Federation of European Accountants
Fédération des Experts comptables Européens

European Commission
Directorate-General for Taxation and Customs Union
VAT - Unit TAXUD/C1
Rue Joseph II 79, Office J79 05/065
B-1049 Brussels
Belgium

7 February 2014

Ref: ITA/AKI/RKO/PWE/JPL

Dear Sir or Madam,

Re: FEE comments on the European Commission's Consultation on VAT legislation on public bodies and tax exemptions in the public interest

FEE (the Federation of European Accountants) is pleased to provide you below with its comments on the European Commission's Consultation on VAT legislation on public bodies and tax exemptions in the public interest. FEE's ID number on the European Commission's Register of Interest Representatives is 4713568401-18[1]. FEE has considered the European Commission's consultation on VAT legislation on public bodies and tax exemptions in the public interest.

The input gathered from FEE members has shown that there is a considerable gap between the desirable and the feasible. FEE would favour a full taxation of public entities (including the use of deemed considerations as tax base), and an almost total deletion of exemptions applied to domestic transactions, which would provide for a truly simple VAT system. However such a step is nonetheless not seen as possible in the short term.

Such a "radical" approach would require Member States to reorganise their entire taxation and subsidies' structure as well as their social security systems.

[1] FEE is the Fédération des Experts comptables européens (Federation of European Accountants), which is an international non-profit organisation based in Brussels that represents 45 institutes of professional accountants and auditors from 33 European countries, including all of the 28 EU member states. FEE has a combined membership of more than 700.000 professional accountants, working in different capacities in public practice, small and large accountancy firms, businesses of all sizes, government and education – all of whom contribute to a more efficient, transparent and sustainable European economy.

Nevertheless, although such a comprehensive reform appears to be challenging and should be carefully considered, which requires time, the idea should not be completely dismissed as unfeasible on the way towards a simple VAT system on the long-term. The indirect tax principles in the "New World" (New Zealand, Australia, South Africa and Canada) show, such a system can work and is much less complex than the current European VAT system, in particular the compliance cost for business and the administrative burden for both taxpayers and tax administrations seem to be much lower[2]. Due to the complexity of the current rules and their lack of conceptual clarity, the compliance cost and the risk of a false assessment is very high. As a result, businesses face either the cost of external advice or reassessments by the tax authorities (including interest).
However, as a first step, in a short-term-view, we would recommend to limit the reform to those sectors where distortions of competition exist or are likely to arise between public and private sector entities. Activities which are currently out of scope according to Article 13[3] could be added to Annex 1 of the VAT Directive to create an exhaustive list of "economic" activities which always fall within the scope of VAT even when they are carried out by public bodies acting as public authorities. The general principles of Art.132 – 134 can be maintained, but it should be possible to opt for the option to tax for businesses.

For further information on this letter, please contact Petra Weymüller, FEE Senior Manager, at +32 2 285 40 75 or via email at petra.weymuller@fee.be.

Yours sincerely,

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President

Olivier Boutellis-Taft
CEO

[2] Henkow: The VAT/GST Treatment of Public Bodies, Kluwer Law International, 2013
[3] Where not specified, references to articles are related to the Council Directive 2006/112/EC.

Q1: General evaluation of the current rules:

- What is your evaluation of the current VAT regime as regards the public sector (including special rules for public bodies, Article 13, and tax exemptions in the public interest, Article 132-134 of the VAT Directive)?

The current value added tax (VAT) rules lead to distortions and inefficiencies on both the input and the output side.

On the input side, the major problem of the current regime is the so-called input VAT, which can be defined as VAT incurred on purchases of goods and services that are to be used for the purposes of the business. Input VAT cannot be reclaimed by public entities that are either regarded as non-taxable persons or that themselves provide VAT-exempt goods and services (Art. 168 (1) VAT Directive). This non-deductible input VAT raises the overall cost of the goods and services provided. To the extent that these higher costs can be passed on, consumer prices of the relevant goods and services increase.

A further consequence of input VAT being non-deductible is the restriction of outsourcing: there is a distinct disincentive for such public entities to source activities out to external service providers that must charge VAT. Thus, efficiency benefits connected with outsourcing either cannot be realised in full or may be only partly realised.

Additionally, private businesses which purchase goods and services produced by public entities are not in a position to reclaim the input VAT suffered by the public sector entity on these goods either. This is due to the fact that public entities are not allowed to charge VAT on their invoices. Hence, the non-deductible VAT incurred also increases costs in both the public and private sectors. The longer the service chain is, the higher this effect will be (also known as cascade effect).

On the output side, distortions arise when a VAT-exempt or non-taxable public entity competes with a VAT-taxed business and both offer the same or a similar goods or services. The public entity is able to offer its product at an end price without VAT having to be added and, thus, has a competitive advantage. From the perspective of a private business, this tax disadvantage is particularly significant when the public entity is itself charged with no, or very little, (non-deductible) input VAT which then is reflected in the end price. Ultimately, in respect of providing goods and services to consumers who are unable to reclaim input VAT, the public sector is being sheltered from competition by being granted tax advantages.

