

The treatment of Government entities, non-profit organizations and other exempt bodies under a VAT: a discussion paper.

To be invited to discuss VAT issues and how to take into account the progress made by a number of countries newly introducing VAT is an honour and a very nice opportunity. Ten years ago Peter Jenkins, Satya Poddar and I made the suggestion to consider a new approach to public sector bodies¹, I do believe it still is the right direction and would like in these few lines to confirm this view.

Having said that, it always looks easier to discuss a paper when you do not share at all the fundamental view of the author. I will not have this chance as I think I do share most of the views expressed on the question of principle by Pierre-Pascal Gendron: let's apply VAT in full to the PNC Sector!

I will then be forced to go into some detail in order to explain some differences that I can nevertheless see between our positions or give some different illustrations of rather converging views in some cases.

The EU VAT System

Let me start with something dear to my heart: the EU VAT System. Here, although I share the judgement on the excessive complexity which results today from the current non-taxation/exemption, I may not share entirely the description which is made. Sometimes that may have consequences on the exact treatment and the level of complexity but also on the possible remedies.

Public bodies: taxable or not?

The description of the different treatments under the 6th VAT Directive (or its recast adopted two years ago² –which do not differ on this point) as it appears from this paper may be misleading. When the Directive defines the scope of the VAT, it is said to apply to Supplies of goods and services made by taxable persons acting as such. These include as a matter of principle all possible economic agents, be they public bodies, non-profit organizations, charities and so on.

This is why, as Pierre-Pascal says we, in the EU, have this tendency to talk about “taxable persons” that realize “taxable transactions” whether or not these “taxable transactions” will effectively be subject to VAT. If they are they will be taxed (then becoming “taxed transactions”) if not they will be “exempt transactions”. In doing so we mean that, unless exception (to be defined), public bodies (i.e. bodies governed by public law) are within the scope of VAT for all of their economic activities whatever they are: the principle is taxation. It is only when these public bodies engage in activities or transactions as “public authorities”

¹ See: Michel Aujean, Peter Jenkins and Satya Poddar; *A New Approach to Public Sector Bodies*; International VAT Monitor Vol. 10 No. 4, July/August 1999.

² Recast

that they are placed by the Directive “outside the scope of VAT”. Then there are two key elements to consider and, according to case-law, these two elements are cumulative:

- the identity of the supplier: is it a body governed by public law?
- his role: is he engaging in his role as a “public authority”?

Both have been the subject of an extensive case-law but it would be hard to say that the legal uncertainty is now removed. In particular the Court has insisted on a strict interpretation of what is (and more often **what is not**) a “body governed by public law”. The result being that when public duties are delegated to an independent third party, its activities do not belong to the scope of activities by a public body, which excludes in principle all kind of outsourcing (but in itself this differentiation will give rise to further distortions!).

Even more controversial is the notion of “activities or transactions in which they engage as public authorities” on which the ECJ has had to rule on many occasions. Although from a general viewpoint the interpretation of this notion is largely left to national tribunals (something which might not result in a harmonised solution), the Court gave some guidance. As indicated by Rita de la Feria in her very convincing paper³: *Public bodies are deemed to be engaging in activities as public authorities when they do so under a **special legal regime**, applicable to them, or where they make use of “**public powers**”*. Once again this corresponds in principle to a rather restrictive interpretation of the exception.

But in addition, there are large exceptions to that exception:

- where the public bodies engage in activities listed in an annex to the Directive (annex I reproduced at the end of this text, a long list), they will always fall within the VAT scope (even if they pretend to do it as “public authorities”), provided that those activities are not carried out on such a small scale as to be negligible;
- where their treatment as non-taxable persons would lead to “significant distortions of competition” (open clause).

This open clause has been subject of many cases before the ECJ, notably on the notion of “significant distortions of competition”. Once again the interpretation is largely left to Member states to determine whether there is a risk of distortion of competition, provided the objective of the Directive is respected⁴.

