



European Commission
VAT Treatment of Public Bodies and
Exemptions in the Public Interest

25 April 2014

1. Identification of the Stakeholder

The Commission services would be interested in receiving contributions from all interested stakeholders on the issues described below. In order to analyse the responses, it will be useful to group the answers by type of respondent. For this reason, you are kindly requested to complete the following form.

You are included in one of the following groups:

- Multinational enterprise
- Large company
- Small and medium sized enterprise (SMEs)
- National Association
- European Association
- Non-Governmental organisation (NGO)
- Tax advisor or tax practitioner
- Citizen
- Academic
- Public body
- Others

Name of your organisation/ entity/ company:

ICAS (Institute of Chartered Accountants of Scotland)

Country of domicile:

United Kingdom

Brief description of your activity or your sector:

ICAS is the oldest professional body of accountants and was established in 1854. ICAS supports its members with technical advice, regulation and compliance support, career development tools, a free and comprehensive information service, courses for continuing education and acting as a professional body for around 20,000 members who work in more than 100 countries around the world. We are an educator and examiner providing tuition to students who are studying towards obtaining the CA qualification.

Please note: The contributions will be published on the website of DG TAXUD. Without publication their content will not be taken into account. If the contributor objects to the publication of his personal data on the ground that such publication would harm his or her legitimate interests the contribution may be published in anonymous form (see also point 8 of this document).

Do you confirm your agreement to have your response to the consultation published along with other responses?

Yes

No

Do you agree to the publication of your personal data?

Yes

No

Q1: General evaluation of the current rules (see point 3):

- 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)?
- What are in your opinion the main problems of the current rules?
- Are there any distortions of competition (output and input side)? If so, how and in which sector do they occur?
- Is the complexity of the current rules and the lack of harmonisation causing problems?

Please give specific examples.

- What is their impact on compliance costs?

- Are the problems identified only of a national nature or do they constitute an obstacle to the smooth functioning of the Internal Market?
- If you are an entrepreneur how do the current rules affect your business?

ICAS considers that the current VAT regime in the UK for the public sector is overly complicated and does not achieve fiscal neutrality both within the public sector itself and in interactions between the public and private sectors.

The UK has applied article 13 by implementing specific rules regarding the VAT treatment of public sector organisations which splits these organisations into three types:

- Local Authorities and similar organisations (including the BBC) – section 33 VATA 1994 allows these organisations to recover all VAT incurred on activities related to the non-business functions of the organisation. There can be issues where the organisation receives non-statutory sources of income where these new activities are outside the scope of section 33.
- Government departments and the NHS and associated organisations – Section 41 VATA 1994 allows these organisations to recover input VAT in certain circumstances
- Other public sector organisations – these are organisations who do not have any specific provisions that allow them to recover VAT on their activities which are for the public good. These organisations use the standard method of splitting their activities between business and non-business and operating and appropriate partial exemption method to determine what input tax can be recovered. In the UK organisations dealt with under these arrangements are mainly charities, housing associations, universities, Government agencies who do not fall into section 41. In effect, these public sector bodies are not treated under article 13 but as normal organisations.

As can be seen, the system differentiates between different types of public sector bodies and in practice there are similar supplies made from different parts of the public sector so that this tripartite system is distortive - an example is the provision of social housing. In the UK the term social housing is used to describe rental accommodation which may be owned and managed by the State, by non-profit organisations or by a combination of the two with the aim of providing affordable housing.

The provision of social housing is outside the scope of VAT in the UK and where the housing is provided by a Local Authority they are able to recover the VAT incurred on repairs and maintenance under section 33 but if the same housing is provided to the same tenant by a Housing Association they are not able to cover these amounts of VAT. A Housing Association is generally a not-for-profit body which may have charitable status and is likely to receive public money; many evolved from the outsourcing of social housing provision in the UK. The VAT anomaly can lead to issues when there are transfers of social housing stock from the Local Authority sector and where the successor landlord does not fall within the statutory shelter of section 33. This can result in convoluted structures to allow the repair and maintenance obligations to remain with the Local Authority so that VAT can be recovered as the cost of making a complete transfer of all obligations is the 20% of VAT incurred on repairs and maintenance. It would be helpful if the UK position could be changed so that where the activities carried on by public sector bodies are the same then the VAT position is consistent. The anomaly means that there is no level playing field even within the public sector in the UK.

Another example relates to the creation of a new unified Police Force in Scotland from the older regional forces that were operated by the Local Authorities and therefore had section 33 VAT recovery. HMRC does not treat the new body, Police Scotland, as qualifying for treatment under section 33 and so the new body cannot recover of VAT it has been charged, despite policing being a core public interest activity. The estimate of the costs of this is around £17 million per annum. There is also an ongoing issue relating to Audit Scotland and whether it is a section 41 organisation.

As can be seen from the examples above, the rules operating in the UK can radically change the funding for an individual organisation depending on its VAT status. From a macro-economic perspective the VAT treatment of public sector bodies makes very little difference – if the organisation can recover VAT then it requires a lower level of funding from Government and Government will receive lower tax receipts as the VAT is recovered. However, these

differences act as a disincentive to reorganise public sector bodies to achieve efficiencies and lower the overall cost of providing public services

The exemption of supplies by certain organisations within the public sector creates an incentive to self-supply – so that organisations who make VAT exempt supplies will undertake as many links in the supply chain as they can to eliminate any non-recoverable tax incurred at intermediate stages of the business process. This creates distortions in competition so that public sector organisations have a 20% (UK VAT rate) disincentive to outsource functions outside of the main organisation.

