Thematic Report – NPOs (Charities) and VAT

No consensus - no clear frame of reference

The subject is quite timely: At present, there are just too many not-for-profit institutions in Europe: Not only charities, but also states and private businesses that were not meant to be not-for-profit, but ended up that way!

The subject is also quite challenging.

The problem of income taxation and NPOs has been along for a very long time. There is not a clear theoretical framework, but there is a certain consensus and convergence between different countries in how to treat NPOs for income tax purposes. To start out with some very simplistic assumptions: That NPOs to a certain degree is not paying income taxes, may not come across as a paradox. The income tax is a tax on profits. No profits – no income tax.

Regarding VAT, one has to decide on how the VAT should be classified. If the VAT is regarded as a tax on transactions, any exemption for NPOs may represent a paradox: If the NPOs enter into transactions, why should they not pay VAT. Most often, and also by the ECJ, the VAT is primarily regarded as a consumption tax. In this perspective, it is only when one describes the technical construction of the VAT that it should be described as a transaction tax. By exempting NPOs from the VAT, some part of the consumption in society may be excluded from the tax. It is not obvious how this may be justified.

VAT is a formidable revenue instrument. But there is much less theory and published research regarding the VAT than what is the case for the income tax. Taken the economic significance of the VAT the difference in interest among tax scholars is striking.

Consequently, there is no clear frame of reference regarding VAT and NPOs.

Within the European Union there is some kind of normative reference, e.g. the VAT Directive art 132 and 134. But these exemptions are not based on any clear theoretical foundation. In addition, the exemptions may be important to NPOs, but most of them are not necessarily limited to NPOs – but may be so under art 133(a), see infra.

A challenge to persons not working within the VAT area, is the fact that NPOs may be charged VAT in basically two ways. If their supplies, the transactions where they provide goods and services are taxable, they shall have to charge VAT to their customers/clients and pay this output VAT to the government. EU VAT Dir art 132 and 133 deal with these kinds of exemptions.
Input VAT

Another, very important part of the VAT tax burden for NPOs is the input tax. Regardless of whether the NPO supplies goods or services to others, it will itself acquire goods and services. NPO will have to pay input VAT on these goods and services. It is treated as just another consumer. For many NPOs this input VAT may amount to much more that the income tax they may be required (or exempt from paying). In the long run the tax on profits, the income tax, of a typical NPO should not amount to much. The input VAT, on the other hand, is a tax on the gross amount for acquiring resources, goods and services. In percentage points it may be lower than any income tax. The revenue may amount to much more because it is calculated according to a gross basis, not a net basis.

Some countries have tried to moderate the input VAT burden for NPOs. The problem that may arise for EU member states is quite simply that any kind of refund arrangement for input VAT may be regarded as in breach of the regulations regarding the deductibility of input VAT in the EU directive. The national reporter for Portugal informs us that the reintroduction of reimbursement rules for NPOs regarding 50% of input VAT, has reopened an earlier discussion regarding the compatibility of such rules with the EU VAT Dir.

In Norway, there was after the widening of the VAT tax base to more services through the VAT Reform 2001, implemented a partial reimbursement system for some NPOs. Not all NPOs are covered, the rules and calculation of the reimbursement is very complicated and may appear somewhat idiosyncratic or erratic. They have been changed several times. As Norway is not a EU member, but a member of the EEA (European Economic Area), Norway is not bound by the EU VAT Dir. Most likely, the Norwegian partial reimbursements rules might have been considered partly or fully in breach of the EU VAT Dir.

The situation for NPOs regarding input VAT may be considered to have some parallels to their taxation under payroll taxes - another tax on the utilization of resources. Most countries have no broad exemption for NPOs regarding payroll taxes. To ease administrative burdens, there may be higher threshold and some exemptions. But the common rule is that NPOs are subject to payroll taxes —.

Two questions regarding input VAT may be discussed:

Would most feasible reimbursement arrangements for input VAT for NPOs be in breach of the EU VAT Dir?

From a theoretical point of view, is there any reason that the input VAT tax burden for NPOs may be regarded as unsound, unjustified or illogical?

Reduced rates

In some countries, reduced rates have been used as a mechanism to achieve deductibility for input VAT to the price of a rather low output VAT. In Sweden this is the case for cultural activities, 6% VAT. The result is considered to be a lower net VAT for cultural activities than when they were exempted. Most favorable is of course zero-rating. The scope of reduced rates are regulated in an annex to the EU VAT directive. One advantage of using reduced rates as a way of including the NPOs under the
VAT system, is that cascading effects are avoided if the NPO enters into transactions with VAT registered entities.

One might discuss to what extent reduced rates should be used to reduce the input VAT of NPOs, and perhaps get some more examples of countries where such a solution has been found satisfactory.

