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DIRECTORATE-GENERAL
TAXATION AND CUSTOMS UNION
Indirect Taxation and Tax administration
Value added tax

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VALUE ADDED TAX COMMITTEE
(ARTICLE 398 OF DIRECTIVE 2006/112/EC)
WORKING PAPER NO 1085

CONSULTATION
PROVIDED FOR UNDER DIRECTIVE 2006/112/EC

ORIGIN:	**Germany**
REFERENCE:	**Article 281**
SUBJECT:	**Flat rate scheme for small enterprises operating under public law**

1. INTRODUCTION

The German authorities have informed the Commission services that, in accordance with Article 281 of the VAT Directive[1], they wish to consult the VAT Committee on the introduction of a simplification measure for the deduction of input tax by public bodies with a limited business activity.

The text of the consultation is annexed to this document.

2. SUBJECT MATTER

2.1. Justification of the measure

Article 281 of the VAT Directive allows Member States to introduce simplified measures for charging and collecting the VAT where they might encounter difficulties in applying the normal VAT arrangements to small enterprises by reason of their activities or structure, provided that they do not lead to a reduction of the VAT.

Germany explains in its consultation that public bodies with a small taxable turnover (less than EUR 45 000) often have difficulties in allocating their input tax because of the broad scope of their activities, their organisational structure, and the role they play in society, factors which are not driven by normal business considerations. This is further exacerbated by the fact that many such bodies do not have commercial accounting systems, which would assist in the allocation of input tax.

2.2. Description of the measure

The measure will allow certain taxable persons governed by public law to determine their input tax deduction based on a percentage reduction of their output tax. It will apply to taxable persons meeting all of the following conditions:

- Bodies governed by public law;
- Who do not have a commercial accounting system, and
- Have had a taxable turnover of less than EUR 45 000 in the previous year.

As the German paper explains, the flat rate deduction rate is to be based on the ratio of costs, minus personnel costs and a 20% ‘risk markdown’, to taxable outputs. This ‘risk markdown’ is intended to account for expenditure not subject to VAT and other uncertainties. The ratio can be used for a period of one or more years, provided that the circumstances do not change.

[1] Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (OJ L 347, 11.12.2006, p. 1), as amended.

This deduction rate is explained in the consultation paper using the following formula:

$$\frac{((\text{Total Expenditure} - \text{personnel costs}) - 20\%) \times 19/119}{\text{Total expenditure}}$$

The consultation document provided by Germany gives the following example, by way of explanation:

> *The total expenditure of a legal person governed by public law in year 1 amounted to EUR 5 million, comprising staff expenditure of EUR 3 million and other expenditure of EUR 2 million. In year 3 the legal person generates taxable output from various activities of EUR 30 000 plus 19% VAT (= EUR 5 700) and EUR 1 000 plus 7% VAT (= EUR 70). The ratios of expenditure did not change significantly between years 1 and 3.*
>
> *The percentage for the flat-rate input tax deduction is as follows:*

$$\frac{\text{(EUR 2 million minus 20\% risk markdown =) EUR 1.6 million x 19/119}}{\text{EUR 5 million}} = 5.11\%$$

> *For year 3, the legal person may claim a flat-rate deduction of EUR 1 584.10 (EUR 31 000 x 5.11%). The amount payable is EUR 5 770.00 VAT minus EUR 1 584.10 input tax = EUR 4 185.90.*

2.3. Impact of the measure

The German request states that the measure does not lead to a tax reduction because the determination of the flat-rate input tax rate is 'based on the circumstances of the individual taxable person', and by the inclusion of the 20% risk markdown.

3. COMMISSION SERVICES' OPINION

3.1. Using Article 281 of the VAT Directive to introduce a measure relating to deductions

Article 281, contained within Section 1, Chapter 1 of Title XII (relating to the special schemes for small enterprises) of the VAT Directive allows Member States to apply simplified procedures for charging and collecting the VAT provided that they do not lead to a reduction thereof. The Commission services have some doubts whether Article 281 is the best legal basis for this type of measures, for the following reasons.

The German proposal is not strictly speaking aimed at what would generally be considered a 'small enterprise' but at certain public bodies which have a broad scope of activity, of which only a small percentage is taxable. The understanding is that these public bodies have, in addition to those taxable transactions, outputs which are outside the scope of VAT. However, as the activities of public bodies vary substantially, it is difficult to understand precisely to which public bodies this measure is targeted and what the specific

difficulties these public bodies have with charging and collecting VAT. The Commission services would therefore like to know if Germany has envisaged introducing a maximum threshold of global turnover under which the measure would apply.

