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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.

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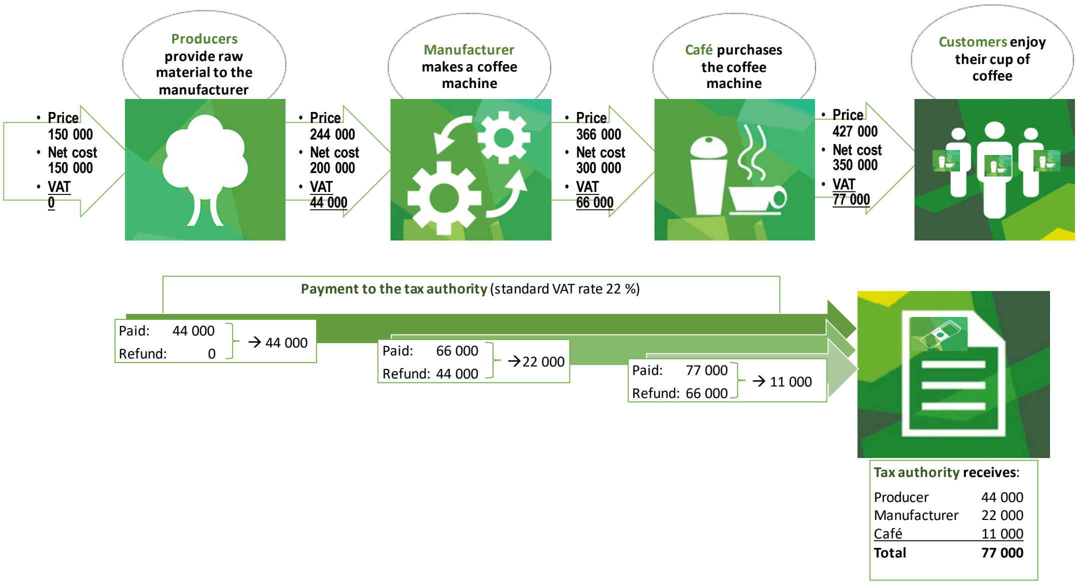
[3] Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (OJ L 347/1, 11.12.2006).

[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.

Figure 1 – How VAT works



Source: European Court of Auditors.

Eligibility rules for VAT in cohesion expenditure

06 EU spending often involves subsidising costs related to the purchase of goods or services. The related VAT can account for up to one fifth of a project's cost (see paragraph 03). This makes the treatment of VAT an important issue in the context of the eligibility of expenditure co-financed from the EU budget.

07 *Cohesion policy* funds reimburse expenditure to beneficiaries that comply with EU and national eligibility rules. VAT is one of the few areas where eligibility principles are defined at EU level. These rules have remained more or less unchanged since 2000[5]. In principle, VAT is only eligible for co-financing if it is not recoverable under national VAT legislation[6].

08 Similar to previous programming periods, the 2014-2020 Common Provision Regulation (CPR) uses the term 'recoverable' as an eligibility criterion. This means that where beneficiaries are able to recover VAT, it is not an eligible cost, irrespective of whether or not they actually recover the VAT expenditure. Consequently, for beneficiaries who are not VAT-taxable persons and therefore cannot recover VAT, such VAT would normally be an eligible cost.

09 The European Court of Justice (ECJ) introduced a broader interpretation of the concept of recoverability in two of its rulings[7] in 2012. It concluded that a formal

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[5] Rule No 7: VAT and other taxes and charges of Commission Regulation (EC) No 1685/2000 of 28 July 2000 laying down detailed rules for the implementation of Council Regulation (EC) No 1260/1999 as regards eligibility of expenditure of operations co-financed by the Structural Funds (OJ L 193, 29.7.2000, pp. 9–48).

[6] Article 69(3) of Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006 (OJ L 347, 20.12.2013, p. 320).

[7] Case T-89/10 and T-407/10 Hungary v Commission, judgment of 20 September 2012 issued by the General Court.

examination of a beneficiary's tax status is an insufficient basis for deciding about VAT recoverability and thus its eligibility. Member State authorities should also take account of the operational structure of a co-financed project, which might include different entities. This implies that even if a public entity with non-taxable status is the beneficiary of EU aid for building an item of infrastructure, the related VAT should be considered recoverable if the infrastructure is/will be operated by a different entity that charges fees including VAT to end users. ***Box 1*** summarises the case and illustrates the ECJ's binding legal interpretation of the recoverability of VAT.

