

## The VAT encashment system's impact on return on invested capitals. Romania's case

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**Abstract.** *The modifications related to the fiscal regulations in Romania that refer to the VAT encashment system are considered as a fiscal relief for companies. Our purpose is to analyze the way in which the VAT encashment system becomes efficient and companies can benefit from the advantages offered by it. Taking into account the variety of domains in which companies enjoying this relief are activating, we are analyzing the impact that this particular VAT system can have on multiple industries and we aim at proving that the VAT encashment system cannot be always regarded as a fiscal relief policy. There are cases in which this particular measure to stimulate economic growth does not achieve its designated target. Throughout the paper we will simulate the implications on different industries, based on the organizational performances, we will emphasize the favored domains of economic activities as well as those for which the VAT encashment system can produce negative externalities.*

**Keywords:** VAT encashment system; return; invested capitals; economic re-launch; audit.

**JEL Classification:** M41, M42, H21.

**REL Classification:** 14I.

## Introduction

Many of the member states of the European Community adopted various austerity measures or measures for economic re-launch so far. The austerity measures applied have an impact on the targeted budgetary deficit so that states might not enter incapacity of payment or to avoid accessing loans in order to perform on short-term payments. In our opinion, the austerity measures need to be justified, meanwhile the resource reserves generated need to be used in order to trigger measures for economic re-launch.

The VAT encashment system can be regarded as a measure for economic re-launch. Still, it is only natural to ask ourselves with regard to the utility and advantages offered by such a VAT system. By applying the new VAT encashment system the desired outcome is an economic re-launch by enhancing investments, minimizing unemployment as well as increasing economic competitiveness in Romania to further attract foreign direct investments.

Also, another target is to create a fiscal environment that might support the performance of SMEs, which are going through tribulations from a financial point of view, given the absence of liquidities. The VAT encashment system has as objective to increase the speed of currency circulation within an economy to which a more efficient collection of value added taxes is added. In this sense, the system is based on the idea of VAT paid at the cashing of invoices. Nevertheless, the legislation concerning the VAT, in its current form, applicable since 2013, can raise a question mark on the utility of measures applied and even on the attainment of objectives established through the fundamenting note of modifications in the fiscal code, by which the VAT encashment systems is being introduced.

There are other states applying the VAT encashment system and in which this system has proven to work coherently. Romania should analyse carefully the particularities that the VAT encashment system proposes, as it will introduce it starting with the following year, so that the state might not enter conflict with the European legislation and to avoid the opening of infringement procedure for not complying with the obligations assumed based on the 2006/112/CE Directive.

## Literature review

In terms of VAT legislation, the European Commission present what the value added tax represents and its function. By this we can identify the neutral character of VAT, indifferent of the number of transactions recorded. By VAT neutrality we

understand that this tax is to be included in the VAT collection-deduction mechanism for transaction withing taxable legal persons that have registered for VAT purposes (European Commission, 2012). Moreover, based on the same documentation, we observe that the VAT is a tax on consumption that is beard by the final end user. Therefore the bearer of the tax is the end-user, while the tax is collected by the state though chargeable legal persons registered for VAT purposes, who act as tax-collectors, in this case, as VAT is an indirect tax. By analyzing the literature available in this domain, we can notice that there are some series of generally applicable principles regarding VAT: the equivalence and effectiveness principle, the reliability principle, the principle of interdiction of breach of trust, the principle of fiscal neutrality (Terra, Kajus, 2006). The principle of fiscal neutrality is mentioned even from the first European directive concerning VAT as it regulates that VAT is a general tax on consumption applied to both good and services, in a direct proportional manner to their prices, indifferent of the number of transactions recorded in the creation and distribution process previous to the date of collection of tax. For each transaction VAT will be exigibile after the deduction of the value added tax quantum bared directly though different components reflected in the cost of goods or services (Directiva 67/227/CEE). The same guidelines are re-introduced by the 112/2006/CE Directive.

