Selected VAT Issues

Introduction

1. This paper reviews VAT issues under three headings:

I. VAT rating and structure, and scope for change (page 1)
II. Current VAT issues at domestic level (page 5)
III. VAT developments at EU level (page 6)

Annual VAT Revenue

2. VAT was the largest source of revenue within the Irish tax system between the years 2003 and 2008, however, from 2009 it fell below Income Tax/Levy. As VAT is a transaction tax the yield greatly depends on the level of economic activity and consumer spending from which it derives. In 2009, VAT accounted for approximately €10,638 million or 32% of the overall tax yield to the Exchequer. The current estimate for the VAT yield in 2010 is €10,090 million.

I. VAT Rating and Structure, and Scope for Change

VAT Rates and Structure

3. The structure and scope under which Member States can apply VAT to goods and services are determined by EU law. Ireland operates three rates of VAT[1]:

- **Zero-rate** which generally applies to most food, childrens' clothes and shoes, and oral medicines accounts for **10%** of goods and services subject to VAT. While it is possible to retain the zero rating for goods and services that were in place on 1 January 1991, the zero-rate cannot be applied to any new items.

- **Reduced rate** of 13.5% applies mainly to residential housing, labour intensive services and general repairs and maintenance. Member States may have up to two reduced VAT rates of not less than 5% for a specified number of goods or services which are set out in Annex III of the EU VAT Directive (see Appendix A).

- Member States also have the option of maintaining, at a reduced rate of not less than 12%, any items not listed in Annex III, provided they carried a 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%. Fuel used for heat or light, and commercial construction are examples of parked items. All items at the reduced or parked rate account for **41%** of goods and services subject to VAT.

- **Standard rate** of 21% applies to the remainder of goods and services accounting for **49%** of all goods and services, including cars, petrol, diesel, alcohol, tobacco, electrical equipment and CD/DVDs. Under the VAT Directive Member States may set the standard VAT rate not lower than 15% and there is political agreement that the standard rate of VAT applying in each Member State does not exceed 25%.

[1] Ireland also applies a VAT rate of 4.8% but this is limited to livestock sold by VAT registered persons/firms. Unregistered farmers are also allowed to apply an addition of 5.2% to the sale price of all agricultural produces to VAT registered persons/firms. This reduces administrative burden on small farmers.

4. Services provided by charities, non profit organisations and certain financial services are **exempt** from VAT, as are schools and hospitals etc. Exempt suppliers do not generally charge VAT on the services they provide and cannot reclaim VAT incurred on the goods and services they purchase.

Recent Changes to the VAT Rates

5. In Budget 2009, the standard rate was increased from 21% to 21.5% as a revenue raising measure. In Budget 2010 this increase was reversed in order to assist businesses, increase competitiveness and consumer confidence and to reduce the burden of VAT on individuals. Previously, in Budget 2001, the standard rate was reduced from 21% to 20%, but was restored to 21% in Budget 2002.

6. The reduced VAT rate of 13.5% has remained in place since Budget 2003 when it was increased to that level from 12.5%.

Options for changes to VAT Structure and Rates

7. While the Commission on Taxation reviewed the VAT structure, it did not make any recommendations in regard to changing the VAT structure or rates. The following are five options that could be considered should one wish to change the VAT structure and/or rates.

Option 1: Increasing the VAT rates

8. The effect of increasing the reduced and standard VAT rates by 1%, including their inflationary impact, is outlined in the following table. These figures would be lower in the first year because of the pattern of payments.

Rate	**1% increase**	**CPI effect***
Reduced 13.5%^	+ €262m	+ 0.13%
Standard 21%	+ €311m	+ 0.36%

* Where passed on in full to the customer.

^ The reduce-rate costings include parked-rate items.

9. Ireland has always been among the Member States with the highest VAT rates. However, in recent years in response to the global financial crisis many Member States have chosen, or were forced, to increase their VAT rates. In this context, the average standard VAT rate among Member States increased from 19.5% in 2008 to 20.5% in 2010. Over this time, Ireland has gone from having the joint *fifth* highest standard rate in the EU along with Belgium; to having the joint *eight* highest standard rate in 2010 along with four other Member States (see Appendix B).