Box 1

ECJ judgment on non-recoverable VAT

In Hungary, a 100 % state-owned public joint venture manages motorway construction on behalf of the state. After completion of the motorway, ownership rights are transferred free of charge to another public company, which manages state property. A further state-owned company operates the motorway, which collects tolls including VAT.

The company that manages construction was the beneficiary of EU aid and calculated the rate of eligible expenditure by taking into consideration both the total cost of the infrastructure (including VAT) and the income from toll revenues. Since it has no commercial operations, it considered VAT as eligible expenditure and requested the corresponding reimbursement. However, the Commission argued that VAT is de facto recoverable under this arrangement by virtue of the company collecting the tolls, and is therefore ineligible. The ECJ judgment confirmed the Commission's view.

Source: European Court of Auditors' summary of Case T-89-10.

Reimbursement of VAT: A frequent source of errors, inconsistencies and sub-optimal use of funds

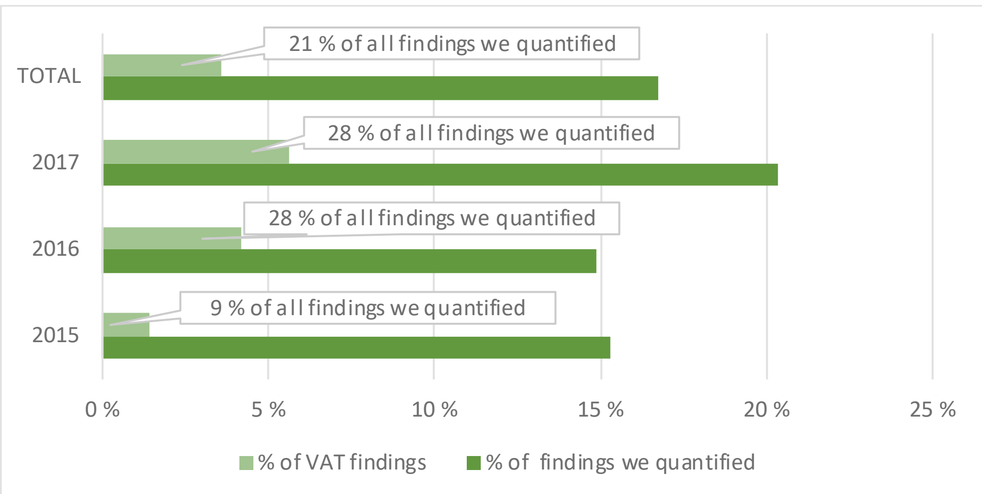
10 In our SoA work, we came across VAT eligibility issues, which frequently led to errors we quantified. We have also identified inconsistent treatment of VAT as an eligible cost within and between Member States, and situations where the reimbursement of VAT clearly led to sub-optimal use of EU funds in terms of sound financial management. Most of these cases occurred when public bodies were the beneficiaries of EU aid.

11 The following paragraphs present the results of our analysis of the projects we have examined in previous SoA audits and provide details of our findings.

Quantified errors due to the reimbursement of ineligible VAT

12 From 2015 to 2017, we audited 561 operations as part of our SoA audits. In 73 % of cases, the beneficiaries of the EU aid were public bodies. We quantified 94 errors, 20 of which (21 %) concerned the reimbursement of ineligible VAT. Almost all these errors (95 %) concerned public bodies. ***Figure 2*** shows the VAT errors we found as a percentage of the total quantified errors in 2015, 2016 and 2017.

Figure 2 – VAT findings in SoA audits from 2015 to 2017



Source: European Court of Auditors.

13 In 14 cases, beneficiaries declared non-refunded VAT as a cost even though the beneficiary – or the final recipient – had the right to recover it, i.e. it was *recoverable.* In six cases, beneficiaries requested the reimbursement of VAT based only on a formal examination of their beneficiary status. In these cases, neither the beneficiary nor the Member State authorities recognised that the set-up of the co-financed activity made the VAT recoverable de facto. This meant that the VAT was not eligible for reimbursement. ***Figure 3*** shows the different types of errors we found and provides examples of the various cases.

