

VAT tax audits are challenging; here are a few tips to survive

Although a tax audit conducted by a tax authority primarily aims to verify the circumstances relevant to the correct determination of taxes by investigating compliance with binding provisions of applicable laws or uncovering various unlawful schemes leading to tax evasions, it often happens that legitimate business owners unfairly fall victims to the strict collection apparatus.

While the commencement of a tax audit does not automatically mean there is a grounded suspicion of an illegitimate operation, the process itself typically imposes a significant administrative burden on the tax payer. In addition, if the tax audit also results in an imposition of additional tax and sanctions, the operations of an entrepreneur may be affected significantly and, from time to time, also unlawfully. Let us dive deeper into the topic.

While in substantially all relationships involving an intervention of a public power into personal rights and freedoms, the principle of proportionality should be observed, there is not a universal rule determining where exactly the border between public and private interests lies. In tax law, the concept of a presumption of innocence is not recognised and it is the taxpayer who carries (subject to certain specific exceptions) the entire burden of proof at first. For this reason, it can be argued that where taxation is concerned, the weighing scales are shifted closer towards the side of public interests compared to some other legal disciplines (such as criminal law). Consequently, entrepreneurs often mistakenly assume

that in the absence of sufficient evidence rebutting their claims, the tax authority will not be able to increase the tax bill, while the opposite is true.

Another deficiency in a confrontation with the tax authority is to rely solely on formal evidence. Unlike the exercise of a taxpayer's claim (through filing a tax return), which is based primarily on received invoices and book entries, state auditors are keen on examining material facts of selected transactions. The extent of investigation is determined by the tax authority on a case-by-case basis and the proceedings continue until the factual background has been established beyond a reasonable doubt.

More often than not, taxpayers find themselves unable to provide evidence satisfying the curiosity of state auditors, whether due to the lapse of time since the relevant transaction (generally, the tax audit may go as far as 6 years back in time), insufficient internal processes (especially the failure to document certain information or activities at a required level of detail) or the seeming impossibility to support specific claims (a particular difficulty often arises in connection with evidencing the absence of something).

Based on our experience, most cases in which the VAT deduction is denied are founded on: (i) challenging the true supplier (in particular in cases where part of the supplied services are secured through sub-contractors, where the tax authority tends to consider the sub-contractors as the actual suppliers), (ii) scrutinizing the real economic purpose of a transaction (especially in transactions between related parties such as in businesses organised in a group structure controlled by a holding entity), (iii) questioning the relevance of the VAT on the input for the supply of taxable transactions on the output or (iv) considering the taxpayer being involved in a tax fraud.



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Since the tax authorities have a tendency to believe that the burden of proof generally lies with the taxpayer (which is not entirely true, especially in the case of deemed participation in fraudulent chains), it is sufficient for the tax authority to cast a shadow of doubt over the taxpayer's declarations in order to deny a VAT refund. As a consequence, entrepreneurs suffer on many occasions not because they did not comply with their material statutory obligations, but merely because they could not satisfactorily support their claims in formal proceedings.

While the initial decision of a tax authority may be appealed and, if unsuccessful, challenged before court, there are practical limitations to an effective protection of the legitimate interests of a taxpayer.

First of all, if a financial authority rejects a taxpayer's claim for

a VAT deduction, as a general rule, it starts investigating other taxable periods as well. Pending the investigation, the VAT is withheld by the state, which may have considerable impact on the entrepreneur's cash flows. Secondly, the initial phase of the tax audit is dedicated to presenting evidence – only exceptionally is new evidence admissible in later stages of the proceedings.

It is therefore crucial not to underestimate the early stages of a tax audit and to ideally seek guidance from a professional advisor from the outset. An experienced attorney can not only help in structuring the defence, proposing effective means of evidence and protecting the taxpayer from any actions exceeding the statutory framework, but can also implement processes preparing a business for the possibility of a tax audit, making the subsequent proceedings much more efficient.