10. As regards the differenential between the Irish and UK VAT rates, this was a significant issue throughout 2009 because the Irish standard VAT rate had been increased to 21.5% from October 2008 and in December 2008, the UK reduced their standard rate to 15%. Much attention was drawn to this and calls were made for a similar reduction to 15% in our standard VAT rate. However, by 1 January 2010 the UK rate increased back to 17.5% and the Irish rate reduced to 21%, reducing the substantial differential between the rates from 6.5 percentage points to 3.5. Furthermore, the UK intend to further increase their standard rate from 4 January 2011 to 20%, which will leave only 1 percentage point between the standard rate of both jurisdictions.

11. In this context of VAT rate changes in the UK and throughout the EU, the Irish standard VAT rate is in a more favourable position and as such any potential increase in the rate would not be perceived to be as damaging as in previous years, similarly any reductions in the rate could be perceived to impact favourably in competition terms.

12. However, experience has shown that when a VAT rate is increased, some retailers use this opportunity to further increase prices above budget day increase, which would add to the effect on inflation. Increases in indirect taxes can also act as a motivation for shadow economy activity and the creation of VAT avoidance schemes.

13. Ireland's reduced rate of 13.5% is high compared to that of other Member States, being currently the second highest in the EU. Despite the near parity in standard VAT rates that will apply between Ireland and the UK from 2011, there remains an 8.5 percentage point differential between the UK and Irish reduced VAT rates. Ireland's higher reduced VAT rate is due in large part to the extensive range and higher proportion of goods and services to which we apply the reduced rate, relative to other countries.

14. It is often argued that reducing VAT rates would create some buoyancy and encourage additional consumer spending. However, EU Member States have generally not opted for VAT rate reductions as a means of boosting consumer spending. A significant number of Member States have increased their VAT rates to help cover the budgetary shortfall generated by the fiscal downturn. Since May 2007, 15 other Member States have increased or intend to increase their VAT rates, and of the remaining Member States, Denmark and Sweden already have their standard rate set at the maximum of 25%.

15. It must also be pointed out that items at the "parked" rate of VAT cannot be reduced below 12%.

Option 2: Moving Zero-Rated items to the Higher Rates

16. Under EU rules we can retain the zero rating of items which were zero rated on 1 January 1991 but cannot introduce any new items to the zero rate. Ireland's zero rate applies in the main to most foods, children's clothes and shoes, books and oral medicines. With the exception of children's clothes and shoes, which would have to be standard rated at 21%, the remainder of the zero rated items could be subject to the existing reduced rate. The yield to the Exchequer from such a change would be in the region of €1 billion. However, once moved, it would not be possible to revert them back to the zero rate.

17. positive rating of food, oral medicines and children's clothes and shoes would fall disproportionately on the less well off. In addition, applying the 13.5% rate to existing zero-rated goods and 21% to children's clothes and shoes would increase the CPI by 4.16%.

Option 3: Restructuring the VAT system on a Revenue-Neutral Basis

18. It is possible to restructure the VAT system on a revenue neutral basis. If the VAT system were to be restructured on this basis so that all goods and services currently subject to VAT at the zero, 13.5% and 21% rates were at a single rate this would imply a rate on all goods and services of 15.8%. Such a change would result in a CPI increase of roughly 3.3% as the impact of different goods on inflation can vary considerably.

19. It would also be possible to restructure the VAT system on a revenue neutral basis leaving aside items currently at the zero rate. If the VAT system were to be restructured in such a manner the VAT rate for goods and services currently subject to the reduced and standard rates of VAT would be re-aligned to a rate of 17.6% which would effect a CPI decrease of -0.64%.

20. It is argued that restructuring the VAT system would be more user-friendly and to an extent more equitable. However, re-aligning the VAT rate structure into just one rate would be regressive, giving rise to increases in the cost of most foods and reductions in more expensive items such as cars, auto fuel, alcohol, cigarettes, etc.

