Exemption in the public interest

Indirect Tax | Tax voice



21 December 2015

Ian Harris examines the interaction of fiscal neutrality and distortion of competition in the context of the public services exemption

A recurring conflict in VAT law arises between the conferring of exemption from VAT on services regarded as being in the public interest - the presumed intention being not to burden such public interest services with VAT - and the impact this might have on the market for the provision of such services, ie by introducing potential distortion of competition to the disadvantage of consumers.

Furthermore, distortion of competition is generally regarded as a sub-set of fiscal neutrality, the 'cardinal principle' of EU VAT law that similar supplies that meet a common interest and which must, therefore, be presumed to be in competition, cannot be treated differently for VAT purposes.

It is in this context that the Republic of Ireland has recently referred the following questions to the CJEU on the scope of the significant distortion of competition condition in Article 13(1) in *National Roads Authority* [C-344/15] -

> '1. If a body governed by public law carries on an activity, such as providing access to a road on payment of a toll, and if, in the Member State, there are private bodies who collect tolls on different toll roads pursuant to an agreement

with the public body concerned under national statutory provisions, is the second indent of Article 13[(1)]… to be interpreted as meaning that the public body concerned must be deemed to be in competition with the private operators concerned, such that to treat the public body as a non-taxable person is deemed to lead to a significant distortion of competition, notwithstanding the facts that (a) there is not and cannot be any actual competition between the public body and the private operators concerned, and (b) there is no evidence that there is any realistic possibility that any private operator could enter the market to build and operate a toll road which would compete with the toll road operated by the public body?

2. If there is no presumption, what exercise should be conducted to determine whether there is a significant distortion of competition within the meaning of the second indent of Article 13[(1)]…?'

Exemption in the public interest

As implicit from the Order for Reference in '*National Roads Authority*', Article 13(1) of the EC Principal VAT Directive (Directive 2006/112/EC) is the key provision governing public bodies, conferring what amounts to exemption from VAT on those economic activities undertaken by public bodies in pursuit of their public service obligations (colloquially referred to in the UK as their non-business functions).

To this end, Article 13(1) states that -

'States, regional and local government authorities and other bodies governed by public law shall not be regarded as taxable persons in respect of the activities or transactions in which they engage as public authorities, even where they collect dues, fees, contributions or payments in connection with those activities or transactions.

However, when they engage in such activities or transactions, they shall be regarded as taxable persons in respect of those activities or transactions where their treatment as non-taxable persons would lead to significant distortions of competition.

> In any event, bodies governed by public law shall be regarded as taxable persons in respect of the activities listed in Annex I, provided that those activities are not carried out on such a small scale as to be negligible.'

It is thus the second sub-paragraph that is relevant to this discussion.

Similarly, many of the exemptions conferred by Article 132(1) on services in the public interest are subject to a comparable caveat, contained in Article 133(d), that such 'must not be likely to cause distortion of competition to the disadvantage of commercial enterprises subject to VAT'.

Despite this clear legislation, precisely what is meant by distortion of competition and how such is to be measured and gauged remains uncertain, further clouded by the jurisprudence on fiscal neutrality.

'Isle of Wight council'

On the narrow question of whether a significant distortion of competition arises in breach of Article 13(1), the seminal *Isle of Wight Council & others* [C-288/07] Judgment is paramount.

'*Isle of Wight Council*' concerned - and still concerns, the litigation awaiting judgment of the Court of Appeal - whether local authority off-street parking falls within Article 13(1) or rather is prevented from doing so because non-VATable treatment would cause a significant distortion of competition.

The High Court [(2007) *EWHC 219(Ch)]* referred this question to the CJEU which ruled that -

> '1. [Article 13(1)] is to be interpreted as meaning that the significant distortions of competition, to which the treatment as non-taxable persons of bodies governed by public law acting as public authorities would lead, must be evaluated by reference to the activity in question, as such, without such evaluation relating to any local market in particular.
>
> 2. The expression 'would lead to' is… to be interpreted as encompassing not only actual competition, but also potential competition, provided that the possibility of a private operator entering the relevant market is real, and not

purely hypothetical.

3. The word ‘significant’ is… to be understood as meaning that the actual or potential distortions of competition must be more than negligible.

It is perhaps pertinent though that Advocate-General Poiares Maduro, whose Opinion the Court broadly followed, relied heavily on the principle of fiscal neutrality in arriving at this conclusion.

Fiscal Neutrality

On fiscal neutrality, *The Rank Group plc [joined cases C-259/10 and C-260/10]* is relevant, the Court of Appeal *[(2010) unreported]* referring the following question to the CJEU -

‘1. Where there is differential VAT treatment:

as between supplies that are identical from the point of view of the consumer; or
as between similar supplies that meet the same needs of the consumer;

is that of itself sufficient to establish an infringement of the principle of fiscal neutrality or is it relevant to consider (and, if so, how):

the regulatory and economic context;
whether or not there is competition between the identical services or, as the case may be, the similar services in question; and/or
whether or not the different VAT treatment has caused distortion of competition?

