TSG 06/07

VAT Issues and Options

Introduction

1. This paper discusses VAT issues under three main headings:

- The VAT rating structure in Ireland and the options for changing VAT rates;
- VAT issues arising in the domestic context; and,
- VAT developments at EU level.

Annual VAT Revenue

2. VAT represents the largest single revenue resource within the Irish tax system. However, yield from VAT depends on the state of the economy and consumer spending from which it derives. In 2005, VAT accounted for approximately €12,125m or 31% of the overall tax yield to the Exchequer.

VAT Rates and Structure

3. VAT rates are applied in accordance with the rules provided for under EU VAT law and specifically the EU Sixth VAT Directive. In this regard, Ireland, apart from the farmers' flat rate VAT addition, operates three rates of VAT:

- **Zero-rate** which generally applies to most food, childrens' clothes and shoes, and oral medicines. While it is possible to retain the zero rating for goods and services that were in place on 1 January 1991, no new zero VAT rates can be introduced;
- **Reduced rate** of 13.5 per cent which applies mainly to domestic fuels, labour intensive services and general repairs and maintenance. Member States may have up to two reduced VAT rates of not less than 5 per cent for a specified number of goods or services which are set out in Annex H of the EU Sixth VAT Directive;
- Member States have the option of maintaining, at a reduced rate of not less than 12 per cent, any items not listed in Annex H, provided they carried the reduced rate on 1 January 1991. These items are considered to be 'parked' and Ireland's parked rate equates to our reduced rate of 13.5%. Domestic fuels, restaurant services and labour intensive services are examples of parked items.

- **Standard rate** of 21 per cent for goods or services which are not zero rated or reduced rated. Approximately 52% of all goods and services are subject to the standard VAT rate. Examples would include; cars, electrical equipment and CD/DVDs. Under the Sixth VAT Directive Member States may set the standard VAT rate not lower than 15% - there is political agreement that the standard rate of VAT applying in each Member State does not exceed 25%.

4. Services provided by charities, non profit organisations and certain financial services are **exempt** from VAT. In general, Government Departments and local authorities are also exempt. Operators in these sectors do not generally charge VAT on the services they provide and cannot reclaim VAT incurred on the goods and services they purchase.

Options for changes to VAT Structure and Rates

Standard Rating of all Goods and Services

5. Applying VAT at the standard rate of 21 per cent to all goods and services currently subject to VAT would yield an estimated additional €4,696 million in a full year. However, this would involve very large price increases across a range of goods and services. This could led to pressure for compensation from those on social welfare and on other state services which would reduce the net benefit to the Exchequer. In addition, such a move would have a negative impact on our competitiveness as an economy.

Restructure VAT System on a revenue neutral basis

6. If the VAT system were to be restructured on a revenue neutral basis so that all goods and services subject to VAT were at a single rate this would imply a rate on all goods and services of 15.91 per cent. Re-aligning the VAT rate structure in such a manner would give rise to increases in most food and reductions in more expensive items such as cars.

Possible changes to zero rating

7. Under EU rules we can retain the zero rating of items which were zero rated on 1 January 1991 but cannot introduce any new zero rates. It is possible to move existing zero rated items to either the reduced rate, provided they are listed in Annex H, or to the standard rate. However, once moved, it would not be possible to revert them to the zero rate.

Introduction of a Second Reduced VAT Rate

8. It is only possible to introduce a reduced rate in respect of the list of goods and services set out in Annex H of the Sixth VAT Directive. The Directive requires that any second reduced rate has to be a minimum of 5 per cent. The goods and services in Annex H include certain foods, medicines, supply, construction and alteration of housing provided as part of a social policy, and newspapers and periodicals.

9. We have already taken advantage of some of the options in Annex H to introduce a reduced rate in respect of some goods and services, while others have been retained at the standard rate. If the items which are currently at the standard rate but listed in Annex H were reduced from 21% to 13.5%, it would cost €158.2m in a full year of which foodstuffs would account for €121.4m**;** pharmaceuticals (i.e. non oral medicines) €32.4m**;** and, periodicals €4.3m.

