

## CHAPTER 1

# Ending VAT Exemptions: Towards a *Post-Modern VAT*

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### §1.01 INTRODUCTION

Struggling to rebuild its economy three years after the end of the Second World War, the French government decided to try a unique gamble, rebating the turnover tax borne by a selected range of enterprises exporting their goods. The hope was that the increase in exports from a more competitive and efficient export sector would more than offset the initial revenue cost of the refunds. The gamble paid off and the experiment was extended a few years later to more turnover tax transactions.<sup>1</sup> By the 1960s, plans were put in place to transform the entire turnover tax system to one that would rebate the turnover tax all the way along the production chain to the final consumer, shifting the turnover tax from an inefficient compounding tax on production or sales to an efficient and fair tax on final consumption. Europe was on the path to a value added tax.<sup>2</sup>

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1. At the time, the introduction of the value added tax was characterized as ‘an invention of the first order’, and France as an ‘innovator in taxation’: see C.S. Shoup, *Taxation in France*, 8(4) Natl. Tax J. 325–344 (1955).
2. An earlier VAT had been enacted in 1953 at state level in Michigan in the United States, but without the VAT’s invoice-credit format that now prevails around the world. For an analysis of this earlier VAT see C.W. Lock, D. Rau & H. Hamilton, *The Michigan Value-Added Tax*, 8(4) Natl. Tax J. 357–371 (1955); and J.A. Papke, *Michigan’s Value-Added Tax After Seven Years*, 13(4) Natl. Tax J. 350–364 (1960). A VAT had also been enacted in 1950 in Japan but was repealed a few years later, prior to commencement; see M. Bronfenbrenner, *The Japanese Value-Added Sales Tax*, 3(4) Natl. Tax J. 298–314 (1950); and A. Schenk, *Japanese Consumption Tax: The Japanese Brand*, 42 Tax Notes 1625 (1989).

From Europe to the rest of the world, the new value added tax (VAT) quickly spread, becoming what has been described as an unparalleled tax phenomenon,<sup>3</sup> and the most important event in the evolution of tax structure in the last half of the twentieth century.<sup>4</sup> Yet, despite its overwhelming popularity and its undeniable appeal in its pure form, in practice VATs applied around the world are – to different degrees – imperfect with exemptions, an anathema to the logic of the VAT,<sup>5</sup> being a common and significant design imperfection in many of those tax systems.<sup>6</sup> Not only do they constitute exceptions to the core principle of VAT as a tax on consumption, but they are also equally perceived as being particularly damaging to the efficiency and neutrality of the tax.<sup>7</sup> In European countries, where VAT was first introduced, exemptions constitute a very sizable – and growing – portion of the potential tax base. In most other countries around the world, where a VAT was enacted later, the number of exemptions is typically significantly smaller and alternative legal designs for taxing specific sectors of the economy that are exempt under the European VAT have been adopted. However, whether considering a traditional VAT – like that applied in European countries – or a modern VAT – such as that applied in New Zealand, Australia or Canada – questions remain over the suitability of exemptions.<sup>8</sup> Are VAT exemptions, in the words of one contributor to this volume, a necessary evil, an unnecessary evil, or no evil at all?<sup>9</sup> Thirty years since the first appearance of modern VATs on the world stage the debate on (or battle against) exemptions continues, and if anything has actually intensified.<sup>10</sup> Is it time to consider a shift in tax design and progress towards a *post-modern* VAT?<sup>11</sup>

The various chapters in this volume attempt to answer these questions through in-depth analysis of existing exemptions and consideration of alternative legal designs – both of those designs that have already been attempted in different countries around the world, and of others that are as yet untested. It would be impossible to do justice in this introductory chapter to the wealth of knowledge and insight displayed in all these contributions. Our aim, therefore, is merely to bring together in a systematic

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3. A.A. Tait, *Value Added Tax – International Practice and Problems* 3 (International Monetary Fund 1988).
  4. S. Cnossen, *Global Trends and Issues in Value Added Taxation*, 5(3) Intl. Tax & Pub. Fin. 399–428 (1998).
  5. I. Crawford, M. Keen & S. Smith, *Value-Added Tax and Excises*, in *Dimensions of Tax Design – the Mirrlees Review* 275–422 (S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles & J. Poterba eds., Oxford University Press 2010).
  6. V. Lenoir, *April 1954–April 2004 – VAT Exemptions: The Original Misunderstanding*, 10 *European Taxn.* 456–459 at 459 (2004). The multiple rates found in some jurisdictions, particularly in European countries, constitute another serious deviation from the theoretically ideal VAT.
  7. See OECD, *Consumption Tax Trends 2010*, at 15 (OECD Publishing 2011).
  8. The expression ‘modern VAT’ to classify this new, improved VAT model, as opposed to the ‘traditional VAT’ used in Europe, appears to have been coined by L. Ebrill, M. Keen, J-P. Bodin & V. Summers, *The Modern VAT* (International Monetary Fund 2001).
  9. See J. Englisch, *The EU Perspective on VAT Exemptions*, Ch. 2 in this volume.
  10. As predicted by L. Ebrill (n. 8 above), at 198.
  11. As referred to in the Preface to this volume, the use of the expression ‘post-modern’ is not meant in the cultural sense of ‘postmodernism’, but rather to express the shift from a modern VAT to a new, improved, VAT.

fashion all the various topics discussed therein, as well as to offer our own thoughts on the future of VAT exemptions.

In section §1.02, we start with general considerations on VAT exemptions, discussing their origins, namely through consideration of their historical roots in the European model and the attempt to limit their scope in modern VATs; and then consider the concept of exempt supplies, particularly when compared to that other similar concept of out-of-scope supplies. In section §1.03, we delve deeper into the concept of out-of-scope activities and analyse the two main types of activities which fall within this concept: those that are deemed to be out-of-scope for reason of the type of supply in question (out-of-scope supplies), and those that are regarded as out-of-scope because of the nature of the supplier (out-of-scope suppliers). In section §1.04, typical exemptions are analysed in detail. We consider first the so-called merit or concessional exemptions, such as those typically applied to healthcare, cultural activities and education services; and we then move on to technical exemptions, applied to what is known as difficult-to-tax supplies, namely gambling, immovable property and financial and insurance services. We conclude in section §1.05 with considerations on the current state-of-play as regards VAT exemptions and potential alternative designs, and on a possible move to a *post-modern* VAT.

## §1.02 GENERAL CONSIDERATIONS ON VAT EXEMPTIONS

### [A] On the Origin of Exemptions

The theoretical roots for the VAT were sown shortly after the First World War when an American scholar and a German industrialist separately, but almost at the same time, wrote papers setting out proposals for the tax. The timing of the first proposals remains unclear, with one later scholar attributing the first articulation to T.S. Adams, a leading public finance scholar in the US.<sup>12</sup> However, it is more likely that industrialist Carl Friedrich von Siemens' pamphlet slightly preceded Adams' work by a year.<sup>13</sup> Ironically, neither advocate for the VAT viewed their proposals as reforms for turnover taxes; rather, both saw it as a possible substitute for corporate income tax, which they thought to be inferior to a tax that ultimately fell only on final consumption. It is almost certain that neither was aware of the other's contributions to the subject.

As is so often the case, the ultimate adoption of the VAT had little to do with the grand theoretical concerns of academics or industrialists, but rather was a response to, on the ground, pragmatic considerations. At the time VAT was adopted in France, there were two models for final consumption taxes that eliminated cascading taxes on

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12. See R.W. Lindholm, *The Origin of the Value-Added Tax*, 6(1) J. Corp. L. 12 (1980). Lindholm suggests Adams had supported the concept from 1911, although his earliest papers on the topic appear to date from 1921: see T.S. Adams, *Fundamental Problems of Federal Income Taxation*, XXV Q. J. Econ. 553 (1921).

13. Cf. von Siemens, *Veredelte Umsatzsteuer* (Siemensstadt 1919), who cites his brother, Wilhelm von Siemens, as originator of the proposal: see R.A. Musgrave, *Schumpeter's Crisis of the Tax State: An Essay in Fiscal Sociology*, 2 Evolutionary Econ. 89–113, at fn.9 (1992).

business, which distorted business decision-making and encouraged possibly inefficient practices such as vertical integration. The first was the retail sales tax (RST), adopted in most sub-national jurisdictions in North America, which avoids tax on business through a suspension system: the tax is, in theory, suspended on any supplies made to registered enterprises making acquisitions for business purposes. The VAT in contrast, imposes tax on every supply, be it to a registered business or final consumer, but then rebates, through a refundable input tax credit, any tax borne on business acquisitions. Each business will collect tax on the full value of its supplies but only remit a net amount after recovering all tax on inputs used for business purposes. It will pay tax on the entire price to the supplier but then recover it from the customer and only remit the portion of the VAT collected equal to the value added at that stage. Thus, while VAT is paid by the purchaser on the full value of supply, the seller only passes on to the government a slice of the tax received equal to the tax on the excess of the sale price over the value that has previously been taxed. Only if no part of the value has been subject to tax previously (all the inputs were entirely tax free) would the tax remitted be the same as the tax collected. The title ‘value added tax’ refers therefore to the mechanics of the remittance system, not the intended tax base, which is the full value of the supply.<sup>14</sup> For that reason, a number of modern VAT systems have adopted the name ‘Goods and Services Tax’ (GST) to reflect the tax base as opposed to the remittance method.

Although an ideal RST and an ideal VAT should be economically equivalent,<sup>15</sup> in practice their differences, in particular as regards the remittance method, may affect their economic impact<sup>16</sup> and administrative efficiency. Since the time of adoption of the RST and VAT, there has been, therefore, an ongoing debate on the relative merits of the two bases.<sup>17</sup> Proponents of VAT argue – amongst other aspects – that it is more

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14. Ebrill et al. illustrate the difference with a restaurant meal in a tax regime in which raw food products are entirely free of tax from the farmer through wholesaler through retailer, see n. 8 above. The value added by the restaurant may represent only a small amount of the final selling price but if the sale of raw food is tax free while restaurant meals are taxable supplies, the entire value of the meal will be taxed at the restaurant level.

15. See W. Hellerstein, *Comparing the Treatment of Charities under Value Added Taxes and Retail Sales Taxes*, Ch. 5 in this volume. See also S. Cnossen, *VAT and RST: A Comparison*, 35 *Canadian Tax J.* 3 (1987); M. Gillis, P. Mieszkowski & G. Zodrow, *Indirect Consumption Taxes: Common Issues and Differences Among Alternative Approaches*, 51(4) *Tax L. Rev.* 725–774 (1996); C.H.E. McLure & W. Hellerstein, *Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals*, 31 *State Tax Notes* 721–735 (2004); and M. Keen & S. Smith, *VAT Fraud and Evasion: What Do We Know and What Can Be Done?*, LIX(4) *Natl. Tax J.* L861–887(2006).

16. See S. Fedeli, *The effects of the interaction between direct and indirect taxation: the cases of VAT and RST*, 53(3-4) *Pub. Fin.* 385–418 (2003). On the economic impact of who remits tax, see also J. Slemrod, *Does It Matter Who Writes the Check to the Government? The Economics of Tax Remittance*, LXI(2) *Natl. Tax J.* L 251–275 (2008).

