

Extract from the report “Reform the Swedish VAT-base – time to question the VAT exemptions”

Summary

The VAT revenue in Sweden amounts to SEK 450 billion annually and represents more than one fifth of the total tax revenue. The VAT system is difficult to comply with, outdated and characterized by complexity. It is obvious that the rules have not followed the development of society. As a result, distortions of competition, high compliance costs and a not insignificant legal uncertainty, arise.

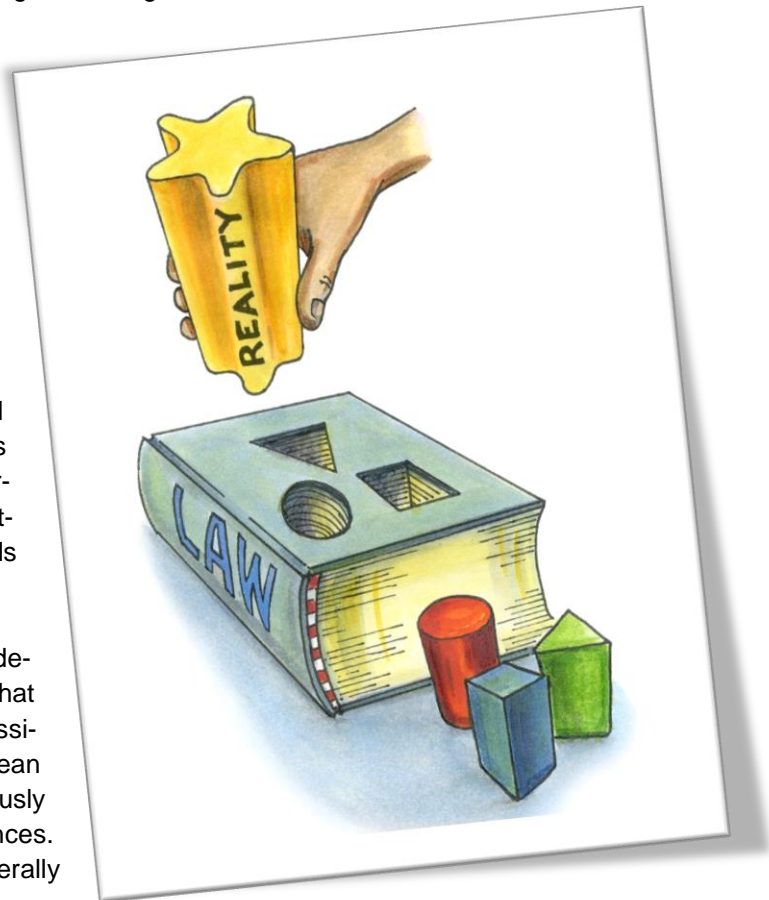
If you scratch on the surface of identified problems, it can be noted that these problems reappear due to VAT-exempt transactions. By widening the VAT base, a more manageable system would be achieved with positive effects for consumers, business and the state. As long as VAT is applied in accordance with its purpose, as a general tax and with few exceptions, it is relative other taxes both more efficient and have less impact on behavior. Positive dynamic effects can be expected to occur and spread to other parts of the business community. The blocked input (hidden) VAT that currently burdens companies can be used for investments, increased accessibility and lower thresholds for entry into markets.

Blocked input VAT occurs when suppliers cannot deduct VAT on their purchases; VAT becomes a cost that is passed on in the transaction chain without the possibility of deduction for any part. OECD, IMF, European Commission, researchers and others unanimously points out that hidden VAT has negative consequences. It is emphasized that exempted transactions generally lead to under-taxation of

consumers and over-taxation of companies - it becomes a tax on investment rather than consumption. Such effects entail undesirable social costs and conflict with the basic purpose of VAT.

In the EU, VAT is in principle harmonized. This is governed by the VAT Directive¹. However, there are numerous national deviations - also in terms of the scope of the VAT-base. Contrary to the general opinion, there are options for Member States to influence national design. Thus, there are possibilities to unilaterally broaden, or reduce, the VAT base. The exempted areas differ between Member States in both design and size. Regarding the Swedish exemptions, there are variations in how complicated it is to assess the taxable base, in which way a broadening of the VAT-base can be done in practice and how much freedom of choice can be applied for each exception.