…’.

Proceeding directly to Judgment, the CJEU broadly supported the submission of the European Commission that -

‘…there is no need for any further enquiry into actual distortion of competition once it is established that identical supplies or supplies which meet the same needs of the consumer are treated differently for VAT purposes;

…;

the test for determining a breach of fiscal neutrality requires focus on whether the services are comparable from the average consumer's point of view…;

…'.

In reaching this conclusion, the CJEU noted that key to answering the question is whether the principle of fiscal neutrality must be interpreted as meaning any difference in the VAT treatment of two supplies, which are identical or similar from the point of view of the average consumer - and which meet the same needs of the average consumer - is sufficient, in itself, to breach fiscal neutrality or whether such requires, in addition, both the existence of competition and that that competition is demonstrably distorted as a result of the different VAT treatment.

It is established case-law - *EC v France [C-481/98], Kingscrest Associates Ltd and another [C-498/03], Marks and Spencer plc [C-309/06], EC v Netherlands [C-41/09]* - that the similar nature of two supplies presumes they are in competition, while a long line of cases - *EC v France [C-481/98], Roders and others v Inspecteur der Invoerrechten en Accijnzen [joined cases C-367/93 to C-377/93], EC v France [C-302/00]* - determines that two supplies are regarded as being similar, in this context, where they have similar characteristics and so meet the same needs of the average consumer (the test being whether differences between the competing supplies have no significant influence on the average consumer's preference for one or the other).

Citing *EC v Germany [C-109/02]* and *Finanzamt Gladbeck v Linneweber and Finanzamt Herne-West v Akritidis [joined cases C-453/02 and C-462/02],* the CJEU in '*Rank*' thus confirmed that the actual existence of competition is not a necessary condition before a breach of fiscal neutrality is established if the supplies in question are, nevertheless, similar from the point of view of the average consumer and meet the same needs of that consumer.

That two identical or similar supplies, which meet the same needs of the average consumer, are treated differently for VAT purposes, must, therefore, be presumed to give rise to a distortion of competition and so a breach of fiscal neutrality.

The CJEU thus concluded that:

> ‘…the principle of fiscal neutrality must be interpreted as meaning that a difference in treatment for the purposes of VAT of two supplies of services, which are identical or similar from the point of view of the consumer and meet the same needs of the consumer, is sufficient to establish an infringement of that principle. Such an infringement thus does not require, in addition, that the actual existence of competition between the services in question or distortion of competition because of such difference in treatment be established.’

The implications are that the mere existence of competing supplies, from the average consumer’s point of view, is sufficient to result in a breach of fiscal neutrality. Consequently, if fiscal neutrality must prevail and the distortion of competition condition in Articles 13(1) and 133(d) be interpreted accordingly, such a distortion must almost inevitably be caused whenever exemption is conferred on services capable of being delivered by other suppliers subject to VAT.

Exceptions to fiscal neutrality

However, the CJEU in ‘Rank’ did observe that this general rule on the application of the principle of fiscal neutrality can be relaxed in certain exceptional cases. For example, differences in the regulatory framework or the legal regime governing the supplies at issue - such as whether or not the cost of providing drugs on a medical practitioner’s prescription is reimbursable from public funds (*EC v France [C-481/98])* or whether or not the supplier is subject to an obligation to provide a universal service (*TNT Post UK Ltd [C-357/07]*) - may create a distinction in the eyes of the average consumer in terms of the satisfaction of their own needs.

While this may be questionable, it is pertinent that in ‘*TNT*’ what was at issue was the provision of a regulated universal postal service in the public interest, something which Royal Mail Ltd was obliged by statute to provide as the licenced universal service provider but ‘TNT’, as a provider of commercial courier services was not. There is an obvious parallel with many services in the public interest.

This possibility, that there can be justifiable exceptions to the principle of fiscal neutrality, as alluded to in ‘*Rank*’, goes back to the origins of the principle.

The principle of fiscal neutrality is now to be found in the preamble to the EC Principal VAT Directive - notably paragraphs 5 and 7 - and is, as held most recently in *CopyGene A/S v Skatteministeriet* [C-262/08], intended to reflect, in

matters relating to VAT, the general EU law principle of equal treatment.

Equal treatment, however, is both a much wider concept - of which fiscal neutrality is but one aspect - and it allows for exceptions on the basis of objectively justifiable reasons (see, for example, *Codorniu SA v European Council [C-309/89], R v Minister of Agriculture, Fisheries and Food (ex-parte National Farmers Union) [C-354/95]* and, most recently and pertinently from a VAT perspective, *MyTravel plc [C-291/03]*).

The key difference between the two principles is that equal treatment, as a fundamental principle of EU law, can be relied upon to challenge that law and its interpretation. Fiscal neutrality, by contrast, is merely a requirement of interpreting EU law, not challenging it, and, as such, is susceptible to being overridden where the law explicitly provides there for (see *Finanzamt Steglitz v Innes Zimmermann [C-174/11]*).