17. The key issues in the debate are surveyed in R. Bird & P-P. Gendron, *The VAT in Developing and Transitional Countries* Ch. 3 (Cambridge U. Press 2007), ‘Is VAT Always the Answer?’. The relative merits of the two versions of a ‘final consumption’ VAT were considered in S. Cnossen, *The Technical Superiority of VAT or RST*, in *Australian Tax Reform in Retrospect and Prospect* 325–359 (J.G. Head ed., Australian Tax Research Foundation 1989), and later debated at some length in N. Leccisotti & M. Maré, *On the Presumed Technical Superiority of VAT*, 9(3)

resistant to losses through fraud because of the incremental collection on the way,<sup>18</sup> while proponents of the RST argue a VAT system which offers refundable tax credits all the way up an economic chain may actually be more susceptible to fraud. They also argue the churning – collection of VAT and subsequent upfront refund in cases where the buyer would use acquisitions to make supplies over a long period – is inefficient and costly to businesses that have to fund finance for the period between remittance and refund. In response to this particular concern, the VAT in many jurisdictions has moved to adopt the RST model and suspend any tax – via a zero-rating mechanism – on supplies in a range of circumstances such as sales of going concerns<sup>19</sup> or intra-group supplies.<sup>20</sup>

This debate did not feature in the initial decision to adopt the VAT in Europe. The first moves towards a VAT in France consisted of a slight tinkering of an existing tax to provide refundable input tax credits in limited circumstances.<sup>21</sup> The very gradual expansion of the program in France pointed the way to a method by which existing European turnover taxes could be transformed into final consumption taxes, without replacement with a radically new tax such as a RST. The Neumark Committee, appointed by the European Commission to assess tax impediments to and options for a common market, suggested in 1962 that Europe's existing turnover tax systems could follow the French example and be easily shifted to a final consumption tax through the use of input tax credits,<sup>22</sup> a proposal which has been characterized as

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- Australian Tax Forum 259–269 (1992) and S. Cnossen, *Misunderstanding VAT: A Comment on 'On the Presumed Technical Superiority of VAT'*, 9(3) Australian Tax Forum 271–276 (1992).
18. For a recent view on why VAT is a preferred form of taxation, see S. Cnossen, *A VAT Primer for Lawyers, Economists and Accountants*, 55(4) Tax Notes Intl. 319–332 (2009).
  19. In the EU, Articles 19 and 29 of the Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ L347 of 11 December 2006, 1–118, hereafter 'EU VAT Directive' allows Member States to consider that no supply of goods or services has taken place on sales of ongoing concerns. On the EU Court of Justice interpretation of these rules, see recent commentary by G. Richards, *Finanzamt Ludenscheid v. Christel Schriever: shedding more light on transfers as a going concern*, 2 British Tax Rev. 151–153 (2012).
  20. In the EU, Article 11 of the EU VAT Directive gives Member States the option to introduce a VAT grouping scheme, although it does not provide any guidelines on its design. Consequently just over half of the EU Member States have introduced a VAT grouping scheme, but with legal designs that vary greatly. On this topic see European Commission, *Communication from the Commission to the Council and the European Parliament on the VAT Group option provided in Article 11 of Council Directive 2006/112/EC on the common system of value added tax*, COM(2009) 325 final, 2 July 2009; A. van Doesum & G.J. van Norden, *T(w)o become one: the communication from the Commission on VAT grouping*, 6 British Tax Rev. 657–667 (2009); and J. Swinkels, *The phenomenon of VAT groups under EU law and their VAT-saving aspects*, 21(1) Intl. VAT Monitor 36–42 (2010). Australia, New Zealand, Canada and Singapore are just some of the other countries which also allow VAT/GST groups; for a general overview of the applicable rules in these countries, see P. Stacey, *A rational basis for setting GST and VAT grouping thresholds*, 17(3) Intl. VAT Monitor 186–190 (2006); R. Millar, *Time is of the Essence: Supplies, Grouping Schemes and Cancelled Transactions*, 7(2) J. Australian Taxn. 132–195 (2004); and R. Thomas, *Leaving a GST group – Is a Clean Exit Possible?*, 9(6) Australian GST J. 73–76 (2009).
  21. The work of M. Lauré was particularly influential in the French process of adopting a VAT: see M. Lauré, *La Tax à la Valeur Ajoutée* (2d ed., Librairie du Recueil Sirey 1953) and M. Lauré, *Au Secours de la TVA* (Presses Universitaires de France 1957).
  22. Also known as the Fiscal and Financial Committee, the Neumark Committee was set up by the European Commission to assess the manner by which the disparities of public finance within

‘audacious’.<sup>23</sup> In light of the recommendations of the Neumark Report, the European Commission submitted legislative proposals which envisaged the adoption by Member States of a common system of VAT that followed the fundamental principles of the French VAT system.

The final proposal by the European Commission deviated from the majority recommendation of the Neumark Committee that the VAT operate up to but not including the final retail stage, instead calling for the adoption of a full VAT through all stages of production and sales. The mandatory rollout throughout the Community commenced with promulgation in 1967 of the Commission’s First and Second VAT Directives<sup>24</sup> and by 1973 all original members of the EEC had transformed their turnover taxes into VATs. Ten years later, motivated by the introduction of VAT as a Community own resource, and in an attempt to address the existing divergence of VAT national systems, a blueprint for common rules, the Sixth VAT Directive, was approved amidst high expectations,<sup>25</sup> and effectively regarded at the time as a new ‘European VAT Code’.<sup>26</sup> As this new VAT legislation became part of the *acquis communautaire*, the introduction of a VAT system, subject to the rules set out therein, became a pre-condition for accession of any countries subsequently joining the European Economic Community, its successor the European Community and today’s European Union.

This redesign of the turnover tax into a VAT enjoyed significant advantages over the adoption of a new tax base, particularly in terms of the administration, compliance and acceptance by the business community. The VAT could be presented to this group as a continuation of the existing turnover tax with a benefit in the form of full recovery by businesses of all taxes incurred on acquisitions. To this day, in Europe the VAT is often referred to both unofficially and officially as a ‘turnover tax’.<sup>27</sup>

Winning over the business community, however, was not the only political challenge faced by proponents of the VAT. An equal, and perhaps greater, challenge was achieving acceptance by those who would ultimately be most affected by the move to a comprehensive tax on final consumption, the consumers. To gain the acceptance needed for the change, the first VAT contained a wide range of implicit subsidies by

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Member States could prejudice the establishment of a common market; included within this mandate was the potential harmonization of turnover taxes: see *The EEC Reports on Tax Harmonisation – The Report of the Fiscal and Financial Committee and the Report of the Sub-Groups A, B and C* (Amsterdam: IBFD Publications, 1963).

23. See B. Terra and P. Wattel, *European Tax Law* 200–201 (4th ed., Kluwer Law International 2005).
24. OJ 71 of 14 April 1967, 1301–1312.
25. Sixth Council Directive 77/388/EEC of 12 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes, OJ L145 of 13 June 1977, 1. For a detailed analysis of the process which preceded the approval of these Directives and ultimately led to the introduction of VATs in European countries, see R. de la Feria, *The EU VAT System and the Internal Market* 47–56 (IBFD 2009). See also J. Englisch (n. 9 above).
26. P. Miconi, *Razões Justificativas da Introdução de um Sistema de Imposto sobre o Valor Acrescentado*, 244/246 *Ciência e Técnica Fiscal* at 429 April/June (1979); and A.E. Genot, *Fiscal Harmonisation and European Integration: A 1978 Appraisal*, 3 *European L. Rev.* 355–369, at 360 (1978).
27. See Article 113 of the Treaty on the Functioning of the European Union.

way of reduced rates for some types of supplies and ‘exemptions’ for selected other types of supplies, which often replicated those that had been in place under the previous turnover taxes.<sup>28</sup> Alongside these concessional quasi-subsidy exemptions were a number of exemptions adopted for ‘technical’ reasons, namely the perceived difficulties of fitting these supplies into the ordinary VAT regime. The most significant examples of such supplies are financial and insurance services, some types of transactions on immovable property and gambling services. The implication is that these activities would ideally have been subject to VAT, but pragmatic considerations determined that they be exempt. Preparatory work to the Sixth VAT Directive confirms this reasoning.<sup>29</sup> Crucially, all the exemptions included in European VAT legislation, both concessional and technical, have been from the outset mandatory in nature. While the EU legislator allowed Member States to depart from the rules set out therein in many other areas of the tax, such as the application (or not) of reduced rates, insofar as exemptions are concerned Member States are in principle obliged to apply them, and cannot to this day deviate from what is set out at European level. The fact that there are a few exceptions – where Member States have retained some level of discretion as regards the application of exemptions – does not take away from this general rule.<sup>30</sup>

The theoretical economic neutrality advantages of the VAT, its potential for enhanced compliance as a consequence of multi-stage collection and invoicing, and its proven ability to raise significant revenues, led advisors from Europe and international organizations such as the International Monetary Fund (IMF) to recommend adoption of a VAT in their development models,<sup>31</sup> and over the next decades approximately 150 nations adopted taxes they called VATs.<sup>32</sup> In practice, few of these were VATs in the European sense of applying in a relatively comprehensive fashion to goods and services

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28. See S. Clossen, *What Rate Structure for a Value-Added Tax?*, 35(2) Natl. Tax J. 205–214, at 209 (1982); and V. Lenoir (n. 6 above), at 456–457.

29. European Commission, *Proposal for a Sixth VAT Directive on the harmonisation of legislation of Member States concerning turnover taxes – Common system of value added tax: uniform basis of assessment*, COM(73) 95, 20 June 1975, Bulletin of the European Economic Communities, Supplement 11. See also the Hutchings Report, which was a broad consultation on VAT and financial services undertaken by the tax authorities in the then six Member States in close liaison with the industry, European Commission, *Les Opérations Financières et Bancaire et la Taxe sur la Valeur Ajoutée*, Working Document XIV/241/71, June 1971.

30. Article 137 of the EU VAT Directive allows Member States to grant taxable persons the option to tax in respect of financial services and immovable property; and under Article 133 of the Directive Member States may make the granting of some concessional exemptions conditional on specific requirements. On this point see J. Englisch (n. 9 above).

31. For an assessment of the comparative advantages of VAT, as well as other historical and practical reasons for its spread, see L. Ebrill et al. (n. 8 above), at 4–13; M. Keen & B. Lockwood, *The Value-Added Tax: its Causes and Consequences*, 92(2) J. Dev. Econ. 138–151 (2010); and R.M. Bird & P-P. Gendron (n. 17 above), at 16 et seq. For a critical view of the IMF approach to tax reform, including its role on the spread of VAT, see M. Stewart & S. Jogaarajan, *The International Monetary Fund and Tax Reform*, 2 British Tax Rev. 146–175 (2004).

32. A complete list as of 2007 can be found in A. Schenk & O. Oldman, *Value Added Tax – A Comparative Approach* app. A. (Cambridge University Press 2007).

while providing a robust input tax credit system to avoid cascading taxes on business-to-business transactions. Some only applied to goods and others provided at best limited input tax credits.<sup>33</sup>

Attempts to enact VAT systems outside of Europe revealed some of the shortcomings of the European model. While European tax administrations had long turnover tax experience that could be applied to develop administration systems capable of handling the complexities of multiple VAT rates and concessional exemptions, the complexity of the European model was beyond the capabilities of administrations in developing countries. More significantly, the resulting narrow base required exceptionally high – and, outside of Europe, politically unsustainable – standard rates to raise sufficient revenue, and there was considerable concern with respect to the economic costs of biases and embedded tax in a multi-rate, multiple exemption VAT system.

An alternative model appeared in 1984 with the enactment in New Zealand of what has become known as the modern VAT – in contrast to the traditional European VAT. Like its European counterpart, the New Zealand GST uses invoices to track acquisitions and determine entitlement to refundable input tax credits (invoice-credit method). Unlike the European VAT, however, the New Zealand VAT has a single, and consequently much lower, standard rate with no reduced rate(s), no merit concessional exemptions and limited exemptions for technical reasons.<sup>34</sup> From the mid-1980s onwards, most non-European VAT laws have followed the modern VAT model and while most have adopted one of the foundation principles of the New Zealand law, a single rate, few have adhered as closely as New Zealand to the second principle of no concessional exemptions or exclusions. In addition to rejecting the use of exemptions to subsidize particular activities or types of consumption, the modern VAT showed it was possible to apply the VAT to many types of supplies that had been classified as too difficult to tax under the traditional VAT, and therefore, appropriate for exemption. It illustrated how gambling services, certain types of immovable property transactions, some types of insurance services, and entities such as government departments, public bodies and charities, could all be included in the VAT system.

Not all modern VATs have opted for the same design alternatives as New Zealand, with different countries opting for different solutions as regards traditionally exempted sectors. Moreover, even the modern VAT had its limits at the time it first appeared, the most significant of which was the maintenance of the traditional VAT's exemption for financial services. A quarter century after its introduction, the model for the modern VAT, the New Zealand's GST law, finally addressed in part this remaining

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33. China being one of the most well-known examples of both these phenomena: see W. Cui & A. Wu, *China*, in *The Future of Indirect Taxation – Recent Trends in VAT and GST Systems Around the World*, EUCOTAX Series on European Taxation 159–190 (T. Ecker, M. Lang & I. Lejeune eds., Wolters Kluwer 2012); and X. Yang, *Merger of Business Tax into VAT in China*, 2 *Intl. VAT Monitor* 120–123 (2009).

34. On the introduction of the GST in New Zealand, see in particular R. Douglas, *The New Zealand GST Policy Choice and its Political Implications*, in *GST in Retrospect and Prospect* 3–11 (R. Krever & D. White eds., Thomson Brookers 2007); R. Green, *Consulting the Public in Developing a GST*, in *GST in Retrospect and Prospect*. 13–25 (R. Krever & D. White eds.); and J. Todd, *Implementing GST – Information, Education, Co-ordination*, in *GST in Retrospect and Prospect*. 27–43 (R. Krever & D. White eds.).



exemption, perhaps in the process paving the way to the consideration of a post-modern VAT.