Wide variation in output VAT for NPOs under the VAT Directive and member states’ VAT legislation

The exemptions from output VAT listed in EU VAT Dir Title IX Ch 2, art 132 is given the heading Exemptions for certain activities in the public interest. Some of the exemptions are not relevant to NPOs, e. g. point (a) the supply by the public postal services and (e) the supply of services by dental technicians. Other exemptions are highly relevant to many NPOs, e. g.(b) hospital and medical care, (g) the supply of services and of goods closely linked to welfare and social security work, (i) the education exemption for children and young people. Art 132 point (m) exempting services closely linked to sport or physical education states as a mandatory requirement that the services should be provided by non-profit making organizations.

The exemptions in art 132 are not optional for the member states: Member states shall exempt the following transactions.

The obligatory nature of the exemptions in art 133 are, however, considerably reduced by art 133. The member states may make seven of the exemptions in art 132 "subject in each individual case to one or more of the following conditions:

(a) the bodies in question must not systematically aim to make a profit, and any surpluses nevertheless arising must not be distributed, but must be assigned to the continuance or improvement of the services supplied;
(b) those bodies must be managed and administered on an essentially voluntary basis by persons who have no direct or indirect interest, either themselves or through intermediaries, in the results of the activities concerned;
(c) those bodies must charge prices which are approved by the public authorities or which do not exceed such approved prices or, in respect of those services not subject to approval, prices lower than those charged for similar services by commercial enterprises subject to VAT;
(d) the exemptions must not be likely to cause distortion of competition to the disadvantage of commercial enterprises subject to VAT."

It is not quite clear from the national reports how many member states have implemented these conditions. If all four conditions are applied, not many large NPOs would remain. All professionally administered NPOs might find it hard to satisfy point (b) that the organization should be managed and administered on an essentially voluntary basis. Consequently, the VAT EU Dir may make for a wide variation in how NPOs are treated with regard to output VAT even if they supply the services that are listed in art 132.

Furthermore, there is a wide variation in the national regulations attending output VAT due to the derogation provision in EU VAT Dir art 371 allowing older Member States "which, at 1 January 1978, exempted the transactions listed in Annex X, Part B, may continue to exempt those transactions, in accordance with the conditions applying in the Member State concerned
on that date”. The list in annex X Part B is quite comprehensive. It may explain why some of the national reports describes exemptions from VAT not listed in EU VAT Dir art 132.

The national reporters have not had much room to elaborate. It may be discussed whether there is a need for a more thorough listing of the various requirements and exemptions that are in place in the Member States under art 133 and art 371.

From the national reports it also may appear that some member states have stretched the exemptions prescribed under art 132. A more thorough comparison might also be of interest.

However, such an overview may not be in the interest of the NPOs. Both due to the financial crisis and the general pressure under VAT to eliminate exemptions, a comprehensive survey of existing exemptions may just result in making existing national VAT accommodations of NPOs more controversial. This may not be the time to speak up about tax exemptions that one would like to retain.

Also, one might ask the question whether it should be the aim of VAT scholars to provide the Commission with a list of possible national infringements attending VAT provisisons concerning NPOs(!).

**Output VAT: Is a conditional exemption conceptually consistent with the VAT?**

EU VAT Dir art 133 (d) allows the Member States to subject exemptions for activities in the public interest under Art 132 to the condition that the exemption “must not be likely to cause distortion of competition to the disadvantage of commercial enterprises subject to VAT”. If the goods and services supplied by the NPO are also supplied by commercial enterprises, such a distortion may easily exist. The principle of neutrality is one of the basic principles of VAT. It is referred to in many cases decided by the ECJ. One example regarding NPOs is C-498/03 Kingscrest Associates Ltd. The ECJ stated: “54 In addition, it must be recalled that the principle of fiscal neutrality precludes, in particular, treating similar supplies of services, which are thus in competition with each other, differently for VAT purposes (see, to that effect, Kügler, paragraph 30, and Commission v Germany, paragraph 20).” Consequently, it may be in breach of the principle of neutrality to exempt services provided by NPOs if ordinary businesses supply the same kind of services.

If one holds that the VAT is a tax on consumption (or transactions) and that the principle of neutrality is of paramount importance, one might discuss whether a differentiation between NPOs and For-profit-enterprises is at all sound or relevant. If one wants to exclude, e.g. small NPOs from the requirements of the VAT, one might instead formulate the registration requirements, the turnover thresholds etc in such a way that they accommodate the needs both of small NPOs and For-profit-enterprises.
An alternative point of view might be that it is vital not to make the VAT controversial due to its function as a very efficient revenue machinery for the Member States. There are huge differences among the VAT provisions across the Member States. This may be due to cultural and national variations that it is politically important to respect. Constructing a tax is not only a question of theory, but of political sensitivity. The many and varied VAT exemptions for NPOs in Member States may be due to such a political compromise. It may also explain why this is an area where the Commission does not appear that eager to initiate infringement proceedings.

