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## Substitute performance without VAT deduction

### Tax Alert

Dear Readers,

**On 6 July 2017, the Supreme Administrative Court issued an important judgment (file ref. No. I FSK 2173/15) concerning the right to deduct VAT resulting from an invoice issued by a substitute subcontractor. The judgment is final.**

The case concerned a company that provided construction services and provided a guarantee to the investor in this respect. The company, being the main contractor, subcontracted the execution of individual works to subcontractors, who, under the agreement, were obliged to repair the defects occurring during the warranty period. For securing the performance of the defects repair, the subcontractors brought in a guaranteed deposit. If the subcontractor failed to remove the defects within the specified deadline, the company was entitled to entrust the repair to a substitute subcontractor and deduct the costs incurred due to the substitute performance from the guarantee deposit paid by the subcontractor. The company's doubts consisted in whether they had the right to deduct the tax arising from the invoice issued by the substitute subcontractor.

**The opinions of tax authorities, the Provincial Administrative Court (WSA) and the Supreme Administrative Court (NSA) were unfavourable at first glance only**

Both the court of the first and second instance agreed with the opinion of the tax authority that the reimbursement of the costs of the removal of faults and defects is a compensation claim that has no connection with the provision of services taxed by the company and is not subject to VAT, and hence the input VAT calculated by the substitute subcontractor is not deductible.

WSA in Szczecin emphasized that the substitute performance aims to repair damage resulting from non-performance or improper performance of an obligation, i.e. it is a compensation, and the appropriate beneficiary of a substitute performance is solely the company – and therefore the input tax indicated on the invoice issued by the substitute subcontractor is not associated with the taxable activities of the company (file ref. No. I SA/Sz 781/15). Otherwise, the input tax for the same construction works would be deducted twice, i.e. from the invoice issued by the defaulting subcontractor for the originally rendered (though defectively) service and by the substitute subcontractor for the removal of defects – ruled WSA. In addition, in the verbal justification to the judgment, the Supreme Administrative Court explained that the lack of possibility to deduct the tax from the invoice issued by the substitute contractor does not infringe the principle of neutrality (which the applicant company referred to), as it is not the general contractor that bears the cost of the tax. The compensation due to the general contractor should include the full cost of execution, including VAT, which, in such a case, needs to be paid by the unreliable subcontractor.

## Practical significance of the judgment

It should be noted that on the basis of the state of affairs analysed, the tax authority and administrative courts treated the criterion of the relationship between the purchase of construction services and taxable activities in a very rigid way. Such a point of view is often stressed in the jurisprudence of the EU Court of Justice as well. The result of adopting such an approach, however, is that the substitute performance may not entitle you to deduct VAT. Consequently, one cannot deal with such type of settlements automatically, but rather pay attention to fact that the manner of making settlements with the subcontractor of construction works (e.g. by deducting the expenses for repairing the defects from the guarantee deposit) may determine whether it will be possible to deduct VAT by the general contractor, or not. The good news is that excluding the settlement of the guarantee deposit for the removal of potential defects from VAT saves a lot of work related to the settlement of this tax. In addition, we do not need to analyse the difficult subject of reverse charge settlements in relation to the construction services (which was presented in [Tax Alert 13/2017](#)).

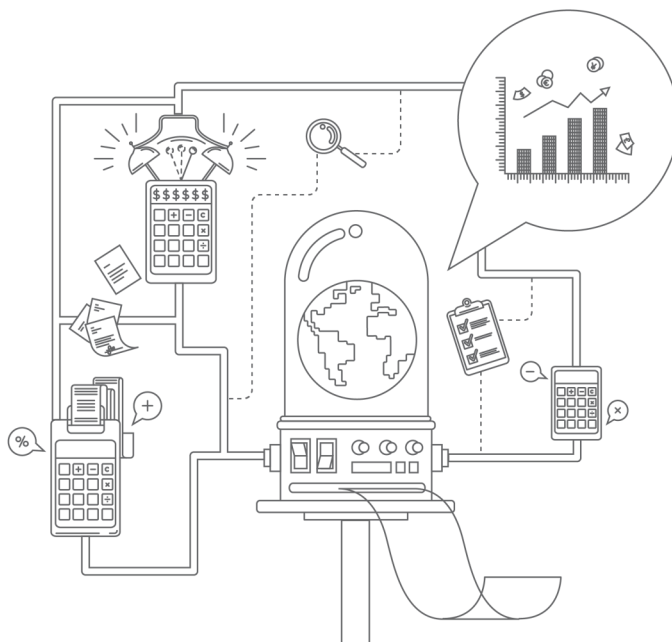
Therefore, we recommend examining the provisions of agreements concluded with construction work subcontractors relating to the execution of substitute performance in terms of securing the main contractor's right to deduct VAT and avoid the risk of a dispute with the tax authority.

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Should you wish to discuss the above mentioned amendments in detail, feel free to contact us:

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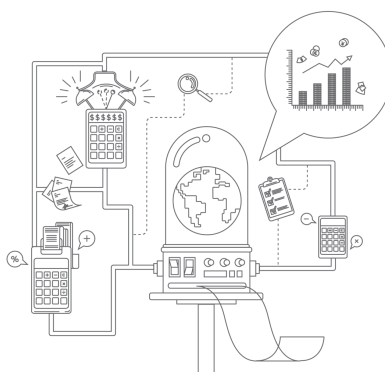
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