A summary of some of the excluded areas, follows.



¹ Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax.

Regarding immovable properties etc., the rules in Sweden are complicated with several exemptions, and exemptions from the exemptions. In addition, an option to tax can be applied. The directive gives Member States the right to decide on the design of the exemption themselves, and significant reforms can be made. The taxable base for immovable properties can, in simplified terms, be divided into three different areas: business premises, rental properties (housing) and other types of housing. For business premises and rental properties, the taxable basis is the compensation paid by the tenant to the property owner. We believe that the VAT base for the real estate sector should be broadened. For business premises the annual public financial effect is estimated at SEK -3.0 – 11 billion. The equivalent of VAT on rental properties is estimated at SEK 0.9–6.2 billion. Whether tax revenues increase or decrease depends mainly on the extent of investment costs the property owners have for each year. For rental properties, where transactions are made to consumers, the effect is estimated to be positive in the longer term. The public financial effect for other types of housing is difficult to assess as a result of how the value of living can be calculated (i.e. imputed rents).

Financial services are not currently subject to VAT in Sweden. However, within the framework of the EU rules, there is the possibility of an option to tax financial services. Member States are given a great deal of freedom to design VAT as appropriate for the national banking and financing market. Within the EU, there are currently six countries that have introduced an option to tax financial services. The taxable base for financial services consists of the value of the transactions between financial companies and natural or legal persons. However, it is not easy to identify taxable amount as the "price" of a financial service is often combined in an interest rate. A large part of the VAT-base is made up of the difference between lending and deposit rates. In addition, there are more obvious taxable grounds for the sector in the form of pure fees. However, there is no corresponding provision for the option to tax insurance services. The European Commission is currently reviewing these rules. A base broadening of financial transactions, including insurance, is estimated to have a positive public financial effect of SEK 14-18 billion per year. However, in order to be able to apply VAT to insurance services, changes are required at EU level.

The VAT exemption for betting and lotteries is primarily based on practical problems in deciding the taxable amount. However, Member States have a great deal of leeway to decide what forms of gambling or lottery activities that can be subsumed in the VAT system. Several countries have introduced VAT on gaming services. It seems that the technological development has allowed taxation of a previously difficult base to identify. The determination of the taxable base has been discussed at EU level, where most working documents and judgments point to the fact that the tax base should constitute the gaming companies' net sales. For 2018, the gaming companies' net sales after disbursements were SEK 23.4 billion in Sweden. Annual public financial income can be estimated at just under SEK 5 billion.

The exemptions for health and medical care, social care and education (welfare services) are based on general policy objectives where the exemptions are seen as a complement to society's direct contribution to these activities. There are some possibilities for Member States to reduce the scope of the exemptions. However, these possibilities for Member States are limited. Parts of the exempted sectors can only be taxed after changes at EU level. The complexity of the welfare services is also evident in the assessment of the taxable base. Since it is not possible to discern a clear price for the services provided, it is only possible to give a general reasoning what the tax base could consist of. Patient fees and other costs that consumers pay out of their own pocket for health care could be a basis for taxation. The taxable base of these fees amounts to approximately SEK 75 billion. In the end, a VAT on the welfare area has no public financial effect, if it is financed by the public sector. A broadening of the base would just then be a redistribution of resources irrespective of whether the service is supplied by the private or public sector. The benefits of including welfare services in the VAT system are primarily due to efficiency and competition reasons.

It is possible for Sweden to expand the VAT-base on its own and to address a large part of the problems that the exemptions entail. In addition to the basic purposes of VAT a future VAT reform must pay

particular attention to the fact that the legal VAT rules today are too complicated and that major simplifications are needed. In a reform, VAT-management in IT and financial management systems, where there is both lack of knowledge and discussion, must be considered. There is a belief that IT and financial management systems can solve today's complex VAT handling. In addition, a broadened VAT base could in the end increase the tax burden for consumers. This entails a need for transitional adjustments with good anticipation.