In fact in the past there has been a tendency, at least in some Member states, for public bodies to consider that being non taxable, not having to charge VAT, was an advantage. In addition, as the judgement as to whether a given public body is engaging in an activity as public authorities is largely left to Member states, some of them have been rather flexible when conferring this status. In some case they were simply trying to prevent deduction of input VAT (see the case of tolls on motorways in France which took about 15 years to conclude that it was an economic activity into which the bodies engaged were not public bodies engaged as public authorities!).

Public bodies taxed or not?

³ See the detailed review of this treatment in Rita de la Feria: “*The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction*”, Oxford University Center for Business Taxation 2008; WP08/08.

⁴ Note an interesting request for preliminary ruling in *Salix* (March 2008) where the ECJ is asked by a German court whether the distortion may also be a distortion against the public body concerned and whether it is optional or compulsory for Member states to treat exempt activities of public bodies as activities in which they engage as public authorities.

Even when they are considered as taxable persons, public bodies may not be “taxed” if they fall under one of the exemption provided for in the Directive. In addition, some non public bodies can also benefit of an exemption. The exemption concerns “*Exemptions for certain activities in the public interest*” and covers a rather wide area of activities of the whole PNC sector. The reason for that is clear: in the mid-seventies it was considered a social priority not to subject to VAT certain activities rendered in the interest of the public so as to lower their cost.

When dealing with these exemptions, the Directive explicitly mentions occasions the “public body” nature of the supplier and also very often the “recognition” by the Member state of other (equivalent) types of organisations. The list of exempt activities/transactions includes notably:

- public postal services (whatever public means!);
- hospital and medical care as well as some paramedical services undertaken by bodies governed by public law or, under social conditions comparable with those applicable to bodies governed by public law,
- welfare and social security work, protection of children and young people...undertaken by bodies governed by public law or by other bodies recognised by the Member State concerned as being devoted to social wellbeing;
- provision of education and university education by bodies governed by public law having such as their aim or by other organisations recognised by the Member State concerned as having similar objects;
- the supply of certain cultural services... by bodies governed by public law or by other cultural bodies recognised by the Member State concerned;
- the activities, other than those of a commercial nature, carried out by public radio and television bodies.

Most of these exempted activities include those effected by public bodies but also all the activities realized by other bodies “recognised by the Member state concerned”. That says how much “discretion” Member states have been given when defining which persons can benefit from an exemption. That was the price to pay to harmonise the VAT base in the old days of the mid seventies.

In general the interpretation by the ECJ has been restrictive: it has refused the benefit of the exemption to other bodies like intermediaries or subcontractors for example, but more and more the Court also takes into account the “principle of neutrality” for justifying its acceptance of some extensions of the exemption. This is what Rita de la Feria is calling: *Slowly moving in the wrong direction!*

For some other exempted services where the provider is not a public body, the difficulties are the same and for all of them, exemption is a non-sense today. This concern:

- the supply of services in relation with religious, political, philosophical, patriotic, trade-union activities etc...;
- and charitable activities.

Let’s talk about postal services as an example. Today they are in direct competition for most of the value added services with non public/private services (sometimes delivered by public bodies!) like express carriers which are of course subject to VAT. The non-deductibility of input VAT is a clear obstacle to investment and competitiveness and most providers in the EU

are calling for the application of VAT to their services. Unfortunately, in spite of a proposal presented by the Commission in 2003, it has been impossible up to now for mostly political reasons to remove this exemption⁵.

