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DIRECTORATE-GENERAL
TAXATION AND CUSTOMS UNION
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VALUE ADDED TAX COMMITTEE
(ARTICLE 398 OF DIRECTIVE 2006/112/EC)
WORKING PAPER NO 853

QUESTION
CONCERNING THE APPLICATION OF EU VAT PROVISIONS

ORIGIN:	**Commission**
REFERENCES:	**Articles 2, 9, 13, 143(1)(fa) and (g), and 151(1)(aa) and (b)**
SUBJECT:	**VAT treatment of collaborative projects and other defence-related activities**

1. INTRODUCTION

In recent years, with Common Security and Defence Policy taking centre stage, the Commission services have increasingly been faced with questions about the VAT implications of enhanced collaboration in this field.

This coincides with questions surfacing on other defence-related activities such as those undertaken by bodies set up by NATO.

With a view to clarify all these questions, this paper was drawn up.

2. SUBJECT MATTER

According to the first subparagraph of Article 13(1) of the VAT Directive[1], "States, regional and local government authorities and other bodies governed by public law shall not be regarded as taxable persons in respect of the activities or transactions in which they engage as public authorities, even where they collect dues, fees, contributions or payments in connection with those activities or transactions".

Commonly referred to as "public bodies", those bodies also include the armed forces which, acting in their capacity as a public authority, qualify as a non-taxable person. As non-taxable persons are not able to recover VAT on their input, the armed forces will be faced with the cost of VAT unless there is scope for exemption on the individual supplies made to them. The same applies for the defence as a whole.

With the Common Security and Defence Policy, efforts are made to make the best use of scarce national and Union resources through increased and more systematic cooperation and coordination among Member States and making coherent and effective use of the EU's instruments and policies. In that context, VAT can present a particular challenge and the Council has therefore called "to examine the further development of incentives for cooperation in Europe, including by investigating non-market distorting fiscal measures for collaborative projects in accordance with the existing European law"[2].

It is with that in mind and with a view to also address other questions which have surfaced that we will take a closer look at which are the possible measures available and which are the constraints.

3. THE COMMISSION SERVICES' OPINION

Before examining which measures are available for collaborative projects and other defence-related activities, it is worth noting that, as set out in Article 1 of the VAT Directive, "the common system of VAT entails the application to goods and services of a general tax on consumption which is exactly proportional to the price of the goods and

[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).

[2] Council Conclusions on Common Security and Defence Policy adopted on 25 November 2013, (doc. 15992/13 of 25 November 2013).

services, whatever the number of transactions which take place in the production and distribution process before the stage at which tax is charged".

The scope of VAT is very wide and covers, as set out in Article 2 of the VAT Directive, each supply of goods and services for consideration by a taxable person within the territory of a Member State and each importation of goods into the European Union.

Not all taxable transactions are actually taxed but for any transaction to be exempted from VAT, provision must have been made for exemption in the VAT Directive. One of the aims of the Directive was to draw up a common list of VAT exemptions so that the EU own resources may be collected in a uniform manner in all the Member States.

Any VAT exemption for which provision is made must, according to settled case-law, be interpreted strictly, since exemptions constitute exceptions to the general principle that turnover tax is to be levied on each service supplied for consideration by a taxable person.

3.1. Cost incurred by the defence

The VAT Directive does not in general allow for the supply of goods or services to, or the importation of goods by the defence for its activities, to be exempted from VAT, although there is scope for exemption under Article 148(b) of the VAT Directive when goods are supplied for the fuelling and provisioning of fighting ships, falling within the combined nomenclature (CN) code 8906 10 00, leaving their territory and bound for ports or anchorages outside the Member State concerned.

It is therefore normally so that goods or services supplied to, or goods imported by the defence or its armed forces will carry VAT. That is the case no matter whether the armed forces are stationed within their Member State or are deployed abroad.

The cost of VAT is reflected in an increase in the revenues that the tax generates for the Exchequer which in turn feed into the budget that finances activities such as the defence.

3.2. Expenditure linked with collaborative projects or other defence-related activities

Similar to what was seen to be the case for assistance programmes[3], there is no scope for an exemption from VAT to be granted for goods imported or goods or services purchased in the context of collaborative projects or other defence-related activities whether or not they result from an international agreement.

The only circumstances where in their effort to collaborate the defence may benefit from exemption under the VAT Directive would be where:

- goods or services are supplied to, or goods are imported by the armed forces of any State which is party to the North Atlantic Treaty, for the use of those forces, or of the civilian staff accompanying them, or for supplying their messes or canteens whilst the forces are outside their Member State, but only if those forces are taking part in the common defence effort (Articles 143(1)(h) and 151(1)(c) and (d));

[3] See Working paper No 705 which dealt with the Second Line of Defense.