VAT exemptions are not VAT free

High or low VAT is often the issue of discussion. It seems easy to have opinions whether a particular goods or service should have low VAT, but it seems more difficult to discuss the effects of the exemptions. Exempted transactions are usually called VAT-free, which is a wrong interpretation. VAT-free is not free of VAT, it is loaded with blocked input VAT.

Blocked input (hidden) VAT occurs when the suppliers that carry out exempt transactions cannot deduct VAT on their costs. For society, hidden VAT causes several problems, e.g. that preschools and elderly care find it difficult to get hold of premises, that in-house work is encouraged instead of subcontracting services of someone more qualified, that housing construction is disadvantaged compared to offices and that investments are pushed into the future. This puts companies that are concerned by the exemptions in a worse position than competitors in other countries that do not suffer the corresponding distorting effects. Consumers are also affected in the form of hidden double taxation and that certain transactions are not exercised at all. The Swedish VAT base is underutilized and the system's design limits both growth and social development.

There is a need for a political discussion about the exemptions and the effects of blocked input VAT and cumulative effects have as a result of the Swedish VAT base not being fully utilized. High, low or hidden (blocked input) VAT is the question - but what is the answer? If you seek the answer from the OECD, EU, IMF, ICC and researchers, the solution is a broad VAT base. This is in line with effects on the tax area in general; data from the IMF shows that raising tax rates has a significantly greater negative impact on long-term growth and short-term cyclical effects on GDP, compared with a corresponding broadening of the tax base.²

Blocked input VAT and cascading effects

The VAT system aims to tax the end consumer. The companies' right of deduction ensures that only the added value at each stage of sales is taxed and that the tax burden is pushed forward in the transaction chain to the final consumer. If a sales stage is exempt (VAT-free), and the company does not have the right to deduct, the VAT becomes an expense. Then hidden VAT is created when the company needs to raise the price in order to cover the VAT cost. There is a breach in the VAT chain, and the basic neutrality on which the system is built is disturbed.

Some jurisdictions describe hidden (blocked input) VAT as "input taxation", which clearly shows that an exempt transaction does not mean that the transaction is tax-exempt. This highlights something that deserves attention in the debate - exempt ("VAT-free") transactions are not exempt from VAT but instead burdened by hidden, blocked input VAT. Furthermore, if several companies in the transaction chain cannot deduct their input VAT, cascade effects occur.³ Even if a company with full deduction enters at a later stage, this company cannot fully claim the VAT (deduct VAT on costs) in the previous stage as it is hidden among the total costs and is not found openly charged in invoices or receipts.⁴

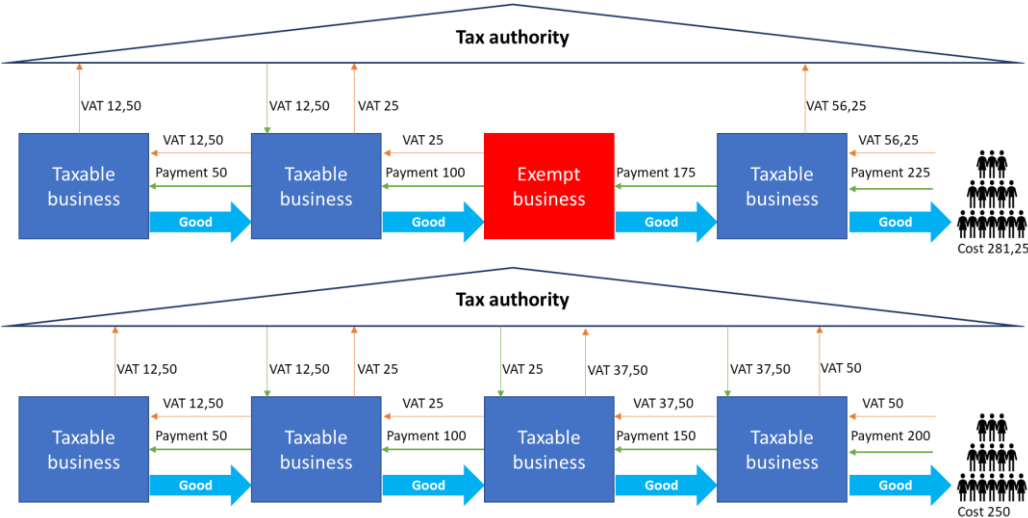
² Dabla-Norris & de Mooij (2018) and Dabla-Norris & Lima (2018).