10. The introduction of a second reduced rate, while possible under the Sixth Directive, has been rejected in the past due to the cost to the Exchequer. The introduction of a reduced rate for one particular good or service would serve to initiate campaigns for VAT reductions in the other areas where such a rate change is possible. The Exchequer cost and the pressure for the widening of any reduced rate regime continue to be valid reasons to reject the introduction of a second reduced rate.

Increasing/Decreasing the Standard Rate of 21 per cent

11. The standard rate of VAT was reduced from 21 per cent to 20 per cent in the 2001 Budget and increased to 21 per cent in the 2002 Budget. There are a number of issues to consider in determining whether there should be any change in the standard rate.

12. A <u>decrease</u> of one per cent in the standard rate would have a full year cost of about €440 million. This revenue would be lower in the first year because of the pattern of VAT payments and also if transitional provisions were introduced. Such a reduction would reduce the CPI by 0.455 per cent. It is not clear however that the standard rate reduction was passed on in full when the standard rate was previously reduced in 2001 thus diminishing the possible beneficial inflation effect. A reduction may create some buoyancy and encourage some further consumer

spending however, thus offsetting the cost to the Exchequer of such a reduction. There would also be some limited benefits for those segments of the e-commerce sector who sell digital services to private consumers within the EU.

13. An increase in the standard rate to 22 per cent would raise in the order of €440 million in a full year but increase the CPI by 0.455 per cent. Issues that would arise are:

- An increase would add to inflationary pressures in the economy;
- It would widen the differential with the UK standard VAT rate to 4.5 percentage points;
- A 22 per cent rate would make us one of the countries with the highest standard rate in the EU. The higher the standard rate, the greater the risk of evasion and the development of avoidance schemes;
- Such a rate could have a negative effect on consumption and could reduce overall consumption rates;
- An increase could discourage e-commerce retailers who sell to EU private citizens from establishing in Ireland. However, this will not be a factor if the Place of Supply proposal (See Annex 1) is agreed since e-commerce services would then be taxed in the Member State of consumption;
- Increases in indirect taxation may have a greater impact on the less well-off because more of their income is consumed.

Changing the 13.5 per cent Reduced Rate

14. An increase in the reduced rate by 1 per cent to 14.5 per cent would yield some €402 million in a full year and add 0.184 per cent to the CPI. This figure would be significantly less in the first year because of the pattern of payments and if transitional measures were applied. However:

- An increase in the rate would add to the cost of most services. It seems moreover that some retailers and suppliers of reduced rate goods and services may have taken advantage of the last change in the rate to increase prices above the 1 percentage point increase. It is likely that the same would occur in 2007 if the rate was increased;
- It would increase the price of houses;

- A further increase in the reduced rate may lead to an increase in shadow economy activity;
- As already stated the higher propensity to consume of the less well-off increases the impact of any increase in indirect taxation although more of this income also goes on zero rated (food) items.

15. It would also be possible to lower the reduced rate, though the existing 'parked' rate provisions would prevent such a reduction below 12 per cent for certain goods and services. A reduction to 12.5% from 13.5% would cost approximately €402 million in a full year and reduce the CPI by 0.184% if passed on in full. However,

- previous experience of rate reductions has shown that retailers are unlikely to pass these on to the consumer.
- it would have little or no effect on the price of houses as this is dictated by the market and any decrease would therefore be absorbed as profit by the supplier.

Domestic VAT Issues

Childcare Services

16. The issue of VAT on childcare arises against the backdrop of recent developments in the sector, particularly in the area of commercial childcare services where service providers are becoming increasingly interested in registering for VAT. This would result in VAT at the standard rate of 21% being applied to childcare in certain circumstances.

17. To date, childcare services have been treated as effectively exempt from VAT on the basis that these services were provided by a public body, a not-for-profit or charitable organisation, or by commercial childcare bodies whose activities are governed by public law. In addition, services where the annual turnover of the service provider is below the VAT registration threshold of €27,500, their services would also be generally outside the scope of VAT.