### [B] What Are Exemptions?

The term ‘exempt supplies’ is used in most VAT systems to describe supplies that do not bear output tax – the supplier need not collect or remit any tax in respect of the supply – and do not entitle the recipient to any input tax credits in respect of tax borne on acquisitions related to the making of the supply.<sup>35</sup> The irony of the term is not lost on VAT experts, even if other economic players, particularly final consumers, are misled by the terminology. From the perspective of registered businesses an ‘exempt’ supply in the VAT system is actually a taxable supply, while a ‘taxable’ supply is actually an exempt supply. As there is no recovery of input tax embedded in the price of exempt supplies, the cost of the tax included in the price must be borne by the business that acquires the exempt supply and can only be recovered if the tax is passed on to customers. A taxable supply, on the other hand, is tax-free to a registered business customer as the tax can be recovered through the input tax credit system. Ultimately, both taxable and exempt supplies are taxed supplies from the perspective of the final consumers – albeit at different levels – with an explicit tax levied on the first type of supply, and a (smaller) embedded tax included in the cost of the second.<sup>36</sup>

Unlike the case with an explicit tax levied on taxable supplies, measurement of the tax embedded in the cost of an exempt supply may be problematic, as it is dependent on various factors. The level of VAT embedded in the price of an exempt supply will depend on the value of services provided by the supplier making the exempt supply and the character of supplies up the supply chain. Where there is little labour input in the supply and relatively little mark up by the supplier for his or her work in making the supply available, the embedded VAT may not be far below the VAT that would have been charged had the supply been taxable.<sup>37</sup> If most of the value of the supply is attributable to the labour input of the person making the supply and that person draws upon few inputs to provide the labour, the rate of embedded tax relative to the value of the supply may be small.

The Organisation for Economic Co-operation and Development (OECD) has identified a range of standard exemptions which vary greatly across member nations,

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35. Some label these supplies as ‘exempt without credit’ - both outside Europe, e.g., Brazil, and within Europe, e.g., Portugal - while Australia uses the term ‘input taxed supplies’, both alternatives being more accurate in terms of the effect of the rules applicable to supplies of this type.
  36. As Keen puts it, when referring to the financial services exemption, ‘business users pay too much tax (in the sense that the normal crediting mechanism of the VAT would wipe out such input VAT ...), while final consumers pay too little (because the value added by the financial institutions is not taxed)’; see M. Keen, *The Taxation and Regulation of Financial Institutions*, IIPF Musgrave Lecture (2010).
  37. Of course the level of the mark up may itself be influenced by the amount of embedded VAT. Depending on the price elasticity of the products offered or/and the competitiveness of the market, the supplier might not be able to set prices that reflect the full extent of the embedded VAT, having instead to decrease its profit margin.

with significant differences between European nations and other members. Generally, jurisdictions outside the EU have a very limited number of exempt supplies. In contrast, exemptions proliferate in Europe. Standard exemptions in European countries include postal services, transport of sick/injured persons, hospital and medical care, human blood, tissues and organs, dental care; education, sporting activities, cultural services (excluding radio and television broadcasting), charitable work, non-commercial activities by non-profit organizations, certain fund-raising events, the supply of land and buildings (including letting of immovable property), betting, lotteries and gambling, insurance and reinsurance, and a range of financial services including loan intermediary services and capital raising operations. Beyond these core items are exemptions covering a wide diversity of sectors such as legal aid, passenger transport, public cemeteries, waste and recyclable material, water supply, precious metals and certain agricultural inputs.<sup>38</sup>

Two other types of supply may replicate the effect of an exempt supply in the VAT: out-of-scope supplies made by VAT registered suppliers and supplies made by out-of-scope suppliers. The first of these is a supply that falls outside the scope of the VAT legislation, either for technical reasons related to its design or as a result of narrow judicial interpretations of provisions in the VAT law. Whether an out-of-scope supply will bear embedded input tax in the same manner as an explicitly exempt supply will depend on the technical design of the input tax credit measures in the VAT law. In cases where the entitlement to input tax credits for acquisitions is not directly tied to the use of those acquisitions in making taxable supplies, the supplier will be able to recover the input VAT and the supply will be tax-free. If, however, the law only allows input tax credits where the acquisition is directly connected with a taxable supply, the out-of-scope supply will bear embedded VAT in the same manner as explicitly exempt supplies.

The second type of supply that can replicate the effect of an exempt supply is a supply made by an out-of-scope supplier. Suppliers may fall outside the scope of a VAT law for three reasons. First, they are taxable enterprises with turnovers less than the threshold for compulsory registration under the VAT law. Second, they may be excluded from the definition of taxable enterprises as a result of a narrow definition in the VAT law or narrow judicial interpretation of the concept of taxable enterprise. Third, they may be explicitly excluded from the operation of the VAT system by the relevant legislation.

### **§1.03 ACTIVITIES OUTSIDE THE SCOPE OF VAT**

#### **[A] Out-of-Scope Supplies**

The use of restrictive terminology in VAT legislation or the effect of restrictive judicial interpretation of terms used in the law can leave supplies made by registered persons

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38. See OECD (n. 7 above), at 76–81. See also R. Bird & P-P. Gendron, who offer a sample of exemptions applicable in some countries outside the OECD; see n. 17 above, at 121–123.

(or persons who are required to be registered) as out-of-scope supplies, often also referred to as non-taxable supplies. The result is an under-taxation of supplies to final consumers and over-taxation of business customers.

Occurrences of out-of-scope supplies by registered businesses are found in both the EU traditional VAT and the modern VAT. Many instances in the former are attributable to the ‘direct and immediate link’ doctrine developed in the European Court of Justice in the 1980s. The doctrine established as a condition of a taxable supply that there be a direct (and formal) link between a supply and payment (consideration) received in respect of that supply.<sup>39</sup> Thus, for example, a voluntary payment to a person making supplies at large would not be treated as consideration for a taxable supply in the traditional VAT.<sup>40</sup>

Another source of out-of-scope supplies found in both the traditional and modern VAT is a narrow understanding of ‘supply’ to exclude, for example, supplies of inaction, supplies made at large and involuntary supplies. An example of the first is the fulfilment of a non-competition covenant or agreement to cease activities upon receipt of consideration for non-performance.<sup>41</sup> An example of the second is the assumption by an entity of social or economic responsibilities or undertakings in return for payment.<sup>42</sup> An example of the third is an expropriation of property where the supply is the result of compulsory acquisition by the acquirer, not voluntary disposal by the vendor.<sup>43</sup>

A third cause of out-of-scope supplies is the characterization of some dealings in financial securities such as shares and bonds by an otherwise fully taxable enterprise as investment activities undertaken by the firm rather than part of its business activities. If the impugned transactions constitute a significant enough portion of the enterprise’s activities, the entire enterprise may be tainted as an out-of-scope person, not engaged in requisite economic activities.<sup>44</sup>

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39. The doctrine was first introduced in Cases 154/80, *Staatssecretaris van Financiën v. Coöperatieve Vereniging Cooperatieve Aardappelenbewaarploaats GA (Dutch Potato)* [1981] ECR 445; and 102/86, *Apple and Pear Development Council (APDC) v. Commissioners of Customs and Excise* [1988] ECR 1443.

40. See Case C-16/93, *R. J. Tolsma v. Inspecteur der Omzetbelasting Leeuwarden* [1994] ECR I-743, a case involving a street musician receiving ‘donations’ from passers-by. The approach used by the Court to exclude the transaction in that case from VAT is analysed in A. Schenk & O. Oldman (n. 32 above), at 120. The nexus required by courts to establish the link between consideration and a supply has been more relaxed in some cases. See for example Case C-498/99, *Town & County Factors Ltd v. Commissioners of Customs & Excise* [2002] ECR I-7173.

41. See, for example, Case C-215/94, *Mohr v. Finanzamt Bad Segerberg* [1996] ECR I-959, where a farmer was paid to withdraw from milk production.

42. See, for example, *Chatham Islands Enterprise Trust v. CIR* (1999) 19 NZTC 15,075 (Ct of A) (NZ) where a trust received funds from the government after agreeing to assume responsibility for what were previously government responsibilities; and *CIR v NZ Refining Co Ltd* [1997] 18 NZTC 13,187 (Ct of A) (NZ) where a company received a payment from the government in return for an agreement to stay in business following deregulation.

43. *Hornsby Shire Council and Federal Commissioner of Taxation* (2008) AATA 1060 (AAT) (Australia) where a local government expropriated property owned by a registered enterprise.

44. See, for example, Cases C-333/91, *Sofitam SA (formerly Satam SA) v. Ministre chargé du Budget*, [1993] ECR I-3513; C-4/94, *BLP Group plc v. Commissioners of Customs & Excise* [1995] ECR I-983; C-80/95, *Harnas & Helm CV v. Staatssecretaris van Financiën* [1997] ECR I-745; C-98/98, *Commissioners of Customs and Excise v. Midland Bank plc* [2000] ECR I-4177; C-16/00, *Cibo Participations SA v. Directeur régional des impôts du Nord-Pas-de-Calais* [2001]

**[B] Out-of-Scope Suppliers**

As noted earlier, there are three groups of suppliers that may fall outside the scope of VAT law. The first are businesses that would otherwise be subject to VAT but with turnovers below the compulsory VAT threshold; the second are entities that fall outside the scope of the tax as a result of judicial interpretations of legislative charging provisions; the third are entities explicitly prevented from registering by legislative exclusions. The first category of out-of-scope supplier is common to the traditional VAT and the modern VAT. The second and third types of out-of-scope supplier are found most often – albeit not exclusively – in the traditional European VAT systems.

**[1] Unregistered Businesses**

Most VAT laws, both traditional and modern, contain registration ‘thresholds’ that exempt small businesses from compulsory registration and inclusion in the VAT system, although the thresholds vary widely across countries.<sup>45</sup> These registration thresholds were not always well perceived. When VAT initially appeared on the world stage, the general view was that the ideal VAT threshold should be zero, and therefore the usual expert advice was to set the threshold as low as possible.<sup>46</sup> This view was in line with optimal taxation theory which stated at the time that differentiation of tax liability based on firm size violates production efficiency.<sup>47</sup> A number of disadvantages to establishing a registration threshold were cited to buttress the case for no or very low thresholds.

The first disadvantage – or advantage, if the rationale is to enhance the competitive position of small firms – of thresholds is that they may distort competition between those above and below the trigger point, particularly in the case of firms selling directly

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ECR I-6663; C-465/03, *Kretztechnik AG v. Finanzamt Linz* [2005] ECR I-4357; C-437/06, *Securenta Göttinger Immobilienanlagen und Vermögensmanagement AG v. Finanzamt Göttingen* [2008] ECR I-597; and C-29/08, *Skatteverket v. AB SKF* [2009] ECR I-10413. For comprehensive discussion on this jurisprudence see A. van Doesum & G.J. van Norden, *The Right to Deduct under EU VAT*, 5 Intl. VAT Monitor 323–329 (2011); and P. Melz, *Activities Outside the Scope of VAT and Exempt Activities*, 5 Intl. VAT Monitor 330–331 (2011). See also R. de la Feria, *When Do Dealings in Shares Fall Within the Scope of VAT?*, 1 EC Tax Rev. 24–40 (2008); J. Englisch, *The Future of Indirect Taxation – Recent Trends in VAT and GST Systems Around the World*, EUCOTAX Series on European Taxation 159–190 (T. Ecker, M. Lang & I. Lejeune eds., Wolters Kluwer 2012), at 549–585; D.R. Jensen & H. Stensgaard, *The distinction between direct and general costs with regard to the deduction of input VAT – the case of acquisition, holding and sale of shares*, 4(1) World Tax J. 3–32 (2012); A. van Doesum, H. van Kesteren & G.-J. van Norden, *Share disposals and the right of deduction of input VAT*, 19(2) EC Tax Rev. 62–73 (2010); G. Richards, *Skatteverket v AB SKF: exploring the impact on input tax recovery on the boundary between exempt transactions and non-business activities*, 3 British Tax Rev. 273–275 (2009); and C. Amand, *VAT: deductibility of the costs of issuing new shares – the direct and immediate link test*, 5(3) EC Tax J. 203–230 (2001).

