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## APPLICATION OF THE REVERSE-CHARGE MECHANISM IN THE FIELD OF CONSTRUCTION

*Amendments to the Law on Value Added Tax from 2012 introduced the application of the reverse-charge mechanism into Serbian legislation in the construction industry. Subsequent changes from 2015 have expanded the scope of the reverse-charge mechanism in the construction industry, and one of the reasons were uncertainties that arose while applying the said mechanism in former practice. Namely, the main concern was whether a given supply should be treated as a supply from the construction industry for the purposes of VAT or not, under the applicable rules. However, the abovementioned changes have further complicated the situation, significantly increased legal uncertainty and additionally burdened VAT-payers (as well as the Ministry of Finance itself, which drafted the new provision) due to the fact that there is a need to interpret, on a daily basis essentially, who is liable to compute VAT for a vast variety of supplies that might be deemed as supplies from the construction industry. Furthermore, the (official) reasons for introducing the reverse-charge mechanism are not entirely in line with the reasons for which this mechanism is used within the EU. Therefore potential changes should be considered regarding the application of the said mechanism in the construction industry on the territory of the Republic of Serbia.*

Key words: *Value added tax. – Reverse-charge mechanism. – Construction.*

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## 1. INTRODUCTION

Amendments to the Law on Value Added Tax<sup>1</sup> (hereinafter: VAT Law) from October 2015 included also the provision of Article 10 (2) (3) of the VAT Law, which regulates the application of the reverse-charge mechanism in the field of construction. Although the intervention of the legislator was inspired by the intention to eliminate ambiguities in the application of the previously valid provision,<sup>2</sup> the revised provision has not led to the desired results. Moreover, it is fair to say that practical difficulties have become more noticeable, and that the present uncertainty causes higher business expenses not only for taxpayers, but also for the Ministry of Finance, as a result of the continuous engagement in clarifying disputed situations.<sup>3</sup>

In this paper we will identify the most important practical problems in the implementation of the current provision and point to their implications on the operations of business entities engaged in the construction industry. We will try to draw the attention of professional public to the necessity of its further development or application of an alternative suitable for accomplishing the goal for the purpose of which the reverse-charge mechanism in the field of construction was originally implemented into our VAT system.

### 1. ABOUT THE REVERSE-CHARGE MECHANISM IN GENERAL

The reverse-charge mechanism assumes that the recipient of goods or services has the obligation of computation and payment of VAT instead of the person supplying the goods or providing services. It is, therefore, an exception to the main rule, which undoubtedly stems from the provision of Article 10 (1) (1) of the VAT Law, according to which the tax debtor (the person liable for payment of VAT) is “a person who carries out the taxable supply of goods and services, except when another person

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<sup>1</sup> Law on Value Added Tax, *Official Gazette of the Republic of Serbia*, No. 84/04, 86/04, 61/05, 61/07, 93/12, 108/13, 68/14, 142/14 and 83/15.

<sup>2</sup> Proposal of the Law on amendments to the VAT Law from 2015 states that the objective of the new legislation is “a simpler and more adequate taxation of supplies in the construction industry”.

<sup>3</sup> Thus, in the first four months of application of the new provision, the Ministry of Finance published almost 40 official opinion papers devoted to this issue. By comparison, the Ministry of Finance published less than 5 official opinion papers in the first four months of application of the reverse-charge mechanism in the field of construction industry upon its initial introduction into the VAT system at the end of 2012. The presented data testify, *inter alia*, in favor of the presented theory that the former situation is further complicated by the amended provision of Article 10 (2) (3) of the VAT Law.

has the obligation to pay VAT (in accordance with Article 10 of the VAT Law)”. The consequences of such an approach are twofold and can be defined as primary and secondary, having in mind the sequence of their occurrence.

The primary consequences arise from the statutory provision *per se*. The mere fact that there is a deviation from the general rule opens up a practical dilemma of when to apply the rule, and when the exception. This dilemma becomes more noticeable if the provision which envisages the deviation provides room for different interpretation. Then, according to the circumstances of a particular case, it is necessary to properly assess whether the tax debtor is the person who carries out a supply of goods or services or the person to whom the supply is being carried out. If this is disputed, the conflicting interests of the participants in a transaction will lead them into an unpleasant situation. The supplier will insist on the computation of VAT, in order to eliminate the risk of penalty at his own expense for the non-payment of tax.<sup>4</sup> The customer will, however, advocate the use of the reverse-charge mechanism, not only because in his opinion such is “required by law” (specifying him as the tax debtor), but also in the interest of protection of current liquidity (especially if he has the right to deduct the computed VAT at the same time – in the same tax return – as input tax in accordance with Article 28 (5) (2) of the VAT Law). It is therefore important that the application of the reverse-charge mechanism is unambiguous. Wider room for interpretation implies higher costs of taxation for businesses.

