Partial deduction of input value added tax

If a taxable person uses goods or services for the purposes of both taxable supply and supply exempt from tax, input VAT shall be partially deducted from the calculated VAT. Upon partial deduction of input VAT, a taxable person may use either the method of proportional deduction or the method combining direct calculation and proportional deduction during one and the same calendar year.

In accordance with the provisions of subsection 1 of § 29 of the VAT Act, a taxable person has the right to deduct from the VAT payable the input VAT on goods or services used for the purposes of taxable supply of the same taxable period, as well as the input VAT on goods or services used for transactions or acts specified in subsection 2 of § 4 of the VAT Act and related to business or for business carried out in a foreign state, except transactions deemed to be supply exempt from tax (§ 16) of the same taxation period. Therefore, if a company can directly separate in its accounts the input VAT on the goods or services acquired for the purposes of taxable supply and supply exempt from tax, then the deduction of input VAT on those goods and services is subject to direct calculation.

On the remaining costs used for both taxable supply and supply exempt from tax, input VAT must be deducted proportionately. In most cases, such costs are company's general costs such as electricity, utilities, rent etc.

If the taxable person does not consider it necessary to deduct input VAT directly, he can apply the proportional deduction method in respect of the deductible input VAT on all the goods or services used for the purposes of the taxable supply and supply exempt from tax.

DETERMINATION OF PROPORTION WHEN THE GOODS AND SERVICES ACQUIRED ARE USED FOR BOTH TAXABLE SUPPLY AND SUPPLY EXEMPT FROM TAX

The partial deduction of input VAT on the basis of the proportional deduction method is based on the proportion of the supply of the taxable person effected in Estonia and foreign countries during a calendar year where the input VAT can be deducted pursuant to subsection 1 of § 29 of the VAT Act to the total amount of the supply effected by the person in Estonia and foreign countries (hereinafter proportion of taxable supply to total supply).

In calculating this proportion, the transfer of fixed assets is not taken into account regardless of whether or not the transfer of goods is taxed on the basis of subsection 3 of § 16 of the VAT Act. Nor shall account be taken of the incidental provision of services referred to in clause 6 of subsection 2 and subsection 2^1 of § 16 of the VAT Act or the incidental transfer of immovables as goods. This includes both the provision of occasional financial services and the transfer of securities. The provision of financial services and the transfer of securities can be regarded as incidental or ancillary activities in cases where the economic operator also has its main activity, the resources of which are used, for example, when granting loans or acquiring securities. One-off transactions in which an economic operator acquires immovables and transfers the immovables as goods and does not itself use the immovables as fixed assets can be regarded as incidental transfer of immovables.

Where a taxable person is able to use the method combining direct calculation and proportional deduction, that method distinguishes between the goods and services used:

- only for the purposes of taxable supply – input VAT is deducted in full;
- only for supply exempt from tax – no deduction of input VAT;
- for both taxable supply and supply exempt from tax – input VAT is deducted according to the proportion of taxable supply to total supply on the basis of the abovementioned proportion of taxable supply to total supply.

DETERMINATION OF PROPORTION UPON PARTIAL DEDUCTION OF INPUT VAT UPON ACQUISITION OF FIXED ASSETS, INCLUDING IMMOVABLE PROPERTY

According to the provisions of subsection 4 of § 32 of the VAT Act, the input VAT payable upon the acquisition of fixed assets (including immovable property) and upon the acquisition of goods or services for the purposes thereof is deducted in the month of acquisition of fixed assets or goods or services for the purposes thereof, on the basis of the estimated proportion of the use of fixed assets for taxable supply in the year of acquisition of fixed assets.

Upon acquisition of fixed assets (including immovables), input VAT is not deducted according to the general, i.e. the proportion referred to above, but is based on the use of specific fixed assets for taxable or tax-exempt supply or for non-business purposes. Input VAT is adjusted according to the proportion of actual use of fixed assets for taxable supply as of the year of acquisition of the fixed assets during the period of adjustment of input VAT. The input VAT is to be adjusted only in respect of goods and services acquired for fixed assets which increase the cost of fixed assets and only in respect of goods and services acquired for the purposes of immovables which increase the book value of the immovables.

The period for adjustment of input VAT is ten calendar years in the case of immovables and goods and services relating thereto and five calendar years in the case of other fixed assets and goods and services relating thereto. The first calendar year is the period from the date of acquisition of fixed assets until the end of the current calendar year. In the case of goods or services acquired for fixed assets, the first calendar year is the period from the date of acquisition of goods or services for fixed assets until the end of the current calendar year.

The deducted input VAT must be adjusted at the end of each calendar year (by 1/10 or 1/5, respectively), and the calculations must be recorded in field 10 or 11 of the December VAT return. **As of 2025, upon the initial use of fixed assets, the input VAT must be adjusted <u>in full</u> according to the actual proportion of the use of fixed assets for taxable supply during the taxable period of the use of fixed assets and**

thereafter 1/10 or 1/5 – this change applies to fixed assets that are put into use on or after 1 January 2025 (<u>also if such fixed assets were acquired before the beginning of 2025</u>).