The schemes outlined in the other sections of Chapter 1 of Title XII of the VAT Directive relate to outputs, specifically, the general principle of exempting outputs below a certain turnover limit. Whilst Article 281 sits in its own section (Section 1), it is doubtful that Article 281 can be used to introduce measures derogating from the deduction rules. The Commission services would therefore like to know if Germany has envisaged a simplification scheme covering both inputs and outputs, such as a flat rate scheme.

The German measure relates exclusively to an input tax issue, i.e. according to the consultation document it is conceived for those public bodies which may have difficulty allocating their input VAT to taxable or non-taxable (i.e. outside the scope) outputs. The Court of Justice of the European Union ("CJEU") has consistently stated that Member States have discretion when it comes to dealing with this matter, although this must be exercised in such a way that the deduction is proportional to the taxed transactions[2].

It therefore seems to the Commission services that a measure such as this, which specifically deals with deductions, could better sit within the realm of deductions, rather than the special scheme for small enterprises.

3.2. Practical application of the measure

The consultation document put forward by Germany does not go into significant detail in how the measure would work in practice. For example, it appears to the Commission services that it does not address the subject of when the calculation of the ratio is carried out and for how long this ratio remains valid. It is mentioned that the same ratio can be used for 'one or more years' as long as there are no changes to the circumstances, but there is no indication of what these changes to circumstances may be, or whether there are particular changes which would trigger the necessity for a recalculation of the ratio. Neither does it clarify who would assess these changes – whether there will be monitoring role for the administration, or whether they would be relying on the public bodies to 'police themselves'.

It would seem to the Commission services that this could lead to a level of abuse, or at least planning in order to reduce the amount of tax payable. Therefore, the Commission services would suggest that either there is a regular recalculation of the ratio, or at least a clear indication on what circumstances precisely would trigger a recalculation of the ratio (for example, a significant increase or decrease in staff costs or expenditure) and where needed an adjustment is made. Further, it should be recalled that other measures used to calculate the proportional deduction of input tax are determined on an annual basis (Article 175 of the VAT Directive). It would seem odd that a business apportioning input VAT on the basis of Article 175 would have an annual revision, whereas a public body which partially acts as a taxable person for VAT purposes would, essentially, be able to use the same ratio indefinitely or with no clear rules on adjustment to changes.

[2] See in particular CJEU, judgments of 13 March 2008, *Securenta*, C-437/06, EU:C:2008:166, paragraphs 32 to 39, and of 6 September 2012, *Portugal Telecom*, C-496/11, EU:C:2012:557, paragraphs 42 and 47.

In addition, the reference to the taxable turnover relates not to the current year, but to the previous year. This would mean that should the taxable turnover in year X be EUR 100 000, the public body would still be eligible for the scheme if the taxable turnover in year X – 1 was less than EUR 45 000, which could lead to a loss in tax revenue. An adjustment mechanism seems logically needed here too.

It is mentioned in the consultation document that one of the criteria for eligibility for the measure is the lack of a commercial accounting system. The Commission services would like to draw attention to Article 242 of the VAT Directive, which states that every taxable person shall keep accounts in sufficient detail for VAT to be applied and its application checked by the tax authorities. It is unclear, then, from the consultation document, what is precisely meant by 'commercial accounting systems'.

Finally, it is unclear to the Commission services whether this measure is optional or mandatory for those eligible public bodies.

Therefore, the Commission services would like to hear from the German representatives some further explanation of how the scheme will work in practice, and how they will mitigate any opportunity for tax planning/avoidance.

3.3. The formula used

The formula the German delegation put forward in its consultation document is described as being 'based on the ratio of total expenditure less personnel costs and a risk markdown of 20% to total expenditure.'. However, looking at the formula itself, this appears to be a slightly misleading description. It appears to the Commission services that the ratio is in fact not the total expenditure less personnel costs and a risk markdown, but the nominal VAT on such an amount, at the standard rate, to total expenditure.

Using the German delegation's example, the ratio is 255 462.18/5 million (5.11%), whereas the 'ratio of total expenditure less personnel costs and risk markdown' would be 1.6 million/5 million (32%).

The Commission services would be interested to hear the German delegation's explanation of the formula used.

4. DELEGATIONS' OPINION

Delegations are asked to express their opinion on the Commission services' opinion.

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ANNEX

Consultation in accordance with Article 281 of Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax

Flat-rate input tax rate for legal persons governed by public law with limited business activity

I.

