

## **Client Newsletter – European VAT Update November 2005**

We issued a newsflash recently telling you about the latest press release from Brussels promising a “level playing field” between the VAT treatment of public sector and private sector bodies. The purpose of this Client Newsletter – we limit the circulation to our current fee-paying clients – is to expand on that newsflash and to bring you up to date with our understanding of the current thinking regarding public sector VAT.

The main thrust of what is now referred to as the “Lisbon Strategy” is to make Europe a more attractive place in which to invest and work; to promote knowledge and innovation; and to shape policies that allow European businesses to create more and better jobs. To do this, we need to raise the efficiency of our economies and, in doing so, generate more competition in the markets and boost trade.

The Strategy seeks to achieve this in three ways:

- To eliminate tax distortion and thereby increase competitiveness;
- To extend and deepen the internal market; and
- Increase investment in Research & Development

It is the first and second of these points which will involve changes to the VAT system which might well affect local authorities.

As part of the overall tax strategy, the report recognises that a simplified tax system benefits the private sector which in turn creates the wealth to fund public services. A balanced VAT system helps to ensure open and competitive markets, but creating this “level playing field” involves removing the imbalances where public bodies provide services similar to those supplied by private bodies. The report says this about public/private sector imbalances:

### *Public authorities competing with private business*

The rules governing the exemptions of services in the public interest and the **exclusion of public bodies from the scope of the application of VAT** will also need modernising. The current rules are outdated and no longer correspond to the economic reality of the 21<sup>st</sup> century, where former monopolies have been subjected to liberalisation processes and broad areas of public services have been partially or totally privatised. This is causing distortions of competition and economic inefficiencies and is encouraging tax avoidance schemes. The Commission intends to amend the current VAT rules by making a proposal by the end of 2006 to re-establish a level playing field in certain activities in which both public and private entities are involved.

So what does this mean to local authorities in UK?

The truth is, nobody knows yet – we can only speculate. As this review is being carried out at the European level, it seems unlikely that section 33 or similar refund mechanisms in other EU countries will be affected. However, we might see a re-drawing of the rules concerning what is deemed to be non-business, although it is difficult to see how else, as an alternative to Article 4.5, one might determine when an activity falls outside the scope of VAT. There are no clues to be found in the proposed re-draft of the 6<sup>th</sup> Directive, although that is to be expected as that process is more a consolidation of existing law than a re-think on how the Directive should be framed. I think we will have to wait for more hints to be dropped from the Commission prior to the release of their report in 2006 before we have any firm info to consider.

It seems that there is scope for change. Within the proposals for redrafting the Sixth Directive, certain exemptions which are currently limited to public bodies or charities have been reworded such that they now include private sector bodies carrying out the same functions. They achieve this by replacing the term “charitable bodies” with “bodies devoted to social wellbeing”. This is perhaps an area where the Commission sees a need for restructuring of the rules relating to exemptions in the social interest, but if they are seeking to widen their availability, might they not also seek to apply them more rigorously?

What of non-business treatment? As you know, Annex D to the Sixth Directive lists those activities which must always be treated as business activities, even when supplied by public bodies (provided they are not carried out on such a small scale as to be negligible). The Commission has promised to review the rules by which public bodies are removed from the scope of VAT – in other words, the range of activities which they can treat as non-business. Could the Press Release herald a move to review this list?

There will doubtless be speculation on what the outcome of this modernisation programme will mean to local authorities both in UK and across the EU. One thing is sure, we can expect to see some changes.

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