Constitutional judgment 3-4-1-6-02

JUDGMENT
OF THE CONSTITUTIONAL REVIEW CHAMBER
OF THE SUPREME COURT

No. of the case	3-4-1-6-02
Date of decision	12 June 2002
Composition of chamber	Chairman Uno Lõhmus, members Tõnu Anton, Lea Kivi, Ants Kull, Jüri Põld
Court case	Petition of the Tallinn Administrative Court to review the constitutionality of the second sentence of § 18(8) of the Value Added Tax Act (in the wording in force from 01.01.2000 to 01.01.2002).
Date of court session	29 May 2002
Persons participating at session	Representative of the Riigikogu Marek Sepp, representative of the Chancellor of Justice Aare Reenumägi and representative of the Minister of Justice Jaanus Ots.
Decision	**To declare unconstitutional the second sentence of § 18(8) of the Value Added Tax Act, in the wording in force until 1 January 2002, established by the Value Added Tax and Taxation Act Amendment Act, passed on 17 November 1999**

FACTS AND COURSE OF PROCEEDINGS

1. On 25 June 2001 the Harju Tax Board Office issued a precept to private limited company Gizmo, obligating the public limited company to pay value added tax, income tax and interests according to tax arrears. The AS Gizmo filed a complaint against the precept with the Tallinn Administrative Court. By its judgment of 12 April 2002 in administrative matter no. 3-145/2002 the Tallinn Administrative Court partially invalidated the precept and declared unconstitutional and did not apply the second sentence of §

18(8) of Value Added Tax Act (hereinafter “the VATA”) in the wording in force from 1 January 2000 until 1 January 2002.

2. § 18(8) of the VATA, which was not applied and was declared unconstitutional, reads as follows:

"Deduction of value added tax is permitted only on the basis of an original invoice. If the taxable value of goods or services purchased for money in Estonia exceeds 50 000 kroons per transaction, deduction is permitted in the case the payment for the goods or services is carried out in full through a credit institution either by a bank transfer or a cash payment made to the bank account of the seller. The value added tax paid upon importation of goods is permitted to be deducted regardless of whether the corresponding goods were paid for by a bank transfer of in cash."

REASONING OF THE COURT AND PARTICIPANTS

3. The court judgment gives the following reasons for declaring the second sentence of § 18(8) of the VATA unconstitutional and for not applying it:

1. The second sentence of § 18(8) of the VATA is in conflict with the general right to equality provided in § 12(1) of the Constitution, because under the referred provision of the Act the tax payers who paid in cash for large transactions and taxpayers who carried out non-cash payments are treated unequally, restricting the right of the former to deduct value added tax.

2. The second sentence of § 18(8) of the VATA is in conflict with the freedom to engage in enterprise provided in § 31 of the Constitution, because the right is restricted disproportionally. The requirement of proportionality springs from § 11 of the Constitution.

3. The right to engage in enterprise is restricted disproportionally, because the restriction imposed by the second sentence of § 18(8) of the VATA does not prevent value added tax fraud and does not facilitate the detection of such fraud. In its judgment of 6 March 2002 in case no. 3-4-1-1-02 the Supreme Court declared unconstitutional the same provision in the wording in force until 1 January 2000 because it was not proportional, whereas the effect of the provision in force at that time was less intensive.

The petition of the Tallinn Administrative Court of 12 April 2002 to review the constitutionality of the second sentence of § 18(8) of the VATA reiterates the reasoning of the referred Supreme Court judgment.

4. The Finance Committee of the Riigikogu has informed the Supreme Court that the opinion of the Riigikogu concerning the declaration of unconstitutionality of the second sentence of § 18(8) of the VATA is reflected in the new Value Added Tax Act, which was passed on 13 June 2001 and entered into force on 1 January 2002. There is no analogous restriction on the freedom to engage in enterprise in the new Act. The representative of the Riigikogu argued at the court session that the disputed provision did not violate the principle of equal treatment, but the freedom to engage in enterprise has been restricted disproportionally.

5. The Chancellor of Justice was of the opinion that the petition of the Tallinn Administrative Court to review the constitutionality of the second sentence of § 18(8) of the VATA was justified, because the referred provision was in conflict with §§ 12, 31 and 11 of the Constitution. This amounts to violation of the principle of equal treatment because there is no reasonable ground to treat tax payers differently, depending on the manner of payment. Conflict with §§ 31 and 11 of the Constitution lies in the fact that the freedom to engage in enterprise has been restricted disproportionally, namely the restriction imposed by the second sentence of § 18(8) of the VATA is not appropriate for the achievement of the aim of the provision.

6. The Minister of Justice argued that for the reasons given in an analogous constitutional review case no. 3-4-1-1-02 the disputed provision, too, in the wording in force until 1 January 2002, is in conflict with §§ 11, 12(1) and 31 of the Constitution.

THE OPINION OF THE CONSTITUTIONAL REVIEW CHAMBER

7. By way of constitutional review has been disputed the second sentence of § 18(8) of the Value Added Tax (hereinafter the VATA) in the wording in force until 1 January 2002, established by the Value Added Tax and Taxation Act Amendment Act, passed on 17 November 1999, which reads as follows: "If the taxable value of goods or services purchased for money in Estonia exceeds 50 000 kroons per transaction, deduction is permitted in the case the payment for the goods or services is carried out in full through a credit institution either by a bank transfer or a cash payment made to the bank account of the seller."