Secondary effects are a direct result of the practical application of the reverse-charge mechanism. We would like to point out the following:

1. *fractional collection of VAT is de facto abandoned* because the state treasury does not receive revenue until the stage of final consumption (or the equivalent phase of a transaction cycle – if the transaction is carried out to another person who is not entitled to deduction of the computed VAT from the actual transaction).<sup>5</sup> The amount of the tax owed is “offset” in the same tax return with the corresponding amount of input tax on the basis of Article 28 (5) (2) of the VAT Law, with a fiscally neutral outcome, both for the taxpayer and state treasury.<sup>6</sup>

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<sup>4</sup> Let us keep in mind that in the field of construction a potentially high value of a particular transaction can generate high amount of tax.

<sup>5</sup> Note that in the structure of gross value added in the last quarter of 2015 in Serbia, construction accounted for 6.9%, Ministarstvo finansija Republike Srbije, *Bilten javnih finansija za januar 2016. godine*, Beograd 2016, 19. This area generates a significant amount of taxes whose collection is deferred.

<sup>6</sup> We can say that even in a regular taxation regime, the same effect is created, due to the customer’s deduction of input tax. In literature, this phenomenon is known as

2. *a taxpayer may be more frequently, if not constantly, in a position to ask for a refund of input tax* which is the result of the purchase of goods and services under the auspices of the above mentioned general rule, which are then used for the purpose of carrying out the transaction subject to the reverse-charge mechanism.<sup>7</sup> The refund entails higher costs of tax control to which the taxpayer is not immune either (e.g. in the case of the site control).

3. *a contradictory effect on the anti-evasion potential of VAT system* – the application of the reverse-charge mechanism automatically eliminates some forms of VAT evasion, but may create room for others. Thus, for example, it may be assumed that the more difficult control of the merits of refund requests, as a result of an increased number of requests, will encourage an unfounded refund of input tax.

4. *a different effect on the liquidity of the participants in a transaction* – from the viewpoint of the supplier, the liquidity is safeguarded, as he does not have to pre-finance the tax which he has not collected from the customer. However, at the same time the liquidity of the supplier worsens in the amount of VAT which would have been at his disposal from the moment of collection from the customer until the day the tax becomes due in accordance with the statutory deadline,<sup>8</sup> which, on the other hand, has a positive effect on the liquidity of the other participant in a transaction.<sup>9</sup> Also, the VAT payer who acquires goods or services according to gross and performs supplies according to net price, will have

“zero-sum game” (German: *Nullsummenspiel*) in which the same amount of tax “circulates” between participants in a transaction and tax administration (the customer pays it to the seller, the seller to the tax administration and tax administration back to the purchaser) without the realization of tax revenue, Ministerium der Finanzen Rheinland-Pfalz, “Einführung von Vorstufenbefreiungen als Mittel zur Umsatzsteuerbetrugsbekämpfung”, *Umsatzsteuer-Rundschau* 9/2001, 385. Nevertheless, as a rule, the amount of VAT based on VAT payer’s turnover in the tax period will be higher than the amount of input tax, resulting in budget realizing the revenue fragmentarily, in proportion to the value added at each stage of the turnover cycle. On the other hand, by applying the reverse-charge mechanism, the revenue on the total turnover value will be fully realized in the last phase of the turnover cycle, M. Milošević, *Nezakonita evazija poreza na dodatu vrednost*, Pravni fakultet Univerziteta u Beogradu, Beograd 2014, 223–224.

<sup>7</sup> Particularly exposed to such effect are construction companies which incorporate the acquired (construction) material burdened with VAT within the supply performed pursuant to Article 4 (3) (6) of the VAT Law, Ministry of Finance of the Republic of Serbia, Explanation on the implementation of Article 10 (2) (3) of the VAT Law in the field of construction, No. 011-00-1180/2015-04 of 10 November 2015.

<sup>8</sup> Particularly exposed to such effect are taxpayers who file tax returns quarterly in accordance with Article 48 (2) of the VAT Law.

<sup>9</sup> For an empirical confirmation of the presented statement, European Commission, *Assessment of the application and impact of the optional ‘Reverse Charge Mechanism’ within the EU VAT system*, European Union 2014, 66.

to cope with longer deadlines for the refund of input tax (as a rule 45 days from the expiry of the deadline for submitting the tax return, if it is timely submitted)<sup>10</sup> compared to input tax deduction (which is achieved by submitting the tax return). *Summa summarum*, the impact on the liquidity of the supplier is not necessarily positive.

5. *there is a possibility of calculating additional VAT liability which could not be adjusted* – in practice it may happen that a tax inspector, in the procedure of site control with the person who has computed VAT as a tax debtor by applying the reverse-charge mechanism, challenges the application of the mechanism in a specific case, due to which the controlled taxpayer would undoubtedly be denied the right to deduct input tax on that basis, but it is questionable whether (each) tax inspector would at the same time adjust the corresponding VAT liability (which should certainly be done, since “falling off” of the basis for the recovery of input tax was conditioned by the previous challenging of the basis for calculation of VAT liability by the recipient). Namely, if the tax inspector would not carry out the adjustment of VAT, which is shown on the “output” side in the VAT return, the VAT payer would no longer have the legal possibility to make the adjustment for that VAT by making subsequent amendments, since the filing of supplementary VAT return for the controlled period would no longer be possible, and also it would not be correct to adjust the VAT liability through the VAT return for some other tax period. Bearing in mind that the current statutory provisions do not explicitly require that tax inspectors carry out the control and adjustments of data reported in the VAT return even if an error which is detrimental to the controlled VAT payer is noticed (which we think is not in dispute in the case when the taxpayer has not e.g. recovered all input tax to which he was entitled), in this case we believe that it is necessary to issue at least an official instruction according to which such acting would be seen as obligatory for tax inspectors, which would be in line with, *inter alia*, the principle of neutrality.

