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Lord Justice Leveson
The Leveson Inquiry: culture, practices and ethics of the press
Royal Courts of Justice
Strand, London, WC2A 2LL
(By email to the Secretary to the Inquiry)

Date 18 April 2012
Our Ref SLR 244739

Dear Lord Justice Leveson

Re Leveson Inquiry – Application of different rates of VAT to supplies of newspapers

Introduction

1. My name is John Evans and I am the Deputy Director in the Solicitor's Office in HM Revenue and Customs (HMRC) who is head of the team which includes the lawyers advising on issues in relation to VAT. The matters referred to in this letter are my opinion which takes account of specialist advice on fiscal neutrality issues from one of the Grade 6 VAT lawyers in my team and input from Ian Stewart the HMRC Director responsible for policy on VAT.

2. I understand that during the course of your Inquiry you have heard proposals recommending the use of VAT exemptions as a regulatory incentive. As requested, I am writing to provide HMRC's response to the proposals. As I understand the proposal, this involves establishing a self regulatory body for newspaper publishers. Only members of the body would be able to continue to benefit from the existing VAT zero-rate that applies to newspapers, magazines and other printed matter. Any publishers who did not sign up to the scheme would be required to apply VAT at the standard rate.

3. The main difficulty with the proposal is that it would contravene fiscal neutrality - a fundamental principle that underpins the VAT system. The principle of fiscal neutrality does not allow for similar products or services to be treated differently for VAT purposes.

4. Before focusing on the issue of fiscal neutrality, in order to understand the restrictions on the UK in terms of its freedom to determine the application and rate of VAT to the supply of goods and services, it will be helpful to the Inquiry for me to set out the background and context to VAT. This will necessarily be an over-simplification of the system to which many exceptions and special rules apply (which it is not necessary for me to set out in detail here).

Background to VAT

5. VAT is a European tax. The Treaty on the Functioning of the European Union ('TFEU') is widely drafted emphasising provisions for the free movement of persons, goods, services and capital as well as powers for the implementation of common policies in many areas of economic and social life. The TFEU regulates the internal market. Article 113 TFEU states that for the functioning of the internal market '*the Council shall, in conjunction with the European Commission, adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation*'.

6. In order to accede to the European Union a Member State must adopt a common system of value added tax. The Value Added Tax Act 1994 ('VATA') currently provides the main framework of VAT in the UK. VAT Directive 2006/112/EC (the Principal VAT Directive ('PVD') is currently the main source of Community Legislation in relation to VAT. The preamble to the PVD sets out, inter alia:

> *(4) The attainment of the objective of establishing an internal market presupposes the application in Member States of legislation on turnover taxes that does not distort conditions of competition or hinder the free movement of goods and services. It is therefore necessary to achieve such harmonisation of legislation on turnover taxes by means of a system of value added tax (VAT), such as will eliminate, as far as possible, factors which may distort conditions of competition, whether at national or Community level.*
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> *(5) A VAT system achieves the highest degree of simplicity and of neutrality when the tax is levied in as general a manner as possible and when its scope covers all stages of production and distribution, as well as the supply of services. It is therefore in the interests of the internal market and of Member States to adopt a common system which also applies to the retail trade...*

(7) The common system of VAT should, even if rates and exemptions are not fully harmonised, result in neutrality in competition, such that within the territory of each Member State similar goods and services bear the same tax burden, whatever the length of the production and distribution chain.

7. A national court is under a duty to give full effect to EU provisions (in this instance the PVD) and, if necessary to refuse to apply any conflicting provision of national legislation (*Amministrazione delle Finanze dello Stato v Simmenthal SpA*, Case C–106/77).

Application of VAT to supplies of goods and services

8. Articles 1 and 2 of the PVD provide:

Article 1

This Directive establishes the common system of value added tax (VAT).

The principle of the common system of VAT entails the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, however many transactions take place in the production and distribution process before the stage at which the tax is charged.

On each transaction, VAT, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of VAT borne directly by the various cost components.

The common system of VAT shall be applied up to and including the retail trade stage.

