Constitutional judgment 3-4-1-1-02

**JUDGMENT
OF THE CONSTITUTIONAL REVIEW CHAMBER
OF THE SUPREME COURT**

No. of the case	3-4-1-1-02
Date of judgment	6 March 2002
Composition of chamber	Chairman Uno Lõhmus, members Tõnu Anton, Lea Kivi, Ants Kull, Jüri Põld
Court case	Petition of the Tallinn Circuit Court to declare the second sentence of § 18(8) of Value Added Tax Act invalid
Date of court session	30 January 2002
Persons participating at session	Representative of the Riigikogu, head of the legal department of the Chancellery of the Riigikogu Marek Sepp, Chancellor of Justice Allar Jõks and representative of the Minister of Justice, acting head of Tartu department of the Ministry Jaanus Ots
Resolution	**To declare the second sentence of § 18(8) of the Value Added Tax Act, in the wording of the Value Added Tax Act Amendment Act passed on 12 June 1996, unconstitutional**

FACTS AND COURSE OF PROCEEDINGS

1. On 4 December 2000 the the Lääne Tax Board Office issued a precept to private limited company SIVI assessing the payable amount of tax. According to the precept the private limited company had to pay additionally 97,292 kroons of value added tax and 54,542 kroons of interest for 1998. The assessment of the amount of tax was based on the fact that SIVI OÜ had paid for goods in cash irrespective of the fact that the taxable value per transaction exceeded 50,000 kroons. Under § 18(8) of the Value Added Tax Act in the wording which was in force until 1 January 2000 (hereinafter “§ 18(8) of the VATA) deduction of value

added tax was not permitted if the taxable value of goods exceeded 50,000 kroons per transaction and payment for the goods was carried out in cash. By resolution of the the Lääne Tax Board Office of 4 December 2000 the precept was amended as to the payable amount of tax and interest. Under the amended precept the company had to pay 89,333 kroons of value added tax and 50,666 kroons of interest.

2. On 27 December 2000 the SIVI OÜ filed a complaint with an administrative court requesting the repeal of the precept of the Lääne Tax Board Office. The complainant contended that the second sentence of § 18(8) of the VATA was in conflict with §§ 11 and 12 of the Constitution and thus should not be applied. There is no reasonable justification for prohibiting deduction of value added tax in the case of cash payments for larger transactions. This restriction hinders the ordinary course of commercial activities, gives rise to double taxation and is in conflict with the principle of uniform taxation, is disproportional and not necessary in a democratic society. Under § 18(7) of the VATA value added tax shall be deducted during the taxable period in which the goods and the invoice from the seller of the goods are received. Thus, in accordance with the Value Added Tax Act it is not important whether and when the goods were paid for. Consequently, also the manner of payment is not decisive for the purposes of determining the right to deduct value added tax.

3. The Tallinn Administrative Court decided on 27 March 2001 not to satisfy the complaint of the SIVI ÜO. The court found that the purpose of the second sentence of § 18(8) of the VATA was to prevent tax fraud upon payments in cash. As large sums are not paid into state budget as a result of tax fraud, the court considered the restriction provided by § 18(8) of the VATA reasonable and proportional.

4. The SIVI OÜ submitted an appeal against the judgment of the Tallinn Administrative Court, requesting *inter alia* that the circuit court declare § 18(8) of the VATA to be in conflict with §§ 11 and 12 of the Constitution and not apply the provision. The appellant justified the appeal with the same arguments as submitted to the Tallinn Administrative Court. By its judgment of 26 November 2001 the administrative chamber of the Tallinn Circuit Court annulled the judgment the Tallinn Administrative Court, satisfied the complaint of the SIVI OÜ and initiated a constitutional review proceeding. On the basis of the referred judgment the Tallinn Circuit Court submitted a petition to the Supreme Court requesting that the second sentence of § 18(8) of the VATA be declared invalid because of conflict with §§ 11, 12(1) and 31 of the Constitution.