We may conclude that in the wider application of the reverse-charge mechanism, the described secondary consequences (both positive and negative) become more noticeable, and vice versa. They are particularly important when dealing with large tax amounts which are not uncommon in the construction industry.

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<sup>10</sup> Article 52 (4) of the VAT Law.

## 2. REASONS FOR THE INTRODUCTION OF THE REVERSE-CHARGE MECHANISM IN THE FIELD OF CONSTRUCTION

### 2.1. Motives of the Serbian legislator

Proposal of the Law on amendments to the VAT Law from 2012 states as the sole reason for the introduction of the reverse-charge mechanism in the construction industry “*the reduction of insolvency of business entities – VAT payers, who are, as contractors, engaged by an investor – a VAT payer or entities referred to in Article 9 (1) of the VAT Law (state and political subdivision or local authority thereof and legal entities established for the purpose of performing tasks of state administration and local authority) in such a way that investors will have the obligation to compute and pay VAT for the supply of goods and services performed by the contractors – VAT payers*”.<sup>11</sup> The aim of the legislator was, therefore, to safeguard the liquidity of the contractor by eliminating taxation disadvantages stemming from the principle of accrual accounting, according to which the obligation of payment of VAT on the basis of a performed supply is independent of the collection of the agreed consideration, which can lead to pre-financing of taxes by the supplier.<sup>12</sup> Next to this, we should not forget that significant amounts may be involved, bearing in mind the potential value of turnover in the construction industry. Proposal of the Law on amendments to the VAT Law from 2015 reiterates the above mentioned explanation, and states: “The proposed solution will reduce the insolvency of business entities in this (construction) industry”.<sup>13</sup>

Also, the fact that, unlike in other cases of application of the reverse-charge mechanism under Article 10 (2) of the VAT Law, only in the field of construction it is envisaged that the person liable for payment of VAT shall also be a person who is not a VAT payer (referred to in Article 9 (1) of the VAT Law), witnesses the aim of Article 10 (2) (3) of the VAT Law, given that the mentioned persons are frequent ordering parties in practice. With this approach, the Serbian legislator has overlooked the

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<sup>11</sup> Proposal of the Law on amendments to the VAT Law from 2012, Justification, 21, [http://www.parlament.gov.rs/upload/archive/files/cir/pdf/predlozi\\_zakona/2707-12.pdf](http://www.parlament.gov.rs/upload/archive/files/cir/pdf/predlozi_zakona/2707-12.pdf), last visited 30 November 2016.

<sup>12</sup> Taxation according to the principle of accrual accounting favors delinquent payers. While the supplier is forced, to the detriment of his liquidity, to pre-finance the tax amount, the customer is entitled to input tax deduction, even though he did not pay the price, for the benefit of his liquidity.

<sup>13</sup> Proposal of the Law on amendments to the VAT Law from 2015, Justification, 12–13, [http://www.parlament.rs/upload/archive/files/lat/pdf/predlozi\\_zakona/2232-15%20lat.pdf](http://www.parlament.rs/upload/archive/files/lat/pdf/predlozi_zakona/2232-15%20lat.pdf), last visited 30 November 2016. Although the immediate cause for amending the provision of Article 10 (2) (3) of the VAT Law in 2015 lies in simpler application, its *ratio* has remained the same.

risk of evasion which such a solution entails, or has remained consistent with the motives set forth at the cost of that risk.

However, with the revised provision of Article 10 (2) (3) of the VAT Law, the application of the reverse-charge mechanism has also been extended to low-value cases where it cannot be seriously spoken about pre-financing of tax which would significantly undermine the VAT payers' ability to pay, such as e.g. the supply of air conditioning units with installation.<sup>14</sup> Such cases are, however, the inevitable consequence of the interpretation of the term "construction activity". Without a detailed elaboration of it, it is impossible to exclude them. Therefore, this argument cannot be accepted as valid for challenging the above mentioned objective.

## 2.2. Motives of the communitarian legislator

The reverse-charge mechanism in the construction industry was implemented in the Directive 77/388/EEC<sup>15</sup> by means of the Directive 2006/69/EC<sup>16</sup> at the initiative of the European Commission in 2005. From the explanation of the document by means of which the modification of the communitarian legislation was proposed, it may be concluded that the motives for such intervention were primarily anti-evasive,<sup>17</sup> which also stems from the opinion<sup>18</sup> given by the European Economic and Social Committee regarding the proposal of the European Commission and the preamble of the Directive 2006/69/EC. The confirmation of the aforementioned can also be found in literature,<sup>19</sup> as well as in current legisla-

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<sup>14</sup> Opinion of the Ministry of Finance, No. 430-00-14/2016-04 of 5 February 2016, Ministarstvo finansija Republike Srbije, *Bilten javnih finansija za februar 2016. godine*, Beograd 2016, 81–82.