21. Even where only the 13.5% and 21% rates are re-aligned, this would affect most services, and would, for example, increase VAT on domestic fuels which would fall disproportionately on the less well off. It should be noted that the structure of the VAT system in Ireland is somewhat unique in that we apply the reduced rate of VAT to a high proportion (41%) of goods and services. Furthermore, a policy change in relation to items at the zero and parked rates would not be possible to reverse.

Option 4: Applying the Reduced VAT Rate to all items listed in Annex III

22. It is only possible to introduce new reduced rates in respect of those goods and services listed in Annex III of the VAT Directive. We have already taken advantage of options in Annex III to introduce a reduced rate in respect of some goods and services, while others have been retained at the standard rate. Some of the standard-rated goods and services that could be applied at the reduced rate are certain more-luxury type foodstuffs, non-oral medicines and periodicals.

23. If the items which are currently at the standard rate but listed in Annex III were reduced from 21% to 13.5%, it would cost €129m in a full year of which foodstuffs would account for €95m**;** pharmaceuticals (i.e. non oral medicines) €30m**;** and periodicals €4m.

Option 5: Introduction of a Second Reduced VAT Rate

24. The VAT Directive allows Member States to operate up to two reduced VAT rates. Ireland, along with most other Member States, operates only one reduced rate of VAT. Were a second reduced rate to be introduced, it would have to apply only to those goods and services listed in Annex III and the VAT Directive requires that any second reduced rate has to be a minimum of 5 per cent. The cost of introducing a second reduced rate would depend on the level of the rate and on what goods and services are applied to that rate.

25. If those items currently zero rated to which a reduced rate may apply [see paragraph 16, e.g. most foods, books and oral medicines (but excluding children’s clothes and shoes)] were to be moved to a new 5% rate for those items, it is estimated that it would yield around €300 million in a full year.

II. Current VAT issues at domestic level

26. A number of VAT issues arise at domestic level. These are mainly:

- Consolidation of the VAT Act
- Place of Supply Changes

Consolidation of the VAT Act

27. In the interest of better regulation and in line with consolidation of legislation relating to Income & Corporation Tax (1997), Stamp Duties (1999) and Capital Acquisitions Tax (2003), it is considered that VAT legislation should now be consolidated. The provisions of the new VAT Act will be remodeled on the recodified EU VAT Directive 2006/112/EC in order to facilitate better alignment and thereby easier reference to the Directive. In particular, the Finance Act 2010 reordered the Schedules to the VAT Act in order to reflect the origins of exemptions or reduced rates under the Directive. Revenue have finalised a draft of the VAT Consolidation Bill, which is being examined by the Office of the Parliamentary Counsel to the Government, with a view to it being shortly certified by the Attorney General as being a 'Consolidation Bill'. It is hoped the legislation will pass through the Houses of the Oireachtas with a view to it being enacted before Budget Day.

Place of Supply Changes

28. The ECOFIN Council on 12 February 2008 adopted a package of VAT measures designed to streamline the VAT arrangements for cross-border business-to-business (B2B) and certain business-to-consumer (B2C) services, so that cross-border services would be taxed in the Member State of the *consumer* and not that of the *supplier*, as was the case. The Directives, collectively referred to as the VAT Package, provide for changes in the VAT treatment of cross-border services; a new VAT refund regime for cross-border traders, and enhancements to the VAT Information Exchange System (VIES) in order to facilitate proper control and assist in combating VAT fraud in cross-border transactions. The main rules for the supply of B2B services, legislated in Ireland by Ministerial Regulation, came into effect on 1 January 2010.

29. Changes to the B2C rules for telecoms, radio and television broadcasting and electronically supplied services are due to come into operation in 2015. However, Regulations are due to be made before the end of this year to change the place of supply rules for B2B services of a cultural, artistic, sporting, scientific, educational or entertainment nature. From 1 January 2011, such services will be taxed where the business recipient is established. In this context, the place of supply for services provided to a concert promoter will be where that promoter is established even if the event takes place in another Member State. This change may, in Ireland, have a negative Exchequer impact; however, the cost will not be fully apparent until the end of 2011. The place of supply of admissions to such events will remain taxable where the event takes place e.g. the place of supply for admission to a concert in Dublin will still be Ireland.