From the national reports, it is quite clear that the principle of neutrality is an important part of much legislation attending NPOs and VAT. The special German system of reduced VAT rates rendered by corporations which serve public-benefit, charitable or religious purposes, is not applicable if the activities are primarily carried out to generate additional income and the corporation enters into direct competition with other enterprises. To an outsider, the Greek restriction to two VAT exempt financial support events per year may be a way of trying to limit these activities so as to limit the distortion of competition. Also, one might ask the question whether the threat of distorted competition may be exaggerated. The Dutch report e.g. informs about the possibility of issuing a governmental decree that might refuse a VAT exemption relevant to NPOs. Such a decree has, however, never been issued.

One might also ask the question: Is it reasonable to impose VAT on activities that have almost exclusively been produced by NPOs or governments because private producers have entered the sector in recent years? To what extent should one apply the neutrality test with a historical perspective in mind? Or should it always be the present situation that defines what is neutral and what is not? An affirmative answer to the last question might imply that many exemptions from output VAT may be liable to change if ordinary businesses enter an area where NPOs traditionally have been the suppliers.

**Conditions for VAT status – harmonization with income tax provisions**

Under the income tax, the definition of what may constitute a taxable business may be narrower than under the VAT. For the purposes of the income tax, it may be important to ask whether the economic activities will contribute to a profit. Under the VAT, the main focus may be on the transactions. Sweden may appear to be the only surveyed state that has tried to closely link the criteria for eligibility for income tax and for the VAT. The Commission has made objections that the Swedish rule are not compatible with the EU VAT Directive.
Irrespective of the requirements of the EU VAT Directive one might ask whether there is any point in working towards a greater convergence between the subjective criteria for income taxability and qualifying as a taxable person under the VAT.

It appears from the national reports that there are various requirements and controls that may be satisfied to qualify for VAT exemptions. In Hungary, there is a separate act specifying the requirements that must be met before a NPO may qualify. One might ask whether such requirements may be used for any kind of political control with the NPO sector.

Free supplies to the NPO – exemptions for free goods and pro bono services

A subject that is fairly unique to NPOs is the question of supplies received without any consideration. There is, of course, no input VAT for the NPO. But there may be some a question of output VAT to be paid by the donor on the supplies characterized as deemed supplies. Consequently, it is the business that donate goods or services to the NPO that may be subject to output VAT. Such an output VAT on such donations of goods and services as deemed supplies would be the normal procedure under the regular VAT rules and under the EU VAT Dir. There will be no input VAT for the NPO as the input VAT is only VAT levied on sales for consideration (and reverse charge situations). If a donor sells goods or services to a NPO for some consideration, it is not a deemed consideration according to the EU VAT Directive ((C-412/03, Scandic Gåsabåck). The donor will thus only pay VAT on the received consideration, but not on the higher value that is applied to deemed considerations (purchase prize or market value). A taxation according to article 80 in the directive is normally also not applicable.

Some of the national reports describe some exemptions from output VAT for donors to NPOs. It is not quite clear on what basis such exemptions may be compatible with the EU VAT Directive.

Another question is how to treat an NPO that receives goods that is sold (second hand) when VAT is to be charged on the sales price. There is probably no deduction for input VAT (does not exist) and the special rules for VAT only on the marginal when used goods are sold gives little relief if the marginal is calculated as the difference between sales prices and purchase prices (zero).

It may be discussed whether the present EU VAT Directive allows for exemptions from output VAT in the case of supplies of goods and services free of charge to NPOs. A more interesting question may be whether such supplies should be allowed free of VAT. In the case of services, one pro argument may be that it may be hard to control whether services are supplied. Therefore, it may be better not to force pro bono activities into some kind of grey bush country.
One might also ask the question whether the donor should be able to claim a credit for the relevant input VAT regarding the free goods and pro bono services.

Cross-border services and supply of goods

Many important NPOs and NGOs (non-governmental organizations) operate on an international level.

The rules under the EU VAT Directive regarding cross border transactions are quite complicated, especially attending services. Several reporters describe exemptions for NPOs relating to cross border transactions. There does not appear to be a common pattern relating to these exemptions. Due to the underlying complexity of the VAT rules and the different needs the exemptions in the national legislation try to accommodate, this lack of common pattern may appear quite logical.

To what extent should there be exemptions for NPOs regarding cross border acquisitions and supplies of goods and services? To what extent are such exemptions allowed under the EU VAT Directive?