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EUROPEAN COURT OF AUDITORS

Rapid case review

VAT reimbursement in Cohesion - an error-prone and sub-optimal use of EU funds

November 2018

Contents

Introduction

01 In our 2015 and 2017 annual reports, we highlighted the complexity of how value-added tax (VAT) was treated as an eligible cost in Cohesion, especially in the case of *public bodies*[1]. This document provides additional information thus complementing the observations and the views we expressed in Opinion No 6/2018 on the Commission's proposal for the future treatment of VAT in the Common Provision Regulation[2].

02 To this end, we analysed our audit results for Cohesion spending in previous years of our Statement of Assurance (SoA) audits. Based on our analysis, we provide an overview of the main issues we found in relation with VAT:

- the underlying reasons for the quantifiable errors we found;
- inconsistencies in the treatment of VAT and
- the sub-optimal use of EU funds.

[1] Annual report concerning the financial year 2017, paragraphs 6.40 to 6.42; ECA (2016): Annual report concerning the financial year 2015, paragraphs 6.31 to 6.35.

[2] See paragraphs 87 to 89 of our Opinion No 6/2018.

What is VAT and how does it work?

03 VAT is an indirect tax on the consumption of goods and services, and is governed by rules laid down at Member State level. *Standard VAT* rates in the EU range from 17 % in Luxembourg to 27 % in Hungary. To ensure a certain level of harmonisation across the EU, the VAT Directive of 2006[3] provides a common VAT system that Member States are required to build into their national rules.

04 A taxable person[4] is required to charge VAT on its taxable activities (sales) and forward the amount it has collected to the national tax authority. In turn, the taxable person can request a refund of the VAT already charged on its own related purchases of goods and services.

05 At the end of the production and/or trading process, the state budget receives the total amount of VAT present in the final price. The end consumer, who adds no additional value to the product, has no right to a refund and therefore ultimately bears the total cost of the VAT as part of the final price of the purchased product (see ***Figure 1***).

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

[4] In general, 'taxable person' means any person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity.

beneficiaries[13]. According to this rule, VAT – whether recoverable or not – would be reimbursed if the total project cost is below €5 million. For projects above this threshold, all VAT (including non-recoverable VAT) would be ineligible.

What could happen in the next programming period

27 The Commission's proposal provides greater legal certainty than in previous programming periods, and in principle is simpler to apply. However, we are not aware of any reason why the threshold of €5 million has been set at this level.

28 Furthermore, the proposal does not solve the issue of the sub-optimal use of EU funds for projects below €5 million:

- public bodies will continue to receive EU funds for VAT that does not represent a genuine cost for the Member States; and
- the EU budget would also reimburse VAT for projects where it does not represent an actual cost for the beneficiary (e.g. private businesses that can recover VAT).

29 The proposed CPR provides considerable flexibility for Member State authorities to define the scope of a project. This may lead to beneficiaries setting up projects artificially below the 5 million euro threshold in order to maximise the possibility of obtaining EU funds[14].

30 In addition, the Commission's proposal for 2021-2027 Cohesion policy remains inconsistent with the rules applicable to other policy areas. The Financial Regulation, which lays down general financial rules for the EU budget, defines how to treat VAT in

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[13] Article 58.1(c) of the Proposal for a Regulation of the European Parliament and of the Council laying down common provisions on the European Regional Development Fund, the European Social Fund Plus, the Cohesion Fund, and the European Maritime and Fisheries Fund and financial rules for those and for the Asylum and Migration Fund, the Internal Security Fund and the Border Management and Visa Instrument (COM(2018)375 final)

[14] For a project with a budget of €8 million, the beneficiary would not obtain any reimbursement of VAT. However, if the same beneficiary set up two projects for €4 million, the VAT would be eligible for both projects. With a 70 % co-financing rate and a 20 % VAT rate, the difference in the grant received under the two scenarios is around €1 million.

the case of grants managed directly by the Commission[15]. VAT is only eligible[16] if it is not recoverable under applicable national VAT legislation and is paid by a beneficiary other than a non-taxable person within the meaning of the VAT Directive. Thus, in general, public bodies (states, regional and local government authorities, and other bodies governed by public law) cannot declare VAT as eligible costs.

