

## DETERMINING VAT PRO RATE. CASE STUDY AT A PAWNSHOP IN ROMANIA

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### Abstract

Determining VAT pro rate entails in terms of theory the calculation of the share of taxable transactions made by an entity in total transactions. Thus, the entities that use VAT mixed regimes will be able to deduct the VAT related to operations afferent to the transactions with deductibility right and without deduction right, just in the same proportion with calculated pro rata. Also, regulations and adjustments will be made using the final pro rate applied for the entire ending year in the last statement of every year. By the 25<sup>th</sup> of the first month of the financial year, any entity must declare the provisional pro rate for the coming year to the tax administration body, which is equal to that determined for the ended year. The method used for capturing the main practical tax and accounting problems inherent to determine the VAT pro rate is the case study made at a pawn shop in Romania over the year 2016. Thus, given the multiplicity of operations carried out by pawnshops (pawnshop with gold and silver goods, pawnshop with electronics, selling goods unclaimed at the expiration of the pawn contracts, melting gold and silver and sale in the form of ingots or bars etc.), in this article there will be discussed the main problems which may occur in practice on the VAT pro rata, using the example of an entity of this kind in Romania for 2016.

**Keywords:** pro rata, VAT, pawnshop, mixed regime, deduction, reverse charge, VAT return

**JEL Classification:** M41, H25

### 1. Introduction

Determining the correct VAT pro rate is an obligation with profound implications for all entities registered for VAT purposes.

Its level directly influences the value added tax permitted to be deducted by the VAT return (monthly or quarterly), and implicitly the fee owed to the state or to be recovered from this [5].

There is a direct and close relationship between the deduction degree of outputs (exempt income without deductibility right and income with deductibility right) and the deduction degree of VAT related to inputs.

Thus, if the entity does not perform exempt transactions with no right to deduct, the pro rate VAT is 100%, enabling full deduction of value added tax related to the the inputs.

Therefore, when the inputs (purchases, services, works) are exclusively intended to carry out operations with the right to deduct, the VAT afferent to inputs is integrally deducted. Conversely, when inputs are exclusively intended for operations without the right to deduct, the VAT afferent to inputs is not deducted (integrally).

If the entity performs both exempt transactions without the deduction right and transactions with the right to deduct, VAT deduction afferent to inputs will be made in proportion with the value of the pro rate amount [1], the entities being classified as entities which apply the mixed regime.

### 2. Determining VAT pro rate

Determining VAT pro rate entails, in terms of theory, the calculation of the share of taxable transactions related to all outputs made by an entity (1).

$$\begin{aligned} \text{VAT pro rate} &= \frac{\text{Total transactions (outputs)} - \text{VAT exempt transactions, without deduction right (outputs)}}{\text{Total transactions (outputs)}} * 100 \\ &= \frac{\text{Taxable transactions, with deduction right}}{\text{Total transactions (outputs)}} * 100 \end{aligned} \quad (1)$$

Thus, entities that use mixed VAT regimes will be able to deduct input VAT related to operations with deduction right and without deduction right, just in the same proportion with the calculated pro rata. Also, regulations

and adjustments will be made using the final pro rate applied for the entire ending year in the last statement of every year. By the 25<sup>th</sup> of the first month of the financial year, any entity must declare the provisional pro rate for the coming year to the tax administration body, which is equal to that determined for the ended year. [1].

### 3. Determining VAT pro rate in entities from the pawnshops category

Given the multitude of operations carried out by pawnshops, in this article we will discuss the main problems which may occur in practice, using the example of an entity of this kind in Romania for 2016 (case study).

To this effect, there will be analyzed the transactions made by the pawnshop under study (having the same specific, the operations of the pawnshops in Romania recorded at least one of the operations described below), namely:

- pawning activities for which fee is charged (exempt without deduction right under art. 292, par. 2, letter a, pt. 1 of the Tax Code),
- rental activities (exempt without deduction right; notwithstanding, the entity may require the application of the normal charging regime),
- activities for which it is applied the charging system to "margin" (second hand goods under art. 312, par. 1, letter d of the Tax Code, left as warranty for the granted loans; for example: telephones, laptops etc.),
- activities related to sales of silver and gold (it is about the goods retained as warranty and which have not been given back to the owners at the expiry of pawn contracts, being later sold as a commodity),
- activities related to sales of bars/ ingots of silver or gold obtained by melting the silver and gold objects (objects unclaimed by owners after the expiry of the pawn contracts).