REASONING OF THE COURT AND PARTICIPANTS

Reasoning of the petitioner

5. According to the petition of the Tallinn Circuit Court the second sentence of § 18(8) of the VATA was not applied on the following motives:

1. The second sentence of § 18(8) of the VATA is an applicable law in this matter, because in the case of invalidity of the provision the right of tax payer to deduct value added tax should be recognised, in the case of validity of the provision the deductions are not permissible.
2. § 31 of the Constitution establishes: "Estonian citizens have the right to engage in enterprise and to form commercial undertakings and unions. Conditions and procedure for the exercise of this right may be provided by law." The second sentence of § 18(8) of the VATA establishes a restriction on the freedom to engage in enterprise as the state imposes negative consequences on undertakings if they pay in cash for larger transactions.
3. The second sentence of § 31 of the Constitution establishes a simple reservation that restrictions shall be provided by law. In the given case the freedom to engage in enterprise has been restricted by the Value Added Tax Act. In order to check the substantive constitutionality of the restriction the court evaluated whether the restriction was necessary in a democratic society and whether the principle of proportionality had been observed upon imposition of the restriction, i.e. conformity to § 11 of the Constitution. The purpose of the disputed provision is to prevent tax fraud and to guarantee as effective detection thereof as possible. But it is questionable whether the disputed provision prevents commission of and helps to detect tax fraud. The transactions in cash have to be documented both by the purchaser and the seller pursuant to

requirements of tax assessment and accounting. Thus, the fact of payment can be checked also if transactions are carried out in cash. Furthermore, the fact of payment itself is not important from the point of view of deduction of value added tax, because deductions can be made before the payment. Although the imposed restriction is not very intensive, because for an undertaking the payment through bank account is not significantly more complicated, expensive or time-consuming than payment in cash, such a restriction is not necessary for achieving the desired aim. The Tax Board can control the actual existence of a transaction and the validity of deduction of value added tax on the basis of the accounting and tax assessment information of the tax payer and in this way detect tax fraud. Also, it is possible to control the other party of the transaction, who is under the obligation to pay value added tax into the state budget. Proceeding from the aforesaid the restriction established by the second sentence of § 18(8) of the VATA is not proportional and is not in conformity with the principle established in § 11 of the Constitution.
4. § 12(1) of the Constitution establishes equality before the law. Persons must not be treated unequally without an appropriate reason even on the basis of law. In the given case a tax payer who has made a payment in cash in a transaction exceeding 50,000 kroons and a tax payer who has paid by a bank transfer, are differentiated and treated unequally under the law. Unequal treatment is unconstitutional if there is no appropriate reason for such a treatment. For the implementation of the second sentence of § 18(8) of the VATA it is necessary to preliminarily check the purchase and receipt of goods, the relation thereof with the enterprise, and the original invoice. When all these conditions are fulfilled, there is no reasonable justification to prohibit deduction of value added tax irrespective of the manner of payment. Furthermore, the person shown in the invoice is under the obligation to transfer the indicated value added tax into the state budget even when payment is carried out in cash. Thus, one and the same object of taxation is taxed twice. The right to deduct input tax from output tax has been established precisely to avoid double taxation. As there is no reasonable cause to prohibit deduction of value added tax in the cases of payment in cash, the second sentence of § 18(8) of the VATA is in conflict with the principle of equal treatment and thus with § 12(1) of the Constitution.

Reasoning of parties

6. The Riigikogu is of the opinion that the purpose of the disputed provision of the Value Added Tax Act is to help to prevent and detect tax fraud. As the wording of § 18(8) of the VATA in force before 1 January 2000 was disproportional, the Riigikogu amended the provision.

7. The Chancellor of Justice argues that the petition of the Tallinn Circuit Court is justified, because the disputed provision is in conflict with §§ 11, 12(1) and 31 of the Constitution.

The Chancellor of Justice was of the opinion that the purpose of the disputed provision was to make the fight against tax fraud more effective. As § 18(8) of the VATA is applicable only if the conditions established in § 18(1) are fulfilled (goods and services have to be purchased and have to be used for the purposes of enterprise by the taxable person) the restriction imposed by the disputed provision is not reasonable and is not necessary in a democratic society. Thus, the referred restriction is disproportional and in conflict with § 11 of the Constitution. As there is no reasonable cause for unequal treatment of persons taxable with value added tax depending on the manner of payment, the disputed provision is also in conflict with § 12(1) of the Constitution.