The 112/2006/CE Directive regulates the VAT treatment applicable within the member states and norms the edibility of VAT in articles 63 to 66. Art. 66 covers the optional measures and stipulated that for certain operations or for particular chargeable persons VAT can become demandable the latest at the date of encashment. We can observe that the VAT payment at invoice encashment is a measure that can not be generalized for all economic agents or for all operations, but it could be applicable in specific conditions, established by taking into consideration the nature of operations and of tax-payers.

Other member countries of the European Comunity are also applying currently the principles of VAT encashment system: Belgium, Germany, Italy, Great Britain, The Netherlands, Poland, Slovenia and Sweden, to be more precise. A successful case, in these terms, is that of the integrations of the VAT encashment system in Slovenia, where it has been running since 2007. In the case of Slovenia, the VAT encashment system's introduction was implemented in two phases: in the first phase, starting with 2007, the tax-payers having a chargeable turnover less than the 208.000 EUR threshold, in the last twelve months received the right of transferring the VAT related to issued invoices at the date of cashing-in (and not at the date of issuance of invoice as stipulated in the VAT Law (TVA-1A),

art. 131 paragraph (1) adopted by the General Assembly of the Slovenian Republic). The second stage was launched in 2009 and it extended the special treatment concerning the collection of VAT encashment to the tax-payers whose chargeable turnover was less than 400.000 EUR in the last twelve months.

In Great Britain, Estonia and Sweden, based on some exemptions obtained from the European Commission, we can also find the principles of VAT encashment system being applied at the casing-in of invoices. The tax-payer entering the incidence of the special VAT encashment system has the right to collect VAT only when it cashes-in the invoices and, in the same time, has the right to deduct VAT as it manages to pay its suppliers.

The VAT encashment system in Poland presents a particularity as the system is not mandatory in application, but optional. The eligible VAT encashment system tax-payers can choose if applying such a system is beneficial in te case of their operations (European Commission - VAT in the European Community).

### Research methodology

In elaborating the study we chose a normative approach. We analyze the regulations of the European legislation on the matter, specifically the European Directive referring to VAT – 112/2006/CE Directive – as well as the national legislation by which the European Directive regarding VAT is implemented. We generated a comparison of measures for economic re-launch that correspond to the VAT encashment system introduced in different member states of the European Union, with the purpose to identify the resembling fiscal treatments as well as the norms differing from the ones implemented in Romania, with regard to the VAT encashment system, by comparison to other member states' expertise in the matter.

On the occasion of participating to various events organized by the Corpul Expertilor Contabili și Contabililor Autorizați din Romania, the professional community of accounting practice in Romania, and by the International Fiscal Association, the Romanian subsidiary, there have been discussions with professionals coming from fiscal law, accounting and taxation with regard to the particularities of VAT encashment system in Romania, on the possible difficulties at implementation as well as on the benefits it brings to the tax-payers. Starting from the 112/2006/CE Directive, ART. 66, where the possibility for certain categories of tax-payers to apply the special VAT encashment system is presented, and taking into consideration, as well, the general aspects concerning

the taxation principles in the European legislation we aim at possibly identifying local regulation currently disharmonious with the international legislation.

Further, we have analysed the manner in which the European Union member states have integrated the VAT encashment system in their own legislation. Thus, the focus falls on the implementation particularities in the case of other EU member states, which successfully managed to run the VAT encashment system so that we might find the differences to the Romanian legislation that might have an important impact on the results for economic re-launch measures.

The final analyzed aspect regarded the impact on the application of VAT encashment system on the cost of financing and on return on invested capitals.

