

International Philanthropy Conference

László KOVÁCS

Member of the European Commission,
Commissioner for Taxation and Customs

“VAT for Charities – State of Play and Plans for the Future”

Ladies and Gentlemen,

(Introductory statements)

I feel privileged to have the opportunity to address this distinguished audience on my views on the VAT treatment of Charities and my plans for future actions in this area.

Let me start by saying that the problems which Charities experience under the common VAT system of the EU are well known to the Commission. The issue has already been the subject of several discussions between my Services and representatives from the European Charities' Committee on VAT.

(The Main Problem)

The main concern which Charities have with the VAT system is that they are unable to obtain a refund of the input VAT which they are charged by their various suppliers because they carry out a number of non-business and exempt operations. The result is that their costs are increased by this non-recoverable amount of VAT.

As you well know, the very nature of charity is that goods or services are given freely. This means however that many of the services supplied by Charities are outside the scope of VAT precisely because they are supplied free of charge. In such

circumstances, a charity is not treated for VAT purposes as if it is carrying out a business and is therefore unable to deduct its input VAT.

In addition, certain activities carried out by Charities for which a charge may be levied (such as education, health, culture, etc) are treated as "exempt" for VAT purposes. This means that no VAT is added if a charge is made by the charity to its "customer" but, as with their out of scope activities, any input tax incurred is non-recoverable.

Finally, certain activities carried out by Charities, such as trading in goods to raise money, involve them in being treated as fully taxable persons. This is necessary otherwise there would be distortions of competition with normal traders. In such cases, however, although VAT has to be charged, tax incurred on related purchases can be deducted.

The inability to deduct VAT in respect of out of scope and exempt activities not only gives rise to administrative complications for charities but is also often seen as an unjustified financial burden.

(Possible Solutions for Out of Scope activities)

Broadly, there are two main ways in which the position for charities could be simplified and made more favourable.

The first would be to amend the VAT rules in order to deem non-business, charitable activities as taxable for VAT purposes in order for the corresponding input tax paid to be recovered. Unfortunately, I am unable to offer much hope for such a solution. It would require unanimous agreement by all Member States and I am afraid this is very unlikely to be forthcoming. Most, if not all, Member States, wish to safeguard the basic principles of VAT,

namely that it is a consumption tax and falls only on supplies of goods and services made for payment. Therefore operations free of charge should remain outside the VAT system except in very specific cases, where non-taxation creates risks of distortions to the system.

The alternative way to address this problem within the VAT system would be to provide for the "zero-rating" of supplies made to charities. Again, however, I am afraid that I can hold out no hope for such a solution. The application of zero rates is regarded by most Member States as an undesirable, possibly even dangerous, mechanism which should be avoided at all costs! Exceptionally a few Member States have been allowed to keep, as a transitional measure, those zero rates they already applied at the time the 6th VAT Directive entered into force, but no further zero rates can be envisaged.

The second, and more feasible, option is to address this problem outside the VAT system. This is an approach which has been adopted in some Member States which have put in place mechanisms for reimbursing to charities some or all of the VAT they have been charged.

The Commission has always considered that any scheme designed to relieve the VAT burden for charitable activities can be regarded as compatible with EU legislation if it is clearly separated from the VAT system itself (since under this system VAT can only be refunded if it is connected with taxable supplies) and does not affect the own resources of the Community. The essential difference is that, under such a scheme, the tax is collected in the first place and then the Government chooses to allocate it back to the bodies from which it has been collected. This is a subtle but important accounting distinction.

I have to underline that the decision to set up such a refund mechanism is strictly a national budgetary issue over which the Commission has no say or influence.

(Reduced rates)

Passing to the question of reduced rates, I would like to stress that Annex H of the Sixth VAT Directive already gives Member states the possibility to apply reduced rates to supplies of goods and services by charitable organisations engaged in welfare and security work, as long as they provided for payment and are not covered by a specific exemption. Tax relief is therefore being provided by permitting those entities to reduce the VAT on their outputs while allowing tax deduction on their inputs. This possibility was kept untouched in the Commission's proposal on reduced VAT rates.

