enterprises who are not subject to VAT;</p> <p>out-of-country supplies;</p> <p>supplies under lease contracts;</p> <p>supplies of services in the country, the tax on which is payable by the recipient: tourist services, used goods and investment gold;</p> <p>supplies of goods and services not paid by bank transfers;</p> <p>supplies between connected persons.</p>
Spain	<p>entrepreneurs with a total turnover in the previous year below EUR 2 million</p> <p>entrepreneurs with cash receipts from one entrepreneur not exceeding EUR 100,000.</p>	2,000,000	<p>transactions involving the reverse charge procedure;</p> <p>acquisitions and imports of goods from another EU Member State;</p> <p>transactions conducted by entrepreneurs subject to special VAT schemes;</p> <p>simplified procedures for small enterprises;</p> <p>general proportional taxation scheme for farmers;</p> <p>special scheme for investment gold;</p> <p>special scheme for electronically supplied services;</p> <p>surtax equalisation scheme for traders;</p> <p>business transactions between connected "VAT groups".</p>

United Kingdom	<p>taxable persons:</p> <p>whose expected taxable supplies next year will not exceed GBP 1,350,000;</p> <p>who have no VAT arrears;</p> <p>who were not sentenced for any VAT-related offences in the previous year;</p> <p>who did not agree on any settlement in connection with VAT-related offences in the previous year;</p> <p>who were not sentenced for dishonest VAT evasion in the previous year;</p> <p>who have no debts towards the Tax Administration, or have agreed on the mode of repayment of their total VAT debts;</p> <p>who were not denied the right to continue applying the VAT system by the Tax Administration in the previous year;</p> <p>who were not denied the right to start applying the VAT system by the Tax Administration.</p>	<p>GBP 1,350,000 (EUR 1,600,000)</p>	<p>goods sold or purchased through lease, rental or conditional sales agreements, or on credit;</p> <p>goods imported from or acquired in another EU Member State (or goods exempt from customs duty or in a free zone);</p> <p>certain goods the VAT on which should be declared in the tax return of the vendor for the purpose of reverse charge.</p>
Hungary	<p>entrepreneurs registered as SMEs under a special law on SMEs;</p> <p>entrepreneurs who are not undergoing bankruptcy or winding-up proceedings;</p> <p>entrepreneurs who do not apply a special VAT exemption scheme.</p>	<p>HUF 125,000,000 (EUR 450,000)</p>	
Ireland	<p>entrepreneurs who:</p> <p>satisfy the threshold requirement,</p> <p>supply goods or services to customers not registered as VAT payers or to those who are not entitled to a full deduction of input tax. Such supplies must account for at least 90% of their total supplies. This largely relates to retail traders, public bodies, caterers, etc., that make most of their supplies to final consumers. The turnover from exempt supplies (e.g. of medical, dental and certain financial services, etc.) is not included in this amount;</p> <p>fail to file tax returns in a timely manner, or to settle their tax liabilities;</p> <p>committed a tax offence or were sentenced for VAT-related offences in the previous year.</p>	<p>2,000,000</p>	<p>supplies of vehicles;</p> <p>commissions on accommodation and advertising services;</p> <p>supplies of goods to exempt recipients;</p> <p>supplies of goods to recipients who are exclusively registered for intra-Community acquisitions or for receiving such services;</p> <p>transactions between connected persons;</p> <p>transactions connected with tax on long-term rental of real estate, occurred before 1 July 2008.</p>
Italy	<p>entrepreneurs with a realised turnover up to the set threshold</p>	<p>2,000,000</p>	<p>transactions involving the reverse charge procedure;</p> <p>acquisitions and imports of goods from another EU Member State;</p> <p>transactions of entrepreneurs subject to special VAT schemes;</p> <p>goods imported or acquired from another EU member State (or goods exempt from customs duty or in a free zone);</p> <p>transactions with government and public bodies.</p>

Portugal	entrepreneurs who satisfy the threshold requirement; have no VAT arrears; and were not sentenced for any VAT-related offences in the previous year; construction services supplied to public bodies; supplies by agricultural cooperatives, depending on their turnover.	500,000	transactions involving the reverse charge procedure; acquisitions and imports of goods from another EU Member State; business transactions between connected entrepreneurs.
Romania	entrepreneurs who satisfy the threshold requirement	500,000	transactions involving the reverse charge procedure; exempt goods and services with a right of deduction of VAT; export supplies; transactions subject to special VAT schemes; transactions between connected persons.
Slovenia	entrepreneurs who satisfy the threshold requirement	400,000	supplies connected with the importation or exportation of goods; financial lease agreements, where goods are acquired after the final instalment is paid; purchase and sale agreements with payment on credit; supplies of goods and services in respect of which VAT is stated on the invoices, as is the information that they do not have to be paid within 6 months from the issuance of an invoice; supplies of goods and services where an invoice is issued before the supply takes place. taxable services rendered by a taxable person without a business establishment in Slovenia, where VAT is paid by the recipient through the reverse charge mechanism; certain supplies of goods and services where the recipient is the person liable for payment of VAT.
Croatia	persons subject to personal income tax who are registered for VAT	not determined	supplies of goods within the EU; acquisition of goods within the EU; the supply or transportation of goods to a Member State, if the shipping or transportation has not started in that Member State, or where the taxable person relocates such goods to another Member State for the purpose of pursuing an economic activity; supplies for a consideration or for no consideration, or supplies in the form of a stake in a company, total assets or a part of them which constitutes an economic entity, to another taxable person (recipient); other supplies of goods and services defined in Article 139 of the VAT Act.

Source: IBFD (2014)