<sup>15</sup> Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment, OJ L 145 of 13 June 1977.

<sup>16</sup> Council Directive 2006/69/EC of 24 July 2006 amending Directive 77/388/EEC as regards certain measures to simplify the procedure for charging value added tax and to assist in countering tax evasion or avoidance, and repealing certain Decisions granting derogations, OJ L 221 of 12 August 2006.

<sup>17</sup> European Commission, Proposal for a Council Directive amending Directive 77/388/EEC as regards certain measures to simplify the procedure for charging value added tax and to assist in countering tax evasion and avoidance, and repealing certain Decisions granting derogations, COM(2005) 89 final, Brussels 2005, 2–9.

<sup>18</sup> Opinion of the European Economic and Social Committee on the 'Proposal for a Council Directive amending Directive 77/388/EEC as regards certain measures to simplify the procedure for charging value added tax and to assist in countering tax evasion and avoidance, and repealing certain Decisions granting derogations', OJ C 65 of 17 March 2006, item 3.7.

<sup>19</sup> J. Swinkels, "Combating VAT Avoidance", *International VAT Monitor* 4/2005, 241–242.

tion of individual Member States. In Austria, for example, it is necessary for the application of the reverse-charge mechanism that the recipient of goods and services from the construction industry is the contractor to whom construction works are entrusted or that this is a subject that normally carries out supplies in the construction industry. Therefore, its application is mostly limited to the relationships of (less reliable) subcontractors and contractors, where the risk of damage to the treasury is the largest in such a way that the subcontractor computes but does not pay VAT, while the contractor exercises its right to deduct input tax. In transactions between the contractor and the investor, on the other hand, the general rule applies (unless the investor himself is the subject that normally carries out supplies in the construction industry), since these are usually reliable taxpayers who are not prone to such evasive conduct.<sup>20</sup> Finland, France, Germany, Ireland, Italy, Sweden and the Netherlands have similar solutions.<sup>21</sup>

The reverse-charge mechanism in the construction industry undoubtedly represents an anti-evasion measure in the eyes of the communitarian legislator. The safeguarding of liquidity of VAT payers is not contained in any of the aforementioned documents as an argument in favor of deviation from the general rule. At the same time, as set forth, it is not certain either.

### 3. APPLICATION OF THE REVERSE-CHARGE MECHANISM IN THE CONSTRUCTION INDUSTRY IN SERBIA

#### 3.1. Situation in the period from January 1<sup>st</sup> 2013 until October 15<sup>th</sup> 2015

Law on amendments to the VAT Law from 2012<sup>22</sup> implemented the provision of Article 10 (2) (3) of the VAT Law which stipulates that the tax debtor is the recipient of goods and services in the construction industry, a VAT payer, or the person referred in Article 9 (1) of the VAT Law, for the supply performed by another VAT payer, if the recipient of goods or services is the investor and if supplier of such goods or services is the contractor, in accordance with the Law on Planning and Construction (hereinafter: LPC). Therefore, the application of the reverse-charge mechanism depended on fulfillment of the following cumulatively prescribed conditions:

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<sup>20</sup> Steuerplattform ÖSV Österreichischer Steuerverein, [http://www.steuerverein.at/umsatzsteuer/019\\_steuerschuld\\_steuerschuldner\\_01.html](http://www.steuerverein.at/umsatzsteuer/019_steuerschuld_steuerschuldner_01.html), last visited 7 June 2016.

<sup>21</sup> European Commission, (2014), 113, 117, 121, 133, 136, 173.

<sup>22</sup> Law on amendments to the VAT Law, *Official Gazette of the Republic of Serbia*, No. 93/12.



- a) that the supplier of goods or services in the construction industry is registered for VAT purposes and has the status of a contractor in accordance with the LPC and
- b) that the recipient of such goods or services in the construction industry is registered for VAT purposes or the person referred in Article 9 (1) of the VAT Law, who acts in capacity of an investor in accordance with the LPC.

As basic disadvantages of the above mentioned provision we would note the following:

1. *practical difficulties, especially when determining the status of a contractor and proving such status.* The status of an investor is quite clear. An investor is a party for whose needs the object is built and in whose name the construction permit is issued.<sup>23</sup> On the other hand, the statutory definition of a contractor stated in Article 150 (1) of the LPC is very broad. Building of an object, or construction activities could be performed by a company, other legal entity or an entrepreneur.<sup>24</sup> The Ministry of Finance was forced to, with reference to other provisions of LPC, rely on additional criteria when determining the status of a contractor,<sup>25</sup> from which practical doubts arose;<sup>26</sup>

2. *too narrow field of application.* Bearing in mind that the notion of an investor assumes existence of a construction permit, the application of Article 10 (2) (3) of the VAT Law was limited to construction of an object for which such permit is issued.<sup>27</sup> In that manner, activities that

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<sup>23</sup> Article 2 (1) (21) of the Law on Planning and Construction, *Official Gazette of the Republic of Serbia*, No. 72/09, 81/09, 64/10, 24/11, 121/12, 42/13, 50/13, 98/13, 132/14 and 145/14.

