

VAT Treatment of Nonprofits and Public-Sector Entities

By Pierre-Pascal Gendron

Pierre-Pascal Gendron is a professor of economics at the Business School of Humber College Institute of Technology & Advanced Learning in Toronto, Canada.

This essay examines the treatment of nonprofit and public-sector entities under a stand-alone U.S. federal VAT based on the credit invoice method and the destination principle.¹ The following definitions are used: Nonprofit entities include nonprofit organizations, charities, nongovernmental organizations, and other tax-exempt entities; public-sector entities encompass federal, state, and local governments, including all agencies and corporations.

Because many nonprofit entities qualify for an income tax exemption in the United States, it is important to clarify at the outset that a parallel exemption need not be the case a priori under VAT. With some important exceptions, the supplies (that is, sales of goods or services) rendered by nonprofit and public-sector entities under many VAT regimes around the world are generally exempt. That means those entities don't charge VAT on supplies, but they aren't entitled to a deduction or credit for VAT paid on purchases of goods and services necessary to deliver the supplies. For clarity here, supplies are often called outputs, while purchases are called inputs.

Under the alternative treatment — full taxation under a VAT — the supplies made by nonprofit and public-sector entities would generally be taxable like those made by any other business. Under the credit invoice method VAT, taxable supplies give rise to the right to deduct VAT paid on purchases incurred to render taxable supplies. There is no inconsistency between the VAT and

¹This essay draws on Pierre-Pascal Gendron, "How Should the United States Treat Government Entities, Nonprofit Organizations, and Other Tax-Exempt Bodies Under a VAT?", 63 *Tax L. Rev.* (2: 2010), pp. 477-508.

income tax treatment of such entities — that is, full taxation under the VAT is fully consistent with exempt status under the income tax. The former simply implies that VAT-registered entities in the nonprofit and public sectors (like VAT-registered businesses in any other sector) simply act as VAT collection agents for the government. Assuming away exemptions, and assuming that all participating entities are VAT-registered, nonprofit and public-sector entities would ultimately pay no VAT on inputs. Only final consumers and other nonregistered persons bear the burden of VAT in the end.

Evaluation Criteria and Best Practices

There are important departures from the full taxation model in traditional VAT regimes like those in place in the European Union. The VAT systems in Australia and New Zealand feature much broader bases; supplies made by entities in the nonprofit and public sectors are in most cases taxable, and entities are essentially treated just like any other business supplier. That is one reason why the VAT regimes of those two countries are sometimes referred to as a modern VAT, as distinguished from the European-style traditional VAT.

Canada's VAT provides an interesting middle ground between those two models. While many supplies rendered by nonprofit and public-sector entities are exempt in Canada, some or all of the VAT incurred in the course of rendering exempt supplies is rebated later by the tax authorities.

As has been shown elsewhere,² there are no convincing conceptual or practical arguments to remove the activities of the nonprofit and public sectors from the VAT base. Arguments concerning income distribution, social objectives, or the difficulty of taxing the sectors don't survive scrutiny when it comes to VAT. From the perspectives of efficiency, equity, and simplicity, the argument for full taxation is strong.

²Most recently, *supra* note 1.

VAT systems in developed countries are a stable revenue source and can produce significant revenue if designed appropriately. For purposes of comparison, this discussion will focus on the distinction between exemption and full taxation of the sectors.

Revenue Needs and Neutrality

The exemption of nonprofit and public-sector entities in most countries breaks the VAT chain at the level of the supplier, meaning the nonprofit or public-sector entity becomes the last unit in the chain. Those entities are thus treated as if they were the final consumers of the supplies.

Like a true final consumer, the entity must absorb the VAT paid on purchases. In that situation, the VAT allows for revenue collection by falling on inputs, resulting in the same economic inefficiencies of a traditional retail sales tax. This sacrifice of revenue can be important because the services rendered by the public sector tend to be income elastic. Treating the supplier as the final consumer is also inconsistent with the overall concept of a broad-based consumption tax.

Also, if the goods and services provided by nonprofit entities or, especially, public-sector entities must compete with those provided by the private sector, private-sector entities may face unfair competition if they absorb VAT on purchases while public-sector entities can obtain funding from general government revenue that would cover VAT on purchases. Either way, the entity shifts the nondeductible VAT forward into higher prices or cuts profit. Competition between the public and private sectors would also be distorted if goods and services are exempt when supplied by the former but taxable when supplied by the latter. Again, the private sector will shift the tax forward or backward.