18. The current treatment of childcare is largely a result of amendments brought in under Finance Act 1997 which effectively exempted the whole of the childcare sector from VAT. These amendments, which focused on pre-school children under six years of age as defined under the Childcare Act 1991, and children attending certain pre-school education, were introduced in response to a vigorous campaign at the time by commercial childcare enterprises to remain exempt from VAT.

19. However, the Revenue Commissioners have advised that the existing legal basis for exemption, which effectively enabled the whole of the childcare sector to be exempted since 1997, is no longer adequate in the emerging childcare environment. For example, current legislation would not confer exempt status on commercial enterprises who provide services for school-going children, a growing element of this market. Such services would be subject to the standard VAT rate of 21%. The current exemption applies only to pre-school children under 6 years of age.

20. Amendments to the Childcare Act which would then enable the existing VAT exemption to be extended to all childcare services are being discussed with the Department of Health and Children.

Homecare Services

21. Following the introduction of the Department of Health and Children initiative aimed at providing 2,000 home care packages for older people to enable them to continue living in the community, concerns were raised regarding the VAT treatment of such services and whether the providers of such services could be made exempt.

22. Home care services provided by Health Boards do not generally come within the scope of VAT, as the Health Boards are not regarded as taxable persons. However, if home care services are provided for consideration in the course or furtherance of business, the provider may be obliged to register and account for VAT at the appropriate rate.

23. There are a number of different types of home care, ranging from social care (visits, light housework etc.) to physical care (personal hygiene, exercise etc.) to medical care (on-going treatment by a medical professional). Each of these types of homecare may consist of a variety of services, such as medical services, cleaning and cooking which are liable to VAT at different rates.

24. The Revenue Commissioners have advised that such services might qualify for exemption from VAT where they are closely linked to welfare and social security work[1], delivered by bodies governed by public law, or by other organisations recognised as charitable by the State. In this regard, the Department of Health and Children have indicated that they are examining a number of options to ensure that such service providers are governed by public law. If the Department of Health and Children make the necessary legislative changes in time, then it will be possible to exempt homecare services from VAT in the Finance Bill.

VAT Relief for Conference related business expenditure

25. A number of submissions have been received from various tourism organisations seeking the right for businesses to deduct VAT incurred in respect of discretionary conference related hotel accommodation and meals. It is argued that where Member States allow such deductibility they have a competitiveness advantage in the corporate tourism market. At present, businesses in Ireland are not entitled to deduct VAT incurred in respect of hotel accommodation and meals and this restriction also applies to cars and petrol. These blocks were introduced to limit tax avoidance.

26. The cost to the Exchequer of allowing VAT deductibility for all non-discretionary business related travel would be in excess of €100m in a full tax year. In addition, allowing deductibility for this type of business input would be difficult to control in terms of possible abuse.

27. Even though the pace of inflation in this sector has recently slowed, business related VAT deductions, if introduced, could merely provide a wider margin for profit in this sector. However, the Department, in conjunction with Revenue, the Department Arts, Sports and

[1] As provided for under Article 13A,1(g) of the Sixth VAT Directive.

Tourism and the hotel industry, is exploring if the focus of the proposal could be narrowed by certain administrative solutions to cater specifically for conference related business expenditure.

VAT Registration thresholds

28. Traders established in the State and making supplies in the State are obliged to register for VAT where certain turnover thresholds are exceeded or are likely to be exceeded in any continuous period of twelve months. Under EU law, with which Irish VAT law must comply, Member States may only increase thresholds in line with inflation. The current thresholds which where increased last year (by €2,000/€4,000) are:

- €27,500 in the case of a person supplying services.

- €55,000 for persons supplying goods.

29. The following considerations arise:

- If thresholds were increased in line with the Consumer Price Index since 1994, this would result in the €27,500 threshold being increased to €36,516 and the €55,000 threshold being increased to €73,032. The costs involved would be €23.1m and €55.1m respectively, amounting to a total cost of €78.2m in a full year. This would remove 11,843 businesses from the VAT net.

- Ireland has the third highest registration thresholds in the EU, after the UK (stg £61,000) and France - some Member States have no registration thresholds and require all firms to register irrespective of their turnover.