<sup>24</sup> Article 150 (2) of the LPC prescribes special conditions for obtaining contractor status only for a company or other legal entity engaged in construction of an object, i.e. performing construction activities enlisted in Article 133 (2) of the LPC.

<sup>25</sup> Accordingly, it was necessary for a contractor to sign a contract with an investor regarding the construction of an object, including upgrading, with rights and obligations of a contractor prescribed by the LPC; that it is a party whose name, as a contractor, is stated on the board used for marking a construction site, provided by an investor; that a contractor's authorized person signed the main project before beginning of construction activities; that a contractor determined a responsible contractor on site by issuing an appropriate decision etc.

<sup>26</sup> Proposal of the Law on amendments to the VAT Law from 2015 regards the aforementioned "simplification" of taxation in the construction industry in a situation where in "every supply in this industry performed by a VAT payer to another VAT payer, or the person from Article 9 (1) of the VAT Law, the person liable for payment of VAT shall be the recipient of goods and services, and *not only* in a situation where the supplier has a contractor status, and the recipient status of an investor, in accordance with the LPC", Proposal of the Law on amendments to the VAT Law from 2015, Justification, 12.

<sup>27</sup> Cekos in, *PDV – časopis za primenu propisa o porezu na dodatu vrednost i akcizama* 5/2014, 38.

clearly represent activities in the construction industry, such as adaptation, reconstruction or recovery of existing objects, would unreasonably be left out therefrom.<sup>28</sup> The same applies to construction of illegal objects. Moreover, the Ministry of Finance in practice reduced the term “construction” of objects pursuant to Article 2 (1) (30) to “building” and “upgrading” in accordance with Article 1 (1) (31) and (33) of the LPC.<sup>29</sup> Article 10 (2) (3) of the VAT Law was also not applicable on transactions between a subcontractor and contractor due to not fulfilling prescribed conditions, which is a diametrically opposite approach compared to previously described practice of Member States who place emphasis exactly on these type of transactions. This reduces the potential of anti-evasion measures;

3. *inapplicability of the reverse-charge mechanism for activities outside the scope of activities for which construction permit is needed.* In practical terms, this led to situations of dual tax treatment within the same construction project.<sup>30</sup>

### 3.2. Situation from October 15<sup>th</sup> 2015

Law on amendments to the VAT Law from 2015<sup>31</sup> amended the provision of Article 10 (2) (3) of the VAT Law. The tax debtor is now the

<sup>28</sup> Explanation of the Ministry of Finance, No. 011-00-77/2012-04 of 18 January 2013, *Ministarstvo finansija Republike Srbije, Bilten javnih finansija za januar 2013. godine*, Beograd 2013, 27. In all three cases the construction permit is not issued in accordance with Article 145 (1) of the LPC.

<sup>29</sup> “Building” of an object pursuant to Article 2 (1) (30) of the LPC includes, *inter alia*, preparation work for subsequent construction (e.g. demolition of existing objects on the lot, relocation of an existing infrastructure, clearing of a site etc.) on which Article 10 (2) (3) of the VAT Law did not apply, Opinion of the Ministry of Finance, No. 011-00-00515/2014-04 of 14 July 2015, *Ministarstvo finansija Republike Srbije, Bilten javnih finansija za juli-avgust 2015. godine*, Beograd 2015, 72–73.

<sup>30</sup> When a VAT payer – contractor makes a supply of goods and services in the construction industry to an investor, whereby part of such construction activities refers to building of an object for which a construction permit is issued, and part refers to building of objects for which construction permit is not needed (e.g. approach roads, parking lots etc.), for supply of goods and services regarding the construction of the object for which the construction permit is issued the tax debtor is the investor, while for the supply of goods and services regarding the construction of objects for which construction permit is not needed the tax debtor is the contractor, Opinion of the Ministry of Finance, No. 430-01-126/2013-04 of 16 September 2013, *Ministarstvo finansija Republike Srbije, Bilten javnih finansija za septembar 2013. godine*, Beograd 2013, 24–25. Same applies when, e.g., based on the same legal act, object construction and reconstruction, or revitalization of an existing object is performed, Opinion of the Ministry of Finance, No. 413-00-657/2013-04 of 26 June 2014, *Ministarstvo finansija Republike Srbije, Bilten javnih finansija za juni 2014. godine*, Beograd 2014, 9–10.

<sup>31</sup> Law on amendments to the Law on Value Added Tax, *Official Gazette of the Republic of Serbia*, No. 83/15.

recipient of goods and services in the construction industry, a VAT payer, or the person referred in Article 9 (1) of the VAT Law, for the supply performed by another VAT payer. It is not necessary an investor and a contractor to be there anymore, in accordance with the LPC.

