Re-examined – VAT treatment of public bodies



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Maric Glaser, Mike Arnold and Ian Harris report that the European Commission is examining the VAT system and that a key issue is the VAT treatment of public bodies

Key Points

The Commission is looking at the taxation of public bodies and with it the exemptions in the public interest Our representatives on the VAT Expert Group are providing input to the Commission There appear to be two main options: bringing public services into the VAT net, or retaining the current option and implementing something like the UK’s VAT refund system Members’ input would be appreciated

In May 2011, we submitted the CIOT's response on the Green Paper on the Future of VAT to the European Commission (**www.tax.org.uk/tax-policy/public-submissions/2011/Green_Paper_VAT**). Among the matters raised by the Commission was the question of how to deal with the taxation of public services. In general terms, we take the view that the existing system supported by the refund system in place in the UK works well.

As members know, we were appointed to the VAT Expert Group (VEG) recently set up by the Commission. Our representative is Mike Arnold, a former Chairman of the VAT and Indirect Taxes Sub-Committee and his alternate is Tarlochan Lall. However, they are supported by members of the CIOT who provide information and evidence to put before the VEG.

One matter now being examined is the treatment of public bodies.

Why is it necessary to look at the taxation of public bodies

To understand the need for a re-examination of the VAT treatment of public bodies, it is necessary to look at why the current system was put in place and what has changed.
First, the public sector historically was the exclusive provider of many services. There was almost no outsourcing of underlying services – most services were undertaken by employees. There was also less specialisation, leading to less choice of service provision. If VAT was applied to these services, the cost would rise significantly and feed into the overall tax burden necessary to fund public services.

It is worth noting that the same situation existed for private providers of public interest services, ie those that fall within the exemption under Article 132 of the **Principal VAT Directive**.

To relieve these services from the cost of VAT, two separate solutions were adopted:

- public sector services were removed from the scope of VAT; and
- certain other public interest services were exempted from VAT.

Practically, the two solutions broadly achieved the same effect, ie no VAT was charged on the services, but any VAT incurred in providing them was not recoverable. However, a residual VAT cost remained. Other consequences exist, eg what happens on change of use and disposal, but these are not considered here.

When the UK joined the forerunner to the European Union (EU), the European Economic Community (EEC), it was obliged to introduce VAT. However, to reduce the burden of local taxation (then primarily domestic rates, now council tax), a system was adopted allowing the refund of VAT incurred on public bodies' services that were not within the VAT net and therefore not covered by the VAT deduction system, in what is now **VATA 1994 s 33**. The system of refunding VAT has been extended somewhat over time, but in essence its purpose is to reduce the burden of VAT incurred in providing public services. A separate but similar system is in place for museums and galleries **(s 33A**) and academy schools (**s 33B**).

Eight of the 27 EU member states have also adopted refund systems; however, these vary with each other significantly (see *VAT in the public sector and exemptions in the public interest:* Final Report For **TAXUD/2011/De/334**, 10 January, 2013 at para 1–8).

> **Copenhagen Economics suggested that a 'full taxation' model should be adopted**

The need for change

The Commission appointed Copenhagen Economics to examine the taxation of public bodies and also the exemptions for services in the public interest contained in Article 132 of the Principal VAT Directive.

The two main issues can be expressed as follows:

- Does the fact that public bodies are not subject to VAT lead to distortion of competition, in relation to services provided by the private sector?
- Does the fact that public bodies incur irrecoverable VAT on goods and services they procure from the private sector create a disincentive to use presumed more efficient private sector services?

In their report, Copenhagen Economics suggested that a ‘full taxation’ model should be adopted. Under this solution, all public services would come within the scope of VAT. This would largely deal with the problem of input tax recovery, since it would not matter that VAT was charged on outsourced services – it would be recoverable provided it was attributable to taxable supplies. However, the VAT on some supplies used to provide exempt supplies such as education and health, which are exempt, would be irrecoverable unless there were also changes to the scope of exemptions, so some VAT might not be recoverable.

As far as the burden on consumers is concerned the solution contemplates the possibility that local taxation, such as council tax, would be subject to VAT, though possibly at the lowest rate applicable in the country concerned or 5%. The model used by Copenhagen Economics predicts relatively small gains in percentage terms – an increase in GDP of 0.38%.