Two more problems arise with exemption. First, entities that make exempt supplies have an incentive to self-supply services internally, as they will not incur VAT on in-house labor services (because labor is untaxed under VAT), while they would incur VAT only if they were to outsource services. This is because outsourced services would generally be taxable. The exemption

is thus seen as penalizing outsourcing and reducing cost savings. In other words, exemptions distort production decisions.

The second problem is that exemptions of some goods and services often result in more exemptions to level the playing field. This has been referred to as exemption creep. VAT systems tend to evolve by increasing the number of exemptions beyond the initial list.³ The non-neutralities are eliminated when supplies made by nonprofit and public-sector entities are treated like any other supplies, as they are under New Zealand's VAT.

Ease of Administrability

Exemptions raise thorny compliance and administrative issues. They require detailed classifications of goods and services so that VAT registrants and tax administrations can distinguish between exempt and taxable supplies. Also, registrants that make a combination of exempt and taxable supplies (like a hospital that delivers exempt medical services and taxable cafeteria or laundry services) must use allocation methods to apportion the VAT paid on purchases between exempt and taxable supplies. This apportionment is difficult and open to manipulation.

In Canada, nonprofit and public-sector entities eligible for the public services rebate must complete application forms that specify different rebate rates depending on the nature of the entity's activities, sector, and province of operation. All of this complicates the job of both the registrants and the tax administration and increases compliance and administrative costs. Those costs can be minimized by minimizing the number of exemptions, which the full taxation model does best.

Another advantage of the full taxation model is that it keeps the VAT chain intact all the way to the final consumer or nonregistered person. Breaks in the VAT chain facilitate evasion and complicate compliance and administration. With an intact VAT chain, coordination of taxpayer audits is also increased

³For a review of some international experiences, see Richard M. Bird and Pierre-Pascal Gendron, *The VAT in Developing and Transitional Countries* (New York: Cambridge University Press, 2007), chap. 7.

through easy cross-checking of revenue and expense figures in VAT and income tax returns. The credit invoice VAT method produces a good paper trail.

Equitable Treatment

Because the burden of the VAT under the full taxation model falls on the final consumer and nonregistered persons, registered businesses and registered nonprofit and public-sector entities should not, in principle, bear any tax. Tax preferences such as the widespread exemption of the supplies of nonprofit and public-sector entities and other sectors often lead to inequitable results. Again, this is especially true when the private and public sectors compete in supplying similar goods and services and private-sector supplies are taxable while public-sector supplies are not.

Under full taxation, supplies rendered by public-sector, nonprofit, and charitable entities that receive no grants would be treated like private goods supplies rendered by the private sector — the VAT would apply to the full amount of consideration. If grants are received by nonprofit and public-sector entities, and if the grants are linked directly to the supply of private goods by those entities, then the correct treatment for VAT requires an adjustment to the VAT base as follows. Grant amounts (on a per-unit basis) must be added to the consideration charged before calculating the VAT due. The purpose of this adjustment is to prevent an unfair price advantage for entities that receive grants over those that do not. Because public-sector, nonprofit, and charitable organizations often receive grants, this treatment ensures equality of treatment between the private sector and those entities.

For nonprofit entities and especially charities, the appeal of full taxation is that all VAT paid on purchases is credited. If an entity makes no taxable supplies during a given period, it should be entitled to a refund of its accrued VAT credits. That is important for entities that depend mostly on outside funding or donations to operate. The New Zealand VAT model is particularly straightforward in this respect since it treats all such entities as any other

registered business, although some minor administrative concessions (simplified accounting methods and lighter filing requirements) are available to ease the compliance burden of nonprofits and charities.

The VAT system is not a suitable mechanism to directly affect income redistribution or achieve social objectives. The primary objective of VAT is to raise revenue efficiently. Other mechanisms such as government transfers and expenditure policies are available to achieve distributional or social goals. The VAT is one of the most efficient taxes. Full taxation must be seen within the broader context of government and third-party funding of nonprofit entities and charities. Full taxation does not provide additional funding (via credits or refunds), but ensures neutral treatment of all entities subject to VAT, in accordance with the internal logic of VAT. Likewise, it is far from clear that exemptions benefit suppliers in the first place; they often don't and even entail larger economic costs.

Special Features

Nil Consideration

Public-sector and nonprofit entities are sometimes involved in the supply of goods and services that are rendered to final users free of charge. In the public sector, examples of nil consideration include the supply of goods and services by governments in situations when it is not feasible to price the supplies. Typically this involves supplies for which there is little or no competition by the private sector. On the nonprofit side, for example, a church may collect donations both in cash and in kind and supply free clothes or toys to needy households. This raises the question of how to treat those supplies.