- goods or services are supplied to, or goods are imported by the armed forces of the United Kingdom stationed in the island of Cyprus pursuant to the Treaty of Establishment concerning the Republic of Cyprus, dated 16 August 1960, for the use of those forces, or of the civilian staff accompanying them, or for supplying their messes or canteens (Articles 143(1)(i) and 151(1)(e)).

These are exemptions put in place in order to allow the Member States to honour certain commitments, notably those made under the auspices of NATO, and they only apply to the extent required for such commitments to be honoured[4]. These exemptions would not apply beyond those commitments and could not be extended to cover other collaborative projects or activities in which the defence may be involved.

Other than that, there would not, in principle, be scope for exemption of collaborative projects or other defence-related activities for which the goods or services supplied or the goods imported will then carry VAT. That could however change if an international body is put in charge of such projects or activities.

3.3. Cost of collaborative projects undertaken in the context of Common Security and Defence Policy and other defence-related activities

There could be scope for collaborative projects and other defence-related activities to benefit from an exemption but that then requires some structure. If the structure qualifies as an international body, that could enable an exemption from VAT to apply.

In the VAT Directive an exemption is, subject to certain limits and conditions, granted for the supply of goods and services to and for the importation of goods by:

- the European Community, the European Atomic Energy Community, the European Central Bank or the European Investment Bank, or bodies set up by the Communities to which the Protocol on the privileges and immunities of the European Communities of 8 April 1965 ("the PPI") applies (Articles 143(1)(fa) and 151(1)(aa));

- other international bodies (Articles 143(1)(g) and 151(1)(b)).

If therefore, as part of its functions and tasks, an international body engages in collaborative projects or other defence-related activities, the expenditure incurred in that regard could benefit from the exemption accorded to that international body.

3.3.1. Collaborative projects conducted by the European Defence Agency

This is particularly relevant with regard to collaborative projects conducted by the European Defence Agency. The Agency was established by the Council Joint Action of 12 July 2004 and is now governed by Council Decision 2011/411/CFSP[5]. It is hosted by Belgium and has been recognised in its capacity as an international body. Having been set up by the European Union it enjoys privileges and immunities and thus benefits from an exemption under the VAT Directive.

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4 CJEU, judgment of 26 April 2012 in case C-225/11 *Able UK*.

5 Council Decision 2011/411/CFSP of 12 July 2011 defining the statute, seat and operational rules of the European Defence Agency and repealing Joint Action 2004/551/CFSP (OJ L 183, 13.7.2011, p. 16).

The exemption granted to the Agency pursuant to Articles 143(1)(fa) and 151(1)(aa) of the VAT Directive covers acquisitions made for its official use. Those are acquisitions aimed at the fulfilment of the mission, functions and tasks attributed to it.

The Agency is there to support the Council and Member States in their effort to improve the EU's defence capabilities in the field of crisis management and to sustain the European Security and Defence Policy. According to recital 18 of the preamble to Council Decision 2011/411/CFSP, it is supposed, amongst others, to "provide the possibility for specific groups of Member States to establish ad hoc projects or programmes". These are the ad hoc projects and programmes for which provision is made in Articles 19 to 22 of the said Decision.

Two types of project or programme are provided for:

- category A (opt out) ad hoc projects or programmes that are submitted to the Steering Board of the Agency by one or more of the participating Member States[6] or by the Chief Executive of the Agency, are approved by the Steering Board and presume general participation of the participating Member States which will all, in principle, have to contribute with funding (Article 19);

- category B (opt in) ad hoc projects or programmes that one or more participating Member States inform the Steering Board that they intend to establish within the remit of the Agency and, where appropriate, inform about the budget which, in the absence of a decision to the contrary, are seen as being endorsed by the Steering Board (Article 20).

Both "opt out" and "opt in" projects or programmes fall within the Agency's functions, and will benefit from VAT exemption under Articles 143(1)(fa) and 151(1)(aa) of the VAT Directive, except for those "opt in" ad hoc projects or programmes which following a decision taken by the Steering Board pursuant to Article 20(3) of Council Decision 2011/411/CFSP are not regarded as Agency projects or programmes.

Not all participating Member States will necessarily take part in every Agency project or programme but still, this does not limit the access to exemption for suppliers in those Member States not participating. Exemption will apply once supply is made in regard to any activity that qualifies as an Agency project or programme.

To qualify as an Agency project or programme, there must be a clear added value. That is not put into question by the fact that beneficiaries are ultimately the participating Member States as the execution by the Agency of such projects or programmes is part of its functions and tasks.