The Chancellor of Justice agrees with the opinion of the Tallinn Circuit Court that the regulatory framework established by the second sentence of § 18(8) of the VATA can not be regarded as direct interference into freedom to engage in enterprise, because it is not prohibited for an undertaking to pay in cash. But the side-effect of the provision can be considered a restriction of the freedom to engage in enterprise, because payment in cash will bring about negative consequences - forfeiture of the right to deduct value added tax, double taxation and decrease of competitiveness.

8. In the opinion of the Ministry of Justice the second sentence of § 18(8) of the VATA is in conflict with §§ 11, 12(1) and 31 of the Constitution.

The Ministry of Justice was of the opinion that the restriction imposed by the disputed provision is not a suitable measure for prevention of tax fraud and does not guarantee the achievement of this aim. Also, there is no adequate reason to treat persons taxable with value added tax differently, depending on the manner of payment. The observance of the principle of value added tax and validity of making exceptions is to be emphasised also in connection with harmonisation of value added tax in the European Union.

The Ministry of Justice agrees with the opinion of the Tallinn Circuit Court that restriction of the freedom of choice of legal persons as to manner of payment, if certain choices result in negative consequences, is a restriction on enterprise. Such restrictions should be imposed on the basis of § 31 of the Constitution and observing the principles proceeding from the Constitution.

THE OPINION OF THE CONSTITUTIONAL REVIEW CHAMBER OF THE SUPREME COURT

The disputed law not applied

9. The second sentence of § 18(8) of the VATA in the wording of the Value Added Tax Act Amendment Act passed on 12 June 1996 (RT I 1996, 44, 845) was not applied; subsections (1), (7) and (10) of the same section are also essential to understanding the contentions submitted upon disputing the referred provision.

The wording of the referred provisions is the following:

"§ 18. Calculation of amount of tax due
(1) The value added tax to be paid by a registered taxable person is the value added tax calculated on taxable supply during a taxable period according to the tax rates specified in § 13 of this Act, from which the following has been deducted:
1) value added tax paid for goods and services which are purchased from other registered taxable persons during the taxable period and which are used for the purposes of enterprise;
2) value added tax paid during the taxable period on goods imported for the purposes of enterprise.
.....
(7) Value added tax shall be deducted during the taxable period in which the goods or services and the invoice from the seller of the goods or services are received, or in which the goods or services are received and value added tax upon import is paid; advance payments made to the customs authorities are deemed not to be payment of value added tax. If the goods are received and value added tax upon import is paid during different taxable periods, the value added tax shall be deducted during the period in which both conditions are fulfilled. If, upon the purchase of goods or services in Estonia, goods or services and the invoice for such goods or services are received during different taxable periods, the value added tax shall be deducted during the taxable period in which the goods or services are received, on the condition that the invoice for the goods or services is submitted during the term provided for in § 24(7) of this Act. If, in the last case mentioned, the submission of the invoice is delayed, the value added tax shall be deducted during the taxable period in which the invoice submitted for the goods or services is received.
(8) Deduction of value added tax is not permitted on the basis of a copy of invoice or an invoice received by fax. Also, deduction is not permitted if the taxable value of goods or services per transaction exceeds 50,000 kroons and the payment for them is carried out in cash.
.....
(10) If a seller receives money from a purchaser but the goods or services are not transferred, the seller is permitted to cancel the calculation of value added tax on such goods or services if the seller refunds the amount received to the purchaser. If a seller submits an invoice to a purchaser but the goods or services are not transferred, the seller is permitted to make a recalculation of the value added tax with regard to the invoice if three months have passed from the issue of the invoice or if the purchaser has given written notice of renunciation of the order to purchase the goods or services."

10. On the basis of § 18(1)1) of the Value Added Tax Act the 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 form the regulation established by subsection(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.

Upon interpreting the second sentence of § 18(8) of the VATA establishing the exception, it is necessary to choose between two possibilities. Firstly, it is possible to take a view that there is no right of deduction irrespective of how large the sum paid in cash was. In the case of such an interpretation there would be no right of deduction even if no matter how small part of the total amount was paid in cash. Such an interpretation is manifestly unreasonable. Another possibility is to link the right to make deductions to the amount paid in cash. Such a view has previously been expressed by the Administrative Law Chamber of the Supreme Court in its judgment of 2 May 2001 in administrative matter no. 3-3-1-18-01 (RT III 2001, 15, 155). The Administrative Law Chamber of the Supreme Court found that "deduction is not permitted, if more than 50,000 kroons were paid in cash per transaction". The Constitutional Review Chamber of the Supreme Court interprets the disputed provision the same way as the Administrative Law Chamber did.