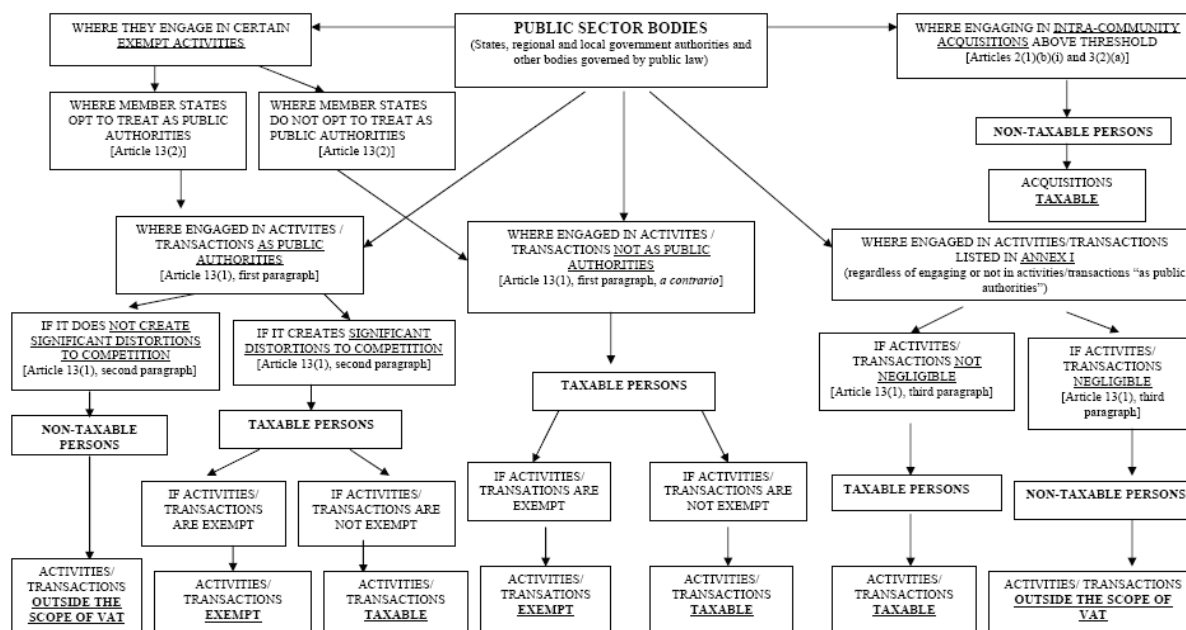
Let's take another interesting example: the exemption of non-commercial radio and television. An attempt was made some ten years ago to remove the exemption which seemed to be completely out of date given that it was difficult to find true examples of non-commercial activities in this area. We had an interesting and informative discussion with BBC. BBC is such an exempted radio and television. They were completely opposed to the removal of the exemption for the following reasons:

- As an exempted supplier of services they cannot deduct input VAT. But they could be considered as "public authorities" as the Directive provides that Member States may regard ...exempt activities engaged in by bodies governed by public law as activities in which those bodies engage as public authorities.
- UK provides for a mechanism of refund of VAT to public authorities so that BBC could obtain a refund of all input VAT;
- When asked how they treated their sales of radio emissions like CDs or DVDs they explained that these supplies to the public are made by BBC Productions which is a different company (not a public body);
- When asked how they could sell to BBC Productions with no VAT they said that in that case, as a taxable person (!) they formed a VAT Group with BBC Productions.

In conclusion BBC is at the same time and for the same transaction: exempted, non taxable and taxable: the best possible world!

All of this illustrates the rather political choices that have been made when it comes to applying VAT to the public and quasi public sector in the VAT Directive framework. But the important thing to keep in mind is that the Directive in itself is not necessarily offering a wider exemption or out of scope position than many other VAT systems. The point is that, unfortunately, it has been extensively pushed in that direction by Member states for years but another scenario could have prevailed. In any case the graph below (extracted from Rita de la Feria's paper) describing the current VAT treatment of public bodies is extremely clear: the system is complex, inefficient, costly and legally uncertain.

⁵ The EU Commission has now entered several infringement procedures against Member states which are either exempting services beyond the the « public postal services » definition or taxing services of a « public postal services » nature.



Input VAT: refunded or not?

Faced with this situation, a number of Member states have introduced refund mechanisms in order to alleviate part of the difficulties resulting from the situation of public bodies (outside the VAT scope or exempted):

«In five Member States (the United Kingdom, Denmark, Finland, Sweden and the Netherlands) systems exist for local authorities for a refund of VAT outside the VAT system. The general aim of these refund systems is either to prevent VAT falling on the activities of local governments funded by the taxpayer or to prevent discouragement of contracting out of services to the private sector. The conditions for these refund schemes vary considerably. In the United Kingdom, for example, the refunds are issued in respect of non-business activities only, while in other Member States (e.g. Finland) the refund applies to the total VAT paid on the inputs of municipalities.»⁶⁷

In fact these solutions have not always resulted in an improvement of the situation and have also introduced new distortions. Notably as most of these systems do not allow for the refund of non national VAT supply of goods by providers from other Member states below the acquisitions threshold and supply of services taxable in the Member state of the supplier are discriminated (and this could also be considered as state aid to domestic suppliers). In addition, distortions arise between Member states in relation with private suppliers specializing in offering outsourced governmental services. Finally whether or not the exempted public services benefit from the refund is also introduce distortions.