According to the Tax Code (art. 300), pawnshop (with the operations referred to above) falls into the category of "taxable" persons "with a mixed regime" since it gets income which is not entitled to deduction (rents, for which the entity has not expressly opted for the application of the normal taxing regime and pawning fee) and income which gives right to deduction (sale of goods unclaimed by owners until the deadline).

For the transactions relating to the sale of gold or silver obtained by melting, the entity shall apply the reverse charge (art. 331 par. 4) [4].

The entity will also not deduct the VAT "related to purchases intended exclusively for transactions which do not give deduction right and investment which are destined to accomplish such operations" (art. 300, par. 4).

As we will show, the pawnshop has the ability to group the operations and to treat them separately in terms of VAT [3].

Specifically, a separate record using the analytical accounts is easy used (for example, for the income of sales of 707Gold 707Silver gold or silver objects or, income from the sales of 707Margin second hand goods, etc.).

At the entries level, operations will be separated into three types:

- "0" for the those for which it is exercised full deduction right (e.g., transactions related to marking gold and silver by NAPC)
- "1" for transactions with mixed charging regime (for these inputs, there will be applied the pro rata to determine the VAT allowed to be deducted because it cannot be precisely set out the deduction regime),
- „2" for the operations where VAT is not deducted.

Applying the provisions of the Tax Code (listed above), based on actual data from the accounting of the pawnshops, we will further determine the final pro rate for 2016, taking into account the following in determining the taxable income:

- all income for which taxation to the margin is applied (this income is fully taxable, not just the profit margin to which VAT is applied);
- all income from the sales of gold and silver (as such or as ingots by melting).

Exempt incomes without deduction right (which do not appear to counter of the pro rate) are those of rents (since it was not expressly chosen their normal charging regime) and of pawn fee.

The actual data for the year 2016 are included in Table 1.

**Table 1 Data on the VAT related to outputs, needed to determine the VAT pro rate for 2016**

Cur. no.	Type of transaction (income / output)	Category of deduction	Amount (lei)
1.	Income from fees related to pawning operations (account 704 "Income from the rendered services")	Exempt, without deduction right	267.531
2.	Income from rentals (account 706 „Income from royalties, management locations and rents")	Exempt, without deduction right	16.800
3.	Income from the sale of pawned and unclaimed goods until the end of the contract expiry period (account 707Margin "Income from the sale of goods" - analytically "Margin")	VAT on the profit margin, having full deduction right	13.989
4.	Income from the sale of gold objects, unclaimed until the end of the contract expiry period (account 707Gold "Income from sale	With integrally deduction right (normal VAT rate applies to the	60.506

	of goods” - analytically “Gold”)	entire amount)	
5.	Income from the sale of silver objects, unclaimed until the end of the contract expiry period (account 707Silver “Income from sale of goods” - analytically “Silver”)	With integrally deduction right (normal VAT rate applies to the entire amount)	11.539
6.	Income from the sale of gold and silver objects, unclaimed when the contract expired, melted into bars and ingots (account 707TI “Income from sale of goods” – analytically “Reverse charge”)	Simplification measures are applied, namely reverse charge is applied (they are considered transactions with full deduction right)	32.240
7.	Total exempt transactions without deduction right (non-taxable) (1 + 2)		<b>284.331</b>
8.	Total transactions (outputs) (1+2+3+4+5+6)		<b>402.605</b>
9.	Total taxable transactions (8-7)		<b>118.274</b>

Source: data taken from the check balance of the entity drawn on 31.12.2016

Therefore, VAT final pro rate for 2016, based on data in Table 1, using equation 1 is:

$$\text{VAT pro rate} = \frac{402.605 - 284.331}{402.605} * 100 = \frac{118.274}{402.605} * 100 = 29,38\% \approx 30\% \quad (2)$$

During 2016, a temporary VAT pro rate of 46% (equal to the pro rata determined for 2015) was used from the first to the penultimate VAT return.