III. VAT Developments at EU Level

Overview

30. At EU level, the following developments are of particular interest:

- VAT on Postal Services;
- VAT on Insurance and Financial Services;
- Proposals to fight VAT Fraud;
- Travel Agents Margin Scheme;
- VAT Infringements.

VAT on Postal Services

31. In July 2009, the Swedish Presidency raised the possibility of resuming discussions on EU Commission proposals on VAT and Postal Services initially introduced in 2003 and revised in 2004. The proposal would remove the existing VAT exemption for public postal services in favour of taxing all postal services at the standard rate, but with an option for Member States to apply a reduced rate. The proposal became deadlocked at an early stage and had last been discussed in June 2004 during the Irish Presidency. The revised 2004 proposal raised the weight threshold for the application of the reduced rate for letters/parcels from 2kg (set out in the 2003 proposal) to 10kg thereby increasing the range of services to which a reduced rate could optionally be applied by Member States.

32. In Ireland, the postal market has been progressively liberalised in accordance with the Postal Directive resulting in private operators entering certain segments of the market in direct competition with An Post, primarily courier services, which are subject to VAT even when provided by An Post. However, public postal services operated by An Post as the universal service provider remain exempt from VAT, a position we wish to protect.

33. The question of resuming discussions comes against the background of full liberalisation of the EU postal market by 1 January 2011 as required under the Third Postal Directive. The taxing of postal services remains a sensitive issue for a number Member States and deep divisions are evident. The matter was discussed by ECOFIN in December 2009 and future presidencies were requested to explore the issues arising with a view to reverting to ECOFIN by the end of 2010. There have however been no further developments to date.

VAT on Insurance and Financial Services

34. The Commission presented proposals in this area in late 2007, the overall objective of which is to modernise and simplify the rules for financial and insurance services under the EU VAT Directive. Discussions on these complex proposals commenced in January 2008 and are continuing as a priority under the Belgian Presidency. Insurance and financial services are normally exempt from VAT which means that while VAT is not charged on most of these services, suppliers are not entitled to recover VAT costs incurred in the delivery of these services. In an increasingly competitive and complex financial services environment, operators have for sometime been concerned about non-deductible VAT, and also the uncertainty regarding the VAT treatment of new services not envisaged under existing VAT rules.

35. The objectives of the proposals are to provide legal certainty for economic operators and tax administrations on the scope of the VAT exemption generally applying to insurance and financial services; and, reduce the impact of VAT costs embedded in the cost structures of insurance and financial services providers. The need for modernisation arises as a result of the

failure of the VAT Directive to keep pace with developments in the insurance/financial services sectors. This has led to inconsistent treatment of these sectors and the development by the European Court of Justice (ECJ) of extensive jurisprudence on the scope of the VAT exemption.

36. The proposal for a Directive sets out three measures to modernise the VAT rules for financial and insurance services including:

(i) clarification of the scope of the VAT exemption applying to insurance and financial services;
(ii) broadening of the existing option to tax these services which would provide an opportunity for operators to recover VAT costs; and,
(iii) the introduction of a cost-sharing group which would allow companies to reduce VAT costs by pooling investments and re-distributing the costs for these investments exempt from VAT from the group to its members.

37. Discussions under the Belgian Presidency continue to focus on defining the scope of the VAT exemption in terms of the various services provided within the financial and insurance sector. While there is broad agreement on the majority of services and their positioning within or without the VAT exemption, a number of important issues remain, including the treatment of financial derivatives and the scope of the definition of investment funds; Ireland being particularly interested in maintaining the existing broad definition regarding the latter. Our main objective is to ensure that Ireland's attractiveness as a location for financial services is preserved and close liaison has been maintained with the sector's representative bodies during the negotiations.