VAT and Charities

30. There is sustained pressure from the Irish Charities Tax Reform Group (ICTRG) for the introduction of a refund of VAT paid on inputs by charities and not-for-profit bodies. Charities are exempt from charging VAT on the goods and services they provide and cannot claim VAT deductions on the goods and services they purchase. It is not possible under EU law to change the current VAT treatment of charities.

31. The European Commission indicated that there is nothing in EU VAT law to prevent national Governments providing grants to compensate them for the irrecoverable VAT which they have incurred. Such grants would not form part of the taxation system and would be an expenditure item. However, State Aid rules would have to be observed.

32. The Revenue Commissioners currently recognise over 7,000 bodies as established for charitable purposes and thereby exempt from tax. Given the number of charities that are currently registered we would be concerned at the potential cost to the Exchequer which would result from the introduction a formal grant mechanism compensating charities and non profit organisations for VAT paid on their expenses.

33. The latest ICTRG estimate for the annual cost for introducing a VAT refund for the 140 organisations which they represent to be €18m. However, this estimate is three years old and would have to be treated as the minimum cost as the number of registered charities and not-for-profit organisations is considerably higher than this.

34. It is questionable whether relieving charities of the VAT paid on their inputs as opposed to grant-aiding their activities using specific criteria represents the most appropriate use of Exchequer funds.

Review of Farmers' Flat Rate Refund (unregistered farmers)

35. The flat-rate scheme is a practical method to compensate unregistered farmers, on an overall basis, for the VAT incurred on their business inputs. This is achieved without applying the normal VAT rules on registration, record-keeping and returns. The tax compliance burden for farmers participating in the scheme is minimal and, in addition, the State is relieved of a significant administrative burden.

36. The scheme sets out a percentage amount, known as the flat-rate addition, which is applied to the price being paid to unregistered farmers when they are selling to VAT-registered businesses (co-ops, meat factories etc.). The VAT registered business can treat the flat-rate amount as a normal business input in its VAT return.

37. The flat-rate refund is reviewed each year in the run up to the Budget and is calculated in accordance with criteria laid down in the Sixth VAT Directive; in particular, the refund must be struck on the basis of macro-economic data (i.e. agricultural inputs and outputs) for flat rate farmers alone for the preceding three years. In Budget 2006, the flat rate refund was maintained at 4.8%.

38. In the context of the recent partnership agreement, Towards 2016, it was agreed to conduct a review of the methodology underpinning the calculation of the farmer's flat rate. It is envisaged that the review will be completed in time for the Budget. The overall objective is to ensure that the methodology properly reflects developments in the farming sector since the methodology was last reviewed in 1988. Concerns expressed by the Revenue Commissioners regarding the current methodology will also be taken into account in the review.

Review of VAT on Property Transactions

39. A review group established by the Revenue Commissioners has assessed the operation of VAT on property. The main objective of the review is to bring about a simpler more robust system for taxing property transactions whilst leaving the VAT status of a property more readily apparent. Briefly, the review examined:

- the main difficulties associated with the current legislation and recommended modifications to eliminate any practical difficulties arising;

- whether the existing system of taxing the capitalised value of long leases should be maintained; the effect of not maintaining the existing system; the implications for any derogations already obtained by Ireland from the EU as a result of any change to the existing treatment of such leases;

- the effect of a change in VAT treatment on the property sector in regard to prices rental returns etc., and the effects on revenue yields in the area of VAT, stamp duties etc.

This is a very fundamental review of an important aspect of VAT. A separate paper on the Revenue review of VAT on property will be presented to the Tax Strategy Group.

VAT Developments at EU Level

Overview

40. At EU level, three issues currently dominate the VAT agenda:

- The 'VAT Package' consisting of the 'Place of Supply' proposal and supporting elements within the 'one-stop-shop' proposal. Agreement on these proposals remains elusive but is a priority for the Finnish Presidency;

- The fight against VAT fraud and specifically 'carousel' fraud. This is currently being spearheaded by Germany and the UK.