Conceptually, the proper VAT treatment of supplies made for nil consideration is to credit and refund all VAT incurred on purchases made by the supplier. Multiplying the positive VAT rate by a nil consideration yields zero revenue. This results in the same outcome as if the supplies were zero rated. (No VAT gets charged when supplies are zero rated and exempt, but a fundamental difference remains in that VAT on purchases gets credited when supplies are zero rated but not when they are exempt.) The

mere transfer of funds by nonprofits and charities would not, in and of itself, be subject to VAT. The tax applies when value-added is created.

Government-to-Government Transactions

Under a strict interpretation of the full taxation model, a public-sector entity providing taxable supplies to another public-sector entity would charge VAT on the supplies. To the extent that the recipient of the supplies is engaged in making taxable supplies itself, it would be allowed to obtain credit for VAT paid. It's clear, in the narrow example of supplies from one federal government agency to another, that those transactions will not be revenue productive.⁴ Charging VAT on such transfers is nevertheless desirable because it simplifies compliance and tax administration by minimizing exemptions and keeps the VAT chain intact so that goods and services that would ultimately reach final consumers would properly bear the VAT.

The Canadian system illustrates the flexibility that is possible under the VAT. The federal government is considered a single entity for purposes of the goods and services tax/harmonized sales tax, the Canadian VAT. The single entity includes all departments, branches, Crown corporations, and agencies. The federal government pays GST/HST on its taxable purchases and charges GST/HST on its taxable supplies. One important benefit of this system is that it greatly simplifies compliance for private-sector entities that deal with the federal government.

Transactions involving provincial governments are conducted in two ways. Some provinces have elected to pay GST/HST on their taxable purchases, while others do not pay GST/HST on their taxable purchases if they provide certification that the purchases were made with government funds. Under a federal-provincial arrangement with Québec — which has its own subnational VAT called the Québec sales tax (QST) — the federal government and its agencies and corporations are not required to

⁴This point was recently made by Richard M. Bird and Pierre-Pascal Gendron, "Sales Taxes in Canada: The GST-HST-QST-RST 'System,'" 63 *Tax L. Rev.* (3: 2010), pp. 517-582.

pay QST on their purchases, but the Québec government and its agencies and corporations must collect GST and QST on their taxable sales.

In the case of government agencies that make no taxable sales, it is possible to think of a system in which the agency is exempted from paying VAT on any purchases, possibly based on a certification model. This is akin to suspending VAT. From an administrative perspective, however, it is preferable for governments to pay VAT on taxable purchases and charge VAT on taxable supplies. Otherwise, complexity arises as government agencies and corporations need to be classified as taxable or outside the scope of VAT. In the European Union, public-sector activities that aren't subject to VAT have led to considerable complexity and litigation.

States as Taxable Persons

According to the Canadian Constitution and federal-provincial arrangements, the federal government of Canada can require provincial and municipal governments to collect the GST/HST on its behalf. In the United States, constitutional limitations would prevent the federal government from requiring state governments to collect a federal VAT on its behalf.⁵ This limitation is serious, but it is narrower than it first appears for two reasons.

First, it would apply only to state and local governments (including their agencies). It would not appear to nonprofit and charitable organizations as long as they are not the responsibility of state or local governments. In principle, therefore, supplies made by such entities and the federal government could be subject to the full taxation model under VAT.

Second, state and local governments could be given the option to collect the VAT. If they do so, their supplies would be taxable, and the VAT paid on purchases made to render those supplies would be creditable. A local government that elected to collect the tax would pay VAT on purchases of city vehicles, but that

⁵For a more detailed discussion, see Gendron, *supra* note 1.

VAT would be deducted from the VAT collected on local user fees and the proceeds from sales of goods in determining net VAT due.

If state and local governments refuse that option, their supplies would simply be exempt. No VAT would be charged on supplies, but VAT paid on purchases would not be creditable or refundable. As shown elsewhere, the existence of distinct state VATs is unnecessary for the solid functioning of a federal VAT with or without the option to collect the tax.⁶

Lessons for the United States

The economic and administrative case for full taxation under VAT of supplies made by public-sector, nonprofit, and charitable entities is strong. The system used in Australia and New Zealand is the best alternative. Under it, essentially all goods and services supplied by the sector are treated like any supplies from the private sector. There are few instances of zero rating or exemptions.

If the United States adopted a federal VAT, it would be well advised to get the design correct from the start and subject the public and nonprofit sectors to VAT, like under the Australia-New Zealand model, and ensure that the VAT system provides for the full taxation of those sectors (and others) as much as possible. ■

⁶Bird and Gendron, *supra* note 4.