45. Several developed countries with good tax administrations, such as Spain, have thresholds of zero, so that every business regardless of how small, must register for VAT, see OECD (n. 7 above), at Table 3.9.

46. See R. Bird & P-P. Gendron (n. 17 above), at 115.

47. See P. Diamond & J.A. Mirrlees, *Optimal Taxation and Public Production I: Production Efficiency*, 61(1) Am. Econ. Rev. 8–27 (1971).

to final consumers. In the case of business customers, the apparent lower VAT included in the cost of supplies from unregistered suppliers is negated by the fact that these suppliers cannot issue tax invoices and no input tax credits are available to recover the embedded VAT included in the supplies. In contrast, the fully taxable supply made by the registered supplier is free of tax after input tax credits are claimed. The registered business customer will thus almost always prefer to limit acquisitions to those supplied by registered persons. To ensure smaller businesses are not at a competitive disadvantage relative to larger firms with turnovers greater than the registration threshold, most VAT systems provide for voluntary registration by smaller firms that may wish to supply registered businesses. On the other hand, small businesses supplying to final consumers may find it advantageous to remain as unregistered suppliers. Their customers will bear the entire cost of embedded VAT included in the price of goods and services acquired by the suppliers, but incur no tax liability in respect of the value added by the suppliers. As final consumers are indifferent between tax that is embedded in the price and tax that appears on a tax invoice as a separate line before the total amount payable, unregistered suppliers will be able to attract non-business customers so long as the embedded tax is less than the explicit tax charged by registered businesses.

The ability of unregistered businesses to make de facto exempt supplies provides small businesses with a slight competitive advantage in some cases, or with a better ability to compete in the face of the economies of scale and volume purchase pricing available to larger registered competitors. It might be argued that this competitive advantage given to unregistered firms is desirable as it tends to be the smaller and hence presumably poorer traders that are relatively advantaged and the implicit subsidy of reduced taxation meets vertical equity concerns.<sup>48</sup> On the other hand, an indirect subsidy delivered by way of reduced consumption tax liability is a very crude redistribution instrument that is impossible to target effectively. To the extent the implicit subsidy keeps less efficient smaller firms afloat,<sup>49</sup> the economic consequences may be counter productive and it might actually further growth by firms approaching the threshold, creating a bunching of firms just below the threshold and an absence of firms for some distance above it.<sup>50</sup> A recent study seems to confirm this possibility, not solely by finding a clustering of companies just below the threshold, but also suggesting that masquerading behaviour – either in the form of avoidance or evasion – in order to fall outside the scope of VAT may be commonplace.<sup>51</sup>

The second disadvantage of establishing a registration threshold is the loss of potential revenue. This aspect must, however, be seen in the context of administrative and compliance costs. The initial view dismissing the benefits of registration thresholds above zero implicitly assumed that there were little or no additional administrative and

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48. M. Keen & J. Mintz, *The Optimal Threshold for Value-Added Tax*, 88 J. Pub. Econ. 559–576, at 564 (2004).

49. Smaller firms tend to be less efficient than their larger competitors; see A. Schenk & O. Oldman (n. 32 above), at 77–79.

50. M. Keen & J. Mintz (n. 48 above), at 568.

51. See K. Onji, *The Response of Firms to Eligibility Thresholds: Evidence from the Japanese Value-Added Tax*, 93(5-6) J. Pub. Econ. 766–775 (2009).

compliance costs from the low threshold. The evidence now suggests that firm-size differentiation can indeed be part of an optimal tax system when there are fixed-per-firm cost elements in the administrative costs of running a tax system.<sup>52</sup> In fact, bringing every small business into the VAT system increases administrative costs exponentially, and the additional VAT collected may be largely absorbed as costs in collecting the tax. Therefore, even if some revenue is forgone by dropping small taxpayers, in most countries any revenue loss could be likely recouped by removing the high administration costs of assessing numerous low-return taxpayers who universally account for relatively little VAT revenue.<sup>53</sup>

Additional rationales for low thresholds concern the interest of tax authorities in gathering information and assessing participants in the shadow economy. Since good tax administration rests on information, it has been argued that including the largest possible share of the economic activity in the tax base has the advantage of capturing as much information as possible; it may also be that dipping as deeply as possible into the pool of potential taxpayers will lead to catching some ‘hidden whales’.<sup>54</sup> Neither of these reasons is particularly convincing, however. There has been no evidence of concealed VAT profit windfalls waiting to be uncovered through broader assessment of small businesses.

Optimal tax administration analysis now suggests the VAT registration threshold should be determined by balancing collection costs against the marginal value of additional tax revenues.<sup>55</sup> Interestingly, the older and more current views are not reflected in distinctions between traditional VAT and modern VAT jurisdictions’ practices. Some traditional VAT systems such as those in place in the Czech Republic, France, Ireland, Slovak Republic and the United Kingdom apply a high threshold compared to those applied in modern VAT systems such as Australia, Canada or New Zealand.<sup>56</sup> To the extent to which these thresholds reflect conclusions on the relative cost of administration relative to revenue collection, there may be room for improvement of administration processes in some jurisdictions.

## [2] *Deemed ‘Non-business’ Enterprises*

The definition of taxable person for VAT purposes varies from jurisdiction to jurisdiction, but a common feature to all definitions is the requirement that the person be carrying on economic activities – a stipulation intended to exclude private household activities. A significant point of departure between the traditional and modern VAT systems, however, is the approach taken by courts when interpreting phrases such as ‘business’, ‘enterprise’ or ‘economic activities’ used within those definitions. In

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52. See D. Dharmapala, J. Slemrod & J.D. Wilson, *Tax Policy and the ‘Missing Middle’: Optimal Tax Remittance with Firm-Level Administrative Costs*, J. Pub. Econ. 95, 1036–1047 (2011).

53. M. Keen & J. Mintz (n. 48 above). In this regard, it is also worth noting that in most countries reportedly ‘a surprisingly small number of VAT registrations, sometimes less than a few dozen, account for 80% to 90% of VAT collections’, see R. Bird & P-P. Gendron (n. 17 above), at 115.

54. See R. Bird & P-P. Gendron (n. 17 above), at 120.

55. See M. Keen & J. Mintz (n. 48 above).

56. See OECD (n. 7 above), at tbl. 3.9.

modern VAT jurisdictions, these terms tend to be given wide interpretations – prima facie, an entity with a significant number of employees, making substantial acquisitions, owning or renting commercial property, and so forth is carrying on economic activities and would be treated as a taxable person under the modern VAT.<sup>57</sup> They would thus be able to register and claim input tax credits, even if they make no taxable supplies – the test for eligibility for input tax credits in the modern VAT is whether the acquisitions are related to carrying on the person’s enterprise and do not give rise to personal consumption, rather than whether they are directly used to make taxable supplies.

In contrast, courts in traditional VAT jurisdictions – in particular the EU Court of Justice – have read down the notion of an ‘economy activity’<sup>58</sup> through a phenomenon of what has been designated elsewhere as creeping case law,<sup>59</sup> so it rarely extends beyond activities involving supplies for consideration in the course of an ongoing business. Three key groups left out of the scope of economic activity by the narrow concept, and thus of the ability to make taxable supplies or creditable acquisitions, are mutual business organizations, holding companies and investment companies. All these enterprises play intermediary roles in the economy, reflecting no final consumption, but nevertheless incur unrecoverable input tax on acquisitions as a result of their exclusion from the VAT system by the judicial interpretations.

The exclusion from the business concept of mutual organizations applies where an organization carrying on substantial activities absorbs all its income into making supplies to its members.<sup>60</sup> If the body’s members are not final consumers, the designation of the organization as a non-business entity results in over-taxation with members unable to claim input tax credits on their membership fees that are in turn used in part or in whole to acquire taxable services through the mutual organization.

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57. On the definition of ‘enterprise’ under Australian GST law, see R. Millar & D. McCarthy, *Australia*, in *The Future of Indirect Taxation – Recent Trends in VAT and GST Systems Around the World*, EUCOTAX Series on European Taxation 159–190 (T. Ecker, M. Lang & I. Lejeune eds., Wolters Kluwer 2012), 21–96, at 32–33; on the definition of ‘commercial activity’ under Canadian GST law, see M. Abbas & A.J. Cockfield, *Canada*, in *The Future of Indirect Taxation – Recent Trends in VAT and GST Systems Around the World*, EUCOTAX Series on European Taxation 159–190 (T. Ecker, M. Lang & I. Lejeune eds., Wolters Kluwer 2012), 109–141, at 114–116; and on the concept of ‘taxable activity’ under New Zealand GST law, as interpreted by the courts in that country, see P. Blanchard, *Some Basic Concepts of New Zealand GST*, in (R. Krever & D. White eds.) (n. 34 above), 91–101.

58. In the language used in Article 9 of the EU VAT Directive.

59. The term is used to describe the phenomenon whereby the introduction of a general principle in a given judgment has demanded extra qualifications, and explanations by the Court in subsequent decisions, resulting in the accumulation of a complex body of case law, riddled with factual minutiae: see R. de la Feria (n. 44 above), at 24–25.

60. For example, the UK House of Lords has held that the activities of the Institute of Chartered Accountants (UK) in ensuring accountants adhere to certain standards are undertaken without a view to profit and thus do not constitute a business, a threshold test for a taxable person in the UK: see *Institute of Chartered Accountants in England and Wales v. Commissioners of Customs and Excise* [1999] STC 398.

The designation by European courts of holding companies as non-taxable persons that are unable to claim input tax credits<sup>61</sup> results in unrecoverable tax becoming embedded in business to business transactions that involve no final consumption, generating the biases that the VAT was intended to eliminate.<sup>62</sup> Despite calls for reform,<sup>63</sup> and indeed the European Commission's recognition of the problem, there seem to be no immediate plans to address the problem in the traditional VAT.<sup>64</sup>

The third group sometimes left out of the scope of economic activity amounting to a business are investment and financial companies, often situated within a corporate group. By using the services of a financial member to source debt and capital and invest excess capital, a corporate group may realize significant economies of scale benefits, reducing costs and increasing returns. As noted previously in the context of out-of-scope supplies, an enterprise that carries on some financial transactions might find the transactions are characterized as passive investment activities rather than business activities and if the scale of these transactions relative to the entire operations of the enterprise is significant, the entire enterprise may be characterized as an out-of-scope enterprise not engaged in business-like economic activities. Lending operations by a factoring company<sup>65</sup> or making annual financing loans to subsidiaries<sup>66</sup> will be considered business activities, as would a fund manager's ongoing investing for the purpose of generating gains,<sup>67</sup> but the managed sale of an investment portfolio will not

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61. This interpretation of the EU VAT Directive was initially introduced by the EU Court of Justice in the *Polysar* case in the early 1990s: see Case C-60/90 [1991] ECR I-3111, a judgment that at the time 'seemed innocuous enough in itself'. See P. Farmer, *Taxable persons and the 'Private Life' of Companies*, 2 EC Tax J. 41–48, at 42 (1997). The doctrine has been reinstated and developed in later decisions, which indicate that a holding company may qualify as an eligible enterprise where different exceptions apply. For an analysis of this case law from both a European perspective and that of national courts, see R. de la Feria (n. 44 above); and J. Englisch, *Input VAT Deduction by Holding Companies – German Practice and Community Law*, 2 Intl. VAT 172–179 (2007).
62. For a principle-based analysis of the EU Court of Justice jurisprudence on holding companies see R. de la Feria, *A Natureza das Actividades e Direito à Dedução das Holdings em Sede de IVA*, 4(3) Revista de Finanças Públicas e Direito Fiscal (2011).
63. See recently M. Aujean, *Harmonization of VAT in the EU: Back to the Future*, 3 EC Tax Rev. 134–143 (2012).
64. In 2010, the European Commission seemed to be considering a review of the VAT treatment of holding companies: see *Green Paper on the Future of VAT – Towards a simpler, more robust and efficient VAT system*, Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee, COM(2010) 695 final, 1 December 2010; for a comment see A. van Doesum & G.J. van Norden, *EU2011, EUtopia and EU2020: the European Commission's Green Paper on the Future of VAT*, 3 British Tax Rev. 253–272, at 263–267 (2011). However, by the following year the issue seemed to have been dropped from the Commission's immediate plans; see *Communication on the Future of VAT – Towards a simpler, more robust and efficient VAT system tailored to the single market*, Communication from the Commission to the European Parliament, the Council and the Economic and Social Committee, COM(2011) 851 final, 6 December 2011.
65. Cases C-305/01, *Finanzamt Gross-Gerau v. MKG-Kraftfahrzeuge Factoring GmbH* [2003] ECR I-6729; and C-93/10, *Finanzamt Essen-NordOst v. GFKL Financial Services AG* [2011] ECR I-000.
66. Case C-77/01, *Empresa de Desenvolvimento Mineiro SGPS SA (EDM) v. Fazenda Publica* [2004] ECR I-4295.
67. Case C-8/03, *Banque Bruxelles Lambert v. Etat Belge* [2004] ECR I-10157.



cross this threshold.<sup>68</sup> The borderline is murky at best and the narrowing of the economic activity concept can result in a compounding VAT liability on enterprises seeking a more efficient allocation of resources and skills within a company group.