The bylaw closely determines what are considered to be “goods and services in the construction industry”.<sup>32</sup> These are goods and services supplied in accordance with Article 4 (1) and (3) (6) and Article 5 (1) and (3) (3) of the VAT Law, when performing any of the enumerated activities from the Regulation on classification of economic activities<sup>33</sup> (Section F – Construction). When a VAT payer performs any of the construction activities, regardless of whether the VAT payer is registered for performing such activities in accordance with the law, by order from a purchaser, with its own material, subject to the condition that it is not merely an additional or some other ancillary material, it is considered that the VAT payer, in accordance with Article 4 (1) and (3) (6) of the VAT Law, performs a supply of goods in the construction industry. Supply of services in the construction industry shall exist under equal conditions, when a service is provided through an order and with purchasers’ material, in accordance with Article 5 (1) and (3) (3) of the VAT Law.<sup>34</sup>

Application of the reverse-charge mechanism now depends on fulfillment of the following cumulatively prescribed conditions:

- a) that a supplier in the construction industry is registered for VAT purposes and that a recipient of goods or services in the construction industry is also registered for VAT purposes or that it is the person referred in Article 9 (1) of the VAT Law;
- b) that a supplier performs construction activities, regardless of whether he is registered for such activities or not and
- c) that there is a supply of goods in accordance with Article 4 (3) (6) or supply of services in accordance with Article 5 (3) (3) of the VAT Law.<sup>35</sup>

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<sup>32</sup> Rulebook on determining goods and services in the construction industry for the purpose of determination of tax debtor for VAT purposes, *Official Gazette of the Republic of Serbia*, No. 86/2015.

<sup>33</sup> Regulation on classification of economic activities, *Official Gazette of the Republic of Serbia*, No. 54/10.

<sup>34</sup> Article 2 of the Rulebook on determining goods and services in the construction industry.

<sup>35</sup> Article 2 (1) of the Rulebook on determining goods and services in the construction industry mentions the supply of goods in accordance with Article 4 (1) and (3) (6) of the VAT Law. The aforementioned provisions govern two different legal situations. Article 4 (1) of the VAT Law regulates “regular” supply of goods, while Article 4 (3) (6) regulates the supply of goods which also includes a service element. According to the linguistic interpretation it is correct to conclude that the author of said bylaw has taken

The new legislation significantly expanded the scope of Article 10 (2) (3) of the VAT Law, in objective as well as subjective sense. For example, reverse-charge mechanism is now applicable in situations of adaptation, revitalization, reconstruction or recovery of an existing object. Also, all subjects (including subcontractors, and not only contractors in direct contractual relationship with an investor), who perform a supply of goods and services in the construction industry, are subject to the amended provision. Thereby previously described secondary consequences, arising from practical application of the reverse-charge mechanism, additionally gained importance. Unfortunately, the same could be stated for primary consequences, bearing in mind that the new provision has increased insecurity when determining whether in particular case this measure will be applicable or not.

### 3.3. Problem of qualification of a supply of goods and services in the construction industry and possibilities for its overcoming

The most important disadvantage of the new provision is reflected in potential difficulties when determining whether a supply of goods and services is considered to be provided in the construction industry or not. These difficulties could arise when assessing if goods and services are supplied in accordance with Article 4 (3) (6) and Article 5 (3) (3) of the VAT Law. For example, transporting and pouring concrete on a construction site could be treated as installation of materials pursuant to Article 4 (3) (6) or as a (regular) supply of materials in accordance with Article 4 (1) of the VAT Law.<sup>36</sup> Also, they could be the result of an ambiguity whether a VAT payer performs a supply in the construction industry or not.<sup>37</sup> Therefore, for example, delivery of props for children (teeters,

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into account both situations. However, from phrasing of Article 2 (2) of the Rulebook follows that the author has taken into account exclusively situation stated in Article 4 (3) (6), despite the fact that the author again refers to Article 4 (1) and (3) (6) of the VAT Law. The confirmation of this fact is also found in previously quoted Explanation of the Ministry of Finance of 10 November 2015, which explicitly excludes (regular) supply of materials *without installation* from the scope of Article 2 of the Rulebook. Our opinion is that at this place it is necessary to align the wording in Article 2 of the Rulebook and to limit the provision only on the supply of goods in accordance with Article 4 (3) (6) of the VAT Law. An analog amendment, according to the same arguments, is desirable with respect to the provision of services.

<sup>36</sup> The Ministry of Finance does not consider a supply of concrete with transportation and pumping to be a supply of goods in the construction industry, Opinion of the Ministry of Finance, No. 430-00-115/2016-04 of 25 March 2016, *Ministarstvo finansija Republike Srbije, Bilten javnih finansija za mart 2016. godine*, Beograd 2016, 25–26.