Article 2

The following transactions shall be subject to VAT:

the supply of goods for consideration within the territory of a Member State by a taxable person acting as such;...

the supply of services for consideration within the territory of a Member State by a taxable person acting as such;

9. These provisions are mandatory although there are many exceptions. The starting point is, therefore, that unless the PVD expressly requires or permits derogation from the general principle, VAT must be charged on all supplies of goods and services made by a taxable person for consideration. The PVD comprises 414 Articles and 12 annexes. It sets out in

detailed terms how the VAT system must operate. For example, the PVD defines what constitutes consideration, who a taxable person is, the time when supplies are deemed to be made, the place where supplies are deemed to be made, which supplies must be exempt from VAT, special schemes that must be applied to certain types of supplies, circumstances in which a supply must be deemed to be made etc.

10. VAT is a tax on the final consumer. Generally[1] a business will not bear the burden of any VAT that is charged on supplies made to it as the business deducts that VAT from the VAT it charges to its customers when accounting for VAT to HMRC. The Inquiry must therefore be aware that the direct effect of standard-rating newspapers supplied by non-members of the self-regulatory body will be that readers of those papers will have to pay 20% VAT on the price of the newspaper: the newspaper supplier will be affected insofar as it loses sales as the result of that effective price increase or, if the supplier absorbs some of the VAT cost, its profit margin will decrease giving rise to competition issues.

11. In general, the UK cannot unilaterally determine which supplies in the UK will be subject to VAT and which will not. The PVD does contain a number of provisions which are discretionary (and therefore Member States may in those limited circumstances determine whether or not certain supplies will be subject to a particular VAT treatment): but those discretions are generally circumscribed by the types of transactions that the exceptions or discretions apply to. There is no general discretion to apply VAT or relieve supplies from VAT available to a Member State.

12. However, under the PVD and pending full harmonisation of turnover taxes in the EU in the form of VAT, Member States have been permitted (until a definitive system is introduced) to, inter alia, maintain some zero-rates (referred to as exemptions with deductibility of the VAT) and some reduced rates and in some cases to continue to tax transactions which are exempt from VAT under the PVD. There is also a procedure whereby a Member State may apply for permission to introduce special measures for derogation from the provisions of the Directive but only in certain circumstances, namely to simplify the procedure for collecting VAT or to prevent certain forms of tax evasion or avoidance. The UK has a number of specific permitted derogations from the VAT system, for example, retail schemes to simplify the collection of VAT for retailers. In light of the mandatory nature of the VAT system it is not otherwise open to a Member State to derogate from the VAT system.

[1] The main exception is where a business makes supplies which are exempt from VAT. In those circumstances the business is in a similar situation to a final consumer.

UK's zero-rates

13. Maintenance of the UK's zero-rates is permitted pursuant to Article 110 of the PVD provided that the conditions set out in that article are met. Article 110 provides:

> *'Member States which, at 1 January 1991, were granting exemptions with deductibility of the VAT paid at the preceding stage or applying reduced rates lower than the minimum laid down in Article 99 may continue to grant those exemptions or apply those reduced rates.*
>
> *The exemptions and reduced rates referred to in the first paragraph must be in accordance with Community law and must have been adopted for clearly defined social reasons and for the benefit of the final consumer'.*

14. The UK has discretion to remove from its zero-rating provisions any items that it no longer wishes to apply the zero-rate of VAT to. Generally those supplies would then become subject to VAT at the standard rate.

15. *In Marks & Spencer plc v Revenue and Customs Commissioners* (Case C-309/06) the CJEU explained (at paras 23 and 24) that:

> *23 ...Community law does not require member states to maintain such exemptions. It is apparent from the actual wording of the original version of art 28(2) that the exemptions which were in force on 31 December 1975 'may be maintained', which means that it is for the member state concerned alone to decide whether or not to retain a particular piece of legislation... '*
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> *Article 28(2)(a) of the Sixth Directive can therefore be compared to a 'stand-still' clause, intended to prevent social hardship likely to follow from the abolition of exemptions provided for by the national legislature but not included in the Sixth Directive.'*

16. The UK's operation of its zero-rates must be in accordance with Community law. This means it is, in principle, open to the UK to remove a zero rate. However, this must be done in a way which is in accordance with EU law, and that imposes a significant constraint on the UK's freedom of action. It also leads to a risk that a removal of zero-

rating for some newspapers would lead to the whole newspaper industry losing zero-rating (I explain this further below).