When goods or services are procured by the Agency for projects or programmes that bring an added value, purchase will be seen as having been made for its official use. The situation is different if procurement is made only with a view to transmit the goods or

[6] According to recital 22 of the Decision, as a result of Protocol 22 to the Treaty on the European Union, "*Denmark does not participate in the elaboration and implementation of decisions and actions of the Union which have defence implications*" and it "*will therefore not be bound by this Decision*".

services directly to one or more Member States. In that case, it may be that the exemption would not apply and the Agency could even be seen as carrying out an economic activity[7].

The provisions of the PPI should not be applied so as to have the effect of distorting competition. This is a requirement replicated by the VAT Directive which limits the exemption to cases where this does not lead to distortion of competition. It would seem to exclude exemption if and when an international body procures goods or services which are then passed on directly to its members for their use.

3.3.2. Other collaborative projects and defence-related activities

It is also relevant where other international bodies would be in charge of collaborative projects or other defence-related activities.

An exemption is available for international bodies, recognised as such by their host Member State, and to their members pursuant to Articles 143(1)(g) and 151(1)(b) of the VAT Directive, but only within the limits and under the conditions laid down by the international conventions establishing the bodies or by headquarters agreements. If an international body is set up with a view to conduct collaborative projects or the like, an exemption could be possible.

- NATO and its subsidiary bodies

The North Atlantic Treaty Organisation (NATO) is one such international body set up by the North Atlantic Treaty signed in Washington D.C. on 4 April 1949, consisting of the Council (NAC) and its subsidiary bodies[8]. Its host country is Belgium and the conditions to benefit from the VAT exemption are governed by the said Treaty.

One of its subsidiary bodies is the NATO Support and Procurement Organisation (NSPO) which is comprised of an Agency Supervisory Board (ASB) and an Executive Body, called the NATO Support Agency (NSPA).

According to its Charter, the NSPO is established with a view to meeting to the best advantage the collective requirements of some or all NATO nations in the fields of capability, support and logistics provision to NATO and its constituent nations.

The NSPO constitutes an integral part of NATO and is part of its international personality. The juridical personality of the NSPO is an integral part of NATO and cannot be distinguished from it. Nevertheless, the NSPO has a clearly defined organisational, administrative and financial independence.

Its mission is to provide responsive, effective and cost-efficient logistics, operational and systems support and services to the Allies, NATO Military Authorities and partner nations, individually and collectively, in time of peace, crisis and war, and where required, to maximize the ability and flexibility of their armed forces, contingents and other relevant organisations, within the guidance provided by the NAC, to execute their core missions.

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7 For more on the status of international bodies if and when involved in economic activities and what this entails, please see Working paper No 754.

8 For further information on NATO, please consult http://www.nato.int/

All NATO members are members of the NSPO. Non-NATO nations may apply for association with the NSPO if they wish to participate in its activities.

The NSPO has been granted authority to conclude agreements and contracts, and acquire and dispose of property in the name of NATO. It can also conclude agreements or contracts with non-NATO nations or international organisations with the previous approval of the NAC.

The assets acquired by NSPO shall be acquired in the name of and as property of NATO. The conditions of transfer of these assets to member nations shall be defined in directives approved by the ASB. Whenever assets are acquired on behalf of a nation, or of a group of nations, special arrangements shall be concluded by the participating nations and shall specify the ownership and methods of financing, managing, selling and disposing.

Responsibility for the activities of NSPO shall be borne by NATO. However, for activities undertaken by a subgroup of nations, only the participating nations shall jointly assume responsibility vis-à-vis NATO as a whole, and shall bear any resulting costs.

As a rule, the NSPO shall be customer funded. Customer funding is the mechanism whereby the agency receives its funding on the basis of an agreement with the fund provider defining the scope, the cost and the timelines of the product or service to be provided.

Customers shall be charged the direct costs of the services provided plus an overhead to cover general administrative expenditures, recuperation of capital investments and agency operating and running costs. Charges to customers are subject to customer agreement prior to being incurred. The ASB shall not conclude contracts the financing of which would require contributions by a customer beyond what has been agreed by that customer for the given activity. Customer rates are set in such a way that a balance between planned income and expenditure is ensured.

From the description of the features of the NSPO and the NSPA we observe that, even though they have no legal personality different from that of NATO, they have a clear organisational, administrative and financial independence. Therefore, these subsidiary bodies could be seen as taxable persons from a VAT point of view whenever they are performing an economic activity according to Article 9 of the VAT Directive.

As previously stated in the VAT Committee[9], no exemption is available for supplies of goods or services made by international bodies if or when they engage in an economic activity. In that case, international bodies carrying out an economic activity are captured by the concept of taxable person, as the decisive element to be regarded as a taxable person is the activity carried out by an entity and not its status.