⁶ See : Aujean, Jenkins and Poddar , n 1.

⁷ A system is also in place in France but it is limited to investments in capital goods by public bodies (Fonds de compensation de la TVA). The refunds are equal to VAT at the standard rate (19.6) minus the part of VAT paid as an own resource to the EU budget. In principle it applies along the same rule wherever the supply of capital goods have been taxed and at whatever rate it was.

From a purely legal point of view, it is more and more difficult to consider these as being pure budget expenditures falling outside the VAT system⁸, at least in the case of Finland where they form part of the national VAT legislation.

Finally would an “EU Refund Scheme” be a solution? Frankly I do not think so. It would keep up with most of the administrative difficulties if not add another layer to them and would become even more complex if it has to remove all risks of distortions.

Alternative solutions suggested by more recent VAT systems

When the suggestion of a new approach to the VAT treatment of public bodies was made ten years ago, the New Zealand system was already there for ten years but it was still considered, at least by many, as a rather experimental solution. Now some other systems have been implemented and the NZ system is seen as the most advanced and probably the most neutral (and consequently efficient!) solution. In addition it has shown to be a very stable one.

In the New Zealand system (as well as for the Australian one), all activities of public sector bodies and non-profit organizations are within the scope of VAT (GST). Of course it may call for a difficult appreciation of a number of situation notably for the calculation of the taxable base in the case of subsidies, grants etc... This is the case with any attempt to go for the full taxation option.

There is little doubt that this is the first best option. The main question is how do we get there? Could the Canadian approach be seen as an intermediate step?

The Canadian system also is presented in Pierre-Pascal paper as a system where “*all supplies by organizations in the PNC sector are within the scope of the Canadian GST...*”. Nevertheless, it looks more as a system where supplies are predominantly “...exempted, although some may be taxable, or zero-rated...”⁹ However, this is where the Canadian system may look similar to some of the national schemes of some european countries in granting a refund of the input tax suffered by the exempted bodies¹⁰.

Although there seems to be an increasing level of outsourcing in countries where a refund is in place, this does not seem sufficient in my view to qualify the Canadian system (or a generalisation at the EU level of the existing national refund schemes) as a useful intermediate step: the main problem remains through distortions, compliance costs and departure from general VAT principle that would inevitably result from such a solution.

Then my conclusion is clear and completely converging with what Pierre-Pascal says:...

⁸ This was the position taken traditionnally by the Commission to explain its « benign neglect ».

⁹ See Rita de la Feria, op cit, p 26.

¹⁰ See also Pierre-Pascal Gendron, « *Value Added Tax Treatment of Public Sector Bodies and Non-Profit Organizations : A Developing Country Perspective* » Bulletin of International Taxation, Dec 2005.

ANNEX I

LIST OF THE ACTIVITIES REFERRED TO IN THE THIRD SUBPARAGRAPH OF ARTICLE 13(1)

- (1) Telecommunications services;
- (2) supply of water, gas, electricity and thermal energy;
- (3) transport of goods;
- (4) port and airport services;
- (5) passenger transport;
- (6) supply of new goods manufactured for sale;
- (7) transactions in respect of agricultural products, carried out by agricultural intervention agencies pursuant to Regulations on the common organisation of the market in those products;
- (8) organisation of trade fairs and exhibitions;
- (9) warehousing;
- (10) activities of commercial publicity bodies;
- (11) activities of travel agents;
- (12) running of staff shops, cooperatives and industrial canteens and similar institutions;
- (13) activities carried out by radio and television bodies in so far as these are not exempt pursuant to Article 132(1)(q).