- VAT and Financial Services on which a public consultation was conducted by the European Commission between March 2006 and June 2006 and for which legislative proposals are expected by early 2007.

41. Other developments of note within the past year include agreement on the roll-over of the experimental VAT scheme under Annex K of the Sixth VAT Directive for reduced rates on certain labour intensive services and adoption of the proposal rationalising VAT derogations on an EU-wide basis. Negotiations are continuing on the "Place of Supply" and "one-stop-shop" proposals in the context of the VAT package and also on the proposal to recast the Sixth VAT Directive. Details on these and other proposals are provided in Annex 1.

42. Ireland is currently the subject of two VAT infringement processes. These are described further below (paragraphs 57-61).

43. VAT cases continue to feature highly at the European Court of Justice. In the last twelve months, Ireland has intervened in 5 European Court of Justice cases.

The VAT Package

44. The VAT Package was presented by the Austrian Presidency in May 2006. This represents a roadmap/strategy for the phased implementation between 2006 and 2010 of the long-running and yet to be agreed Place of Supply (see Annex 1) proposal and certain

supporting elements of the 'one-stop-shop' proposal (see Annex 1). The Place of supply proposal deals with new rules for cross-border B2B and B2C services which will, in general, shift the place of taxation to where services are consumed, replacing the existing rules based on the location of the supplier.

45. The 'one-stop-shop' online facility providing cross-border traders with an online VAT registration and declaration facility coupled with an online VAT refund facility are key to the operation of the new B2B and B2C rules and are envisaged under the package by 2010. In the interim, the VAT package provides for an interim facility based on the existing but technically limited 'one-stop-shop' online facility for third country traders supplying eCommerce services into the EU. Such services are already taxed at the place of consumption and include electronically supplied services, and TV and radio broadcasting services.

46. The timetable set out under the VAT package envisages the new B2B rules entering into force by 1 January 2008. At that stage, the new place of consumption based B2C rules would be applied to telecommunications services, radio and television broadcasting services, and also immovable property and restaurant/catering services. By 1 January 2010, the new B2C rules would be extended to electronically supplied services and private hiring of means of transport (cars, boats). The introduction of the fully-fledged online 'one-stop-shop' system supporting all B2B and B2C transactions is envisaged by 2010.

47. Ireland is supportive of the VAT package as the new B2C rules in particular hold benefits for Irish companies selling services to consumers electronically over the Internet as the generally lower VAT rates operating in other Member States would apply to such services.

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VAT Fraud

49. VAT fraud and specifically “carousel” or “missing trader” fraud continues to be a major concern for a number of Member States. At the High Level Tax Group meeting held in Vienna in February 2006, Germany and the UK who claim to have suffered significant losses, proposed a remedy based on the “Reverse Charge” mechanism to combat this type of fraud. Following a conference on the matter hosted by Germany in Berlin in March 2006, the European Commission issued a discussion paper in June 2006 concerning the need to develop a co-ordinated strategy to improve the fight against fiscal fraud. The Finnish Presidency are dealing with the matter with a view to developing guidance on the matter for the European Commission.

50. Carousel fraud occurs by exploiting the zero-rated VAT supply of goods between member states for the purpose of tax evasion. It involves the consignment of high value, low volume goods, typically computer processing units (CPUs) or mobile phones, through a chain of companies in two or more Member States of the EU. The goods often travel back and forth continuously between Member States. The sole purpose of these transactions is defrauding the Revenue authorities of the VAT payable on the goods in the country of eventual destination.

51. The reverse charge mechanism proposed by Germany and the UK to combat carousel fraud makes the business customer, and not the supplier, liable to pay VAT to the Revenue. It would ensure that no payments or repayments would take place along the supply chain. The UK proposes that this “reverse charge” mechanism would apply only in specific cases, e.g. mobile phones. However, Germany wish to apply the reverse charge on all internal supplies over €5,000 each i.e. as a horizontal measure. The current VAT system would apply under this level. Germany and the UK are seeking derogations as allowed under the VAT directives (in the case of VAT fraud) to apply the reverse charge mechanism.