### Findings and discussions

Many of the EU member states apply the special VAT encashment system. Among these we can name Austria, Estonia, Germany, Italy, Great Britain, The Netherlands, Poland, Slovenia and Sweden. After reviewing the legislation of these countries concerning the VAT, we observe that these countries apply what can be called a “clean” VAT encashment system, in which the exigibility for collecting VAT comes into force at the date of cashing-in the value of the delivered goods or services, while the exigibility for deducting VAT comes into force at the date of payment of value for received goods or services. Therefore, the principle of neutrality in terms of VAT is unaffected and the mechanism respects the general principles of taxation regulated by the European legislation. Whilst in Romania, we can not speak of the same “clean” VAT encashment system. By modifications the Fiscal Code and of Norms of Practice of Fiscal Code, approved by Governmental Ruling no. 15/2012, Governmental Decision no. 1071/2012 and Law nr. 20/2012, the VAT encashment system only supposes a delay in payment of taxes and not necessarily a measure for economic re-launch with positive impact on the treasury of tax-payers.

We would like to emphasize a particularity of the VAT encashment system in Romania: if the tax-payer does not cash-in the invoice in term of 90 days from the date of issue, or the date at which the invoice ought to be issued, according to current legislation – the latest in the fifteenth day of the month following the generating event, the payer is obliged to collect VAT with the expiry of this term. While, the beneficiary would not be able to deduct VAT until the moment in which it will perform on the payment for delivery of goods or services received, according to Law no. 571/2003, Art.134<sup>2</sup>, applicable from 01.01.2013.

Based on this regulation we consider necessary to emphasise an infringement of principle of neutrality of VAT, given the exigibility of collecting VAT for one delivery of goods or services that is not cashed-in within 90 days, happens with the exceeding of the deadline, but the exigibility to deduct does not happen in the same moment, but only at the moment in which the payment is made. Thus, if the beneficiary does not pay the supplier who applies the VAT encashment system within 90 days from the issued invoice, it will not be able to deduct VAT, whilst the supplier is obliged to collect VAT.

In order for Romania to avoid the case of an infringement procedure for not complying with the general taxation principles presented in the 2006/112/ CE Directive, we propose the modification of the national legislation regarding VAT so that the term of 90 days in which the supplier is obliged to collect VAT to be eliminated. With such an approach, both the supplier as well as the beneficiary will be able to collect and deduct corresponding VAT to the transactions performed in the same fiscal period, by this ensuring the sustainability of the neutrality principle. Introducing such a modification, the VAT encashment system becomes an efficient one, it would not mislead, by name only (VAT encashment), the tax-payers and becomes a true measure for economic re-launch, supporting the SMEs by means of non-obligation to pay VAT corresponding to not-yet-cashed-in invoices to the state. In this way, having no cost of supplementary financing, the economic agents will not call on credits in order to be able to fulfill their fiscal obligations generated by un-cashed invoices and the cost of invested capitals will decrease, with a positive impact on the tax-payers' treasury, as well.

Another means to "neutralize" the fiscal legislation in Romania could be offering the option that, whenever exceeded the 90 days term from invoice issue, exigibility of corresponding VAT to become enforceable both for the supplier as well as for the beneficiary. Based on this approach the beneficiary will be able to deduct and the supplier will collect in the same time frame. This method, though, does not offer significant advantages for the tax-payers, given the fact that it behaves as a delay of VAT exigibility and not as a "clean" VAT encashment system in order for it to be considered an economic re-launch measure.

Out of the particularities of the VAT encashment system, one that is different from the ones stipulated in the correlated legislation of other EU member states, concerns the obligation to apply the VAT encashment system if the tax-payers have a turnover less than the 2,250,000 lei threshold, approximately 500,000 EUR. Other states consider the application of the VAT encashment system as optional for the tax-payers that do not exceed a particular turnover threshold. The example of Great Britain presents the case of an VAT encashment system that is

optional and not mandatory for every tax-payer not exceeding a threshold of 1.35 million sterling pounds. Entering the VAT encashment system can be done at the beginning of each fiscal period and exiting it is allowed at the end of every fiscal period, with the observation that there is no mandatory responsibility to submit notifications towards the taxation authorities (Gov.uk - VAT Cash Accounting Scheme, 2012).

The application of the system is optional in the case of Poland, as well, where the tax-payer applies at will the VAT encashment system, if the turnover doesn't exceed the equivalent of 1.2 million EUR (European Commission - VAT in the European Community).