11. On 1 January 2000 the new wording of § 18(8) of the VATA entered into force (RT I 1999, 92, 823), which 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."

The new wording establishes expressly that there is no right of deduction irrespective of how big is the amount paid in cash. Thus, according to the new wording 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. New wording regulates more precisely when a payment is to be considered to have been carried out in cash.

Fundamental rights interfered

12. 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, under the sphere of protection of which are also the activities aimed at gaining profit. On the basis of § 9(2) of the Constitution the freedom of enterprise is also extended to legal persons. Thus, the freedom of enterprise also protects companies.

The sphere of protection of freedom of enterprise as a right to liberty 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 transaction is interference with the freedom of enterprise, because the adverse effect is manifest.

13. 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 Value Added Tax Act treats unequally those tax payers who paid in cash for large transactions and those tax payers who carried out non-cash payment. Unequal treatment consists in the fact that the former may not deduct value added tax, the latter may. Thus, § 18(8) of the Value Added Tax Act also infringes upon the sphere of protection of the fundamental right to equality.

Violation of the right to engage in enterprise

14. 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" prescribes for a simple reservation by law. The Chamber considers interference with the freedom to engage in enterprise by § 18(8) of the Value Added Tax Act formally lawful, because the freedom to engage in enterprise is restricted by an Act, which was passed by the Riigikogu, promulgated by the President of the Republic and has been published.

As a rule, interference into the freedom to engage in enterprise is substantively lawful if it is in conformity with the requirements established in § 11 of the Constitution and is proportional in the narrower sense. The Chamber is of the opinion that in this constitutional review case it is not possible 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 possible to check the proportionality - suitability, necessity and proportionality of the infringement in the narrower sense.

15. The principle of proportionality springs from the second sentence of § 11 of the Constitution, pursuant to which restrictions on 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 in the narrower sense. If a measure is manifestly unsuitable, it is needless to review proportionality on the other levels.

A measure that fosters the achievement of a goal is suitable. For the purposes of suitability a measure, which in 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. A measure is necessary if it is not possible to achieve a goal by some other measure which is less burdensome on a person but which is at least as effective as the former. It is also important to consider how much different measures burden third persons as well as differences of expenditure for the state. In order to determine the reasonableness of a measure the extent and intensity of interference with a fundamental right on the one hand and the importance of the aim on the other hand have to be weighed.

16. In order to assess whether § 18(8) of the Value Added Tax Act is a suitable measure to prevent value added tax fraud, it is necessary to identify what types of value added tax fraud can be committed and what is the effect of the provision on value added tax fraud.

Value added tax fraud can be regarded as a situation where 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 the input 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 input value added tax is excluded pursuant to § 18(1)1) or § 18(6), because no goods or services have been purchased or there is no invoice to that effect. This fraud, too, does not depend on the manner and time of payment of invoice.

The allegation that payment in cash does not render it possible to check whether the supply took place, is not correct, either. The supply has nothing to do with the payment of the invoice, because supply means actual transfer of, not payment for goods or services. Failure to pay the invoice can serve as but one piece of proof that a transaction was fictitious. In that case the Tax Board can, by evaluating the aggregate of evidence, detect the non-existence of a transaction and thus the lack of the right to deduct input value added tax.

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

then it is not allowed. Such a regulation is unreasonable and manifestly unsuitable.

17. Interference with the freedom to engage in enterprise by § 18(8) of the Value Added Tax Act 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 and detection of tax fraud. The latter is what the legislator bore in mind.

Conclusions

18. The second sentence of § 18(8) of the Value Added Tax Act in the wording of the Value Added Tax Act Amendment Act passed on 12 June 1996 violates the freedom to engage in enterprise established by § 31 of the Constitution, because interference with the freedom is disproportional. 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.

The disputed provision is to be declared unconstitutional, because the legislator has already amended this provision by the Value Added Tax Act and Taxation Act Amendment Act (RT I 1999, 92, 823). The wording of § 18(8) of Value Added Tax Act established by that Act was in force from 1 January 2000 until 1 January 2002.

The judgment is effective as of pronouncement, is final and is not subject to further appeal.

Uno Lõhmus
Chief Justice of the Supreme Court