Fiscal Neutrality

17. Although the UK is entitled to maintain zero-rates as set out above, as Article 110 makes clear, it must do so consistently with general principles of EU law. Those principles include the principle of fiscal neutrality.

18. The principle of fiscal neutrality is a fundamental principle which precludes treating similar goods, which are thus in competition with each other, differently for VAT purposes and treating similar economic transactions, which are therefore in competition with each other, differently for VAT purposes (see, for example, *EC Commission v Germany* (Case C-109/02) [2006] STC 1587).

19. The Advocate General in *Talacre Beach Caravan Sales Ltd,* Case C-251/05, set out the context for the application of the principle of fiscal neutrality with regard to maintained zero-rates:

> *'24. Article 28(2) (a)* [now Article 110 of the PVD] *of the Sixth Directive permits only the maintenance of national exemptions which are in accordance with Community law. This condition, expressly included in the Directive only in 1992, can only be understood as meaning that the national rules must be consistent with the requirements of Community law in other respects, thus inasmuch as art 28 does not itself permit derogations, as for example in the case of the rate of tax or the right to deduct.*
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> *25. The Court has power to examine whether the requirements of art 28 of the Sixth Directive are satisfied for the maintenance of corresponding national rules. In so doing, the intensity of its examination is restricted, in so far as Community law gives the member states some latitude, e.g. in regard to the determination of the social objectives pursued by an exemption. However, this restriction does not apply to the observance of Community law in other respects. Thus the Court of Justice has examined national exceptions also in regard to observance of the principle of tax neutrality.'*

20. The CJEU has very recently considered the application of the principle of fiscal neutrality in a UK VAT case – *The Rank Group Plc* (Joined Cases C 259/10 and C 260/10). The UK treated different types of machines used for gaming and betting differently for VAT purposes. A number of questions were referred to the CJEU for a preliminary ruling. The most relevant of which were:

> '1. Where a Member State in the exercise of its discretion under art 13B(f) of the Sixth VAT Directive subjected certain types of machines used for gambling ("Part III gaming machines") to VAT, while retaining exemption for other such machines (which included fixed odds betting terminals, "FOBTs"), and where it is contended that in so doing the Member State infringed the principle of fiscal neutrality: is it (i) determinative, or (ii) relevant, when comparing Part III gaming machines and FOBTs that
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> (a) FOBTs offered activities that were "betting" under domestic law (or activities that the relevant regulatory authority, for the purposes of exercising its regulatory powers, was prepared to treat as "betting" under domestic law) and
>
> (b) Part III gaming machines offered activities subject to a different classification under domestic law, namely "gaming"
>
> and that gaming and betting were subject to different regulatory regimes under that Member State's law relating to the control and regulation of gambling? If so, what are the differences between the regulatory regimes in question to which the national court should have regard?
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> 2. In determining whether the principle of fiscal neutrality requires the same tax treatment of the types of machine referred to in Question 1 (FOBTs) and Part III gaming machines, what level of abstraction should be adopted by the national court in determining whether the products are similar? In particular, to what extent is it relevant to take into account the following matters:
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> ... (b) that FOBTs could be played only on certain types of premises licensed for betting, which were different, and subject to regulatory constraints that were different from those applicable to premises licensed for gaming (although FOBTs and up to two Part III gaming machines could be played alongside each other in premises licensed for betting);...

21. The CJEU summarised the questions as follows:

> *37. By these questions, the referring courts seek, essentially to know whether or not, where there is a difference in the treatment of two games of chance as regards the grant of a VAT exemption under art 13B(f) of the Sixth Directive, the principle of fiscal neutrality must be interpreted as meaning that account must be taken of the fact that those two games fell into different licensing categories and were subject to different legal regimes relating to control and regulation.*