Proposals to combat VAT Fraud

38. Work at EU level on combating VAT fraud continues with three proposals adopted to date in 2010. These include:

- the introduction of a reverse charge mechanism for the trading of greenhouse gas emission allowances - the reverse charge shifts the obligation to pay VAT from the supplier (as normally required by EU rules) to the business customer, in order to counter tax evasion and protect against carousel fraud (adopted in March 2010; introduced in Ireland in the 2010 Finance Act);
- the recast of the VAT mutual assistance regulation (1798/2003) governing information exchange between Member States and the introduction of an early-warning system (Eurofisc) on emerging fraud (adopted in June 2010 and to be implemented on a phased basis between 1 January 2012 and 1 January 2015);
- new rules on VAT invoicing designed to deliver a simplified and more harmonised invoicing environment particularly for cross-border transactions (adopted in July 2010 and taking effect on 1 January 2013).

39. proposal introducing a reverse charge for the trading of greenhouse gas emission allowances was brought forward as an emergency proposal in September 2009, and formed part of a wider proposal involving transactions in certain fraud-sensitive goods including, mobile phones, integrated circuit devices, perfume and precious metals, such as platinum. Agreement on goods is likely in the near future but on the basis of a compromise limited to mobile phones and integrated circuits.

Travel Agents Margin Scheme

40. In January 2010, the Spanish Presidency resurrected the VAT proposal on travel agents, which became deadlocked in 2003. The dossier has been taken up by the Belgian Presidency, although discussions have proved difficult. The proposal is designed to simplify the existing special scheme for travel agents (also referred to as the travel agents margin scheme), citing inconsistency in the operation of the scheme across Member States, and the need to account for developments in the trade including the marked increase in internet sales, the reselling of travel packages among agents, and the supply of goods made in conjunction with a travel package. The travel agent margin scheme was introduced in 1977 and provides that travel agents account for VAT on the profit margin realised in the supply of a travel package. While most EU Member States operate a travel agents margin scheme, Ireland only introduced such a scheme with effect from 1 January 2010, prompted by distortions in the Irish market. Other issues arising in the proposal include the taxation of services provided by non-Community agents to customers within the EU and the question of a "one-stop-shop" allowing such agents to register and account for VAT in the Community through a Member State of their choice.

VAT Infringements

41. Ireland is currently the subject of two reasonably important infringement processes concerning:

- VAT treatment of horses and greyhounds (October 2007);
- VAT groupings (September 2008).

The Commission has also instigated infringement proceedings against a number of other Member States in respect of both these areas.

42. Regarding horses and greyhounds (2007/4171), Ireland applies the livestock rate of 4.8% to all such animals except where they are sold as pets. However, the Commission considers that the standard VAT rate (21%) should apply on the basis that Ireland fails to meet the requirements of the EU Directive for a reduced or super-reduced rate to be applied to such supplies. Having responded to the Letter of Formal Notice on 27 February 2008, a Reasoned Opinion was recently issued which reiterated the Commission's assertions on the matter. Our response to the Reasoned Opinion issued on 20 August 2010. Similar infringement proceedings were taken against seven other Member States, including the Czech Republic and Italy. The infringement cases against the Netherlands, Austria, France, Germany and Luxembourg have all been referred to the European Court of Justice.

43. Regarding VAT groupings (2008/2141), a Letter of Formal Notice was issued by the Commission on 18 September 2008 stating that Ireland was in breech of the VAT Directive by allowing holding companies to be grouped together for VAT purposes. VAT grouping arrangements allow the Revenue Commissioners to treat as a single taxable entity or group, of two or more companies that are closely bound by financial, economic and organisational links. Such an arrangement provides for efficient and effective administration by generally removing the necessity of issuing invoices in respect of inter-group transactions. This is a complex issue. The Commission issued a Reasoned Opinion on 20 November 2009, to which we replied on 20 January 2010. However, on 24 June 2010 Ireland was referred to the ECJ on this matter along with the Netherlands, Finland, Sweden, the UK, the Czech Republic and Denmark.