### [3] *Government Departments, Other Public Sector Bodies, and Charities*

While the treatment of supplies by governments and government bodies attracts much comment and generates many tax disputes and consequent case law, in many cases the question is of little importance in practical terms. The clearest case where the tax status of a government body is irrelevant is where the government that levies the VAT provides monopoly services such as issuing passports or issuing spectrum licences.<sup>69</sup> All customers for the former will be individuals and the acquisition will be private consumption. It makes no difference to the customers if the government charges a lower price and imposes VAT or charges a higher price and has no VAT. A supply such as a telecommunications spectrum licence, on the other hand, will only be acquired by a registered enterprise in the course of a business. When calculating how much to bid for the supply, this customer should be indifferent between a higher price that includes a recoverable VAT component or a lower price that is exempt from VAT, provided it knows beforehand whether the supply will be taxable or not.

Difficulties may arise if the character of a monopoly supply is not made clear prior to the supply being made. If, for example, the government has assumed a supply did not include VAT and the customer assumed it did, the customer may overpay for an acquisition from the government. Alternatively, it may be the customer that assumes the supply is exempt and bids a lower price, later seeking a windfall by claiming the lower amount was VAT-inclusive. Leaving the cases of poor prior communication aside, however, the character of monopoly supplies is relatively unimportant so long as both the government and customers agree beforehand on that character and the government or customer, as need be, adjust their prices or bids respectively.

In terms of the government that levies the VAT, the treatment of government bodies under the VAT will only affect the budget allocation between departments. For example, if the police and army can register and claim input tax credits, their acquisition costs will fall and a smaller funding allocation from the central budget will be needed. If they cannot register, their acquisition costs will rise and the government will fund them with higher direct budget allocations rather than lower allocations combined with input tax refunds.

The treatment of lower tier governments and government bodies is much more problematic in the VAT. Two distinct sets of issues arise – should taxes paid to lower tier governments be treated as consideration for taxable supplies and should lower tier

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68. Case C-155/94, *Wellcome Trust Ltd v. Commissioners of Customs and Excise* [1996] ECR I-3013.

69. Examples of litigation seeking to determine whether VAT is included in the price of these supplies include Cases C-284/04, *T-Mobile Austria GmbH and Others v. Republic of Austria* [2007] ECR I-5189; and C-369/04, *Hutchison 3G UK Ltd and Others v. Commissioners of Customs & Excise* [2007] ECR I-5247.

governments be allowed to register for VAT purposes or should they be kept out of the VAT system and thus treated in effect as persons making out-of-scope supplies?

Agreeing to pay a particular level of taxes (by way of the democratic process) results in forgoing consumption that could otherwise be acquired with the funds used to pay taxes. It can be argued consequently that taxes paid to a democratically elected government are simply another form of consideration for taxable supplies, the supplies being the public goods and services provided by the government and desired by the taxpayers who agree to pay higher taxes and reduce other consumption. On this basis, modern VAT systems may treat taxes paid to lower tier governments as consideration for taxable supplies.<sup>70</sup> The practice is relatively rare, however.

The second issue, whether lower tier governments should be allowed to register for VAT purposes and claim input tax on all acquisitions, not just those used to make taxable supplies that compete with supplies offered by private sector businesses, is a matter of great concern in all jurisdictions and one that leads to considerable political tension and litigation. If lower tier governments are not able to register and claim input tax credits on all their acquisitions, there will be a transfer of tax revenues from the lower tier governments to the higher level government that levies the VAT. The lower tier governments will be forced to raise local taxes to pay non-recoverable VAT on all their acquisitions.

This problem does not arise in modern VAT systems that allow all enterprises to register without regard to whether they are public or private, or for profit or not for profit. In these jurisdictions, lower tier governments simply register within the ordinary VAT system.<sup>71</sup> In other jurisdictions, particularly those modelled after the traditional European VAT with its narrower definition of enterprise that excludes governments, lower tier governments commonly bear a non-recoverable VAT burden on acquisition, resulting in a transfer of funds to the central government. There have been ongoing discussions about the need for a European-wide solution but to date there have been no effective steps taken to resolve the problem.<sup>72</sup> In the meantime, alternative solutions

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70. New Zealand, for example, treats most taxes paid to lower tier governments as consideration for taxable supplies. The Australian legislation provides for similar treatment but delegates to the Treasurer the power to specify that some taxes should in effect be treated as consideration for exempt supplies. In practice, therefore, and for political reasons Australian Treasurers have excluded almost all lower tier government taxes from the VAT system.

71. To overcome constitutional issues, lower tier governments in Canada are registered under a separate system that parallels the national GST system.

72. In 2000, the Commission published a VAT strategy aimed at improving the operation of the Internal Market. Under the heading 'other potential future priorities', the Commission set out the areas which it considered warranted a thorough review. The first item on this list was the treatment of subsidies, public authorities and services in the public interest: see *A Strategy to Improve the Operation of the VAT System within the Context of the Internal Market*, Communication from the Commission to the Council and the European Parliament, COM(2000) 348 final, 7 June 2000. The Commission's intention to reform the VAT treatment of public bodies was reiterated in 2003 in their review and update of the VAT strategy. It stated then that preparatory work for reform of this area was already under way, and despite its complexity, a final proposal would be presented in the fourth quarter of 2004: see *Review and Update of VAT Strategy Priorities*, Communication from the Commission to the Council and the European Parliament, COM(2003) 614 final, 20 October 2003. Yet, six years on, the Commission has not only failed to do so, but equally there are no obvious signs of an intention to initiate the

have been developed at the national level to address the problem of tax transfer from lower tier governments to the government levying the VAT. The most common solution is to establish a parallel regime that allows lower tier governments to file returns in the parallel regimes and claim refunds of all or part of their input tax. While these refund schemes have the advantage of eliminating the bias towards self-supply and away from outsourcing, they, too, give rise to difficulties.<sup>73</sup>

The VAT treatment of government departments and other public sector bodies and charities marks another point of departure between the modern and traditional VAT, with these entities treated as out-of-scope suppliers in the European VAT.

Public bodies are a concept set out (and defined) in EU law,<sup>74</sup> and the special VAT status of these entities is largely an issue only in the traditional VAT. In broad terms, a public body is an entity established by, and largely funded by, a government but which operates outside any government department. An example is a national sports institute or arts organization.

The special rules for public bodies in the traditional VAT are in essence an anachronism derived from the roots of the European VAT in turnover taxes.<sup>75</sup> Today's European VAT law makes a distinction between 'commercial' supplies made by a public body that competes in the market with private profit-making entities and other supplies that are not seen to be offered in competition to supplies from private sector enterprises.<sup>76</sup> EU legislation treats public bodies as out-of-scope suppliers to the extent their supplies are non-commercial supplies, presumably on the assumption that there is some merit to their outputs that deserves a subsidy. The economic distortions and compliance consequences of dissecting and characterizing an organization's outputs may be significant,<sup>77</sup> with a bias towards self-supply and opportunities for aggressive planning and avoidance.<sup>78</sup> At the same time, the treatment of these bodies as out of

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consultation process, which would usually precede such a move. See M. Aujean, *Application of VAT to Public Bodies: The EU VAT System, Current Issues and Proposals*, in *VAT in Africa* 71–79, at 79 (R. Krever ed., Pretoria University Press 2008).

73. See R. de la Feria, *The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction*, 37(3) *Intertax* 148–165, at 161–162 (2009).

74. For example, Article 1(9) of the Procurement Directive defines public body or, in the terms of the definition, a 'body governed by public law' as any body '(a) established for the specific purpose of meeting needs in the general interest, not having an industrial or commercial character; (b) having legal personality; and (c) financed, for the most part, by the State, regional or local authorities, or other bodies governed by public law; or subject to management supervision by those bodies; or having an administrative, managerial or supervisory board, more than half of whose members are appointed by the State, regional or local authorities, or by other bodies governed by public law'.

75. As Advocate-General Jacobs of the Court of Justice so clearly stated in the *Waterschap Zeeuws Vlaanderen* case: 'It is inherent in the existence of exceptions to the VAT system that they will interfere to some extent with the application of the principles of neutrality and of equality treatment. Whatever the merits of the decision to treat public sector bodies as final consumers, it forms an integral part of the Directive. In that and in comparable situations, the treatment of taxable persons and persons excluded from the VAT system will inevitably be different': see Case C-378/02, *Waterschap Zeeuws Vlaanderen v. Staatssecretaris van Financien* [2005] ECR I-4685, at para. 38.

76. See Article 13 of the EU VAT Directive.

77. See R. de la Feria (n. 73 above).

78. Cases C-223/03, *University of Huddersfield* [2006] ECR I-1751 and C-63/04, *Centralan* [2005] ECR I-11087.

scope suppliers to the extent they make non-commercial supplies at best amounts to an inefficient and ill-targeted subsidy.

Unlike public bodies, the concept of charitable organizations is common to both traditional and modern VAT jurisdictions. Their VAT treatment is not consistent, however. In the European traditional VAT systems, charities are treated as out-of-scope suppliers, unable to register and claim input tax credits. The result is input taxation of their charitable supplies, an uneven and perhaps illogical government levy on their activities. In some modern VAT jurisdictions, the activities of charities are viewed as economic activities in the broader sense, even if they are not for profit, and the bodies will be considered taxable persons, able to recover input tax on acquisitions and thus eliminate any embedded tax on their supplies of charitable goods or services. This is not the case in all modern VAT jurisdictions, however. In fact, while there appears to be a consensus that the VAT system should not be modified to deal with the perceived problem of charities,<sup>79</sup> in practice the exclusion of charities from the scope of VAT is not limited to traditional VAT jurisdictions,<sup>80</sup> with some countries, such as Canada, adopting a ‘middle-ground’ approach.<sup>81</sup>

#### §1.04 PARTICULAR CATEGORIES OF EXEMPTIONS

##### [A] Merit / Concessional Exemptions

The original designation of many types of exempt supplies as exempt was based not so much on clearly articulated policy objectives but rather on pragmatic political goals, as designers of the VAT sought to replicate the impact of the predecessor turnover taxes and deflect concerns about the tax on beneficiaries of previous concessions. Over time, two *ex post facto* rationales have been offered for the concessions. The first is based on vertical equity concerns, with the exemption of essential products said to diminish the natural regressivity of a VAT. The second is based on the alleged benefits of subsidizing particular types of consumption that yield positive externalities, with exemptions seen as a way of increasing consumption of so-called merit goods.

Once it is accepted that exemptions for merit goods amount to tax expenditures, the concessions should be subject to the same cost-benefit analysis as direct expenditure programs: what are the objectives of the exemptions and are there alternative spending or subsidy programs that might achieve the intended social and distributional goals more efficiently and fairly.

The equity / countering regressivity rationalization for exemptions derives from the fact that the proportion of income that is saved reduces as income reduces, with the

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79. See W. Hellerstein (n. 15 above); and W. Hellerstein & H. Duncan, *VAT Exemptions: Principles and Practice*, 128 Tax Notes 989–999 (2010).

80. In fact, the OECD lists New Zealand and Turkey as the sole exceptions, see n. 7 above.

81. For an analysis and defence of this middle-ground approach see P.P. Gendron, *VAT Treatment of Public Sector Bodies: The Canadian Model*, Ch. 3 in this volume; for a critique to this approach in defence of the full-taxation model, see R. Millar, *Smoke and Mirrors: Applying the Full Taxation Model to Government under the Australian and New Zealand GST Laws*, Ch. 4 in this volume.

lowest income earners using all their income for consumption and diverting none to savings. As a consumption tax falls only on income used for consumption and exempts income that is applied to savings, consumption taxes fall more heavily on lower income persons than on higher income persons in terms of the proportion of income derived by those persons. The vertical equity principle guiding the design of the income tax suggests that tax should rise as a proportion of income if income is a valid measurement of ability to contribute to public goods and services. A consumption tax that yields the opposite outcome is troublesome for those adhering to this notion of vertical equity and the use of taxation as a tool for redistribution. Exemptions for commodities that form a higher percentage of the spending budget of lower income persons are seen as a way of reducing the tax burden on these persons and thus increasing their consumption capability.