22. The CJEU held:

> *44. Two supplies of services are therefore similar where they have similar characteristics and meet the same needs from the point of view of consumers, the test being whether their use is comparable, and where the differences between them do not have a significant influence on the decision of the average consumer to use one such service or the other...*
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> *47. In addition, it follows from that judgment [Fischer], and from paras 29 and 30 thereof in particular, that the differences between public houses/bars and amusement arcades on the one hand, and licensed casinos on the other, as regards the setting in which games of chance are available, in particular the accessibility in terms of location and opening times and the atmosphere, are of no relevance to the question of the comparability of such games.*
>
> *49. It follows that the **differences in the legal systems relied** on by the referring courts **are of no relevance** to the assessment of the comparability of the games concerned.*
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> *50. That outcome is not called into question by the fact that, in certain exceptional cases, the court has accepted that, having regard to the specific characteristics of the sectors in question, differences in the regulatory framework or the legal regime governing the supplies of goods or services at issue, such as whether or not a drug is reimbursable or whether or not the supplier of a service is subject to an obligation to provide a universal service, may create a distinction in the eyes of the consumer, in terms of the satisfaction of his own needs (European Commission v France (Finland intervening) (Case C-481/98) [2001] STC 919, [2001] ECR I-3369, para 27, and R (on the application of TNT Post UK Ltd) v Revenue and Customs Comrs (Case C-357/07) [2009] STC 1438, [2009] ECR I-3025, paras 38, 39 and 45).*
>
> *51. Having regard to the foregoing considerations, the answer to question 1(a) in Case C-259/10 and to the first question in Case C-260/10 is that, where there is a difference in treatment of two games of chance as regards the granting of an exemption from VAT under art 13B(f) of the Sixth Directive, the principle of fiscal neutrality must be interpreted as meaning that **no account** should be taken of the fact that those two games **fall into different licensing categories and are subject to different legal regimes relating to control and regulation.*** (emphasis added)

23. The Inquiry will note from the part of the judgement I have emphasised that different legal regimes or different systems for control and regulation are (unless exceptional circumstances apply) of no relevance when assessing whether or not supplies of products or services are similar.

24. In the case of *Fischer v Finanzamt Donaueschingen* (Case C-283/95) the CJEU considered whether or not the difference in treatment for VAT purposes between the lawful and the unlawful operation of games of chance breached the principle of fiscal neutrality. The wording of the relevant provision in the Directive provided that gambling is in principle to be exempted from VAT. There was a discretion afforded to Member States to lay down the conditions and limitations of that exemption. The CJEU referred to the principle of fiscal neutrality as precluding a generalised distinction between the levying of VAT between unlawful and lawful transactions. In the *Fischer* case the Member State had provided that lawful games of chance were to be exempt from VAT whereas unlawful games of chance were subject to VAT. The court held:

> *22. ...Since the unlawful transactions at issue in the main proceedings are in competition with lawful activities, the principle of fiscal neutrality precludes their being treated differently as regards VAT...*
>
> *31. The answer to the first question must therefore be that the unlawful operation of a game of chance, in the event roulette, falls within the scope of the Sixth Directive. Article 13B(f) of that directive must be interpreted as meaning that a member state may not impose VAT on that activity when the corresponding activity carried on by a licensed public casino is exempted.*

25. The case of *JP Morgan Fleming Claverhouse Investment Trust plc and another v Revenue and Customs Commissioners* (Case C-363/05) was referred to the CJEU for a preliminary ruling. The UK distinguished between the management of an authorised unit trust scheme ('AUT'), the management of the scheme property of an open-ended investment company ('OEIC') and the management services supplied to an investment trust company ('ITC'). AUTs and OIECs were exempt from VAT whereas ITCs were subject to VAT at the standard rate. The UK sought to distinguish the investments on the basis that, unlike AUTs and OEICs, ITCs are not subject to authorisation by the Financial Services Authority under the Financial Services and Markets Act 2000 and that the management of AUTs and OEICs must be entrusted to an external manager, while ITCs have a board of directors which is empowered to manage investments. The

Advocate General set out the CJEU has frequently held that the identity of the manufacturer or the provider of the services and the legal form by means of which they exercise their activities are, as a rule, irrelevant in assessing whether products or services supplied are similar. At Paragraph 39 the Advocate General explained:

> *39. Those formulations each emphasise different aspects: in some cases* ***equal treatment for economic operators*** *and in others equal treatment for the services supplied by them. However, they are based on the same understanding of the principle of neutrality...'*

26. The CJEU held:

> *46. Second, the principle of fiscal neutrality, on which the common system of VAT established by the Sixth Directive is based,* ***precludes economic operators carrying out the same transactions from being treated differently in relation to the levying of VAT.*** *That principle does not require the transactions to be identical. According to settled case law that principle precludes, in particular, treating similar goods and supplies of services, which are thus in competition with each other, differently for VAT purposes*

27. The Inquiry will note, from the points I have emphasised in the judgement, that the principle of fiscal neutrality requires suppliers of the same products to be treated equally (unless a difference in treatment is permitted by the Directive).