³ This require that there are additional companies in the transaction chain there are subject(s) to VAT.

⁴ This is observed in detail in the Norwegian government committee NOU 2019:11. It would be desirable if the problem was highlighted in a similar way in Swedish government committees and legislative proposals.

In this way, not only is VAT taxed on the transactions, but it can also be VAT on VAT (double taxation). How large the hidden (blocked input) VAT is depends on the stage in which it arises and what type of costs the particular business has. In principle, the later the breakage occurs in a processing chain, the greater the impact on the customer's end price it causes. Whether the hidden VAT in practice can be passed on to a private individual or not depends on what the market and pricing for that particular type of transaction looks like. This is a complex issue that can include everything from competitive conditions and market strategies to the existence of nearby substitutes and neighboring markets' VAT treatment.

It is the existence of VAT exemptions that leads to the creation of hidden (blocked input) VAT being and passed on to the next stage of the transaction chain. The hidden (blocked input) VAT can generally be said to arise on two sides of a transaction. Since the company does not have the right to deduct VAT on their purchases or put VAT on their sales, both the exempt company and the next company will suffer from higher costs. The stage with exempt sales must offset the cost incurred in the absence of deduction rights, which will then be hidden (blocked input) VAT, which the next company cannot deduct because it is subsumed into the price. Next company pays hidden VAT that cannot be deducted, and the VAT that is added on the value in the next transaction. The final product becomes more expensive for the consumer than in the alternative case, and companies that are in a transaction chain with hidden VAT have higher costs than if all the links had been subject to VAT.



This simplified example illustrates, how hidden VAT is created and passed on. If more companies are added, which cannot deduct all of their input tax, cascade effects quickly arise.

Effects of hidden (blocked input) VAT

Hidden (blocked input) VAT and cascade effects influence companies' production decisions and choice of organizational form.⁵ Companies that do not have the right to deduct are given incentives to do the work themselves instead of outsourcing the work to someone who is better suited to perform the task. This is to avoid an invoice with VAT that cannot be deducted. As long as more than 80 percent (at the Swedish standard tax rate) is achieved by the efficiency that an outsourcing company has, self-employment becomes profitable financially. In addition, the administrative burden must be added as the cumbersome handling of VAT in accounting and IT systems can lead to the cancellation of certain transactions to facilitate administration.⁶ These VAT-related behaviors lead to financial inefficiency in the supply chain.

⁵ OECD (2018).
⁶ Even though Sweden is at the top in terms of VAT-gap (European Commission, VAT Gap report 2018), Sweden is only placed in the middle regarding administrative burden (Tax Foundation (2019)). Thus, there is great potential for improvement to facilitate companies that act as unpaid collectors of VAT.

Another effect of hidden VAT is that operators located in an exempt sector may argue that certain purchases should be considered exempt, even though the transaction otherwise is considered to be subject to VAT in order not to be charged with increased costs in the form of VAT. This creates complex material assessments that have led to the emergence of extensive case law and can be expected to continue to grow at both Swedish and EU levels.

Furthermore, the OECD argues that exempted transactions generally lead to under-taxation of consumers and over-taxation of companies - it will be a tax on investment rather than consumption.⁷ Such effects are in direct conflict with the fundamental purpose of taxing the added value at each stage of production and distribution chain.⁸ In addition, the OECD argues that exempt transactions jeopardize the destination principle (taxation in the buyer's country) in international trade when the hidden VAT stops in the country of origin (taxation in the seller's country).⁹