Pursuant to Article 281 of Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (hereafter: Directive 2006/112), Germany intends to introduce a simplification scheme for the deduction of input tax by legal persons with limited business activity. I therefore request that the VAT Committee be consulted as required by that provision.

II.

According to Article 281 of Directive 2006/112/EC, Member States which might encounter difficulties in applying the normal VAT arrangements to small enterprises, by reason of the activities or structure of such enterprises, may, subject to such conditions and limits as they may set, and after consulting the VAT Committee, apply simplified procedures, such as flat-rate schemes, for charging and collecting VAT provided that they do not lead to a reduction thereof.

III.

The simplification scheme envisaged by Germany will allow legal persons governed by public law with only a small number of business transactions to calculate the total deductible input tax on a flat-rate basis at a fixed percentage of taxable output transactions.

The conditions for the application of the simplification scheme will be that:

a. the taxable person is a legal person governed by public law having no commercial accounting system and

b. with a taxable turnover during the previous calendar year not exceeding EUR 45,000.

Taxable persons who satisfy those conditions will be able to determine the total deductible input tax at a flat rate of deduction applied to their taxable turnover. The flat-rate input tax deduction rate is to be based on the ratio of total expenditure less personnel costs and a risk markdown of 20% to total expenditure. The risk markdown is designed to compensate for expenditure not subject to input tax and other uncertainties. Expenditure must be set at its gross value. The amount of input tax is to be calculated from other expenditure at the standard rate of VAT (Article 96 of Directive 2006/112). As long as the relevant circumstances do not change, the input tax rate calculated for a representative period (one or more years) should be applicable.

The flat-rate input tax rate must therefore be calculated using the following formula:

$$\text{Flat-rate input tax rate (\%)} = \frac{\text{Total expenditure minus personnel costs, reduced by a risk markdown of 20\%, x 19/119}}{\text{Total expenditure}}$$

The flat-rate input tax rate thus determined is applied to taxable output transactions, resulting in the flat-rate amount of input tax deduction.

Example:

The total expenditure of a legal person governed by public law in year 1 amounted to EUR 5 million, comprising staff expenditure of EUR 3million and other expenditure of EUR 2 million. In year 3 the legal person generates taxable output from various activities of EUR 30,000 plus 19% VAT (= EUR 5,700) and EUR 1,000 plus 7% VAT (= EUR 70). The ratios of expenditure did not change significantly between years 1 and 3.

The percentage for the flat-rate input tax deduction is as follows:

$$\frac{\text{(EUR 2 million minus 20\% risk markdown =) EUR 1.6 million x 19/119 = 5.11\%}}{\text{EUR 5 million}}$$

For year 3, the legal person may claim a flat-rate deduction of EUR 1,584.10 (EUR 31,000 x 5.11%). The amount payable is EUR 5,770.00 VAT minus EUR 1,584.10 input tax = EUR 4,185.90.

IV.

This simplification scheme fulfils the conditions laid down for simplified procedures for the taxation and collection of VAT under Article 281 of Directive 2006/112.

Firstly, the simplification scheme set out above is intended to apply only in cases where the normal taxation of small enterprises would encounter difficulties because of their activity or structure. The envisaged limitation of the scope of application to taxable persons whose business turnover in the previous year did not exceed EUR 45,000 ensures that only small enterprises which, simply because of the small scale of their business activity, are likely to encounter difficulties in their normal taxation are eligible to benefit from the simplification. In addition, legal persons governed by public law face considerable difficulties in allocating input tax because of their broad scope of activity, different form of organisation and role, which compared to a private-law trader is not characterised by profit-oriented and economic considerations. This situation is further exacerbated by the fact that in Germany legal persons governed by public law do not necessarily have a commercial accounting system. The simplification scheme should therefore relieve these legal persons from the difficulties inherent in the normal taxation of small enterprises.

Secondly, this scheme does not lead to a tax reduction. This is ensured, on the one hand, by the fact that the determination of the flat-rate input tax rate is based on the circumstances of the individual taxable person. In contrast to approaches such as flat-rate schemes for certain sectors or professional groups, where a flat-rate input tax rate generally set for those groups is used, a rate of input tax to be calculated individually for

each taxable person more accurately reflects the actual circumstances of the corresponding taxable persons. Moreover, the fact that the simplification scheme does not lead to a tax reduction is ensured by deducting a 20% risk markdown. In fact the deduction of input tax is not allowed even if, in specific individual cases, the deduction may include input taxes which, in principle, would be deductible without a flat-rate scheme.