28. In summary, the UK must observe the principle of fiscal neutrality in its operation of its zero-rating provisions. Where economic operators, and the supplies made by them, are the same or similar from the point of view of a consumer, the principle of fiscal neutrality requires the UK to apply the same treatment. The UK can only apply a different treatment where permitted by the Directive.

29. Applying the principle of fiscal neutrality to the proposal I am asked to consider, in HMRC's view the activity at issue (that is the supply of newspapers) is likely to be similar whether supplied by a member or by a non member of a self regulating body. HMRC therefore considers that, if the proposed change was challenged on the grounds of fiscal neutrality - either by a business in the UK through the UK courts or by the European Commission (which has power to bring proceedings against Member States for non-compliance with EU law before the CJEU) - it is highly likely that such a challenge

would be successful. As I noted above, the CJEU rejected the argument in the *Rank* case that the different legal and regulatory regimes are factors that should be taken into account: the only exception is where such differences make products so dissimilar in the eyes of the average consumer, in a way that has a significant influence on the consumer's decision to buy one type of newspaper rather than the other. I find it difficult to imagine that any court would accept that, as far as the average consumer was concerned, the difference between a newspaper within the self-regulatory system and a newspaper outside that system would be so great as to have a significant influence on the consumer's buying decision.

30. Finally, there is a significant risk here which I should draw to the Inquiry's attention. As I said above, the UK is permitted only to maintain its zero-rates, not to extend them. Once a zero-rate has been withdrawn (for example in this case from non regulated suppliers of newspapers) it cannot be re-instated. So if the United Kingdom adopted this proposal, but then (perhaps as a result of legal proceedings brought by newspapers on which VAT was then imposed) the different treatment was found to contravene the principle of fiscal neutrality, the UK would not be permitted to reinstate the zero-rate for non regulated newspapers. In order to adhere to the principle of fiscal neutrality the UK would be required to withdraw the zero-rate from the regulated newspapers so that the similar supplies were subject to the same tax treatment. There is, therefore, a significant risk of losing the zero rate for the newspaper industry altogether.

Additional factors in considering the VAT proposals

31. The Inquiry has asked HMRC to identify what additional factors would need to be considered before the Inquiry could make any recommendation on the VAT proposals which have been put to it by parts of the newspaper industry. Given we believe the VAT framework and fiscal neutrality issues are determinative of the issue, we have not undertaken a detailed analysis or consideration of these additional factors. The Inquiry has nevertheless asked HMRC to highlight what additional factors we believe would be relevant were a fuller consideration of the proposal necessary.

Fairness to taxpayers

32. As is well known, HMRC is under a duty at common law to act fairly towards the general body of taxpayers, and towards each individual taxpayer.

33. One issue raised here is that the tax treatment of a particular newspaper would be governed by a non-statutory self-regulatory body. The body would need to have processes and procedures in place to ensure the overall fairness of the treatment of the newspapers given that this would have tax consequences for them. HMRC would not want to be put in a position where it has to separately reach its own assessment on whether a newspaper is properly being excluded from the preferential VAT treatment; but on the other hand, HMRC cannot fetter its discretion when implementing decisions of the self-regulatory body if substantial issues of fairness are raised.

34. The risk here, as we see it, is that HMRC, and therefore a part of the Government, could become involved in a legal challenge to a decision of the regulatory body if the VAT proposals were pursued. This would be linked to altering the VAT treatment of the affected newspaper, whether this was achieved through legislation or done administratively.