As a preliminary conclusion one can say that the current VAT rules produce distortions, which foster inefficiency. A (comprehensive) reform is needed.

Furthermore, it should be noted, that the VAT Directive is not implemented consistently across Member States. The fact that national rules do not always exactly correspond to the requirements of the VAT Directive leads to several problems concerning the interpretation of the current national rules, which can only be solved within that jurisdiction. The interpretation made by courts, however, is often not based on the wording of the national rules. This results in legal uncertainty on a massive scale for taxpayers.

- What are in your opinion the main problems of the current rules?

One of the main problems is the sheer number of the VAT-exemptions in the current regulations, which is compounded by their complexity.

Another major obstacle is the difficulty in assessing whether the particular conditions that determine whether a certain activity can be regarded as VAT-free, are or are not being met in individual cases.

A third crucial point of criticism relates to inadequate transformation of the relevant parts of the VAT Directive into national rules (see above).

- Are there any distortions of competition (output and input side)? If so, how and in which sector do they occur?

In our view, the most significant distortions of competition are on the output side. The main problem is the competitive tax disadvantage private businesses suffer once they compete with public institutions supplying the same type of goods and services to end customers, who do not have the right to deduct input VAT.

This problem can be particularly prevalent in the following sectors:

- Welfare Sector
- Cultural Sector
- Waste/Sewage Management
- Broadcasting and Telemedia
- Tuition services of independent teachers
- Healthcare/medical services

- Are the complexity of the current rules and the lack of harmonisation causing problems? Please give specific examples.

Yes, the complexity of the current rules and the lack of harmonisation are causing problems. This can be clearly seen by the judgments of the Court of Justice of the European Union (CJEU) concerning medical treatment in its broader sense (for instance: CJEU, 21 March 2013, C-91/12; CJEU, 10 June 2013, C-86/09; CJEU, 18 November 2010, C-156/09) and teachers giving tuition “privately” (for instance: CJEU, 28 January 2010, C-473/08; CJEU, 28 November 2013, C‑319/12). These cases demonstrate that it is very difficult to distinguish between VAT-exempt activities and taxable activities.

- What is their impact on compliance costs?

From our viewpoint, the current rules lead to significant tax compliance costs. Due to the complexity of the current rules and their lack of conceptual clarity, the risk of a false VAT assessment of a certain transaction is very high. As a result, businesses face either the cost of external advice or reassessments by the tax authorities (including interest).

- Are the problems identified only of a national nature or do they constitute an obstacle to the smooth functioning of the Internal Market?

In the case of certain cultural services (Art. 132 (1) (n) VAT Directive) and medical services (apart from services provided in medical emergencies) the problems might pose a threat to the smooth functioning of the Internal Market. As an example, if the cost of same cultural event or the same medical treatment varies between Member States solely by the applicable tax, ranging between 0 and 27 per cent, in other words, when the tax influences the buying decision and thus the competition, this is a threat to the functioning of the internal market.

Q 2: Distortion of competition clause:

- Do you think the distortion of competition clause pursuant to the second subparagraph of Article 13 (1) of the VAT Directive and the existing case law from the Court of Justice of the European Union in this respect have been efficient enough in preventing distortions of competition between public and private providers on the output side?

No, the current competition clause is not efficient at all. There are three main reasons for this evaluation.

Firstly, according to CJEU case-law, competition can only be influenced when and if goods and/or services can legally and actually being offered by a third party. Consequently, as long as Member States may create monopolies, this case-law cannot be applied efficiently.

A second shortcoming of the clause is its ineptitude to eradicate those distortions leading to an obstruction of the outsourcing of activities by public entities as outsourcing by public entities is made more expensive due to non-deductible input VAT.

A third aspect is the interpretation of the vague legal definition “significant distortions of competition” in the second subparagraph of Art. 13 (1) of the VAT Directive. Even though there are court rulings on when a “significant distortion” can be assumed, these rulings are not sufficiently specific for practical application. It is particularly unhelpful for a vague legal definition (such as “significant distortions”) to be replaced by other similarly vague legal definitions, since the problems concerning the interpretation of these legal definitions come up again and again. For instance, it is said that a “significant distortion of competition” cannot be assumed if there are only “insignificant distortions” present; when competition can be regarded as “insignificant”, however, remains unclear. Sometimes the “potential” competition is taken into account, but this is not helpful as forecasts about the future are required. Focussing on the “local market” is not helpful either, as it is unclear how the term “local market” is defined.

- Does the national legislation of your country provide for a legal mechanism according to which a private entrepreneur who is experiencing unfair competition from a public sector body could formally raise this issue with the tax authorities or the courts?

This is only possible to a limited extent. A private business may raise the issue and demand information on how a public body is taxed (CJEU, 8 June 2006, C-430/04). However, such a lawsuit involves a tremendous amount of effort and expense and is, thus, not very efficient when it comes to practical application. Also, it is very hard for the plaintiff to prove that his rights have been infringed. In addition to these obstacles, the private business is generally not able to enforce a claim of being taxed in the same way as the public entity. From the plaintiff’s viewpoint it is therefore an unsatisfactory mechanism.