The great regulatory burden of VAT, that the exemptions entail, should also be noted. Complicated demarcations between what is subject to VAT and exempted, assessment problems if the tax base must be covered by the principle of single or composite supplies, self-supplies and how the right of deduction in various cases is affected occupy many advisory experts, tax administrations and courts.¹⁰ In addition, standard tools for managing the VAT exemptions lacks in IT and financial management systems, which requires manual handling or costly special adaptation.¹¹ Companies with mixed transactions (both exempt and taxable transactions) is troubled with complicated handling every day, in every invoice and for every transaction. To prevent this complexity and distortion the ICC also recommends a broad tax base with only a limited number of clearly defined exceptions.¹²

By widening the base, several of the negative effects that result from hidden (blocked input) VAT are corrected. Positive dynamic effects can be expected to occur and spread to other parts of the business community. The cost of VAT that is currently charged to companies can give room for necessary investments, greater availability and lower thresholds for entry into markets. Resources are released when companies can concentrate on their core business. A purer VAT system ensures to a greater extent that the business community is not affected by lock-in effects or the financial burden of what should ultimately be a tax on consumption.

⁷ OECD (2018).

⁸ Rendahl (2015).

⁹ OECD (2018).

¹⁰ Regarding the principle of single or composite supplies, the European Court of Justice has stated that it is impossible to exhaustively determine how to properly approach the question of the scope of a transaction in each case (C-349/96, Card Protection Plan).

¹¹ Deloitte (2015).

¹² ICC (2019).

In addition to the summary, following examples illustrates the problems of blocked input VAT in two areas. The remaining parts of the Swedish report is shown in the table of contents below.

Immovable property

Mainly, it was the problems with blocked input VAT and cumulative effects that led to the introduction of the option to tax in 1979. The aim was to reduce the lack of neutrality between those who operated in their own premises and those who operated on rented premises.¹³ The rules on the options to tax have subsequently been further improved, but the rules are still too complex and far from adequate in their current form.

To apply the option to tax, several conditions are required. For example, it is required that the letting is fixed to a certain definite area. Due to mobile phones, e-mails and constant access to the internet, the need for a permanent workplace has dramatically decreased. However, the VAT rules have not been adapted to these developments, and today's VAT rules prevent for example, an open office landscape for group companies, co-working spaces and innovation hubs. Another clear example where the conditions for the option to tax are outdated is the condition of permanent use. The Swedish Tax Agency states that it is normally required that the letting contract lasts for at least one year or until further notice to be covered by the option to tax. This makes it difficult to use premises in the evenings and weekends or for shorter leases.



This entails several undesirable consequences. Operators engaged in exempt activities have difficulty accessing premises, as several property owners would rather leave their premises empty than rent the premises to VAT-exempt business (e.g. welfare companies). If a property owner should be allowed to add VAT to the invoice even if the tenant does not constitute as a taxable business, these problems would not arise. Today's rules thus exclude exempt actors from the rental market, which not least non-profit associations and private schools attest. In general the immovable property exemption causes inefficient use of premises, delay investments and hinder social development. One particular negative effect



¹³ Prop. 1978/79:141.

is the use of premises in alienation areas, where the exemption opposes important functions that could entail a more living city center, due to the short-term lease requirement.