An exemption may, on the other hand, be available when goods or services are supplied to international bodies pursuant to Article 151(1)(b) of the VAT Directive. To determine whether NSPO and NSPA can benefit from the exemption in Article 151(1)(b) of the VAT Directive in their acquisitions of goods and services, their activity must be examined.

[9] Ibid.

When these subsidiary bodies acquire goods or services in the name and on behalf of NATO, those acquisitions would receive the same treatment as if they were made by NATO itself. Thus, they could benefit, in principle, from a VAT exemption.

It should be noted that the exemption can only be granted when the goods or services, in addition to being acquired in the name and on behalf of NATO, are acquired with a view of being used in the activities that constitute the purpose of NATO.

However, if the goods or services are acquired in the name and on behalf of NATO only with a view to transmit them directly to one or more States, no VAT exemption could be granted to those acquisitions for the same reasons as what is set out with regard to EDA.

Acquisitions made by NSPO and NSPA for purposes different from those of NATO, on behalf of their customers or with a view later to be transferred to these customers, could not benefit from the VAT exemption in Article 151(1)(b) of the VAT Directive. For that exemption to apply it is required that the goods or services are acquired with a view to be used for the purposes that constitute the objective of the international body (in this instance NATO). In so far as goods or services are acquired with a view to serve as input for an economic activity that is unlikely to constitute the objective of any international body[10]. That would imply that, in relation to these transactions, those bodies could deduct input VAT and would need to charge VAT on their output.

First, it should be noted that NSPO and NSPA are not acting in those cases as a public authority. They are not acting under the special regime applicable to them but under the same conditions as those applicable to private traders.

Their activity is very similar to that performed under an agency contract. In that regard, it should be borne in mind that the scope of the term "economic activity" is very wide and objective in character in the sense that the activity is considered *per se* whatever its purpose or results, not necessary being an activity that entails a profit.

The important element to qualify an activity as economic activity for the purposes of the VAT Directive is that the activity is performed for consideration. This requirement is fulfilled when there is a direct link between the service provided and the consideration received.

In the case of NSPO and NSPA, when they operate under the customer funding mechanism that link is evident, as the amount charged to the customer includes the direct costs of the supply plus an amount to cover the general costs of the bodies.

Therefore, in these cases the activity performed by NSPO and NSPA should be qualified as an economic activity. Thus, no VAT exemption could be applied neither to the input (the goods or services acquired by NSPO and NSPA) nor to the output (the goods or services supplied or transferred by NSPO and NSPA to their customers).

[10] See also what is said above to that effect with regard to procurement.

- ERIC-type

To benefit from exemption, it is necessary for there to be an international body and to charge it with the task of carrying out the projects or programmes in question. The need for putting in place such a body, which may entail lengthy negotiations and ratification by national parliaments, can stand in the way of conducting such projects with the necessary speed.

It has been suggested that to streamline the setting-up of international bodies to undertake projects and activities in the field of security and defence, a construction similar to that used with European Research Infrastructure Consortia (ERICs) could be put in place. For that purpose, it would be first necessary to adopt a Regulation at EU level establishing a framework for those consortiums.

However, it should be noted that in the case of the ERICs, Article 187 TFEU provides the legal basis for the EU to create joint undertakings for research programmes. There is no equivalent legal basis that foresees the creation of those joint undertakings in the field of security and defence.

Even if such a legal basis existed, it has to be borne in mind that the VAT exemption for goods and services acquired by an international organisation can only be a consequence of the creation of such an international body; it cannot be the objective of its creation.

In the case of the ERICs, the relevant Regulation[11] does not provide for any exemption, it only serves to facilitate the setting up of an international body. For the ERIC to access the exemption provided for in Article 151 of the VAT Directive, it has to fulfil all the conditions required to be an international body and has to be recognised as such by its host Member State.

If a legal basis were to be found that would enable the setting up of Defence Consortiums, similar to what was the case with the ERIC, the act creating such bodies should not include any reference to the VAT exemption. The VAT exemption could then only be granted once a consortium fulfils all conditions to be considered an international body. It would be necessary for that purpose that the consortium provides an added value being assigned with tasks that could not be performed by its members on their own. It would also be necessary that the consortium is recognised as an international organisation by its host Member State.

If the creation of such consortiums has as its only purpose to purchase goods or services for its members using the consortium as a bridge, no exemption could be granted to the supplies of goods and services to the said consortium, for the same reasons that were set out in the case of EDA and NATO subsidiary agencies.

[11] Council Regulation (EC) No 723/2009 of 25 June 2009 on the Community legal framework for a European Research Infrastructure Consortium (ERIC) (OJ L 206, 8.8.2009, p. 1).

4. DELEGATIONS' OPINION

Delegations are invited to express their views on the issues raised by the Commission services.

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