Figure 3 – Types of VAT errors in SoA audits with examples

Cases	Type of error	Example
14 cases	**Beneficiary/final recipient has a right to a VAT refund (in full or partially)**	• In Poland, the managing authority signed grant agreements to help small businesses purchase equipment, with the overall aim of reducing unemployment. Where recipients stated that they did not intend to recover VAT, the managing authority assessed that the VAT expenditure was eligible for co-financing. This was incorrect, since the recipients were registered for VAT and the VAT expenditure was actually recoverable.
2 cases	**Beneficiary is a non-taxable person, but project expenditure incurred in relation to commercial (i.e. taxable) activity which makes VAT recoverable**	• A local authority in Germany received co-financing to renovate and extend a multi-purpose sports hall and outdoor sports fields. The authority owns the infrastructure which is used partly (around one third of the time) by a local school and partly (two thirds of the time) by sports clubs for training and competition for an hourly fee. Despite the German federal supreme court's verdict on the matter, the beneficiary did not treat the project as a commercial activity and failed to recognise VAT as recoverable and therefore ineligible.
4 cases	**VAT incurred for infrastructure that later collected fees for their use, charging VAT to end users (see ECJ case in *Box 1*)**	• In one case, four authorities jointly received ERDF funds for a cross-border project to improve the quality of drinking water and waste water purification in Bulgaria and Greece. The audited partner (a municipality in Bulgaria) declared VAT as eligible expenditure on the construction of the waste water infrastucture. However, the VAT paid on new infrastructure which the public will be charged to use is in fact recoverable and thus ineligible for co-financing.

Source: European Court of Auditors.

Inconsistencies in the treatment of VAT as eligible expenditure

14 The reimbursement of VAT as an eligible cost from the EU budget depends to some extent on how projects are structured, an area where Member States authorities are free to decide. The implementation of a particular project (e.g. infrastructure) can be organised in various ways in different Member States, leading to inconsistent treatment of the VAT within the EU.

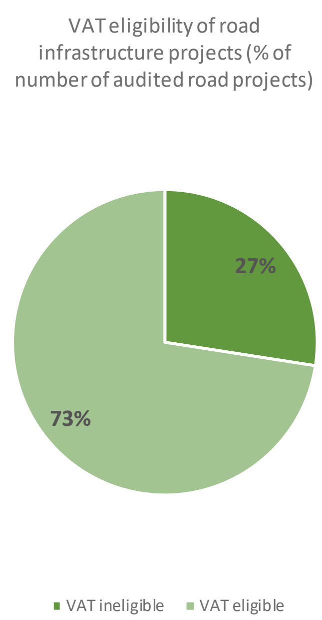
15 Some Member States use single-purpose entities to implement infrastructure projects. In general, these entities are fully owned by the State, regional or local authorities, but they operate within the legal framework of a private company. In these cases, the publicly owned company is a taxable person subject to VAT, which is therefore considered recoverable and ineligible for EU funding.

16 In other cases, the direct beneficiary of EU aid is the State or a regional or local authority (or a body under its authority). Since these public bodies do not normally recover VAT, EU funds may reimburse this cost to the Member State.

17 ***Table 1*** presents the various implementation structures in the roads sector in the Member States we audited[8]. It shows that in 73 % of the cases Member States operate a system where VAT is eligible.

Table 1 – Nature of beneficiaries and VAT eligibility in the roads sector

Member State (1)	Public agency or fund (or similar)	State, regional or local authority	Public company
Bulgaria	eligible		
Czech Republic	eligible	eligible	
Germany		eligible	
Estonia	eligible		
Spain	eligible		
Greece		eligible/ineligible	ineligible
Hungary			ineligible
Italy		eligible	ineligible
Latvia		eligible	
Malta	eligible		
Poland	eligible	eligible	
Portugal			ineligible
Romania		ineligible	
Slovenia			ineligible
Slovakia		eligible	



(1) Member States that are not in the list were either not part of our sample or we did not examine road infrastructure projects in them.

Source: European Court of Auditors.