8. Under § 18(1)1) of the VATA a person taxable with value added tax has the right to deduct from the value added tax to be paid the value added tax payable on goods and services which are purchased from other registered taxable persons during the taxable period and which are used for the purposes of enterprise. If even one of the conditions specified in this provision is not fulfilled, the person taxable with value added tax has no right to make deductions. The second sentence of § 18(8) establishes an exception from the regulation established by § 18(1). Depending on the taxable value of a transaction and on the manner of payment the taxable person has no right, according to the exception, to make deductions. The second sentence of § 18(8) of the VATA establishes expressly that there is no right of deduction irrespective of how big is the amount paid in cash. Thus, a person taxable with value added tax lacks the right of deduction even if no matter how small amount of the total sum was paid in cash.

9. The beginning of the first sentence of § 31 of the Constitution "Estonian citizens have the right to engage in enterprise …" establishes the freedom of enterprise, which extends also to legal persons under § 9(2) of the Constitution. The freedom to engage in enterprise is infringed if the liberty is adversely affected by the public power. Deprivation of the right to deduct value added tax in case of payment in cash for larger transactions is interference with the freedom of enterprise, because the adverse effect is manifest.

10. The first sentence of § 12(1) of the Constitution "Everyone is equal before the law" establishes the general fundamental right to equality, the sphere of protection of which embraces all spheres of life, including enterprise. The fundamental right to equality, just like the freedom of enterprise, is extended also to legal persons under § 9(2) of the Constitution. This fundamental right is infringed in the case of unequal treatment. § 18(8) of the VATA treats unequally those tax payers who paid in cash for large transactions and those taxpayers who carried out non-cash payments. Unequal treatment consists in the fact the former may not deduct value added tax, the latter may. Thus, § 18(8) of the VATA also infringes the fundamental right to equality.

11. The second sentence of § 31 of the Constitution "Conditions and procedure for the exercise of this right [freedom to engage in enterprise] may be provided by law", provides for a possibility to interfere into the freedom to engage in enterprise. The Chamber considers interference with the freedom to engage in enterprise by § 18(8) of the VATA formally lawful, because the freedom to engage in enterprise is restricted by an Act, which was adopted by the Riigikogu, promulgated by the President of the Republic and was published in the Riigi Teataja [Official Gazette].

Interference into the freedom to engage in enterprise is substantively lawful it if is in conformity with the requirements established in § 11 of the Constitution. The Chamber is of the opinion that in this constitutional review case it is not necessary to check whether the infringement of the freedom to engage in enterprise is in conformity with § 11 of the Constitution in its entirety, it is only necessary to check the proportionality of the infringement - suitability, necessity and proportionality in the narrower sense.

12. The principle of proportionality springs from the second sentence of § 11 of the Constitution, pursuant to which restrictions of rights and freedoms must be necessary in a democratic society. The Chamber reviews compatibility with the principle of proportionality on three levels - firstly, the suitability of a measure, then the necessity and, if necessary, proportionality of the measure in the narrower sense. If a measure proves manifestly unsuitable, it is needless to review proportionality on other levels.

A measure that fosters the achievement of a goal is suitable. For the purposes of suitability a measure, which

is no way fosters the achievement of a goal, is indisputably disproportional. The requirement of suitability is meant to protect a person against unnecessary interference of public power.

13. The aim of the disputed provision is to prevent value added tax fraud (see also the judgment of the Constitutional Review Chamber of the Supreme Court of 6 March 2002 in case no. 3-4-1-1-02, paragraphs 6 to 8 -- RT III 2002, 8, 74). In order to assess whether § 18(8) of the VATA is a measure suitable for the purpose, it is necessary to identify the possible types of value added tax fraud and the effect of the provision on value added tax fraud.

We can speak of value added tax fraud when the seller issues an invoice to the purchaser but the seller fails to pay the value added tax shown in the invoice to the state. In such a situation the state acquires the right of claim against the seller. The purchaser has no obligation and as a rule has no possibility to check whether the seller pays value added tax to the state. If the purchaser acted in good faith, there is no ground to restrict the purchaser's right to deduct value added tax. The seller can realise his intent not to pay value added tax to the state irrespective of whether payment is carried out by bank transfer, in cash or no payment is made at all. Consequently, § 18(8) of the VATA does not prevent commission of such a fraud.

If the purchaser deducts value added tax from a transaction which did not take place, the deduction of value added tax is excluded pursuant to § 18(1)1) or § 18(6) of the VATA, because no goods or services have been purchased or there is no valid invoice. This fraud, too, does not depend on the manner and time of payment of the invoice.

§ 18(8) of the VATA is in conflict with the principle of accrual method of value added tax calculation. As the right to deduct value added tax does not depend on the fact of paying the invoice, then in the case of non-payment of the invoice it is allowed to deduct value added tax, but if the invoice is paid in cash, then it is not allowed.

14. Interference with the freedom to engage in enterprise by § 18(8) of the VATA is not substantively lawful because deprivation of the right to deduct value added tax in the case of payment in cash for large transactions is not a proportional measure for the prevention of tax fraud. Consequently, the disputed provision violates the freedom to engage in enterprise established by § 31 of the Constitution, because interference with the freedom is disproportional.

15. The Chamber does not deem it necessary to examine the alleged violation of the principle of fundamental right to equality, because the violation of freedom to engage in enterprise as a right to liberty is decisive in this matter.

16. The disputed provision is to be declared unconstitutional, because the legislator has already declared the VATA invalid by the new Value Added Tax Act, which entered into force on 1 January 2002.

Uno Lõhmus
Chief Justice of the Supreme Court