Exemptions as a social welfare measure fare quite badly compared to the alternative of full taxation and targeted income support, and constitute a blunt instrument for redistribution.<sup>82</sup> They come at a significant revenue cost to the government, a cost that far exceeds the benefit derived by lower income persons. Even though consumption of any particular commodity will represent a lower percentage of the total income of a wealthy person compared to the consumption of a poorer person, in absolute terms the high income person is likely to spend more on the commodity.<sup>83</sup> If the item were fully taxed and low income persons compensated for the tax by direct payments, the government could return the tax to lower income persons and have additional revenue left over to apply to other redistributive programs.<sup>84</sup> In this sense, lower income persons may be much worse off with a tax system that contains exemptions designed to assist them than they would be in a tax system with no exemptions and redistribution of the excess revenue raised under a more neutral tax base.<sup>85</sup>

The 'positive externalities' rationale for exemptions derives from a belief that the market price for some types of supplies does not fully reflect the overall benefits from consumption of those supplies and government intervention to subsidize consumption of those goods is desirable. The assumption is that exempt supplies would be less costly to final consumers than fully taxable supplies, as they would bear VAT on inputs up to

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82. J. Creedy, *Indirect Tax Reform and the Role of Exemptions*, 22(4) *Fiscal Stud.* 457 (2001).

83. Cnossen has argued that VAT is regressive with respect to income but not necessarily with respect to consumption: see S. Cnossen, *The Value-added Tax: Key to a Better Tax Mix*, 6(3) *Australian Tax Forum* 265–281 (1989). Davis and Kay provide amusing examples with reference to the United Kingdom to illustrate the shortcomings of using the VAT structure as a means to diminish its regressivity: see E.H. Davis & J.A. Kay, *Extending the VAT base: problems and possibilities*, 6(1) *Fiscal Studies* 1–16 at 11–12 (1985).

84. Godbout and St. Gerny show that with tax credits targeted at lowest income individuals in place, the effective tax rate of consumption taxes increases with income, see C. Godbout & S. St. Gerny, *Are Consumption Taxes Regressive in Quebec?*, 59(3) *Canadian Tax J.* 463–493 (2011).

85. Ballard and Shoven conclude using US data that using exemptions to partially offset the effects of replacing income tax with a VAT would do little to mitigate the adverse distributional impact of such a change: see C.L. Ballard & J.B. Shoven, *The Value-Added-Tax: The efficiency cost of achieving progressivity by using exemptions*, in *Modern Developments in Public Finance: Essays in Honor of Arnold Harberger* 109–129 (M.J. Boskin ed., B. Backwell 1987).

the final supplier stage but not on the value added by the final supplier. While there are a number of exempt supplies in this class in the traditional VAT, they are rare in modern VAT systems.

The ‘merit’ benefits of many exempt goods and services in the traditional VAT are questionable and to the extent subsidies by way of exemption may stimulate greater consumption of target goods and services, the costs of subsidizing in this manner are likely to be significant. From a legal perspective these exemptions give rise to definitional and interpretative problems, create difficulties in calculating the portion of deductible VAT, and constitute an incentive to engage in aggressive tax planning. For these reasons merit exemptions tend to result in substantial – and increasing – litigation, which in turn results in substantial compliance and administrative costs. In Europe, the steady increase in references from national courts to the EU Court of Justice, focusing on the interpretation of these exemptions,<sup>86</sup> or the application of tax planning schemes by universities and hospitals,<sup>87</sup> is not only significant, but also symptomatic of two factors. The first is the outdated nature of these exemptions, unfit to deal with a new economic environment, where competition between public and private bodies is a common occurrence; the second is the pressure to increase efficiency in the provision of public services, which has resulted in an increase in subcontracting and outsourcing.

The quantitative costs<sup>88</sup> and qualitative effects in terms of distortions of consumption and investment decisions may be significant. The exemptions erode the tax base, create tax cascading and create bias towards self-supply and away from outsourcing. Importantly, they also tend to be inefficient mechanisms for subsidizing chosen types of supplies, as much of the effective subsidy is likely to be capitalized into a higher price for the exempt supplies either through inefficient production (the producers of the exempt supplies do not have to compete on a level playing field with producers of other supplies), or profit taking as the suppliers sell the subsidized supplies into a market that does not subsidize substitute types of consumption.<sup>89</sup>

The results of the cost-benefit analysis as applied to merit / concessional exemptions is therefore particularly negative: not only is it unclear whether they

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86. For recent examples see cases C-86/09, *Future Health Technologies Limited v. The Commissioners for Her Majesty's Revenue and Customs* [2010] ECR I-5215; C-156/09, *Finanzamt Leverkusen v. Verigen Transplantation Service International AG* [2010] ECR I-11733; and C-237/09, *Belgian State v. Nathalie De Fruytier* [2010] ECR I-4985.

87. See for example cases C-419/02, *BUPA Hospitals Ltd, Goldsborough Developments Ltd v. Commissioners of Customs and Excise* [2006] ECR I-1685; C-223/03, *University of Huddersfield Higher Education Corporation v. Commissioners of Customs & Excise* [2006] ECR I-1751; and C-63/04, *Centralan Property Ltd v. Commissioners of Customs & Excise* [2005] ECR I-11087.

88. See R. Bird & P.-P. Gendron (n. 17 above).

89. Whether exemptions actually affect prices downwards is unclear. This is essentially for two reasons. Exemptions actually increase input tax costs, which will be at least partially passed on from the suppliers to the customers. Additionally, studies on the impact on prices of reduced VAT rates seem to indicate that concessions of this type do not necessarily affect prices, and that prices are more likely regulated by the competitiveness of the market in question, as well as the price elasticity of the given product: see R. de la Feria & M. Walpole, *VAT Rates Structures – A Case of Political Obstacles to Optimal Tax Policy* 3–5 (Paper presented at the Australasian Tax Teachers Association Annual Conference 2010).

accomplish any of the social and distributional objectives that they set out to achieve, but they also carry significant costs beyond the mere loss of potential revenue.<sup>90</sup>

### **[B] Technical Exemptions**

Three categories of exempt supplies found particularly in traditional VAT systems are often explained as necessary or appropriate for technical reasons rather than as part of a policy to deliver subsidies through the tax system. The implication is that these activities should ideally be subject to VAT, but pragmatic considerations regarding the perceived difficulty of subjecting these transactions to the VAT led to their exemption from the tax. These three types of supplies are supplies of immovable property, financial services and pooling services, including insurance and gambling. Where these activities were not exempt as a matter of principle in order to attain specific benefits, but because of uncertainty as to how the VAT might apply to them, a cost-benefit analysis – similarly to that conducted for merit / concessional exemptions – may not have been appropriate when the VAT was first adopted in Europe. This is no longer the case. Other key questions include what are the legal and economic collateral costs of excluding these transactions from full taxation and how might the traditional VAT transition to include these transactions within the scope of VAT.

#### **[1] Immovable Property**

It is commonly asserted that no OECD members fully include all types of immovable property within their VAT base<sup>91</sup> and that the treatment of at least some immovable property transactions as exempt is nearly universal.<sup>92</sup> The common misconception arises because some types of immovable property are taxed in modern VAT systems in the same manner as second-hand goods, using a pre-payment system to accommodate sales by unregistered owners of residential premises.

VAT systems commonly distinguish between two types of immovable property – residential premises and other types of property which would include all commercial property. Immovable property other than residential premises is usually taxable under VAT, while residential premises are normally subject to special rules. The application of the ordinary VAT rules to property other than residential premises ensures that input tax credits are available on properties purchased by businesses, and that no non-recoverable VAT is embedded in the cost of these properties. An exception to this rule is found in the European traditional VAT system where, as a consequence of historical factors deriving from the treatment of immovable property under predecessor turnover

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90. Gendron reaches similar conclusions, see P.-P. Gendron (n. 81 above). See also S. Cnossen, *Value-Added Tax and Excises: Commentary*, in *Dimensions of Tax Design – the Mirrlees Review* 275–422 (S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles & J. Poterba eds.) (n.5 above).

91. OECD (n. 7, above) at tbl. 3.1.

92. R.F. Conrad, *Comments on VAT and Housing*, 63 *Tax L. Rev.* 471 (2010).

tax regimes,<sup>93</sup> a supply of both residential property and other (commercial) property may be treated as an exempt supply under default rules. To overcome the problem of embedded non-recoverable VAT for business customers, European VAT laws that use this default rule commonly provide for optional characterization of the supply as an ordinary taxable supply, thus providing qualifying purchasers with entitlement to input tax credits.<sup>94</sup> These rules are, however, themselves problematic. The optional nature of some of these rules results in a complex and non-transparent system that is subject to considerable variation across Europe.<sup>95</sup> In addition, various European countries apply additional or alternative taxes on transfers of immovable property, so that extra rules are needed to prevent overlapping taxation between these taxes and the VAT.<sup>96</sup> It is unsurprising that European rules on the VAT treatment of immovable property have given rise to significant litigation.<sup>97</sup>

Under modern VAT systems, the initial sale of residential premises is treated as an ordinary taxable supply, while subsequent sales are deemed to be exempt supplies. The rule that the original sale is a taxable supply and subsequent sales are exempt supplies is intended to replicate for residential premises the ordinary VAT treatment of second hand goods such as consumer durables. In the case of other second hand goods, the initial sales of the new goods are usually taxable supplies made by a registered retailer and later sales are out-of-scope sales, the equivalent of exempt supplies, because the private owners of the goods are not registered or are not making the supplies in the course of an enterprise.

The treatment of second-hand goods supplied by private sellers as out-of-scope (or effectively exempt) supplies reflects the nature of consumer durables as assets with an effective life stretching over a number of years. In a sense, the person buying consumer durable goods is acquiring assets that amount to savings. The consumption takes place as the assets are used (and depreciate) over their lives. In a truly comprehensive VAT world, all consumers of durables would be registered and entitled to input tax credits on their acquisitions and then be subject to tax as the assets are used and generate consumption benefits to the owner. It would, however, not be feasible to levy tax on this basis for every consumer durable purchased. Fortunately, the initial value of an asset when acquired is equal to the present value of the future consumption over the life of the asset and thus VAT calculated on the purchase price will equal the present value of the tax that would have been levied on consumption over the life of the asset.

Since the purchase price of a consumer durable equals the present value of consumption over the entire life of the asset, the initial purchaser will have paid VAT

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93. S. Clossen, *VAT Treatment of Immovable Property*, in V. Thuronyi, *Tax Law Design and Drafting* Ch. 7 (IMF 1996).

94. Article 137(1)(b), (c) and (d) of the EU VAT Directive.

95. For an overview of the VAT treatment of the various types of immovable property transactions, see S. Clossen, *A Proposal to Improve the VAT Treatment of Housing in the European Union*, Ch. 7 in this volume, at Table 7.1.

96. *Ibid.*, at Table 7.2.

97. See e.g. Cases C-269/03, *Vermietungsgesellschaft and Objekt Kircheberg* [2004] RCR I-8067; C-184/04, *Undenkaupungin kaupunkin* [2006] ECR I-3039; and C-246/04, *Turn-und Sportunion Waldburg* [2006] ECR I-589.



on the entire future consumption from the asset. If the asset is sold over the course of its effective life, the second hand price will represent the depreciated value of the tax-inclusive price. The initial buyer will thus be able to recover from the next owner an amount equal to the VAT component of the remaining value of the asset and the next owner will bear a cost that includes this embedded VAT amount. The government is indifferent as it has already received the full VAT when the asset was initially sold but the burden of the VAT is automatically allocated correctly between all the persons who use it as a consequence of the fact that the value of second hand goods is based on the VAT-inclusive price of new goods.

The VAT treatment of residential premises rests on the same principles as assets that may be sold as second-hand assets. The initial price of the property is based on the present value of future consumption so levying VAT on the first sale of residential premises and treating remaining sales as out-of-scope supplies (or economically equivalent exempt supplies) should yield the appropriate VAT outcome. In practice, therefore, taxing new residential property is a proxy for the VAT that would be payable on the flow of housing services.<sup>98</sup> However, unlike ordinary consumer durables, residential premises have a high value and the sale price of residential property will often place sellers above the registration threshold. As a consequence, in the absence of specific legislative measures, later sales of residential property would not be out-of-scope supplies. To obtain this outcome, VAT systems specify that sales of residential property other than the initial sale are exempt supplies (with European VAT regimes sometimes extending exempt treatment to the initial sale).