<sup>37</sup> From previous practice of the Ministry of Finance it could be concluded that while assessing the fulfillment of this requirement the Ministry of Finance strictly followed the Regulation on classification of economic activities. We consider such approach to be correct since the analogy (bearing in mind the variety of possible situations) is very

swings, merry-go-round) including transportation and installation into concrete foundation is a supply from the construction industry (activity 42.99 – Classification of economic activities). On the other hand, this is not the case in a situation when the delivery includes transportation and placing, i.e. fixing to concrete (without installation) of such goods.<sup>38</sup> Finally, attention should be paid that conditions are met cumulatively. Demolition of an object, for example, clearly represents construction activity,<sup>39</sup> but if purchaser's material is not used, it cannot be considered as a supply of services in accordance with Article 5 (3) (3) of the VAT Law.<sup>40</sup>

We note that in the European Union the precise determination of the scope of the reverse-charge mechanism in the construction industry is also identified as the main cause of complexity of this issue.<sup>41</sup> European classification of economic activities, in its current edition, (Statistical classification of economic activities in the European Community – NACE Rev. 2) is identical to the Regulation on classification of economic activities in the construction industry. Hence, classification problems present in our (domestic) practice could be considered to exist in all Member States who determine the notion of construction activities by relying on the aforementioned classification.

Bearing in mind the conflicting interests of participants in a transaction when deciding whether or not a specific situation should fall under the scope of Article 10 (2) (3) of the VAT Law, it is necessary to consider the ways in which the current situation can be improved. This is conceivable even in the absence of intervention of any kind, assuming that by the time the practice will more closely determine the definition of a supply of goods and services in the construction industry. The alternative to such an approach could be one of the following options. The first option would be to define more precisely the supply of goods and services in the construc-

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dangerous, although it seems desirable and justified. However, it is justifiable to wonder whether this authority has enough competences and if it is authorized at all to assess the fulfillment of this condition.

<sup>38</sup> Opinion of Ministry of Finance, No. 413-00-216/2015-04 of 15 December 2015, *Ministarstvo finansija Republike Srbije, Bilten javnih finansija za decembar 2015. godine*, Beograd 2015, 74–76.

<sup>39</sup> Article 2 (1) (9) of the Rulebook on determining goods and services within construction industry.

<sup>40</sup> As the opposite of previously stated, the Ministry of Finance applies Article 10 (2) (3) of VAT Law in case of maintenance and repair of cooling equipment (which is possible without the use of materials) considering it is a construction activity in accordance with Article 2 (1) (12) of the Rulebook on determining goods and services in the construction industry, Opinion of Ministry of Finance, No. 430-00-14/2016-04 of 5 February 2016, *Ministarstvo finansija Republike Srbije, Bilten javnih finansija za februar 2016. godine*, Beograd 2016, 81–82.

<sup>41</sup> European Commission, (2014), 13 and 68.

tion industry for the purposes of application of Article 10 (2) (3) of the VAT Law. The second option would be to supplement the current legislation by providing an option to the participants in a transactions to, in case of dissenting opinions, agreeably overcome qualification problems. A good example is the Croatian solution. If a supplier of goods, or a provider of services in the construction industry issues an invoice without VAT (mentioning that the reverse-charge mechanism is applied) or issues an invoice with VAT and the recipient considers that such action is incorrect, then, the recipient asks the supplier, in written, within 8 days from the day of the receipt of the said invoice, to correct it. Otherwise, it shall be considered that recipient is consentient with the way in which the invoice is issued. Within 8 days the supplier must notify the recipient if he accepted the recipient's request for the invoice correction. If the supplier does not accept the said request, the recipient must accept such invoice, and then, in written, notify tax administration.<sup>42</sup> We encounter a similar solution in Austria. Participants in a transaction shall agree regarding the application of the reverse-charge mechanism if in a certain situation the application thereof is questionable. If they consider that there is no supply of goods and services from the construction industry, and afterwards turns out they were incorrect, the agreement shall remain applicable if it can be proven that there was no damage caused to the state treasury (i.e. that VAT on this basis is paid).<sup>43</sup> The third option is completely devoted to preserving the liquidity of VAT payers and implies dismissing the current solution and taxation according to the principle of cash accounting pursuant to Article 36a of the VAT Law.<sup>44</sup> Finally, the fourth option implies a limited application of the reverse-charge mechanism above the prescribed threshold (e.g., in Malta the value of a contract may not be lower than EUR 70,000).<sup>45</sup>

We are of the opinion that between previously described options choice should be made by applying the criteria of overcoming qualification problems of goods and services in the construction industry, protecting liquidity of VAT payers and anti-evasion effect of the amendment. It is hard to imagine clear and exhaustive list of goods and services in the construc-

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<sup>42</sup> Article 152 (4) – (5) of the Rulebook on Value Added Tax, *Official Gazette of the Republic of Croatia*, No. 79/13, 85/13 – corrected, 160/13, 35/14, 157/14 and 130/15.

<sup>43</sup> Steuerplattform ÖSV Österreichischer Steuerverein, [http://www.steuerverein.at/umsatzsteuer/019\\_steuerschuld\\_steuerschuldner\\_01.html](http://www.steuerverein.at/umsatzsteuer/019_steuerschuld_steuerschuldner_01.html), last visited 21 June 2016.

<sup>44</sup> Please note that Article 36a (5) (3) explicitly excludes principle of cash accounting in situations that fall under the scope of Article 10 (2) (3) of the VAT Law. However, even in the absence of this provision, the threshold of 50,000,000 Serbian dinars stated in Article 36a (1) of the VAT Law would represent a barrier to preservation of liquidity in this way to certain number of VAT payers.