Example

On 9 January 2020, a taxable person acquired an apartment ownership (immovable) without VAT and begins to renovate it with the aim of transferring the immovable as a new building and adding VAT. As the taxable person expects VAT to be added upon selling, he deducts the entire input VAT from the renovation costs by a total of 1200 euros. The costs related to improvements exceed 10 per cent of the cost of the building before improvements, and in the case of these expenses, the period for monitoring input VAT is 10 years.
The renovation of the immovable was finished in September 2020 and, in the absence of a buyer, was rented out tax-free in October 2020. Since in 2020 the taxpayer used the renovated apartment ownership only for the purposes of supply exempt from tax, in December 2020 the input VAT deducted on the renovation costs must be recalculated for the first year.
The calculation is as follows: deductible input VAT 12 000 euros divided over 10 years = 1200 euros, i.e. the amount used as the basis for the recalculation to be made at the end of each calendar year. Therefore, 1200 euros had to be shown in field 10 of the December 2020 VAT return. The lease contract expired in September 2021 and in October the same year the immovable was transferred tax-exempt, as there is no possibility of adding VAT to the supply of a used dwelling.
Upon the transfer of the immovable, the input VAT had to be recalculated in the month of the transfer, which means that 10 800 euros (9 × 1200 euros) had to be shown in field 10 of the October 2021 VAT return.

If input VAT is adjusted upon the transfer of fixed assets, the using of fixed assets and the goods acquired or services received for the fixed assets, during the year in which the fixed assets are transferred until the end of the period for adjustment, shall be accounted for as being used for the purposes of the fully taxable supply. If the taxable value of fixed assets upon the transfer is lower than half of the purchase price of the assets, the period as of the month following the transfer of fixed assets until the end of the period for adjustment shall not be taken into account upon the adjustment of input VAT. If the input VAT is adjusted upon the transfer of immovable exempt from tax, the using of the immovable and the goods acquired or service received for the immovable, during the year in which the immovable is transferred until the end of the period for adjustment, shall be accounted for as being used for the purposes of the supply fully exempt from tax.

In the case of goods or services (renovation costs) acquired for an immovable, the first calendar year is the period from the date of acquisition of goods or services for the immovable until the end of the current calendar year (Regulation No 39 of the Minister for Finance of 30 March 2004).

According to the above example, the first year of use of the apartment (2020) generated supply exempt from tax and the apartment was transferred tax-free in 2021, so the total amount of input VAT deducted must be refunded.

Example

Under the same conditions, business premises were renovated and lease contracts were concluded as follows: from September 2020 to September 2022 taxable supply was generated and from from October 2022 to November 2023 supply exempt from tax was generated. In December 2023, the immovable was transferred, (including VAT).
As the supply incurred in 2020 and 2021 includes VAT, no recalculation is required.
In 2022, the supply from the premises rented out is taxable during the period from 1 January to 30 September and exempt from tax from 1 October to 31 December. Based on the actual use, the proportion for 2022 was as follows: 75% for taxable supply and 25% for supply exempt from tax. The basis for the recalculation, i.e. the amount to be corrected, was 1200 euros, of which 300 euros had to be shown in field 10 of the VAT return for December 2022, i.e. 25% × 1200 = 300 euros are to be returned to the state budget.
In 2023, the supply generated from renting out the immovable was exempt from tax from 1 January to 30 November and taxable from December 2023 when the immovable was transferred (including VAT). Upon transferring the immovable (including VAT), the use of immovable and goods or services acquired for it during the remaining period, including the year of transfer of the immovable, are considered as use for the purposes of fully taxable supply. Therefore, the whole of 2023 is counted as a use for taxable supply and there is no need to recalculate input VAT in 2023.

DEDUCTION OF INPUT VAT IN THE CASE OF GOODS OR SERVICES USED FOR BUSINESS AND NON-BUSINESS PURPOSES

Subsection 4 of § 29 of the VAT Act provides that if a taxable person uses goods or services for both business purposes as well as for purposes other than those related to business, only input VAT on goods or services used for the business purposes shall be deducted. The application of subsection 4 of § 29 of the VAT Act must generally be based on a cost-based method, i.e. direct calculation, which means that every purchased goods item or service must be classified according to the intended use and, on that basis, deduction of input VAT is made.

If the goods or services purchased are used for both business and non-business purposes, the taxable person himself must distinguish between the proportion of each of the goods and services used for business purposes (taxable supply) and, accordingly, deduct input VAT.

If it is not possible to distinguish between business expenses and other expenses in the accounts of a taxable person, only then must the taxable person apply to the tax authority for a procedure for deduction of input VAT. Since subsection 4 of § 29 of the VAT Act does not lay down methods or formulas, the tax authority, when implementing the aforementioned provision of law, assesses the nature and specificity of the taxable person’s activities and, on the basis of the proposals of the taxable person, the procedure for partial deduction of input VAT is found which is the most appropriate and which gives a reasonable result in the deduction of input VAT. If, upon submission of an application by a taxable person, the taxable person does not yet know the income to be received and the proportion of taxable supply, the tax authority shall also have the right to provide, upon approval of the procedure for deduction of input VAT, for the mandatory adjustment of input VAT during the last taxable period of the calendar year.

In principle, the proportion can be calculated on the basis of the proportion of the taxable supply to the total supply, and the input VAT on electricity costs, utilities, etc. used for business and non-business purposes can also be deducted.

Example

A non-profit association incurs both taxable supply and supply exempt from tax and acquires goods or services for its activities. The taxable supply accounts for 80% of the total supply. In its accounts, the non-profit association does not distinguish the input VAT on electricity, utilities, phone services, rental services, etc. used for the purposes of taxable supply. Consequently, it deducts 80% of the input VAT on those costs according to the proportion referred to above.
20% of input VAT is not deducted for both supply exempt from tax and non-business purposes.

When calculating the proportion, the total supply includes the money received in business or as targeted financing or as a grant, i.e. all income from which goods and services can be purchased.

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