While the system of taxing consumer durables at the time of purchase and treating subsequent private sales as out-of-scope supplies should yield the appropriate tax treatment of these assets, it may not fully tax the value of consumption from residential premises. Unlike consumer durables that have a limited life, the underlying real property in residential premises does not waste and most often rises in value over the longer term, even if the physical structure on it declines in value. In theory, the initial sale price of residential premises should include the present value of anticipated profits that will be realized when the property is sold as second hand residential premises, in which case the initial sale price should include the present value of consumption by subsequent owners. It may be difficult, however, for the market to measure all anticipated future rises in the value of a residential property as it moves through a potentially unlimited number of subsequent owners. Also, the present value of very distant consumption may be so low that it does not materially affect the present price of an asset. For example, the value of a 90-year lease of residential premises may be almost the same as the value of freehold title in the same property. If the initial sale price of residential premises does not fully capture the value of all future consumption from the property, later owners of property will not bear VAT on the full value of their consumption. The general implication, therefore, is that future increases – or decreases – in the value of residential property will be excluded from the VAT base.

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98. S. Cnossen (n. 93 above).

Imposing VAT on the initial sale of residential premises may thus prove to be a flawed surrogate means of taxing the full value of consumption by subsequent owners. The theoretically correct tax could be imposed by treating all sales of residential premises as taxable sales, registering every homeowner, allowing input tax credits on purchase and collecting monthly VAT on the imputed rental consumption by owner-occupiers.<sup>99</sup> This alternative is neither administratively nor politically feasible, however, leaving the VAT on initial sale the only second-best alternative open to governments wishing to tax this consumption.<sup>100</sup> One alternative approach that has been suggested is a margin scheme that would subject the increased value of consumption by purchasers of appreciated residential premises to VAT, replacing the transfer taxes and stamp duties currently applicable in many countries to the sale of residential property – which are highly distortionary.<sup>101</sup>

The logic behind taxation of the initial sale of residential premises and out-of-scope or exempt treatment for subsequent sales extends to rent. If the rental supply of residential premises is treated as an exempt supply, the buyer of property will not be able to recover the tax incurred to acquire the premises and the unrecovered VAT will be embedded in all future rental payments. As with supplies of residential premises by way of sale, this surrogate means of taxing consumption value may miss the full value where property appreciates. But once again, the theoretically correct alternative, in this case allowing all landlords to register and claim input tax credits on the purchase of rental property and then impose VAT on rental payments, is neither administratively nor politically feasible.<sup>102</sup>

## [2] *Financial Services*

All VAT tax systems have special rules for a category of supply known as financial services, with almost all treating them as exempt supplies. There are, however, significant differences in the definition of financial supply and the rationale for special treatment across VAT systems. Subject to many variations on the borderline of each type, the broad category embraces three distinct types of supply. The first comprises

99. By using owner-occupied property directly, the owner realizes a benefit equal to the benefit that would have been received had it been rented to another person. The consumption value or imputed rental value of owner-occupied premises is included in the income tax base of some income taxes. However, no country applies VAT to the imputed rental value of owner-occupied premises.

100. For an discussion of these alternatives see also S. Poddar, *Taxing of Housing Under a VAT*, 63 *Tax L. Rev.* 444–470 (2010); G.J. Harley, *Dilemma for GST Tax Policy Designers – Land Transactions*, in (R. Krever & D. White eds.) (n. 34 above), 213–241; M. Smith, *GST and Immovable Property Transactions in New Zealand – Some Interpretative Issues*, in (R. Krever and D. White eds.) (n. 34 above); M. Evans, *The Value-Added Tax Treatment of Immovable Property – An Antipodean Context*, in (R. Krever and D. White eds.) (n. 34 above); and R.F. Conrad and A. Grozou, *Immovable Property and VAT*, in *VAT in Africa*, 81–112 (R. Krever ed., Pretoria University Press 2008).

101. S. Cnossen (n. 93 above).

102. For a detailed proposal on the appropriate VAT treatment of the various types of immovable property transactions, see R. Millar, *VAT and Immovable Property: Full Taxation Models and the Treatment of Capital Gains on Owner-Occupied Residences*, Ch. 8 in this volume.

intangible ownership rights in legal persons or relations. Examples include shares,<sup>103</sup> interests in unit trusts or mutual funds, and interests in pension or superannuation funds. The second comprises financial intermediary services for loans, the function of banks and similar organizations that link lenders (depositors) and borrowers. The third consists of pooling intermediary services such as lotteries or insurance where a service provider collects funds from a range of persons and allocates the pool to a select group of winners (in the case of lotteries) or losers (in the case of insurance).

[a] *Investments in Ownership Rights*

The first type of financial supply – investments in ownership rights – gives rise to difficulties in the VAT system because a large number of persons acquiring these assets are individuals who are not registered for VAT purposes. In theory, a consumption tax should never be levied on investments; the tax is supposed to fall on consumption and not touch savings. This outcome follows automatically if the consumption tax is imposed as an annual expenditure tax that measures consumption as income and withdrawals from savings minus amounts invested (everything that is not invested is assumed to be used for consumption).<sup>104</sup> This is difficult to achieve, however, in a transaction based consumption tax that relies on registration, tax invoices, and refundable input tax credits as a means of removing tax on non-consumption acquisitions. It would be administratively impossible to apply the normal VAT rules to supplies of intangible ownership assets and then register all investors acquiring these supplies and process input tax refunds for the VAT imposed on the supplies.

The over-taxation of investments caused by the current characterization of these investments as exempt financial supplies undermines one of the economically desirable attributes of a consumption tax, namely its complete non-application to savings and investments. A possible solution to the problem in the context of the VAT mechanism is to treat these supplies as zero-rated. Such treatment would present its own challenges, however. Identifying appropriate types of financial assets to be subject to a zero-rating rule could be difficult and identifying qualifying ancillary expenses such as legal, accounting, or investment advice would also be problematic as these services are also used for both personal consumption and the acquisition or maintenance of investments.<sup>105</sup>

[b] *Loan Intermediary Services*

The second type of financial supply, the loan intermediary service offered by financial institutions to lenders and borrowers, fits awkwardly in the ordinary VAT system for several reasons. To begin with, it is difficult to measure the value of this service as no

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103. Although not all dealings in shares are regarded as exempt under European VATs, see R. de la Feria (n. 44 above).

104. This form of consumption tax was advocated in Institute for Fiscal Studies (J. Meade, committee chair), *The Structure and Reform of Direct Taxation* (Meade Report) (1978).

105. This solution and potential difficulties are explored in detail in H. Grubert & R. Krever, *VAT and Financial Services: Competing Perspectives on What Should Be Taxed*, Ch. 9 in this volume.

explicit fee is charged for it. Rather, lenders and borrowers pay for it in the spread between interest paid to lenders and by borrowers. While it is possible to measure the value on an institutional basis and have the institution remit VAT implicitly charged to customers, it is difficult to attribute specific charges to individual depositors and borrowers, a step that would be necessary for the intermediary to issue tax invoices so investors and business customers could recover the VAT.

These difficulties explain in part why the traditional VAT treated loan intermediation supplies as exempt supplies and why most modern VATs followed suit. The result was over-taxation of business borrowers and lenders and private depositors (all of whom in theory should have borne no VAT burden on their investments or borrowings) and under-taxation of private borrowers. Some jurisdictions that have followed the modern VAT model have since shifted to alternative rules to try and mitigate these outcomes. For example, the tax borne by registered business customers can be removed by zero-rating loan intermediation services provided to these customers or treating all services that are not strictly intermediary services paid by way of interest rate spreads as ordinary taxable supplies.<sup>106</sup>

It is likely that other countries using the modern VAT model will shift to these post-modern VAT rules over time. Europe has considered these and other reform options,<sup>107</sup> with some European countries already giving financial institutions an option to be taxed under VAT.<sup>108</sup> Reform has stalled in recent times, however, more for fiscal reasons than for theoretical or practical considerations. Treating loan intermediation services to business customers and private investors may be wrong as a matter of policy and may lead to significant economic distortions, particularly where the tax compounds along the supply chain, but the over-taxation does generate a lot of revenue.<sup>109</sup> The revenue loss that would result from the return of input VAT to business

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106. For a description of the New Zealand experience, the first jurisdiction to zero-rate intermediary financial supplies to business customers, see M. Pallot, *Financial Services under New Zealand's GST*, 5 Intl. VAT Monitor 310–315 (2011). Singapore has an alternative regime intended to accomplish the same result; Australia provides financial institutions with generous input tax credits on a range of inputs used by financial intermediaries, see M. Walpole, *The Miraculous Reduced Input Tax Credit for Financial Supplies in Australia*, 5 Intl. VAT Monitor 316–323 (2011); and South Africa treats all financial services as taxable supplies if the fees for the services can be identified. For a comparative analysis of these alternatives see also A. Schenk & H.H. Zee, *Financial Services and the Value-Added Tax*, in *Taxing the Financial Sector – Concepts, Issues, and Practices* 60–74 (H.H. Zee ed., International Monetary Fund 2004); T. Edgar, *Exempt Treatment of Financial Services Under Value-Added Tax: An Assessment of Alternatives*, 49(5) Canadian Tax J. 1133–1219 (2001); and H.H. Zee, *VAT Treatment of Financial Services: A Primer on Conceptual Issues and Country Practices*, 34(10) Intertax 458–474 (2006).
107. For a review of attempted reforms over time, see R. de la Feria, *The EU VAT Treatment of Insurance and Financial Services (Again) Under Review*, 2 EC Tax Rev. 74–89 (2007). One of the reforms which was under strong consideration was the transplantation of the Australian system: see R. de la Feria & M. Walpole, *Options for Taxing Financial Supplies in Value Added Tax: EU VAT and Australian GST Models Compared*, 58(4) Intl. & Comp. L. Q. 897–932 (2009).
108. For an analysis of the option to be taxed applied in some EU Member States, see R. de la Feria & B. Lockwood, *Opting for Opting In? An Evaluation of the Commission's Proposals for Reforming VAT for Financial Services*, 31(2) Fiscal Stud. (2010).
109. The revenue collected through over-taxation resulting from exemptions has been calculated in the United Kingdom to be 15% of the total VAT yield: see R. de la Feria, *Partial-Exemption Policy in the United Kingdom*, 21(2) Intl. VAT Monitor 119–123, at 22 (2010).

consumers of financial intermediary services and private depositors might not be as significant as feared, as full taxation of financial services provided to final consumers might go some way to compensate for removal of the over-taxation of business depositors and borrowers and private depositors.<sup>110</sup> There could nevertheless be a net revenue loss and governments seeking to reform the current treatment would thus need to find the political courage to recover the lost revenue elsewhere either through base-broadening or higher rates and furthermore to explain that the broadening or rate increases are needed to relieve banks and business of tax, a difficult sell at the best of times.<sup>111</sup>

Many VAT systems, particularly those following the traditional VAT model, compound the problem of over-taxation of businesses and investor users of loan intermediary services and under-taxation of customer users by extending exempt supply treatment to a range of ancillary services offered by financial institutions and similar organizations even though the value of these ancillary services can be easily ascertained and the ordinary VAT tax rules applied to these supplies.<sup>112</sup> Refining the definition of financial services in these jurisdictions so these ancillary supplies are no longer treated as exempt supplies would be a relatively simple way to begin reform of this area.<sup>113</sup> Europe is taking a step in this direction, with negotiations ongoing with a view to approving legislation which would redefine financial supplies for the purposes of exemptions.<sup>114</sup>

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110. See calculations for loss of revenue under the current European Commission's proposals for reform of VAT on financial and insurance services in R. de la Feria & B. Lockwood (n. 108 above). In a recent paper, Buettner and Erbe provide an analysis of revenue and welfare effects associated with the application of a VAT exemption to financial services using a general equilibrium model. Using German data, they conclude that the revenue effects of removing the exemption would be positive, but quite small: see T. Buettner & K. Erber, *Revenue and Welfare Effects of Financial Sector VAT Exemption*, CESifo Working Paper (June 2012). It is worth noting however that Germany is one of the few European countries that already allow financial institutions an option to tax their financial supplies, a factor that could help explain these limited revenue effects.

111. Concern about the undertaxation of the financial sector is now at the centre of the discussions on the introduction of a new tax on the financial sector, see in particular European Commission, *Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC*, COM(2011) 594 final, of 28 September 2011, and accompanying documentation; J. Vella, C. Fuest & T. Schmidt-Eisenlohr, *The EU Commission's Proposal for a Financial Transaction Tax*, 6 *British Tax Rev.* 607–621 (2011); and M. Keen, *Rethinking the Taxation of the Financial Sector*, 57(1) *CESifo Econ. Stud.* 1–24 (2011).

