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EFC - ECCVAT - Charity Tax Group Information Note on VAT and Foundations

How to improve the VAT system for public-benefit foundations

Executive Summary

Public-benefit foundations and VAT

Public-benefit foundations make a real difference to the public good across the European Union, but the full potential of their activities is being blocked by the unnecessary and unfair burden of Value Added Tax (VAT). The current VAT system creates many problems for the foundation sector and more broadly the charity sector, so the European Foundation Centre (EFC), the Donors and Foundations' Networks in Europe (DAFNE) and the European Charities' Committee on VAT (ECCVAT) are calling for fair VAT treatment of public-benefit foundations, to allow them to maximise the public-benefit impact of their work.

Why act now ?

The 2006 VAT Directive provides the current legal framework for applying VAT across the EU. The European Commission is planning a public consultation on the taxation of public bodies and social exemptions due to start in 2009 when the new Commission starts its work, which will address VAT treatment of foundations and charities. This will be an opportunity for foundations and charities to make their case to the EU institutions.

Cost of VAT on public benefit

In the UK alone, it is estimated that charities and foundations lose over £400m (€570m) a year on VAT: money that could otherwise be used for the public good.

Why do foundations suffer under the current VAT system?

Foundations and other public-benefit organisations were not considered when the EU-level VAT system was planned in the 1960s. Currently the 2006 VAT Directive¹, which replaced the first and sixth VAT Directives, provides the legal framework for applying VAT in EU countries².

- Foundations must pay irretrievable VAT costs
Public-benefit foundations are treated by the VAT system as the final consumer, with no possibility of reclaiming VAT, while companies may pass on the cost of VAT when they sell their products or services. Public-benefit foundations often provide services that are either exempt under the VAT Directive or outside the scope of VAT since they do not charge for their services. In neither case can public-benefit foundations pass on the cost of VAT incurred in delivering services, to their consumers.
- Complex accounting

¹ VAT Directive 2006/112/EC of 28th November 2006

² VAT was first introduced in France in 1954 for large businesses. It was gradually extended to all businesses and became popular in other European countries. VAT is a tax on the value added at each stage of the 'production' process. In calculating its VAT bill, an organisation can deduct any VAT it has paid on inputs into its business products or services. In 1967 the then EEC decided to harmonise its member states' system of indirect taxation and obliged member states to adopt a VAT system.

As foundations provide a mix of fully-taxable business supplies with exempt and non-business supplies, they are subject to the most complex accounting requirements. The administrative burden of calculating which services are subject to which rates of VAT is more complicated than for companies, which provide almost exclusively taxable services.

- **Disincentives to collaboration between foundations**

The VAT system is a disincentive to foundations working together and pooling resources to maximise their impact on the public good. If one foundation provides services to another it must charge VAT, but the foundation paying for the service cannot recover it.

How to relieve the tax burden on public-benefit foundations?

There are several ways to solve the disproportionate tax burden to which public-benefit foundations are subject:

- **Bringing foundations into the VAT system (abolishing exemptions) but allowing a reduced rate on both outputs and inputs**

One option is to abolish existing VAT exemptions so public-benefit foundations as suppliers of currently-exempt goods and services are able to charge VAT on outputs, thus getting back the VAT they paid on inputs.

- **Switching to reduced-rate tax**

Another option is to recognise foundations' right to opt for taxation in the case of exempt transactions. This would allow some foundations to be taxed on their transactions at lower rates so they can deduct the VAT incurred by acquiring goods and services for this purpose.

- **Allowing exemption with refund ('zero-rating' supplies by charities)**

For VAT-exempt supplies, which are sold to the buyer without any VAT, the 'supplying' public-benefit organisation might be allowed to claim back the paid input VAT. Such a solution would lead to zero-rate supplies as the result is no residual VAT in the final price.

- **Recovering input VAT on non-business supplies**

For supplies which are outside the scope of VAT (eg non-business supplies), provided free of VAT, the supplying public-benefit organisation might recover the paid input VAT.

- **General refund schemes to compensate for VAT losses at national level in line with EC rules?**

EU countries might introduce national VAT compensation refund schemes. VAT requirements are subject to national interpretation and national governments have discretion to compensate foundations for the irrecoverable VAT they pay.

What next?