52. While Ireland shares the concerns of other Member States regarding fiscal fraud, we are of the view that a pragmatic approach should be adopted and solutions should not create barriers for business, or result in significant administrative burdens for Revenue authorities. Current instruments offer opportunities for information exchange and these should be exploited and perhaps enhanced, including increased co-operation with third countries.

VAT on Financial Services

53. In March 2006, the European Commission launched a public consultation on modernising VAT for financial and insurance services. This is a direct response to a judgement by the European Court of Justice in March 2005 in the Andersen case concerning the VAT treatment of outsourced 'back office' services in the insurance industry.

54. The Court ruled that the outsourcing of "back office" services by insurance companies, does not qualify as an insurance related service as performed by insurance brokers and insurance agents within the meaning of the Sixth Council Directive. Outsourced 'back office' services do *not* qualify for an exemption from VAT and are therefore liable to VAT at the standard rate. Examples of the "back office" services involved include acceptance of applications for insurance; handling of amendments to contracts and premiums; issuing, management and rescinding of policies; management of claims; and, information technology management.

55. Although the case concerned services provided in the Netherlands, the ECJ ruling have an impact across all EU Member States. The implication of the judgment for Ireland is that the Irish VAT exemption for insurance-related services in the First Schedule to the Value-Added Tax Act 1972, as amended, is currently too broad. Implementation of the ECJ ruling would lead to VAT becoming chargeable on certain outsourced insurance-related services currently provided to insurers. Where insurers use these outsourced services to provide exempt insurance services within the EU, VAT incurred on such services would be irrecoverable.

56. Pending the outcome of the Commission's consultation under which it is expected that proposals will emerge by early 2007, the Revenue Commissioners have advised the financial services industry that, as regards insurance related services provided in Ireland, the provisions of the exemption in the current Irish legislation will continue to apply.

VAT Infringements

57. In June 2006, the European Commission issued two infringements against Ireland in the area of VAT, a Reasoned Opinion under Infringement No 2004/4084 concerning the VAT treatment of services provided by public bodies; and, a Letter of Formal Notice under

Infringement No 2006/2246 concerning the VAT treatment of certain services, referred to as 'Fourth Schedule' services received by public bodies.

58. The Reasoned Opinion arises out of a complaint by private multi-storey car-park operators and represents the Commission's response to our submission of 21 April 2005 arising from the Commission's Letter of Formal Notice of 14 December 2004 on the matter. While the complaint referred to car-parking which would include multi-storey and surface parking facilities, the Reasoned Opinion is much wider in scope. It concludes that we have not correctly transposed Article 4(5) of the Sixth VAT Directive and thereby challenges Ireland's general exemption from VAT for services provided by local authorities. In our response, submitted to the European Commission on 4 September 2006, we are challenging the Reasoned Opinion on the basis that Ireland has correctly interpreted the provisions of the Sixth VAT Directive as they relate to public bodies and also on the basis that the complaint against Ireland has been widened in scope.

59. Under Irish law, public bodies do not charge VAT on their services and cannot recover VAT on goods and services which they purchase. However, under EU law where such treatment leads to 'significant distortions of competition', they are not exempt and must charge VAT. In this regard, the Commission considers Irish law to be lacking regarding the interpretation of those aspects of the Sixth VAT Directive dealing with the VAT treatment of services delivered by local/public authorities where distortions of competition are likely to arise. In effect, the Commission want Ireland to amend Irish VAT law to include a test for distortion of competition, rather than rely on the current situation where the Minister can, by SI, apply VAT where he believes such a distortion arises.

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61. The Letter of Formal Notice concerns the VAT arrangements under which Government Departments and other public bodies must account for VAT to the Revenue Commissioners for certain services received from abroad. The practice of making public bodies accountable for the payment of VAT for service services received from abroad has been in place since 1986. It was introduced as an anti-avoidance and revenue measure. Examples of these services include consultancy, advertising, engineering, data processing and legal services. The Commission are of the view that we have not correctly transposed Article 9(10 of the Sixth VAT Directive. The Commission consider that the recipients of the services indicated above are non-taxable persons such as Government Departments and local authorities and that VAT should be accounted for in the Member State of the supplier and not in Ireland. We have until 4 November 2006 to respond to the Commission in this case.