112. While the bundling of ancillary services under the financial services umbrella has been significantly limited in Europe by the ruling of the Court of Justice in *Accenture*, Case C-472/03, *Staatssecretaris van Financiën v. Arthur Andersen & Co. Accountants c.s.* [2005] ECR I-1719, the EU VAT Directive itself – and the interpretation given to it by the EU Court of Justice – deems many transactions that are not strictly intermediary services to be exempt financial services: see R. de la Feria (n. 107 above).

113. Edgar better summarizes the tax policymakers technique at play: 'modify the application of exemption through partial reform alternatives intended to suppress one of the perceived distortions', in T. Edgar, *The Search for Alternatives to Exempt Treatment of Financial Services Under a Value-Added Tax*, in (R. Krever and D. White eds.) (n. 34 above), 131–161, at 147.

114. The legislative proposals currently on the table envisage the re-definition of financial services, introduction of a cost-sharing group allowing economic operators to pool investments and re-distribute the costs of these investments to the members of the group, exempt from VAT, and introduction of an option to tax: see Commission of the European Communities, *Proposal for a Council Regulation laying down implementing measures for Directive 2006/112/EC on the*

Much more is known today about how to tax financial supplies under VAT than was the case just 20 years ago. The experience of some modern VAT jurisdictions with methods to prevent overtaxation of financial intermediary services to registered businesses may lead to general agreement that businesses should not bear tax on these services under a post-modern VAT. Developing a consensus on the optimal method of taxing loan intermediary services provided to unregistered consumers may prove more elusive.

[c] *Intermediary Pooling Services*

Intermediary pooling services are found in arrangements such as gambling lotteries or insurance where a service provider collects funds from a range of persons and allocates the pool to selected participants in the arrangements. In the case of insurance, a financial intermediary pools contributions from policy holders and distributes amounts from the pool to those who suffer losses. In the case of gambling, the financial intermediary pools contributions from gamblers and distributes amounts from the pool to winners.

The traditional VAT exempted insurance services for technical reasons – at the time the VAT was adopted, policy makers had to consider ways of measuring and taxing the value of intermediary services while reconciling options with the separate insurance taxes in place in many jurisdictions. As is the case with loan intermediation services discussed earlier, customers of insurance services are businesses that would be over-taxed if these services were treated as exempt services or consumers who would be undertaxed. This exemption gives rise to significant difficulties, and over the years it has been the source of much litigation in Europe.<sup>115</sup> In fact, it was a decision from the EU Court of Justice on the interpretation of the insurance exemption in a case concerning outsourcing, which led to the ongoing review of the exemptions applicable to financial and insurance services.<sup>116</sup> As a result, current negotiations include proposals to include some insurance services in the tax base.<sup>117</sup>

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*common system of value added tax, as regards the treatment of insurance and financial services*, COM(2007) 746 final, 28 November 2007; and Commission of the European Communities, *Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax, as regards the treatment of insurance and financial services*, COM(2007) 747 final, 28 November 2007. However, negotiations at the Council of Ministers have concentrated primarily on discussions over clarification and re-definition of exemptions.

115. See amongst others Cases C-349/96, *Card Protection Plan Ltd (CPP) v. Commissioners of Customs and Excise* [1999] ECR I-973; C-240/99, *Forsakringsaktiebolaget Skandia (publ)* [2001] ECR I-1951; C-8/01, *Assurandor-Societetet, acting on behalf of Taksatorringenv Skatteministeriet* [2003] ECR I-13711; C-308/01, *GIL Insurance Ltd, UK Consumer Electronics Ltd, Consumer Electronics Insurance Co. Ltd, Direct Vision Rentals Ltd, Homecare Insurance Ltd, Pinnacle Insurance plc v. Commissioners of Customs and Excise* [2004] ECR I-4777; C-425/06, *Ministero dell'Economia e delle Finanze v. Part Service Srl* [2008] ECR I-897; and C-242/08, *Swiss Re Germany Holding GmbH v. Finanzamt München für Körperschaften* [2009] ECR I-10099.

116. Case C-472/03, *Staatssecretaris van Financiën v. Arthur Andersen & Co. Accountants c.s.* [2005] ECR I-1719. For a detailed analysis of the background to the ongoing review see R. de la Feria (n. 107 above).

117. See n. 114 above.

The technical problems that led to the classification of insurance services as exempt within the traditional European VAT appear to have been solved by VAT designers in many modern VAT systems and to avoid the overtaxation and undertaxation problems that flow from exempt treatment, modern VAT systems commonly treat non-life insurance services as ordinary taxable supplies. The inclusion of insurance intermediary services within the scope of the VAT has not, however, been extended to intermediary services for life insurance which are so far universally exempt, perhaps in part due to the savings component in some types of life policies.

The traditional VAT also exempted gambling services in part because of uncertainty by the designers over how the intermediary services should be measured and taxed.<sup>118</sup> However, as with loan intermediation services, it is possible to measure and collect tax on the value of the service to all customers, if that value is calculated at the level of the pooling service provider. Since all participants in a gambling pooling arrangement are assumed to be final consumers, there is no need to allocate the value to individual participants and issue tax invoices. Accordingly, many modern VAT systems have relatively simple rules to impose tax on gambling services (including the provision of casino gambling and lotteries), with the value of the service being the difference between bets collected by the intermediary service provider and winnings paid out.<sup>119</sup> Although the EU VAT Directive provides EU Member States with an option to tax gambling services, exemption remains the more common approach in the traditional VAT. Judicial interpretations have limited the possibility of extending the exemption to ancillary activities,<sup>120</sup> but conversely also limited the ability of EU Member States to selectively remove the exemption from particular types of gambling, on the basis of the respect for the principle of fiscal neutrality.<sup>121</sup>

### §1.05 CONCLUSION: TOWARDS A POST-MODERN VAT

Exempt supplies and out-of-scope supplies with economic outcomes similar to those of exempt supplies are found in abundance in the traditional VAT and to a lesser extent in the modern VAT. These lead to overtaxation of business and undertaxation of final consumers. The efficacy of explicit exemptions that supposedly further equity or merit good objectives is questionable and the logic for retaining all exemptions supposedly needed for technical reasons is no longer convincing.

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118. Article 135(1)(i) of the EU VAT Directive.

119. See A. Schenk, *Gambling and lotteries*, in (R. Krever ed.) (n. 72 above), 47–70. There is an argument that this approach undertaxes the consumption of gamblers and that the gross amount should be taxed, rather than merely the margin. This issue is explored further in Y. Margalioth, *VAT on Gambling*, Ch. 6 in this volume.

120. See Case C-89/05, *United Utilities plc v. Commissioners of Customs & Excise* [2006] ECR I-6813.

121. See Cases C-283/95, *Fischer, Karlheinz v. Finanzamt Donaueschingen* [1998] ECR I-3369; C-453/02, *Finanzamt Gladbeck v. Edith Linneweber* [2005] ECR I-1131; C-58/09, *Leo-Libera* [2010] ECR I-5189; C-260/10, *Commissioners of Her Majesty's Revenue and Customs v. The Rank Group plc* [2011] ECR I-000; C-464/10, *Belgian State v. Pierre Henfling and Others* [2011] ECR I-000. For a recent analysis of these cases see R. de la Feria, *Rank Group. VAT exemption on gambling. Principle of fiscal neutrality. Court of Justice*, 1 Highlights & Insights European Taxn. (2012).

It has been said that ‘the taxation systems of the major developed countries will grow to resemble each other more and more’, with the spread of VAT being offered as an example of this phenomenon.<sup>122</sup> A close examination of VAT systems, however, reveals significant divergences in practice. Historical factors that led to multiple rates and multiple exemptions in the traditional European VAT were not present in most jurisdictions outside the EU and adopters of a modern VAT model were able to avoid these features of the traditional VAT, for the most part adopting single rates and substantially limiting the number of exemptions. Even these more limited exemptions have imposed economic and administrative costs, however, prompting some modern VAT jurisdictions to explore post-modern alternatives, particularly in the sphere of financial supplies, but also in respect of supplies by SMEs and registration thresholds.

At present the attention is on another possible tax policy transfer, this time in the opposite direction: from modern VATs to the traditional VATs, a transplantation of the modern VAT model for taxing traditionally exempt transactions to the traditional VAT systems. However, there are intrinsic complications to tax policy transfer and regional specificities are a normal occurrence. This is precisely one of the reasons public policy transfer in general, and tax policy transfer in particular, is perilous at the best of times.<sup>123</sup> Lack of information on the real effects of the tax policy in the country of origin will aggravate the dangers. In this context, a debate regarding the adoption by traditional European-style VATs of the modern VATs’ approach of taxing specific supplies must be well-informed. Accepting the inherent risks of tax policy transfer in this case might be unavoidable if reform is ultimately the wisest way forward. If such a transfer is going to succeed, however, it is necessary to realize not solely what are the advantages of the modern VAT model but equally what are its limitations. Understanding their weaknesses might lead to a post-modern VAT: one which takes into account the weaknesses of modern VATs and aims to overcome them.

Indeed, there is already a realization that modern VATs are not a complete panacea. Undoubtedly they are an improvement on the traditional VAT exemption model. They have solved some of the difficulties encountered under the traditional VAT but it is less clear whether they have solved all, or to what extent they have given rise to new problems. Various chapters in this volume draw attention to some of these problems such as the difficulties caused by the rebate system applicable to public sector bodies and charities in Canada or the definitional and planning problems caused by the input tax credits model applied to Australian financial services. Additionally recent research has shed new light over the VAT treatment of some transactions which until now had been relatively untapped; this is the case for example with the treatment of supplies by SMEs and the optimal level of registration threshold.

Table 1.1 summarizes the treatment of specific transactions under traditional, modern, and post-modern VAT. The transactions highlighted in grey represent those where significant departures between modern and post-modern VAT are proposed.

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122. See R.K. Osgood, *The Convergence of the Taxation Systems of the Developed Nations*, 25(2) Cornell Intl. L. J. 339–347, at 339 and 343 et seq. (1992).

123. See D.P. Dolowitz & D. Marsh, *Learning from Abroad: The Role of Policy Transfer in Contemporary Policy-Making*, 13(1) Governance: Intl. J. Policy & Admin. 5–24 (2000).



One recurrent issue throughout this volume and during the conference discussions at Oxford which preceded it – particularly insofar as technical exemptions are concerned – is the definition of consumption. In all chapters regarding technical exemptions the key when considering alternative designs has been the concept of consumption. It has therefore become clear that one of the main challenges of the post-modern VAT will be a rather unexpected one: not about feasible legal designs or about economic consequences, but one with an intrinsically philosophical nature, one about philosophy of tax. That is, how to conceptually define what constitutes consumption for the purposes of a consumption tax.

Table 1.1 Treatment of Specific Supplies under Traditional, Modern and Post-modern VAT

	Traditional VAT		Modern VAT		Post-modern VAT	
	Treatment	Rationale	Treatment	Rationale	Treatment	Rationale
<i>No direct consideration</i>	Out-of-scope supplies	Out-dated legal wording and judicial interpretation	Full taxation		Full taxation	
<i>SMEs</i>	Out-of-scope suppliers (varying thresholds)	Vertical equity versus widening of tax base	Out-of-scope suppliers (varying thresholds)		Out-of-scope suppliers (high threshold)	
<i>Non-business enterprises</i>	Out-of-scope suppliers	Out-dated legal wording and judicial interpretation	Full taxation		Full taxation	
<i>Public sector bodies</i>	Out-of-scope suppliers	Out-dated legal wording and judicial interpretation	Full taxation		Full taxation	
<i>Merit goods and services</i>	Exempt	Vertical equity Positive externalities	Full taxation (or exempt or zero-rated)		Full taxation	
<i>Immovable property</i>	Exempt (option to tax commercial property)	Difficult-to-tax	Full taxation of commercial property Exemption of residential property (except first sale)		Full taxation of commercial property First sale of residential property taxable	
<i>Financial intermediary services</i>	Exempt(option to tax)	Difficult-to-tax	Exemption model Zero-rating of B2B model		Full taxation	
<i>Non-life insurance services</i>	Exempt	Difficult-to-tax	Full taxation		Full taxation	
<i>Gambling</i>	Exempt	Difficult-to-tax	Full taxation		Full taxation (margin model)	