Let me take the opportunity to explain the **Commission's proposal** on reduced rates, the logic behind it, and the reactions from Member States.

In its proposal, the Commission aimed to seek a balanced approach for the whole of the European Union. This requires going beyond a review of the restrictive list of goods and services, those in the Annex H to the Sixth VAT Directive, to which a reduced VAT rate may be applied and examining the various specific derogations available to some Member States. The Commission proposed to introduce in Annex H restaurant services, housing, domestic care services and the supply of gas and electricity, with a view to avoiding potential distortions of competition. The proposal also includes appropriate measures for a final decision on the VAT rate applicable to labour-intensive services.

As you know, any move towards a fully harmonised VAT system, based on the principle of taxation at the place of origin, is clearly

not feasible in the short to medium term. The proposal of the Commission in 2003, therefore, did not seek to radically change the existing framework.

In other words, the current structure of a standard minimum rate of 15%, and one or two optional reduced rates of at least 5% for a restricted list of goods and services, has never been called into question. No Member State would be obliged to introduce new reduced VAT rates.

The main objectives of the proposal were: **simplification, rationalisation, and a greater equality of treatment for all Member States**, in particular in the light of the Enlargement.

This implied, particularly, extending the list of those goods and services to which Member States could choose to apply a reduced rate, taking into account their specific national requirements.

As for **zero rates**, as you are aware, the Commission firmly believes that a thorough review of these derogations should be launched, one which takes the Enlargement into account.

The proposal of the Commission in 2003 limited these derogations to those goods and services listed in Annex H, rather than abolishing them entirely. This implies, for example, that zero rates presently applicable for some supplies to charities could not be zero rated any longer. The same for supplies of children shoes and clothes.

Nevertheless, taking into account the high sensibility of this question, the Commission could accept maintaining the status quo for the time being, provided that a thorough review of these derogations is undertaken and completed before the end of 2006.

This review should take into account that all the derogations granted to accession countries are strictly time limited (at the end of 2007 for most of them; at the end of 2009 for Malta, concerning zero rates for foodstuff and medicines).

As you probably know, **the European Parliament** proposed amendments concerning charities in its opinion on this proposal. These amendments meant:

- To review the category concerning the supply and repair of medical equipment in order to cover "*The supply and repair of medical equipment, aids and other appliances normally intended to alleviate or treat disability, **or improve mobility or access**, for the personal use of the disabled, **including where supplied by charities**, and apparatus and electronic or other **equipment including alarm systems and lifts** and means of transport **intended**, designed or specially adapted for the disabled*".
- **to introduce listed buildings and monuments to Annex H, including buildings operated by bodies recognised by Member States as non profit making charities for purposes other than making of taxable supplies.**
- **to allow reduced rates for all supplies made by non profit making organisations or organisations recognised as charities, and to delete the present limitation to those engaged in welfare or social security work.**

The Commission rejected most of the amendments proposed by the EP. The main reason for that was because, according to the general principles of the 6th VAT directive, it is not possible to envisage a differentiated VAT rate according to the nature of the seller or of the purchaser. Although one could understand the social motivation of such amendments, this would represent an important

extension of the present scope of reduced rates. Moreover, such measures could create distortions of competition against businesses having the same activities.

In its proposal, and during the Council debates, the Commission has explicitly stated that there are a number of sectors in which Member States could apply an optional reduced rate without jeopardising the functioning of the Internal Market. For example, there is room for negotiation in the sector of buildings. On this basis, the Irish Presidency in the first half of 2004 proposed a flexibility mechanism which could have been applied to local services.

As for the state of play of the discussions in the Council, I am sorry to say that there is still no agreement.

I was very disappointed by the outcome of the debate that took place in the ECOFIN last June where the Luxembourg Presidency concluded that the Council could not reach an overall agreement on its compromise proposal.

I can only repeat that we need a global decision on VAT rates by the end of this year, including the very urgent issue of the reduced rates for labour intensive services.