Q3: Reform measures:

- What are your views on the different reform options or reform measures mentioned in this document (including a possible sectorial reform); do you have a preference for any particular option and any particular variant mentioned in relation to the different options and why?

The full taxation of public bodies and the elimination of all VAT exemptions for activities in the public interest (Option 1: Full Taxation Model) would be the theoretically superior approach. The distortions on the output side would be removed. Also, the phenomenon of non-deductible input-VAT becoming a cost passed on to the end customer would be completely eradicated. However, if there is no identifiable fee charged for certain public goods and services (e.g. police, fire department and so on), this type of supply is currently not taxable. Lacking any practical experience, we are not in a position to assess the usage of fictitious prices, but it seems that they work well (see the "deemed supplies" e.g. in New Zealand).

The Refund System (Option 2) would provide a refund of formerly non-deductible input VAT. We are generally in favour of Option 2. A refund system could be achieved within the current VAT system by introducing zero-rates for certain activities in the public interest. In our view, it would be necessary to ensure that only the input-VAT linked to output is refundable; input-VAT linked to goods and services which are consumed by the producer himself must not be refunded. This would necessitate careful differentiation between refundable and non-refundable input-VAT.

There is, however, a disadvantage of the Refund System that has to be taken into account: If the Refund System were implemented, distortions on the output side would be exacerbated, since public entities would be granted an even larger cost advantage compared to private businesses. However, this issue could be addressed by allowing zero-rates for providing goods and services in the public interest, regardless of the nature of the supplier. It would then not matter whether the supplier (of goods or services in the public interest) was a public or a private entity.

In any case, we do not regard a limitation of the Refund System to certain industries (e.g. health care, education and so on) as suitable. Hence, we do not support the second variant of Option 2.

In our view, deleting Article 13 while retaining Articles 132-134 of the VAT Directive (Option 3) is a sensible approach, particularly if Articles 132-134 were to be modernised at the same time. It would be preferable if tax exemptions were only dependent on the nature of the supply and not on the characteristics of the supplier. No distinction should be made between public and private providers, as long as both parties provide goods and services in the public interest. However, it is important to highlight that Option 3 will only reduce distortions of competition. In addition, there is the risk that the legal uncertainties regarding the interpretation of Article 13 of the VAT Directive would merely be transferred to Articles 132-134 of the VAT Directive.

As previously stated, on a short-to-mid-term basis, a sectorial reform (Option 4) would have its advantages. However, we do not favour it as a final solution, because that would create significant problems in terms of determining which sectors need to be reformed. In our opinion, it will be difficult to distinguish between sectors which should be reformed and those sectors which should not. This is due to the fact that if, for example, the focus was on distortions of competition (as a criterion for identifying sectors which need to be reformed), and distortions might vary across Member States.

That is why at least those supplies, which are typically or occasionally offered cross-border, should be regulated in a standardised manner within the EU. Services that are only offered locally might be regulated within the sectors if there are private and public suppliers who are taxed differently (for instance: parking, sewage, waste disposal).

From our viewpoint, the selective amendments of the current rules discussed (Option 5) are all very sensible when taken individually. This option is therefore appropriate on the long term, in particular the option to tax for businesses. As stated above, however a real "Grand Reform" could be envisaged in the future.

- Is there any option which should be excluded and why?

The indiscriminate deletion of Articles 132-134 of the VAT Directive (full taxation model) would presumably lead to a massive increase in the price of health care services. As a consequence, both private and public health insurers would be placed in financial jeopardy. Health insurance premiums could significantly increase and additional public finance, ie taxpayers' money, might be needed to assist health insurers or insured persons who cannot afford to pay their premiums any longer. As said above, however, the VAT system can be streamlined this way, provided that Member States would get the time required to transform their internal financial and social structures.

Q4: Sectorial reform:

In case a sectorial reform would be the way forward, Copenhagen Economics has modelled the sectors postal services, broadcasting, waste management and sewage. Other sectors such as air traffic control, access to roads and parking areas could be potential candidates as well.

- Do you agree with this list?

Yes, we agree with the sectors in this list, including those sectors regarded as potential candidates.

In our view, a sectorial reform can, however, only be a start. In order to resolve the conceptual problems inherent in the current system (outsourcing, cascade effects), a comprehensive reform on the long-term should be considered.

- Which other sectors should in your view be selected for such a review? Why?

A sector that could be added is the cultural sector. In this sector there are numerous private providers in the market. Consequently, this is an area where competition exists.

Q5: Option to tax:

- Do you think that an option to tax as regards tax exempt activities either by taxable persons or Member States should be considered?

Provided that public entities are granted the right to deduct input VAT, the option to tax might be an adequate approach to resolving the conceptual problems (outsourcing, cascade effects) inherent in the current system. It needs to be taken into account, however, that an option to tax will probably make the VAT system and the taxation of public bodies even more complex.

As far as the question whether such an option to tax should be made available to either taxable persons or Member States is concerned, there are arguments for both alternatives.