<sup>45</sup> European Commission (2014), 148.

tion industry. Therefore, the suitability of the first option to ensure clear application of the reverse-charge mechanism is very uncertain. Also, it is reasonable to assume that the “refinement” (more or less) would narrow the scope of the application of this provision at the expense of fulfilling other criteria. The second option does not eliminate initial qualification problems bearing in mind that the current legislation remains substantially unaltered. However, this option provides acceptable modality for overcoming consequences thereof by freeing participants in a transaction from responsibility in a situation of misapplication of the law.<sup>46</sup> Protection of liquidity of a supplier in the construction industry shall depend on the agreement in a particular situation. However, bearing in mind the exceptional occurrence of uncertain cases, the current situation shall not be significantly altered. The proposed solution also does not represent a threat to the volume of collected tax revenue. Tax administration is notified about the reached agreement, while its validity is conditioned by the evidence that VAT arising from the transaction is duly settled. By switching to taxation in accordance with the principle of cash accounting, the objective that the Serbian legislator bore in mind when implementing Article 10 (2) (3) of the VAT Law would be preserved. Also, dilemmas regarding application of exception to the general rule typical for reverse-charge mechanism (in this situation – principle of cash compared to accrual accounting), the application of which exclusively depends on the VAT payer’s will to opt for it, would be eliminated. On the other hand, the system would again be exposed to the above-mentioned aspect of evasion. The fourth option partially eliminates qualification problems by always applying general rule in case of low-value supplies.<sup>47</sup> If relatively low threshold is prescribed (e.g. in the amount of a few hundred thousand Serbian dinars) protection of VAT payers liquidity and anti-evasion potential of the reverse-charge mechanism in the construction industry in significant cases (high-value supplies) would not be endangered.

From previously stated follows that second option is the most appropriate option to eliminate the aforementioned disadvantages of the current legislation. Afterwards follows the fourth option, whose range is somewhat limited. The first option cannot be accepted because of an ex-

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<sup>46</sup> This approach is economical because it reduces the need for intervention of the Ministry of Finance in uncertain situations. The same applies for a VAT payer, who does not incur additional administration expenses.

<sup>47</sup> For example, next to the aforementioned delivery that includes installation, i.e. installation of cooling equipment, delivery of furniture with installation (library, wardrobe and other closets, radiator grille, bookshelves, counters etc.), Opinion of the Ministry of Finance, No. 430-00-522/2015-04 of 12 December 2015, *Ministarstvo finansija Republike Srbije, Bilten javnih finansija za decembar 2015. godine*, Beograd 2015, 46. It is reasonable to assume that VAT payers who participate in such supply actually do not know that the said supply is within the scope of goods and services in the construction industry in accordance with Article 10 (2) (3) of the VAT Law.

treme uncertainty it entails, while the third option deserves further interest only if we disregard anti-evasion potential of the reverse-charge mechanism and exclusively aspire to protecting VAT payers' liquidity.

#### 4. CONCLUSION

The revised provision of Article 10 (2) (3) of the VAT Law has expanded the scope of application of the reverse-charge mechanism in the construction industry. The Serbian legislator has succeeded to, in a more comprehensive way, achieve the objective which initially inspired the implementation of this provision into the VAT Law. Taking into account a more diverse range of goods and services supplied in the construction industry practically all VAT payers will enjoy liquidity protection provided by such tax treatment. However, the Serbian legislator is apparently unaware of the fact that reverse-charge mechanism in the construction industry is in essence an anti-evasion measure, which communitarian sources also confirm. Hence, the legislator, by accident, accomplished to improve existing VAT system by making it more resistant to certain forms of tax evasion.

Certain (secondary) consequences, as an unavoidable result of practical application of the reverse-charge mechanism, are now more worthy of attention. Tax administrations' capacity to cope with an increased number of VAT refund requests is questionable,<sup>48</sup> and implications of absence of fractional tax collection on the budget must also not be ignored. Also, the new solution has increased insecurity when determining whether, in a particular case, the application of a special tax treatment will take place (in the meaning of the described primary consequences). The most elegant solution for overcoming "qualification problems" while preserving positive effects of the reverse-charge mechanism in the construction industry is in amicable solution of an unclear situation by participants in a transaction. If it turns out that the law was misapplied, they are freed of responsibility after they prove that there was no damage caused to the state treasury.

*Summa summarum*, the revised provision of Article 10 (2) (3) of the VAT Law represents an acceptable solution for achieving a twofold objective – protection of suppliers' liquidity and strengthening the resistance of the VAT system in terms of tax evasion. However, a prompt intervention of the legislator is necessary in order to eliminate previously stated practical dilemmas.

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<sup>48</sup> During the 6<sup>th</sup> edition of "Tax evenings" from June 23<sup>rd</sup> 2016 Dr. Svetislav Kostić stated that tax authorities employ only 500 tax inspectors. At the same time, around 333,000 legal entities and entrepreneurs are registered in Serbia. Even if we take into consideration that the number of VAT payers performing construction activities is much lower, our doubts are still valid.



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