The Commission has not yet, however, expressed a preference for either the full taxation model or the refund model (or indeed any other option).

The Mirrlees Review

Chapter 7 of the Mirrlees Review deals with the features of a VAT system and may be found at **www.ifs.org.uk/mirrleesreview/design/ch7.pdf**. In a press release (**www.ifs.org.uk/pr/mirrlees_launch.pdf**) commenting on the Mirrlees Review, the Institute for Fiscal Studies summarises the VAT recommendations in the following terms:

‘VAT should be extended to nearly all spending. This would reduce complexity and avoid costly distortions to consumption choices. The money raised can be spent on cutting income taxes and raising benefits in a way that is broadly distributionally neutral, and that protects work incentives, although inevitably there will be winners and losers from such a change.’
This would support the Copenhagen Economics view.

The position of the CIOT

Our representatives, backed by the small group of members who participated in a discussion on public sector VAT, have expressed some reservations about the full

taxation model. These include:

- The Copenhagen Economics model does not appear to have examined in detail the consequences of a full taxation model on other systems, notably the social benefits system (examined briefly below).
- A full taxation model would need to be accompanied by a change to the exemptions in the public interest and
- this also has consequences for the overall tax system.
- There are a number of assumptions such as an underlying assumption of the greater efficiency of the private sector and that the private sector would replace jobs lost through greater efficiencies. Given the small gains to be achieved, is the tried and trusted refund system a more certain system?
- While there is a predicted net gain from the full taxation model, how would that be distributed?

Interaction with other systems

One of the main areas where tax interacts with another governmental function is the social benefits system. The benefits system comprises a number of elements including:

- direct cash payments for people on either low incomes or no income at all – groups supported in this way include the aged, children and people with disabilities;
- the provision of free services eg care, medicine to those meeting certain criteria;
- tax reliefs, eg zero-rates, reduced rates and exemptions; and
- subsidies to bodies that provide social services, eg certain charitable grants.

> **Taxing services, while simplifying the VAT system, may lead to considerable further complexity in the benefits system**

The rules for most of these are complex and, as has been seen in the UK, subject to considerable adjustment as conditions change. Among the complications is the fact that the benefits system is not limited to a single authority – some benefits are administered by local authorities while others are the task of either central Government or the devolved authorities (Scotland, Wales and Northern Ireland). The

Mirrlees Review suggests that the loss of exemptions and other reliefs can be compensated via the benefits system but accepts that there will be winners and losers.

Our initial view is that taxing services, while simplifying the VAT system, may lead to considerable further complexity in the benefits system. In this regard it should be recalled that LITRG has supported the retention of reduced rates, because they tend to be automatic and are not lost by deserving recipients who fail to apply for cash benefits.

The big advantage of using VAT reliefs is that there is a direct correlation between what is spent and the support that is given. It means, for example, that a family of five will automatically get more relief than a family of two. It also ensures that there is automatic relief for special needs, eg aids for the handicapped.

Other complications arise because there is no clear-cut ‘consideration’. Thus, council tax covers only a small proportion of local authority expenditure – the rest is covered by the ‘block grant’ from central Government and other sources of revenue. The block grant is paid for out of other national taxes, so treating it as consideration raises the prospect of imposing a tax on a tax.

Services in the public interest

Government – national, devolved and local – all rely on charities and other bodies, notably the voluntary sector, to provide specialist support, eg to people with learning disabilities. That is effectively paid for by grants, which under the full taxation model would be subject to VAT.

Charging VAT on such services would not create additional costs where the VAT was borne by a public body able to recover the VAT so that to that extent it would be neutral. However, changing from exemption to taxation (even at the zero-rate) might require registration of a considerable number of third sector bodies currently not required to be registered. That would in turn impose compliance costs on bodies who may not find that the gains from recovery of their VAT outweigh the cost of compliance. Further, some services would presumably not be to publicly funded bodies, leading to a possible tax cost to other recipients, such as private individuals.

Conclusions

There are a considerable number of issues to be resolved but this is not an issue confined to public bodies. Those working with them need to consider the impact of a change on their services. Our VEG representatives would welcome any further views that members have on the VAT treatment of public bodies. Comments can be sent to the technical officer for VAT and indirect taxes at **mglaser@ciot.org.uk**.