31 We therefore maintain that the recommendation in our 2017 annual report[17] to exclude reimbursement of VAT to public bodies from EU funds reduces the risk of errors in Cohesion spending, and ensures better use of EU funds from a sound financial management perspective.

32 In line with the legal situation which formed the basis of our recommendation (see paragraphs 07 and 08), and following the argument presented in paragraph 88 of Opinion No 6/2018, VAT should only be reimbursed to the small number of private bodies which cannot recover VAT, i.e. when it represents a genuine cost[18].

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[15] Article 186(4) of Regulation (EU, Euratom) 2018/1046 of the European Parliament and of the Council of 18 July 2018 on the financial rules applicable to the general budget of the Union, amending Regulations (EU) No 1296/2013, (EU) No 1301/2013, (EU) No 1303/2013, (EU) No 1304/2013, (EU) No 1309/2013, (EU) No 1316/2013, (EU) No 223/2014, (EU) No 283/2014, and Decision No 541/2014/EU and repealing Regulation (EU, Euratom) No 966/2012 (OJ L 193, 30.7.2018, pp. 1–222). These provisions are the same as the eligibility rules defined in Article 126(3)(c) of the repealed Financial Regulation (No 966/2012) and Article 187 of Commission Delegated Regulation on the application of rules) No 1268/2012).

[16] Exceptions to this are defined in Article 186(4) of the Financial Regulation

[17] See paragraphs 6.40 to 6.42 and 6.78 and recommendation 2 of our 2017 annual report.

[18] Based on the 561 projects we examined in the context of our SoA work between 2015 and 2017, we estimate that the share of private bodies that could not recover VAT was only 0.2 % of all beneficiaries.

About ECA Annual Reports and Rapid Case Reviews

In our annual reports, we provide an overview of EU financial management during the year and make suggestions on how it could be improved. In so doing, we assist the European Parliament and the Council in their scrutiny of the way EU funds are used.

Rapid case reviews do not use new audit work or present new audit findings and recommendations. They present and establish facts on specific topics, and provide focused analysis to help understand the issues involved.

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Glossary

Cohesion: Short name for MFF sub-heading 1b 'Economic, social and territorial cohesion'.

Public bodies: National, regional or local government, or any other body governed by public law.

Standard Vat rates: This is the rate that an EU country has to apply to all non-exempt goods and services. A Member State may apply reduced rates on goods or services, subject to certain conditions.

Taxable person: Generally a business, individual trader or other professional.

Refund: 'Refund' does not necessarily mean actual cashflow, but can be a reduction in sales tax.

Cohesion policy funds: For the 2014-2020 programming period, Cohesion policy funds are part of the European Structural and Investment (ESI) Funds.

ECA team

This rapid case review was adopted by Chamber II Investment for cohesion, growth and inclusion spending areas, headed by ECA Member Iliana Ivanova. The task was led by ECA Member Tony Murphy, supported by Wolfgang Stolz, Head of Private Office, Brian Murphy, Private Office Attaché and Peter Borsos, Private Office Assistant; Juan Ignacio Gonzalez Bastero, Principal Manager and Orsolya Szarka, Head of Task. Mark Smith provided linguistic support.

In recent years, we have presented a number of errors and shortcomings in the treatment of value-added tax (VAT) as an eligible cost in Cohesion spending in our annual reports. This review paper aims to complement the VAT-related observations in our annual reports and the views expressed in Opinion No 6/2018.
Using results and data from previous SoA audits, we analysed the relationship between VAT recoverability and eligibility. We provide an overview of the errors and inconsistencies that we found, and highlight cases of sub-optimal use of EU funds resulting from a broad interpretation of VAT recoverability, in particular in the case of public bodies receiving EU aid.
Based on our analysis and in line with our previous recommendations, we believe that the Commission and legislators should consider revising the rules on VAT eligibility. Efforts to simplify the rules should, however, support the principle of sound financial management of EU funds.

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