October 2010

Appendix A

Annex III of the VAT Directive

UPDATED MAY 2009

LIST OF SUPPLIES OF GOODS AND SERVICES TO WHICH THE REDUCED RATES REFERRED TO IN ARTICLE 98 MAY BE APPLIED

(1) Foodstuffs (including beverages but excluding alcoholic beverages) for human and animal consumption; live animals, seeds, plants and ingredients normally intended for use in the preparation of foodstuffs; products normally used to supplement foodstuffs or as a substitute for foodstuffs;

(2) supply of water;

(3) pharmaceutical products of a kind normally used for health care, prevention of illnesses and as treatment for medical and veterinary purposes, including products used for contraception and sanitary protection;

(4) medical equipment, aids and other appliances normally intended to alleviate or treat disability, for the exclusive personal use of the disabled, including the repair of such goods, and supply of children's car seats;

(5) transport of passengers and their accompanying luggage;

(6) supply, including on loan by libraries, of books on all physical means of support (including brochures, leaflets and similar printed matter, children’s picture, drawing or colouring books, music printed or in manuscript form, maps and hydrographic or similar charts), newspapers and periodicals, other than material wholly or predominantly devoted to advertising;’;

(7) admission to shows, theatres, circuses, fairs, amusement parks, concerts, museums, zoos, cinemas, exhibitions and similar cultural events and facilities;

(8) reception of radio and television broadcasting services;

(9) supply of services by writers, composers and performing artists, or of the royalties due to them;

(10) provision, construction, renovation and alteration of housing, as part of a social policy;

(10a) renovation and repairing of private dwellings, excluding materials which account for a significant part of the value of the service supplied;

(10b) window-cleaning and cleaning in private households;

(11) supply of goods and services of a kind normally intended for use in agricultural production but excluding capital goods such as machinery or buildings;

(12) accommodation provided in hotels and similar establishments, including the provision of holiday accommodation and the letting of places on camping or caravan sites;

(12a) restaurant and catering services, it being possible to exclude the supply of (alcoholic and/or non-alcoholic) beverages;

(13) admission to sporting events;

(14) use of sporting facilities;

(15) supply of goods and services by organisations recognised as being devoted to social wellbeing by Member States and engaged in welfare or social security work, in so far as those transactions are not exempt pursuant to Articles 132, 135 and 136;

(16) supply of services by undertakers and cremation services, and the supply of goods related thereto;

(17) provision of medical and dental care and thermal treatment in so far as those services are not exempt pursuant to points (b) to (e) of Article 132(1);

(18) supply of services provided in connection with street cleaning, refuse collection and waste treatment, other than the supply of such services by bodies referred to in Article 13.

(19) minor repairing of bicycles, shoes and leather goods, clothing and household linen (including mending and alteration);

(20) domestic care services such as home help and care of young, elderly, sick or disabled;

(21) hairdressing.

Appendix B

List of VAT Rates applied in the Member States

(1 July 2010)

Member States	**Zero**	**Super**	**Reduced**	**Standard**	**Parked**
Belgium	0	-	6 / 12	21	12
Bulgaria	-	-	7	20	-
Czech Republic	-	-	10	20	-
Denmark	0	-	-	25	-
Germany	-	-	7	19	-
Estonia	-	-	9	20	-
Greece	-	5.5	11	23	-
Spain	-	4	8	18	-
France	-	2.1	5.5	19.6	-
Ireland	**0**	**4.8**	**13.5**	**21**	**13.5**
Italy	0	4	10	20	-
Cyprus	0	-	5 / 8	15	-
Latvia	-	-	10	21	-
Lithuania	-	-	5 / 9	21	-
Luxembourg	-	3	6 / 12	15	12
Hungary	-	-	5 / 18	25	-
Malta	0	-	5	18	-
Netherlands	-	-	6	19	-
Austria	-	-	10	20	12
Poland	0	3	7*	22*	-
Portugal	-	-	6 / 13	21	13
Romania	-	-	5 / 9	24	
Slovenia	-	-	8.5	20	-
Slovakia	-	-	6 / 10	19*	-
Finland	0	-	9 / 13	23	-
Sweden	0	-	6 / 12	25	-
United Kingdom	0	-	5	17.5*	-
Average			**7.4 / 9.6**	**20.5**	

* From 2011, Poland's rates will increase from 7% and 22% to 8% and 23%; while the UK and Slovakia will both increase their standard rate to 20%.