The Commission has already done its best to facilitate the decision of the Council and will examine with an open mind any compromise that could be reached on the basis of the Luxembourg Presidency proposal. All Member States will need however to contribute constructively to finding a solution.

(Exempt Activities)

I would like now to turn to the issue of exempt activities. I know that many of you are concerned by the inability to deduct VAT related to charitable activities exempt from VAT, such as the provision of services and goods closely linked to welfare and social security as well as education and culture. Here the situation is different.

The need for action in this field was pointed out by the Commission in its VAT Strategy Communications of 2000 and 2003 where we have announced our intention to review the present regime of VAT exemptions for services of public interest. I fully intend to carry out this review and come forward with proposals to amend the 6th VAT Directive where this seems necessary and appropriate.

The reason for carrying out this review is that the existing exemptions are a potential source of distortion of competition and are no longer adapted to the current economic and social reality. They reflect and are designed to deal with the circumstances which prevailed in the 1970s (when the 6th VAT Directive was adopted) and are in need of modernisation. This exercise will be undertaken in order to investigate which of the existing exemptions are causing problems and whether their maintenance is still justified.

This will not be a simple exercise. In addition to looking at the role of the "social exemptions" we will need to take account of closely related issues such as supplies by public authorities and the treatment of subsidies under the VAT system. All these issues are closely inter-related and we have decided therefore to treat them as a package.

At this stage it would be premature to give you any commitment as to the specific measures which might be taken. I can however assure you that, in line with our overall VAT strategy, we will be seeking to find ways to simplify and modernise the legal framework. This will almost certainly involve the updating of the wording of the VAT Directive in the light of the new realities and the rulings which have been given in this area by the European Court of Justice.

We will also, as is the case now with all new legislative proposals, analyse the economic and social impact that any possible legislative change is likely to cause. In this context, I have no doubt that the effect of a reform of the current exemptions on Charities will be the subject of special attention.

A solution which is acceptable to all will not be easy to find, since the situation concerning VAT exemptions varies significantly from one Member state to the other. Some countries are more open to change than others and I recognise that there are political difficulties for some of them in removing exemptions. In this context the question of reduced rates may play a role and, consequently, will also have to be examined very carefully.

Currently, the common VAT rules already allow Member states to apply reduced rates to a number of categories of supplies for which no exemption is applicable. If the scope of the exemptions is reviewed it may be desirable to re-consider the actual legal framework concerning VAT rates in order to introduce the possibility of applying reduced rates where currently exemptions are obligatory.

In budgetary terms, the effect of an exemption is roughly equivalent to that of a reduced rate. Substituting a reduced rate for an exemption would not therefore mean that charities would necessarily be any better or worse off but it would mean that they

could make more rational decisions as to what activities they carry out in-house and what they might decide to out-source.

This was the rationale behind the Commission's proposal for the removal of the exemption for postal services that was presented to the Council in 2003. Despite the fact that an exemption does not mean in real terms that the final consumer pays no VAT, the anti-European Press in certain Member States has portrayed this as a measure which is designed to introduce a tax on postage stamps. This has led certain Governments to oppose the proposal despite the fact that a reduced rate would in fact be neutral in budgetary terms.

Although this precedent illustrates the difficulties we will face in getting unanimous acceptance of significant modifications in the area of social exemptions, I can assure you that I remain firmly committed to improve the functioning of the VAT system.

However, in order to do this we need your help and advice. Discussions with the various stakeholders are absolutely indispensable for us in the preparation of our work on future legislation on this matter.

This event therefore provides me with the opportunity to encourage you to participate and contribute to future initiatives to be launched by the Commission. For this particular issue an in-depth impact assessment is planned to be started by the end of 2005, which will be followed by a public consultation prior to the presentation of a legislative proposal in 2006. I urge you to participate in this consultation so that we can take your views into account as much as possible.

In conclusion, I hope I have been able to give you a realistic appraisal of the current situation and sufficient insight as to our possible future policy on VAT and Charities within the broader

context of the review of existing exemptions applied to services in the public interest.

Thank you for listening to me, ladies and gentlemen. I wish you a very successful continuation of this Conference.