Unfair VAT treatment of public-benefit foundations is clearly unacceptable, and diminishes the impact of foundations' public-good work across Europe. EFC calls its members and partners to give greater attention to this issue when they are negotiating with the national tax authorities in their countries. The Commission's public consultation on taxing public bodies, including a possible VAT refund scheme, is an opportunity to ensure public-benefit foundations are listed as organisations eligible for refund. EFC will tell members about the consultation and encourages them to respond to the consultation when it is launched.

In the meantime EFC is hoping to get a better understanding of how much our members spend on VAT. Please would you take a few minutes to answer the questions at: <http://www.zoomerang.com/Survey/?p=WEB227TET2X7WM> and send them back **at your earliest convenience**.

Value-Added Tax (VAT) system for public-benefit foundations needs improvement

Given that public-benefit foundations have a vital role in supporting public-benefit activities across Europe, the tax system should support effective use of their funds. Politicians have recognised this in many ways. Public-benefit foundations receive tax exemptions in most EU countries when it comes to corporate income tax and gift-and inheritance tax as well as other taxes. But the current VAT system does place a major financial burden on public-benefit foundations. Foundations and charities have often expressed concern about this. When they buy goods and services, they are usually considered the final consumer for VAT purposes and cannot reclaim the VAT. This has implications on foundations and their beneficiaries. It is surely illogical to give tax relief to charitable organisations only to tax their spending?

How much do foundations lose on VAT?

The extraordinary situation where companies are treated better than charities produces some striking data. VAT can amount to 10% of a charity's overall spending, while for a typical business it is about 1.5%. According to the Charity Tax Group's research in the UK, charities, NGOs and foundations lose over £400m (€574m) a year through irrecoverable VAT. This is £400m that is not being spent on the organisation's primary targets. The total cost is likely to be even higher as the UK survey was undertaken several years ago, and the UK foundation sector alone incurred a total of €560m in lost VAT last year. Studies in Ireland, Denmark and the UK also show that foundations are paying some 4% of their total spending on VAT. According to an ongoing EFC survey, which has so far been answered by 17 foundations across Europe, their combined expenditure on lost VAT is some €10m annually. Further results are awaited in due course.

With foundations, many of their beneficiaries will also pay irrecoverable VAT which has either to be met by the foundation in the grant or found elsewhere. This considerably reduces the impact of grants. In 2006, the Wellcome Trust paid some €12.5m of irrecoverable VAT (this could fund c.40 three-year project grants). Cancer Research UK (CRUK) paid c.€5m, which it estimates would cover its key contribution to the UK Children's Cancer Study Group for three years.

In recent years, foundations have grown more aware of these 'hidden' costs. EFC, with national foundation networks (DAFNE) and the European Charities' Committee on VAT (ECCVAT) has decided to start a joint VAT campaign for public-benefit foundations and charities. As a first step, EFC and ECCVAT have produced this information note to raise awareness. EFC is also running a quick electronic survey among its members to analyse the scope of the problem. ECCVAT will be doing similar work with its European members, including the broader 'third sector', rather than foundations alone. Since the legal and fiscal principles were drafted in 2002, EFC's members have argued that "*VAT rules and their application should take into account the public-benefit nature of foundations and their activities, and should in no case disadvantage foundations.*"³

To see how that money could be used, the Charity Tax Group has identified some concrete UK examples. Irrecoverable VAT costs the Home Farm Trust, an organisation helping mentally-handicapped children and adults, £700,000 a year. The charity could otherwise use this to employ 35 extra staff to support many more people in registered care homes plus advocacy and supported employment and day services. Sense loses over £600,000 a year through irrecoverable VAT, which would be better spent providing direct support for a further 700 families with disabled children. Sue Ryder Care's annual irrecoverable VAT bill is £560,000, which could fund round-the-clock care for ten people with severe long-term neurological conditions.

How does VAT work: what is the current legal regime?

The 2006 VAT Directive⁴, which replaced the first and sixth VAT Directives, provides the legal framework for applying VAT in EU countries⁵.

³ http://www.efc.be/ftp/public/EU/LegalTF/Fundamental_pples.pdf

⁴ VAT Directive 2006/112/EC of 28 November 2006

⁵ VAT was first introduced in France in 1954 for large businesses. It was gradually extended to all business sectors and became popular in other European states. VAT is a tax on the value added at each stage of the

Several Member States have derogations (reliefs) which allow them to charge lower rates of VAT on some goods and services, and other EU countries have limited-duration derogations on the VAT rules. The current situation is that the zero and reduced rates secured by some countries are protected for the moment, but will probably expire in 2010.