62. The views of the Group are invited.

September 2006

Annex 1

Further Information on EU Commission VAT Proposals

Place of Supply Proposal

1. In July 2005, the European Commission re-presented a proposal to change the place of supply (i.e. the place of taxation) rules governing VAT on cross-border services. The proposal sets out new rules for business-to-business (B2B) transactions and business-to-consumer (B2C) transactions and replaces the original Commission proposal of December 2003 which dealt solely with B2B services.

2. The overall objective of the proposal is to ensure that VAT accrues to the Member State of consumption. Regarding B2B services, the proposal generally puts the onus on the business customer to account locally for VAT for services received from another Member State. While many B2B services traded across borders are already taxed on this basis, the proposal makes this the main rule for determining the place of taxation.

3. For B2C services, the proposal maintains the general rule that the place of establishment of the supplier determines the place of taxation. However, the proposal provides for exceptions to this rule for certain services which can be supplied at a distance. In these cases, the proposal shifts the place of taxation to where the consumer is located. The distance services involved include electronically delivered services, telecommunications services, radio and television broadcasting services as well as distance teaching services.

4. Under the new rules, B2C services supplied electronically from Ireland to consumers in other Member States would benefit from the generally lower VAT rates applying in these Member States to be applied to such services. As a result, Irish companies delivering services over the Internet to private consumers in other Member States should gain significantly from the change in VAT rules. Examples of the types of services involved include the online supply of music, games and videos, software, and distance teaching services.

5. There is empirical evidence that companies are establishing or relocating in Member States with attractively low VAT rates so as to gain competitive advantage in selling to individual consumers throughout the EU. The new rules based on the place of consumption should reverse this trend and should enhance Ireland's position as an attractive location for companies involved in delivering the types of services mentioned. Regarding distance services received (including TV broadcast services) by Irish consumers, these services will now become liable to Irish VAT rates irrespective of where they are sourced.

6. While the proposed new B2C rules would require Irish businesses to register and account for VAT in each Member State where they conduct business, the Commission's proposal on establishing an electronic "one stop shop" facility would allow traders to register online and account for VAT in their own Member State in respect of their Community wide supplies. The "one-stop-shop" is discussed below (paragraphs 10-14).

7. For B2B services traded cross-border, the new rules would significantly reduce the administrative burden on businesses operating cross-border. For example, Irish businesses providing services to businesses in other Member States would, in most cases, no longer be required to register and pay for VAT in those Member States. In addition, the new rules should reduce the existing need for Irish businesses to recover VAT incurred in other Member States under the Eighth VAT Directive procedures.

8. The proposal would also provide a solution to the potential problem of tax-based distortions which could arise in the case of the cross-border leasing of motor vehicles. For both B2B and B2C transactions the VAT treatment of short-term hiring of motor vehicles will be determined by the place where the vehicle is put at the disposal of the customer; and, the VAT treatment of the long-term leasing (i.e. over 30 days) of vehicles will, on the other hand, be determined by the place where the customer is established or normally resides.

9. The shifting of the place of taxation to the place of consumption raises additional concerns regarding the proper application of VAT to cross-border services and, in this regard, anti-avoidance provisions are to be strengthened under the proposal. This would be achieved

through mechanisms for administrative co-operation and information exchange between Member States.

'One-stop-shop' Proposal

10. In November 2004, the Commission brought forward a complex dossier designed to ease the administrative burden imposed by existing VAT procedures on cross-border traders. Simplification of these procedures represents a key element of the European Commission's VAT strategy which recognises the need to modernise the VAT system in the interest of the smoother running of the internal market and promotion of cross-border trade.