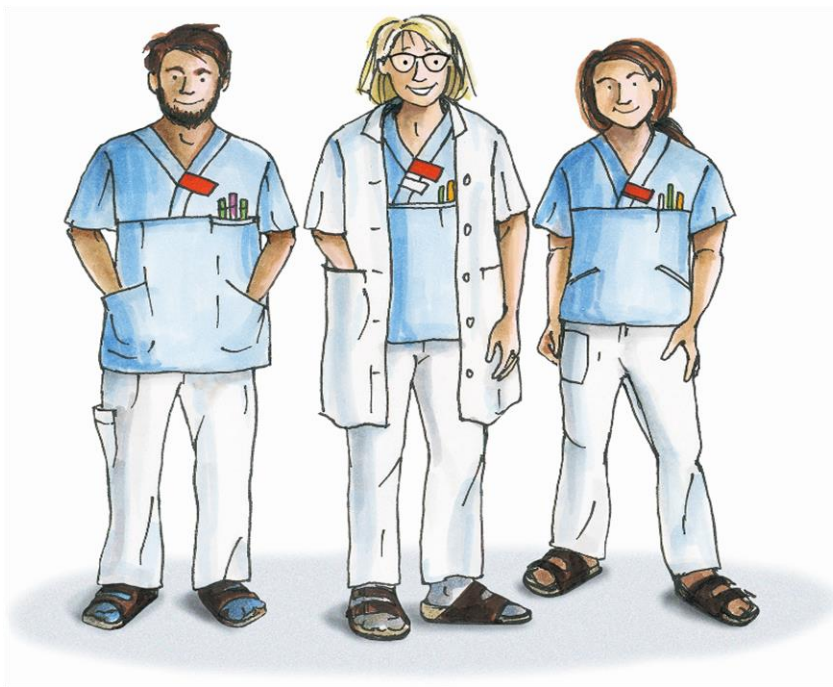
Welfare sector

In this area, VAT is extra complicated and noticeable. Lack of transparency, knowledge and discussion risks hampering developments in the field - not least in terms of staffing and digitalization. Aside the increasing proportion of healthcare conducted under private management, digitalization is causing a change in the way healthcare is exercised. Over the past 20 years, the development of the health care market has been at a higher rate than GDP. Although, a certain proportion of the increase is natural as a result of a larger population, but a large part of the increased costs follow from the way healthcare is conducted.¹⁴

There is great potential for further data-driven innovation in the sector, but today's VAT rules obstruct such development.¹⁵ Investments that private operators cannot deduct pushes the investment to the future and demand a higher return than would otherwise have been the case. Necessary investments are postponed due to obsolete VAT rules.

Today's VAT exemption also creates difficult demarcation problems. One example is the assessment of the demarcation between a healthcare service and a staffing service. The issue has been highly debated in Sweden during the year as a result of a ruling by the Supreme Administrative Court and, above all, the interpretation of the Swedish Tax Agency.¹⁶ The question is not finally settled; however, it may be noted that considerable resources have been devoted to the issue that would never have arisen if it were not for the VAT exemption for healthcare services.

Another undesired consequence due to the exemption of the welfare sector is the fact that certain private actors in education manage to build school buildings at half the price compared to public actors.¹⁷ VAT is often stressed as a crucial obstacle for such investment being economically justifiable. In these cases, today's VAT rules cause that not enough schools are being built, and that the schools that are being built often is constructed at a cost that is significantly higher than necessary.



¹⁴ McKinsey & Company (2016).

¹⁵ SOU 2016:89.

¹⁶ [Ruling from the Supreme Administrative Court and positions from the Swedish Tax Agency] HFD 2018 ref. 41 and Skatteverkets ställningstaganden Uthyrning av vårdpersonal, mervärdesskatt, Dnr 202 398355-18/111, 2018-10-25 samt Social omsorg, mervärdesskatt, Dnr 202 398382-18/111, 2018-10-25.

¹⁷ SvD 2019-05-21.

The Swedish report has, in addition to the above, the following content:

Preface

Summary

Purpose and delimitation

Summary of the report The Swedish VAT base and tax rates

Why a VAT reform?

VAT development and tax base.

VAT free is not free of VAT.

Possibilities in the EU VAT Directive.

Immovable property

Financial transactions

Insurance

Betting and lotteries

Cultural area

Public postal service

Welfare sector

Non-profit organizations

Sports

Summary of taxable base and public financial effects

Content of a VAT reform

Activities in a future VAT reform

Facilitate VAT management in IT and financial management systems

How is the base affected by the municipalities' area of responsibility?

Are changes affected by EU state aid rules?

How is the EU fee affected by a broadening of the tax base?

References

Appendix 1 Comparison between the Directive and the Swedish VAT Act

Appendix 2 VAT on housing rents - calculation method

Contact information:



Erik Blomquist
Tax Lawyer
+46 72 527 21 49



Anna Sandberg Nilsson
VAT-expert
+46 70 255 48 14



Oscar Brissle
Economist
+46 70 572 34 79

Illustrations by: Catharina Ekström www.ekstromform.se