Some VAT-exempt supplies are sold to the buyer free of VAT. So deducting the VAT paid on inputs (by the supplier) is not possible. But there are some exemptions where the supplier may deduct his input VAT. These exemptions are often called zero-rate supplies as the result is that there is no residual VAT in the final price.

Why do public-benefit foundations suffer under the current VAT system?

When the current VAT system was developed, the special position of public-benefit organisations, including foundations, was not considered. Foundations' main concerns are:

- **Foundations face irrevocable VAT costs: they are treated as the final consumer, even when they are not**

Public-benefit foundations often provide services that are either exempt under the VAT Directive⁶ or are outside the scope of VAT because they do not charge for their services. In both cases the organisations do not charge their customer or beneficiary VAT and so cannot recover the VAT on spending which supports their public-benefit aims. In fact public-benefit foundations are in a worse position than companies, which can charge VAT and pass it on to their customers. They are also often treated worse than local authorities (public bodies), which do not charge VAT but in many EU countries may claim back the VAT they incur.

- **Calculating VAT is complicated and onerous**

They are also exposed to the most complicated VAT regime because they provide a mix of fully-taxable business supplies, exempt business supplies and non-business supplies. The task of calculating which bit of VAT relates to which kind of service is onerous for foundations. It is much easier for companies, which almost exclusively offer taxable services.

- **Disincentives to collaborating**

The VAT system also penalises collaboration between foundations. If one foundation supplies services to another it must charge VAT on the supply, but the foundation buying the service cannot recover the VAT. And collaborative activity may generate no business. This discourages charities from seeking economies of scale on shared services (unlike the commercial sector). To minimise VAT inefficiencies, foundations must ensure partnerships with other foundations are carefully planned. This might involve setting up a Special Purpose Vehicle, itself a costly and time-consuming process and a disincentive to collaborate.

- **For fund-raising organisations - VAT cost on fund-raising**

The British Government gives generous tax relief on donations to foundations, but that money is then subject to VAT when it is spent. For example, in 2004, Oxfam spent some €20m on fund-raising and in the process lost about €2m in irrecoverable VAT.

Summary of VAT burden

- Foundations face irrevocable VAT costs: they are effectively treated as the final consumer, even when they are not
- VAT calculation is complicated and onerous
- Distortion of competition between foundation and corporate sectors in delivering services
- Disincentives to collaborate with other partners
- Irrecoverable VAT can amount to 10% of a charity's overall spending

What can be done?

Several Member States and the main European institutions have acknowledged the need to tackle this unfair burden. To counter these negative effects, several EU countries have introduced derogations (exemptions) allowing them to charge lower rates of VAT and in some

'production' process. In working out an organisation's VAT bill, an organisation can deduct any VAT it has paid on inputs into its business products or services. In 1967 the then EEC decided to harmonise its member states' system of indirect taxation and obliged member states to adopt a VAT system.

⁶ Article 132 of the new version of the VAT Directive 2006/112/EC provides for exemptions for certain public-benefit activities (Article 13 of the old version)

cases zero-rates on some goods and services, which apply indefinitely. Other Member States apply limited-duration derogations to the VAT rules. The current situation is that the zero and reduced rates secured by some countries are protected, but they may be removed in 2010.

In November 2007, the European Parliament's Committee on Economic and Monetary Affairs asked that all EU countries should be able to impose lower VAT rates when there is a clear social, economic or environmental benefit.⁷ For several years, the wish to harmonise the VAT system has been expressed. For instance on 5 July 2007 the Commission called for the current VAT structure, particularly reduced VAT rates, to be simplified and rationalised.⁸ More recently, on 22nd April 2008, the European Parliament issued a resolution on the role of volunteering in contributing to economic and social cohesion, which calls for the Commission, to consider together with the Member States the strong social arguments for introducing VAT exemptions for voluntary organisations registered in the Member States on purchases intended for the accomplishment of their objectives, and also to consider the arguments for exemption, in specific cases, from payment of VAT on goods and services that are donated to voluntary organisations.⁹

There are various possible solutions to the issue of irrevocable VAT costs:

- a) Bringing charities into the VAT system (abolishing exemptions) but allowing a reduced rate on both outputs and inputs
 - b) Giving the option of switching to reduced-rate tax
 - c) Allowing exemption with refund (equivalent to zero-rating)
 - d) Providing the right to recover input VAT on non-business supplies
 - e) Establishing general refund schemes to compensate for foundations' VAT losses at national level in line with EC rules
 - f) Setting up a mandatory EU refund scheme
- or a mix of the above

- **Bringing charities into the VAT system (abolish exemptions) but allowing a reduced rate on both outputs and inputs**

One option is to abolish existing VAT exemptions so public-benefit foundations as suppliers of currently exempt goods and services could charge VAT on outputs, thus recovering the VAT they paid on inputs. VAT rates on both outputs and inputs might be reduced. This would require revision of the VAT Directive. The Commission proposes to review "exemptions for certain activities in the public interest" in Article 132 of the new version of the VAT Directive (Article 13 of the old one). This would not necessarily be bad for public-benefit foundations, although the tax rate charged on the foundation's outputs would be crucial. In that case, Point 15 of Annex III in the Directive's new version (Point 14 of Annex H of the old Sixth Directive), which lists supplies of goods and services (certain outputs of public-benefit organisations) to which reduced rates may be applied, would need to be implemented and made mandatory at EU level. But according to ECCVAT, there might still be major problems for charities, since the VAT rate charged on charities' outputs would still, in most countries, be too high to produce a neutral fiscal effect. So ECCVAT believes a special reduced rate on charities' social welfare outputs is needed.

- **Switching to tax at a reduced rate**

Another option might be to recognise foundations' right to opt for taxation in the case of exempt transactions. This would allow some foundations to be taxed on their transactions at lower rates to be able to deduct the VAT incurred in acquiring goods and services for this end. On 28 November 2007, the Commission submitted a proposal for a Council Regulation to modify Directive 2006/112/EC on the treatment of financial and insurance services with the aim of safeguarding the principle of VAT neutrality.¹⁰ These services are also exempt under

⁷ http://www.europarl.europa.eu/news/expert/infopress_page/042-13347-324-11-47-907-20071119IPR13313-20-11-2007-2007-false/default_en.htm

⁸ European Commission press release IP/07/1017 and memo/07/277

⁹ European Parliament resolution of 22 April 2008 on the role of volunteering in contributing to economic and social cohesion, Rapporteur: Marian Harkin, [http://www.europarl.europa.eu/RegData/seance_pleniere/textes_adoptes/provisoire/2008/04-22/P6_TA-PROV\(2008\)04-22_EN.doc#_Toc196655471](http://www.europarl.europa.eu/RegData/seance_pleniere/textes_adoptes/provisoire/2008/04-22/P6_TA-PROV(2008)04-22_EN.doc#_Toc196655471)

¹⁰ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2007:0746:FIN:EN:PDF>

community VAT law¹¹ and the proposed Directive specifically allows the option of tax as a means of recovering VAT¹².

- **Allowing exemption with refund ('zero-rating' of supplies by charities)**

For VAT-exempt supplies, sold free of VAT, allowing the supplying public-benefit organisation to reclaim the paid input VAT is an option. This would lead to zero-rate supplies, with no residual VAT in the final price. 'Zero-rating' supplies by public-benefit organisations would require the VAT Directive's modification. But the Commission has cited "difficulties with the general application of zero-rates across the EU".

- **Granting the right to recover input VAT on non-business supplies**

Foundations cannot currently recover input VAT for 'non-business' activities. For supplies outside the scope of VAT (eg non-business supplies), which are provided free of VAT, it should be possible to allow the supplying public-benefit organisation to recover the paid input VAT. But this would change the whole concept of VAT as it is a tax on business production. Foundations often have a mix of activities (non-business and business): some of their activities, such as free-of-charge services, are outside the tax system's scope, while others fall within the VAT system's scope (eg goods or services sold). The 1991 European Court of Justice's 'Lennartz case'¹³ ruled that if there are both business and non-business activities in a building, organisations can reclaim VAT on all construction costs and reimburse the VAT on the part of the property used for non-business purposes each year. The EU is again looking at application of the Lennartz case and might recommend that foundations may only claim the expected business proportion at the outset, which would be adjusted each year to reflect the actual business element.