18 We also found situations where the same type of beneficiary for the same type of project executed in a single Member State treated VAT in different ways, as ***Box 2***

[8] The same applies to other types of infrastructure such as railways.

shows. This inconsistent interpretation of tax law creates uncertainty regarding the eligibility of expenditure.

Box 2

Example of inconsistent treatment of VAT claimed in the construction of research infrastructure

As part of our SoA audits, we audited four projects involving the construction of research infrastructure in the Czech Republic. The beneficiaries were four public universities in different Czech cities. Each university treated VAT in a different way and considered different proportions of the VAT as an eligible cost. Although the same legislation applies to all universities, the range of non-recovered VAT varied from 23 % to 100 %.

The Czech authorities accepted the non-recovered VAT declared by the beneficiary as an eligible cost, but did not evaluate the actual recoverable amount. The main source of different treatment was that each university interpreted Czech tax law differently, in particular the interpretation of the term "economic activity" and how it should be applied to calculate the pro-rata tax deduction.

Source: European Court of Auditors.

Sub-optimal use of EU funds when reimbursing VAT to public bodies

19 In general, public bodies are regarded as end consumers, i.e. they have no right to a VAT refund for the activities they carry out in their capacity as public authorities (e.g. education, healthcare or social services).The Commission and the Member States take the view that VAT in such situations is actually borne by the public body in its capacity as beneficiary, and therefore constitutes eligible expenditure.

20 However, VAT declared as expenditure by public bodies does not represent a net cost to the Member State. This is the case particularly when national governments implement large infrastructure projects, e.g. through a ministry or a body directly under its authority. They may claim VAT as an eligible cost since the ministry cannot recover it (see paragraph 16) and the EU reimburses it to Member State authorities. At the same time, however, the national budget also receives the VAT revenue via its normal taxation system.

21 The EU reimbursement may even exceed the actual costs incurred for the project, net of VAT, meaning that the national budget's overall income is higher than the actual expenditure (see example in ***Figure 4***). This occurs when the national share of a project's funding is lower than the VAT rate[9]. In the current programming period, this is particularly relevant for the Cohesion Fund, which finances large infrastructure projects, and where the vast majority of projects have an EU co financing rate of 80 % or more[10].

22 In our view, this represents a sub-optimal use of EU funds from a sound financial management perspective, and does not add any value. Based on the sample of projects we examined between 2015 and 2017, we estimate that around €750 million of declared VAT expenditure comes from projects implemented by public bodies. Around half this amount concerns Cohesion Fund projects where the co-financing rate is higher than 80 %.