11. Under the dossier, the European Commission sets out specific measures which it considers necessary to achieve these objectives. These measures include:

- A one-stop scheme, or one-stop-shop, enabling non-established cross-border traders to use a single VAT number for all supplies made throughout the EU and to make declarations online through a website operated by national tax authorities;
- An online VAT refund facility for cross-border traders;
- Harmonisation of the scope of goods and services for which Member States may apply restrictions on the right to deduct or reclaim VAT on business expenses;
- Broadening the scope of the reverse charge mechanism under which the business customer is obligated to account for VAT locally in respect of certain business-to-business transactions with non-established suppliers;
- Introducing an optional maximum registration threshold of €100,000 for small traders;
- Simplifying the existing VAT rules regarding the distance selling of goods typically by phone or via the Internet to private consumers through the introduction of a single global threshold of €150,000 for all supplies made to consumers in Member States.

12. Progress to date has been slow with discussions concentrating mainly on the details underlying the operation of the proposed one-stop-shop facility and also on the new VAT refund procedures for cross-border traders.

13. In general, Ireland is supportive of these proposals and particularly in the context of achieving a reduction in the administrative burden for businesses supplying goods and services

cross-frontier. Streamlined VAT procedures should enhance efficiency, reduce administrative costs and encourage increased activity within the internal market. As discussed in the context of the VAT package, the one-stop-shop facility will ultimately enable new rules for cross-border business-to-consumer (B2C) services proposed under the place of supply proposal to be introduced.

14. The new proposals on deductibility and registration thresholds are being closely monitored during negotiations to ensure that Ireland's interests are protected.

Scheme for Labour Intensive Services

15. In July 2003, the Commission proposed significant changes to the structure of the reduced VAT rates regime. For Ireland the proposal would have resulted in some currently zero-rated goods, particularly children's' clothes and shoes, and many existing reduced-rated (13.5 per cent) goods being subjected to the standard VAT rate of 21 per cent. The proposal also sought to terminate an existing experimental VAT scheme for labour intensive services (e.g. hairdressing, bicycle and shoe repairs) under Annex K of the Sixth VAT Directive which was due to expire on 31 December 2003.

16. This proved a very difficult dossier and political agreement was not possible on the overall proposal. In this regard, Ireland consistently opposed any changes to the reduced rates regime which would have affected our current zero and reduced rate VAT arrangements.

17. However agreement was reached in December 2005 to roll-over the Annex K scheme for reduced rates for labour intensive services to 31 December 2010 and to open up this scheme, first introduced in 1999, to all Member States. A proposal from the Commission to conduct a study of the impact of reduced rates applied to locally supplied services was also agreed. The outcome of this will hold particular interest for France which has been seeking to significantly reduce the VAT rate on its restaurants from 19.6 per cent to 5.5 per cent.

18. The European Commission is proposing to allow seventeen Member States to apply reduced rates of VAT until 31 December 2010, on certain labour-intensive services such as renovation of private dwellings, hairdressing, window-cleaning, domestic care services and

small repairs.

19. Ireland is not participating in the Annex K scheme as the bulk of the services involved are already reduced rated here. While reduced rates for domestic care services are available under the scheme, our priority is to exempt such services from VAT in the context of the Sixth VAT Directive.

Rationalisation of VAT Derogations

20. In June 2006, the European Council adopted a proposal to rationalise the derogations available to Member States under Article 27 of the Sixth VAT Directive. Article 27 derogations are designed to meet individual Member State requirements in combating VAT fraud and, to date, 140 such derogations have been granted, many duplicated across Member States.

21. Under the rationalisation, a common pool of derogations has been made available which Member States can choose to incorporate into their national legislation as required. Member States are also afforded a degree of flexibility in tailoring measures to suit their own national requirements.

22. Two provisions within the common pool of derogations established under the agreement are of particular interest to the Revenue Commissioners who intend to avail of them in the fight against tax evasion and avoidance. XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

Recast of Sixth VAT Directive

23. Work is continuing on the Commission proposal of April 2004 to recast the Sixth VAT Directive (77/988/EEC). The recast Directive will incorporate all of the amendments made to the Sixth VAT Directive since it was first adopted in 1977. It will also remove provisions which no longer apply, and include any provisions found in separate legal acts. This consolidation exercise is designed to simplify and clarify EU VAT law by delivering a single legislative text for VAT.