- **General VAT compensation refund schemes at national level in line with EC rules?**

EU countries could introduce national refund schemes. National governments often claim they have little flexibility on VAT and are limited by EU law. But VAT requirements are subject to national interpretation and national governments may compensate foundations for irrecoverable VAT. In 2005, the EU Tax Commissioner, László Kovács, said at an ECCVAT-organised conference: "*The more feasible option is to address this problem outside the VAT system. This is an approach which has been adopted by some Member States which have put in place mechanisms for reimbursing to charities some or all of the VAT they have been charged*". He confirmed this was compatible with EU law and 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*." The British Government refunds local authorities for VAT paid on service provision. Many services are identical to those provided by charities, yet charities are not entitled to any VAT refund. Denmark's national refund scheme might be an example for other countries, such as Sweden, which has examined this option.

- **Setting up a mandatory EU refund scheme**

A rather unlikely solution would be setting up a mandatory EU refund scheme for public-benefit organisations, which face irrecoverable VAT costs on inputs.

How do EU institutions see the matter?

The European Commission and Parliament have long recognised the unfairness of the status quo, and both acknowledge that VAT treatment of charities is unsatisfactory. Parliament acknowledged this in its 22 February 2002 report on tax policy priorities. Section G-7: "*notes that when the Sixth Directive on VAT was drafted, no account was taken of the special needs of charities which, despite their role as providers of services in key areas of the economy (specifically health, education and welfare), are treated as consumers according to the prevailing regulations governing VAT as it is considered that their activities do not constitute a business or they are exempt under letter a) of Article 13 of the Sixth Directive*", and "*it requests that the Commission establish analogous rules regarding the refund of taxes because these are easy to bring in and administer as they have no bearing on the rest of the supply chain*."

The way forward

In 2009, the Commission will launch a consultation on the review of the VAT taxation of public bodies and the future of social exemptions. This consultation is a prime opportunity for

¹¹ Article 135 (l) of Directive 2006/112/EC

¹² By modifying article 137 (a) of Directive 2006/112/EC

¹³ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:61990J0097:EN:HTML>

the charitable sector to speak out on a radical rethink of VAT. The consultation is expected when the new Commission starts its work in 2009, with the results and a possible legislative proposal by the Commission emerging in 2009-2010. In reviewing special arrangements for public bodies, the Commission is considering including VAT refund schemes in the VAT system. If this suggestion is to be adopted, it is imperative that public-benefit foundations are listed as bodies eligible for a refund when they provide public services under contract to central or local government. Another solution potentially provided by the new proposal is the inclusion of public bodies and public-benefit organisations into the VAT scheme, whereby they could pass on the VAT incurred by them. This is also a good opportunity to review the overall introduction of an EU-wide refund scheme for public-benefit organisations.

EFC is currently running a simple survey asking members how much they lose annually on unreclaimable VAT. The survey is available at <http://www.zoomerang.com/Survey/?p=WEB227TET2X7WM>. For more information please contact EFC at legal@efc.be or +32 (0)2 512 8938.

ECCVAT, assisted by the London-based Charity Tax Group, is currently studying the impact various scenarios (refund scheme, zero-rate, etc) would have on different categories of charitable organisation. For more information please contact Mathieu Mori (mathieu.mori@centrallobby.com or by phone +44 (0)20 7222 1265) and visit EECVAT's website (<http://www.eccvat.org/>).

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European Foundation Centre

The European Foundation Centre (EFC), founded in 1989, is an association of over 200 public-benefit foundations and corporate funders active in philanthropy in Europe and beyond. Our goal is to strengthen independent funding in European philanthropy using four key approaches. We foster a legal and fiscal environment where foundations can thrive. We analyse and recount what foundations are doing. We reinforce the philanthropic sector by setting standards and building capacity. And we promote collaboration among foundations and with other stakeholders, to advance the public good. All members back the EFC Principles of Good Practice, which reinforce good practice and transparency.

www.efc.be

European Charities' Committee on Value-Added Tax

The European Charities' Committee on Value-Added Tax (ECCVAT) is a group of European charities that has come together to research the impact of VAT and other taxes on the work of NGOs and to make representations to the EU institutions on behalf of the sector.

www.eccvat.org

Charity Tax Group

The Charity Tax Group (CTG) was formerly known as the Charities' Tax Reform Group (CTRG) and has over 400 UK members of all sizes representing all types of charitable activity. CTG was set up in 1982 to make representations to Government on charity taxation and it has since become the leading voice for the sector on this issue. It has persuaded successive Governments to introduce a range of tax reliefs and has also successfully campaigned to protect existing concessions.

www.ctrg.org.uk