European Union law

35. The VAT proposals put to the Inquiry by industry as part of any new regulatory system would also need to be more generally EU-law compliant to the extent that they have the potential to affect cross-border situations. To illustrate this, I have briefly considered the position of: (1) state aid and (2) freedom of establishment.

36. First, state aid issues rarely arise in the VAT context because the Principal VAT Directive sets the framework for VAT within the European Union. However, putting that general point aside, in this case, consideration would need to be given as to whether differences in VAT-treatment could amount to an illegal state aid within the broader terms of EU-law. This would be on the basis that tax measures can constitute the use of state resources for state aid purposes.

37. A state aid is financial aid to a business within the terms of Article 107 of the Treaty on the Functioning of the European Union. The criteria which need to be met for there to be a state aid are the following:

    (a) Aid is provided by the State or through State resources.
    (b) The aid favours certain undertakings, or the production of certain goods.
    (c) The aid distorts, or threatens to distort competition.
    (d) The aid affects trade between Member States

38. This would require a detailed analysis of the framework being proposed as this emerges and whether the regime differentiates between economic operators who are in a comparable factual and legal situation.

39. The risk would be that a newspaper that falls outside the regulatory system, or the European Commission, might seek to argue that the differential VAT treatment amounts to a state aid. If it did amount to state aid, then (unless it had been previously cleared by the European Commission) the consequence would be that any newspaper benefitting from the aid (i.e. newspapers within the regulatory system) would be liable to "repay" that aid (i.e. pay the amount of VAT that would have been due had it been imposed on them) to HMRC.

40. Second, the regulatory system will need to be consistent with the fundamental freedoms; the most relevant freedom here being the principle of freedom of establishment contained in Article 49 of the Treaty on the Functioning of the European Union. This is the freedom of an entity to seek permanent establishment in another member state in order to pursue economic activities. In Gebhard (Case C-55-94) the ECJ stated that freedom of establishment extends to preclude national measures that are liable to hinder or to render less attractive the exercise of the freedom, even if the measures do not directly discriminate on grounds of nationality.

41. Where this is the case, the restrictive measure may be objectively justified if it is –

(a) Applied in a non discriminatory manner;
(b) Justified by imperative or overriding requirements in the general interest;
(c) Suitable for securing the attainment of the objective it pursues; and
(d)Proportionate (that is, it does not go beyond what is necessary in order to achieve the objective).

42. The VAT proposals which have been put to the Inquiry will engage Article 49 to the extent they could hinder or discourage a newspaper from another member state from establishing a base in the UK.

Human Rights

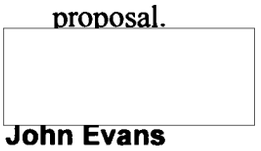
43. Finally, the proposed difference in VAT treatment would require legislation and the Government would have to be satisfied that the legislation is human rights compliant. In this case, to the extent it would represent an interference with the right to freedom of expression contained in Article 10 of the European Convention on Human Rights, there would be a need to show that the proposals met a legitimate aim and are proportionate.

Compliance costs

44. In addition to the legal issues set out above, the Inquiry should note that this proposal would increase compliance costs – in other words the costs to business of complying with the VAT regime - for newspaper publishers, wholesalers and retailers. For example, some small businesses that currently sell newspapers do not have to register for VAT as their turnover is below the VAT registration threshold. This proposal is likely to lead to a number of them having to register for VAT. Another example is that, whenever a newspaper joined or ceased to be a member of the regulatory body, all the businesses in the supply chain would have to be notified and would have to amend their accounting systems and re-programme their tills to ensure that the correct VAT rules are being applied. Depending on the frequency of changes to the membership of the regulatory body, there could also be concerns about complexity and the risk that newsagents and others would be applying the wrong VAT rate to newspapers which they sell.

Conclusion

45. In summary it is my view that the principle of fiscal neutrality is likely to be breached if VAT at the standard rate were applied to supplies of some newspapers and not others. There is a danger that the zero-rate might be lost for all supplies of newspapers if the zero-rate is removed from supplies made by non-regulated suppliers and subsequently the difference in treatment was found to amount to a breach of the principle of fiscal neutrality. As outlined above there are also other factors that the Inquiry may wish to take into consideration in reaching its conclusions and recommendations in respect of the proposal.



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