In terms of needed notifications concerning the level of turnover for VAT encashment purposes, having as submitting deadline the 25th of October 2012 with the taxation authorities, there have been issued guidelines concerning the means of calculus of VAT by means of Methodological Norms for Application of Fiscal Code, as it was published on the 6th of November 2012, after the deadline for notifications. We would like to signal that there are essential modifications that may affect the manner in which the turnover threshold has to be computed. There are significant differences between turnover in terms of accounting and the manner of establishing the threshold turnover level for VAT encashment system purposes, particularly given the fact that the delivery of goods or services for which the tax-payer was not registered for VAT purposes do not count according to the latest adjustments in legislation.

Consequently, we support the case in which the entrance and exist in/out of the VAT encashment system would be optional for the tax-payer, because it highly depends on the bargaining power between suppliers and beneficiaries. There are cases in which the suppliers payment deadlines are longer than the deadlines to cash-in debts, in this situation the supplier finding as beneficial to apply only the general VAT rules and not the special VAT encashment system. If it were for the VAT encashment system to truly support the development of SMEs and for the measure to be that would come to the benefit of the tax-payer, then it is imperative to adjust the current legislation so that it may enhance the optional dimension of applying the system.

In Romania, the VAT encashment system doesn't influence only the tax-payers applying the VAT encashment system, but also the beneficiaries. One client of a tax-payer applying the VAT encashment system will incur difficulties with deducting VAT related to goods or services received. The economic agent, although not being included in the VAT encashment system, will not be able to

deduct VAT related to acquisitions but in the moment in which it delivers payment for goods and services received. Therefore, in our opinion, the measure can not be regarded as an economic re-launch procedure or as stimulating for SMEs, because applying the VAT encashment system supposes a higher degree of bureaucracy, detailed information recorded in the transactions journals. In order to avoid highly complex journal, which for big economic agents means costly investments in software applications, there will be a negative shift, on behalf of these economic players, from conducting business partnerships with SMEs applying the VAT encashment system. Therefore, additional pressure will be imposed on economic actors applying the VAT encashment system, as, on one hand, they will be looking market share or will be forced to decrease the commercial margin or selling prices in order to maintain their clients, all the above having a significant impact on turnover, on costs of financing and on the return on invested capital. In no other country in EU is the VAT encashment system affect third parties not applying such a system.

One of the most important challenges in implementing the VAT encashment system in Romania is the analytical recording by which transaction journals will need to be kept.

The chargeable legal persons registered for VAT purposes that apply the VAT encashment system in Romania have the obligation to record in their transaction journal the invoiced issued for delivery of goods or services for which the VAT encashment system is being applied, even though the exigibility of the tax does not become enforceable in the same fiscal period in which the invoice has been issued. Moreover, the journals ought to include additional information regarding the number and date of the cash-in document or the date at which the 90 days period expired for which the VAT becomes exigible, the total value of delivery of goods or services containing the related VAT figures, the taxable base and the related value added tax, the cashed-in amounts including VAT, as well as taxable base and VAT exigible related to the cashed-in amount or the exceeding of the 90 days deadline and should emphasize if there are differences from uncashed amounts maturing to exigibility and the taxable base and exigible VAT related to the respective amount, the difference representing the taxable base and VAT non-exigible (Law no. 571/2003 applicable starting with 01.01.2013 adjusted by Governmental Decree no. 15/2012, Governmental Decision no. 1071/2012 and Law no. 208/2012).

Moreover the transaction journals for big economic agents will need to include recordings both for business partners under the VAT encashment system as well



for those for which the system has no incidence, so that the type of transaction, from a VAT encashment perspective, might be identifiable.

An additional disadvantage for tax-payers concerns the need to look up every supplier in order to establish if they are applying or not the VAT encashment system, so that the date at which the exigibility of deducting VAT enters force. Furthermore, there have been identified as procedures increasing the complexity level the means by which the date for cashing-in for compensation, cession of debt or using payment instruments as cheques, or other resembling payment instruments.

Under the current conditions applying the VAT encashment system will generate supplementary costs regarding software adjustment, employing more labour.