In respect of VAT related the inputs for “0” and “2” type operations throughout 2016 (“0” for those for which is exercised the integral deduction right and “2” for the operations where VAT is not deducted), no adjustment will be made.

In the penultimate VAT return submitted for the last period of 2016 (it is about the statement from December 2016), the entity will also mandatorily carry out VAT regularization for type “1” operations (transactions with mixed taxing regime), the difference is stated in “Pro rate adjustments” in the VAT return (line 31).

For this, we determine the deductible VAT deducted the entire year, applying the previously determined final pro rate, namely 30%, to the amount of the value added tax recorded for inputs to which the mixed regime is applied (marked with “1”). Given that during 2016 there was recorded in the account 4426 “Deductible VAT, the whole value added tax retaed to inputs, on all three operations (“0”, “1” and “2”), we have two possibilities of determination:

1. from the monthly records of purchases (from January until December), deductible VAT related to mixed regime transactions (marked with “1”) is accumulated;
2. based on the amount recorded in the VAT returns as being non-deductible (the difference between 100% and the provisional pro rate of 46%) and reflected using the account 635 “Expenses with other taxes, fees and assimilated payments” / analytically “Non-deductible VAT under the final VAT pro rata”, it is determined the deductible VAT to which the final pro rate is applied.

In order to use the latest version, we will use the data in Table 2.

Table 2 Data on expenses with non-deductible VAT related to the provioinal pro rate

Cur. no.	Month / year	Non-deductible VAT according to the provisional pro rate (lei)	VAT provisional pro rate	Share of non-deductible VAT
1.	Jan.16	476	46%	54%
2.	Feb.16	416	46%	54%
3.	Mar.16	552	46%	54%
4.	Apr.16	429	46%	54%
5.	May.16	389	46%	54%
6.	Jun.16	407	46%	54%
7.	Jul.16	851	46%	54%
8.	Aug.16	275	46%	54%
9.	Sep.16	577	46%	54%
10.	Oct.16	429	46%	54%
11.	Nov.16	387	46%	54%
12.	Dec.16	333	46%	54%
13.	<b>Total</b>	<b>5.521</b>	*	*

Source: data from the General Ledger for the account 635 analytical “Nedeductible VAT pro rata”

The deductible VAT for transactions with VAT deduction mixed regime is calculated as follows:

$$\text{Deductible VAT year 2016 for mixed regime transctions} = \frac{5.521}{0,54} = 10.224 \text{ lei} \quad (3)$$

Applying the final VAT pro rate of 30% to the previously determined amount, it is determined the deductible VAT for the whole year, namely the amount of 3,067 lei compared to 4,703 lei (10,224 lei \* 46% provisional pro rata or 10,224 lei – 5,521 lei) . Therefore, in row 31 in the return of December 2016, VAT will be adjusted according to the final pro rate of 30%, in amount of 1,636 lei (4,703 lei – 3,067 lei), which will be recorded with the minus sign (because the deductible VAT was deducted on the pro-rata basis of 46%, instead of 30% as it is the final pro rate).

In accounting, the following accounting article will be recorded:

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<b>635</b> „ Expenses with other taxes, fees and assimilated payments” / analytically “Non-deductible VAT under the final VAT pro rata”	=	<b>4426</b> „Deductible VAT”	<b>1.738</b>
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#### 4. Conclusions

We believe that by this case study there are highlighted accurate ways to determine the VAT pro rate and its implications. VAT adjustment in the last VAT return is performed in addition or in minus, given the final pro rate.

The complex activity of pawnshops require increased attention on the correct assessment of pro rate. Within taxable transactions (to the numerator of the equation for determining the pro rate) there will be considered all incomes from the sale of second hand goods [3] for which it is applied the special taxation scheme to the profit margin.

Even if the VAT collected for these sales is determined only for the profit margin, the entire income should be considered as taxable (the pawnshop does not deduce VAT related to goods unclaimed by owners who have pledged their borrowings with these goods). This can also be explained by the fact that VAT itself has as operating mechanism the application of the fee to the value added (i.e., profit margin), by deducting the fee related to inputs from the fee afferent to outputs [2]. Therefore, the numerator of the equation will take into account the entire amount of 13,989 lei (row 2 of Table 1), and not only the margin (which would have been for that entity of only 730 lei, according to accounting record).

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