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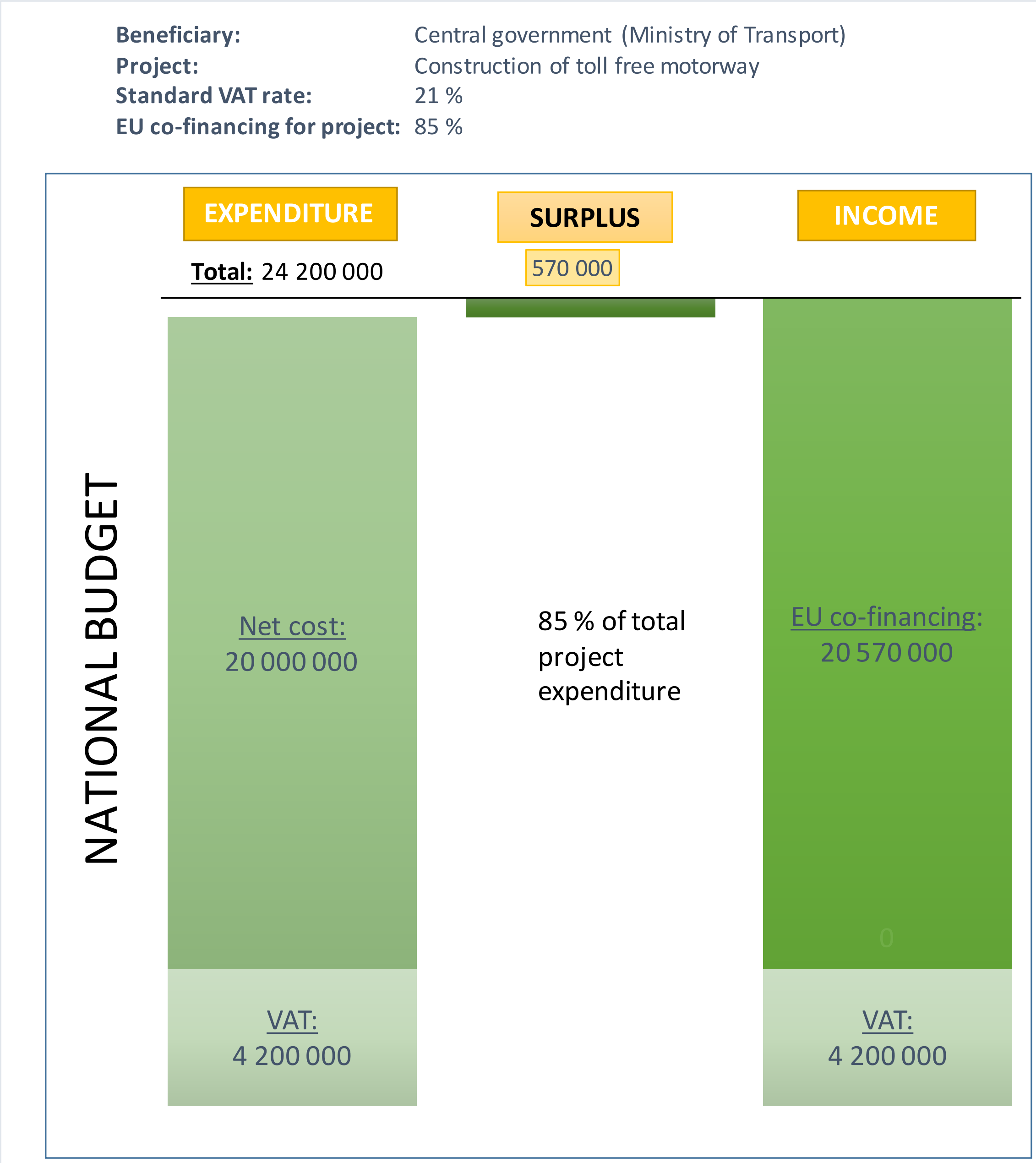
9 Member States are free to set the co-financing rate at project level as long as they respect the average co-financing rate set for the priority axis of the OP.

10 84 % of the Cohesion Fund projects in our sample had a co-financing rate of 80 % or more. This proportion is only 50 % in the case of ERDF projects.

Figure 4 – Over-compensation of VAT expenditure



Source: European Court of Auditors.

The commission's attempts to improve the situation

What has happened so far

23 The Commission attempted to address VAT recoverability issues in its proposal for the 2014 2020 CPR for the ESI Funds[11]. Although the basic eligibility requirement was that only non-recoverable VAT should be reimbursed, the proposal suggested excluding the reimbursement of VAT paid by non-taxable persons as defined by the VAT Directive (in general, public bodies), or paid on infrastructure projects. Legislators did not retain this option in the Regulation as finally approved.

24 We recommended to the Commission in 2015 that the notion of recoverable VAT should be clarified in order to avoid inconsistent interpretation and the sub-optimal use of EU funds, in particular for public beneficiaries. In response to our recommendation, the Commission prepared guidance on the subject, which was published in November 2018[12].

25 The Commission's guidance note is a comprehensive document dealing with eligibility conditions for VAT under Cohesion policy rules in the 2014-2020 period. It explains the principles on which the assessment of VAT eligibility should be made and clarifies how to deal with VAT eligibility in different scenarios (in particular how to interpret the ECJ case law). However, VAT eligibility in Cohesion remains a complex matter and the Commission highlights in its guidance note, that it will establish its final position on this issue on a case-by case basis, taking into account particularities of the different operations.

26 We also recommended to the Commission in our 2017 annual report that it should propose legislative changes in the CPR for the post-2020 financial framework that would exclude reimbursement of VAT to public bodies from EU funds. Instead, the Commission proposed a simplified rule on VAT eligibility for both public and private

[11] Article 59.3(c) of COM(2011)0615 final.

[12] SWD(2018)459 final – Guidance note on Conditions for eligibility of VAT under Cohesion policy rules in the 2014-2020 programming period.

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.

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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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