We would refer to comments made on this issue in the Mirrlees report which noted that the VAT system has failed to keep pace with the economy and the change in the boundaries between public and private sectors (<http://www.ifs.org.uk/mirrleesReview/design> - section 7).

HMRC has identified the additional VAT costs associated with outsourcing as an issue in line with the EU Cost Sharing Directive and have introduced the concept of the Cost Sharing Exemption which would allow public sector organisation to outsource functions to a company set up with other similar organisations and for the supplies made by this new company to be treated as exempt. However, there are very detailed conditions associated with the relief that is offered by HMRC and it does not appear to have changed behaviours within the public sector. It is example of how the impact of exemption is to create complications and additional work for partially exempt businesses.

ICAS has received feedback from members regarding the operation of VAT in connection with the supply of staff to the NHS by employment agencies. There has been litigation on this issue in the UK recently and it has become a very contentious area – see First Tier Tribunal case of Rapid Sequence – 2013 FTT 432. The current situation in the UK is that HMRC are treating all costs from a staff employment agency – their fee together with the costs for the staff supplied – are being treated as a supply on which VAT is due which increases the non-recoverable input tax cost to the NHS body. This is a significant disincentive to flexible working models and an efficient public sector.

This level of complexity in the rules results in significant compliance costs for public sector organisations in dealing with their VAT issues. These organisations do not necessarily have the budgets or expertise to identify when there is an issue and the result of this is that many public sector organisations may not recover as much VAT as they are entitled too. The complexity affects HMRC as well and means that it is easy for errors to be made by both sides.

Some of the issues identified above are national issues and are created because of the administrative arrangements for VAT in the UK. However, the complexity relating to the public sector extends across the EU and the types of issues highlighted – differences between definitions etc. – would apply equally across the EU. Sophisticated taxpayers might be able to use these differences to their advantage but most public sector bodies do not have access to this level of expertise and are disadvantaged by the complexities of the VAT system they operate within.

Q2: 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?
- 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?

As noted above, ICAS does not believe that 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 has prevented distortions of competition between public and private providers on the output side. The introduction by the Cost Sharing Exemption in the UK has tried to go some way to address this issue but has introduced yet more complexity.

There are understood to be no provisions in UK competition law that would allow a challenge by a private sector business to a public sector business that was able to supply a customer at a lower price because of VAT. It seems likely that this type of issue would actually end up with HMRC challenging the VAT status of the supply rather than a complaint by a competitor.

Q3: Reform measures (see point 5):

- 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?
- Is there any option which should be excluded and why?
- Do you have any additional ideas or proposals?

ICAS believes that many of the distortions in the UK system arise as a result of the particular UK rules and their implementation by HMRC more than the exemption for certain activities in the public interest provided under the VAT directive and the UK rules. We do not believe that reforming the exemption as outlined in the consultation would address the issues and we have concerns that the seismic nature of this change would create more complexity for public sector organisations.

We believe that there is scope to ask the Governments of the member states to review their own public sector arrangements with a view to reducing anomalies and distortions before the Commission considers the position at a supra-national level. There would be some merit in requiring Governments to ensure that the national legislation would extend the coverage of the local interpretation of the directive to all government controlled or publically funded bodies undertaking similar public interest activities. Most public sector organisations currently operate within national boundaries so action at the national level would be most appropriate.

Q4: Sectorial reform (see point 5.4.):

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

As noted above, ICAS does not believe that reform at the European Commission level is appropriate at this time.

Q5: Option to tax (see point 5.5.):

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

ICAS believes that this course of action would increase complexity still further and does not address the underlying issues. The complexity in the UK exists because of the way in which Article 13 has been implemented into UK law and there is a distortion – public bodies carrying on the same public interest activities are treated differently depending on which of the three categories of public bodies they fall into.

The introduction of an option to tax would not change this position- the problem which should be tackled in the UK before any further change is made is to have a level playing field across public sector bodies where there are public interest supplies. Once this has been achieved, it will highlight areas where the current regime for the VAT treatment public interest supplies distorts competition with the private sector. We also have concerns that an “option to tax” regime would allow public sector organisations who are able to afford advice and have the resources to make the election to be more effective with their financial resources and would create further distortions within that sector itself.

7. Some Important Messages about this Consultation

Stakeholders are invited to reply to those questions that are of concern to them. Figures and concrete examples of e. g. distortions of competition within the internal market or specific problems encountered due to the current VAT rules or – in contrast – examples why the current rules could be justified would be highly appreciated.

As already indicated above, it is important to keep in mind that this public consultation is part of the assessment process and that no policy decisions have been taken at this stage.

Our comments and examples are included in section 1 above.

8. Final Observations

It is important for contributors to identify clearly: name, address, e-mail, activity, other information and, in the event of representative organisations, the level of representation. It is important to read the specific privacy statement on how your personal data and contribution will be dealt with on the consultation website.

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