In order to apply the VAT encashment system under the current economic conditions of Romania, there will be multiple additional costs related to software upgrades, increasing labor to ensure proper application of the VAT encashment system as well as for collecting VAT, even if the invoice can not be cashed in within 90 days from date of issue, correlated with the impossibility to deduct VAT for invoices unpaid within 90 days from the date of delivery. These costs will diminish the accounting result and will decrease the return on invested capitals. So far, there have been no studies emphasizing the impact of the current VAT encashment system on SME performance.

## Results

The Romanian VAT encashment system contains some particularities, by comparison to other EU member states. The rest of EU states apply a “clean” VAT encashment system, in which VAT is deducted at payment of invoice and VAT is collected at cash-in of invoice. According to current Romanian legislation, the principle of VAT neutrality – principle regulated by the EU legislation in the matter, is affected, entering conflict with 112/2006/CE Directive. This aspect is important enough to become the point of start for an infringement procedure, with negative effects in attracting new investors, in the same way in which it is presented in the explanatory memorandum in the project of adjusting the Fiscal Code that introduces the VAT encashment system. In its current form, this VAT system is one that generates delays in VAT payments and not payment of VAT at cash-in.

The Romanian tax-payers not exceeding the 2.25 million lei are obliged to apply the VAT encashment system, without option for applying the special VAT regimes.

The manner of computing the turnover threshold is a controversial one, because it was only after the mandatory responsibility to declare the turnover level that there have been brought precious guidelines for computing turnover figures for VAT encashment purposes. Therefore the effects will be also felt by tax-payers' business partners who apply the VAT encashment system, with additional, significant costs. The administrative informatic tools will need enhancement, therefore additional costs, both for the tax-payers obliged to apply the special VAT system as well as for all business partners. In order to faithfully represented the transactions in the transaction journals the economic actor will need additional amounts of time-resources, which also translate into increased costs. In all, the return on assets is negatively impacted. The impact of implementing the new VAT encashment system will also have implications on the financial audit processes. Under this paradigm the effect is on the cost of audit, given the rise in audit fees, because, being the case of a financial audit activity, when the new system is implemented, the materiality threshold is minimised, whilst the quantity of audit samples will increase.

The VAT encashment system influences will not only cover the VAT dimension, as it will extrapolate on the informatic systems used by economic agents, on suppliers accounts for tax-payers who are not applying the VAT encashment system, having that the latter need to record transactions for all parties, depending on the VAT system the former are using.

## Conclusions

The VAT encashment system in Romania seems not to have had, as starting point, a study of impact on supplementary costs generated by the introduction of the system. We recommend reviewing the implication of the new VAT encashment system before ruling its mandatory application. It is imperative to sustain the taxation principles established at EU level through European Community Directives and for this reason we consider that the VAT encashment system should be adjusted so that it may allow the beneficiary to deduct and for the supplier to collect of VAT in the same time frame.

The VAT encashment system should be optional in terms of application and should not have a negative impact on tax-payers who do not apply such a system.

In its current form, the VAT encashment system generates high costs for society that can not be compensated by proposed benefits, as its effect is only a delay from payment and not a payment of VAT at cash-in of invoice.

We consider the unavailability of data as a limitation of this research to compute the effects of the new VAT system on the return on invested capital, as well as the absence of relevant studies conducted in this direction, given that the VAT encashment systems implemented in other countries are harmonised with the European legislation and do not cover aspects of obstacles in implementation. For further research we would like to develop a model that might emphasise the impact of applying the VAT encashment system in terms of manufacturing, cash-flows, costs of financing and returns on invested capital and will update the model as soon as additional information is received related to economic agents, directly or indirectly affected by the VAT encashment system. On top of the already mentioned costs we need to add the increase of fees related to audit activities delivered, because the risk of implementing the new VAT encashment system will generate further higher risks that will impose a need to diminish audit risk, as the economic actors performing audit activities would be forced to analyse massive amounts of data – requiring additional time to review.

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