So, given specific exemptions are allowed for under Articles 13(1) and 132(1) for services in the public interest, it must be presumed that the distortion of competition inevitably caused as a result does not amount to a breach of fiscal neutrality (a point considered in *Waterschap Zeeuws Vlaanderen v Staatssecretariat van Financiën [C-378/02]* and developed in *Hutchison 3G UK Ltd and others [C-369/04]*).

Indeed, if the concept of distortion of competition is not to be deprived of meaning, it must be seen as a different concept to fiscal neutrality and, unlike the latter, must, therefore, necessitate an economic analysis of the market in order to determine whether competition would be distorted by treating public interest activities as non-VATable. Otherwise, the distortion of condition caveats in Articles 13(1) and 133(d) appear superfluous, given the overriding principle of fiscal neutrality.

Thus, as held by the CJEU in '*Isle of Wight Council*, it is necessary to recognise the underlying primacy of EU VAT law and, providing an objectively justifiable reason can be discerned therefrom, it is permissible to depart from otherwise overriding principles, such as fiscal neutrality.

That being so, it is clearly arguable that Articles 13(1) and 132(1) constitute clear, objectively justifiable, exceptions to the principle of equal treatment - and so fiscal neutrality - by providing that the provision of services in the public interest should not be burdened by the imposition of VAT.

This was broadly the line taken by the CJEU in both *Haderer v Finanzamt Wilmersdorf [C-445/05]* and '*Zimmermann*'; while the principle of fiscal neutrality normally prevents different persons carrying on the same activities being treated differently for VAT, that principle must be interpreted in the light of the wording of the legislation and, where the legislation clearly creates such differences, the principle of neutrality does not apply. Indeed, in '*Zimmermann*', the Court went further, expressly holding that fiscal neutrality cannot be used to override a clear distinction explicitly set out in the EC Principal VAT Directive, such as between public bodies and other non-profit making bodies acting in the public interest on the one hand and commercial providers of similar services on the other.

Determining distortion of competition

Having established that competition is permissible in certain circumstances, notwithstanding fiscal neutrality, that only a VAT-driven distortion of competition matters is borne out by the CJEU Judgment in *Assurandør-Societat (on behalf of Taksatorringen) v Skatteministeriet [C-8/01]*, which considered that condition in the context of Article 132(1)(f) and cost-sharing groups.

'*Taksatorringen*' concerned a Danish association of small insurance companies and whether the association's insurance assessment services, carried out on behalf of its individual member companies, could be exempt from VAT under Article 132(1)(f).

Among the issues considered by the CJEU were -

(a) whether the prohibition on distortion of competition means only services never likely to cause such are covered by the exemption, and

(b) how any distortion of competition is to be judged and measured,

both familiar questions from the '*Isle of Wight Council*' litigation.

On (a), it is clear from '*Isle of Wight Council*' that potential competition must be taken into account (providing such is real and genuine not merely hypothetical). And, while pre-dating '*Isle of Wight Council*' - and not referred to therein - '*Taksatorringen*' arrived at broadly the same conclusion, that:

> '…the expression 'provided that such exemption is not likely to produce distortion of competition' is not directed solely at distortions of competition

> which the exemption is likely to produce immediately but also at those to which it may give rise in the future [providing] the risk that the exemption will by itself give rise to distortions of competition must none the less be real.'

So, based on '*Taksatorringen*' (and '*Isle of Wight Council*'), exemption is prohibited if there is a genuine risk that exemption, ie not charging VAT, may by itself - be that immediately or in the future - give rise to distortion of competition.

In terms of measuring and gauging distortion of competition, Advocate-General Mischo, in '*Taksatorringen*', was quite clear; what matters is whether exempting supplies made by an identified supplier, whilst requiring other suppliers of comparable services to account for VAT thereon, is the determining cause of the distortion.

Put another way, all that matters is whether not accounting for VAT is the cause of the distortion, not other factors that may be inherent, including other VAT law constraints that may have to be met before exemption is possible.

The CJEU in '*Taksatorringen*' made no more than passing reference to the highly informative Opinion of the Advocate-General but it was clearly influenced by his thinking in holding that it is the conferring of exemption, in itself, ie not having to charge VAT on the supply, that must not give rise to a distortion of competition.

Of course how that is gauged and measured is a moot point, as is currently before the Court of Appeal in '*Isle of Wight Council*'.

Conclusion

What emerges from this is that exempting from VAT services in the public interest - in order to prevent VAT being a burden thereon - is legitimate, even where the consequence might be a prima facie breach of fiscal neutrality, providing the law provides for such a clear difference in VAT treatment of similar supplies.

Furthermore, any prohibited distortion of competition must be a consequence of not charging VAT on the supply, not other inherent factors, including any contained in or consequent upon the exemption in question.