



## VAT on postal services

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Under EU law common criteria are set for the VAT base in all Member States: that is, the goods & services which are liable to VAT. As part of this agreement, public postal services are VAT-exempt. In 2003 the European Commission published proposals to amend these rules, which, if adopted, would have required state-owned mail operators – the Royal Mail included – to charge VAT on stamps and other services they provide.<sup>1</sup> At the time the Government's position was that it was “opposed to VAT on stamps” and “would make this clear in negotiations on the proposals.”<sup>2</sup> The Commission published an amended draft directive in July 2004;<sup>3</sup> this retained the provision to charge VAT on stamps – and on these grounds was opposed by the UK.<sup>4</sup> In the next few years no substantive progress was made on these proposals because many Member States strongly objected to VAT on these supplies – leading to a recent decision by the Commission to withdraw the draft directive.<sup>5</sup> This note looks at the current VAT-exemption for public postal services in EU VAT law, before discussing the debate over reforming these rules, and some minor changes that have been made to the scope of the VAT exemption in UK VAT law. A second Library note discusses the separate, if related issue of the privatisation of Royal Mail.<sup>6</sup>

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<sup>1</sup> COM(2003) 234 final, 5 May 2003

<sup>2</sup> HM Customs & Excise explanatory memorandum, *Commission proposal COM(2003)234*, 19 May 2003 para 9

<sup>3</sup> COM(2004) 468 final, 8 July 2004

<sup>4</sup> European Scrutiny Committee, *Thirtieth report*, 22 September 2004 HC 42-xxx 2003-04 pp 6-7

<sup>5</sup> European Scrutiny Committee, *Thirteenth report*, 2 November 2012, HC 86-xiii 2012-13 pp193-4; European Commission, *Official Journal*, OJ C109/8, 16 April 2013.

<sup>6</sup> [Privatisation of Royal Mail](#), SN6668, 21 June 2013

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## 1 EU VAT law & postal services

VAT is charged on the supply of all goods and services made in the course of a business by a taxable person, unless they are specifically exempt. In the UK VAT is charged either at the basic rate - currently 20% - or the zero rate, though there is limited use of a reduced rate of 5%.<sup>7</sup> All businesses must register for VAT if their turnover of taxable supplies exceeds a set threshold, which is currently £79,000.

VAT is charged on the additional value of each transaction, and is collected at each stage of production and distribution. A business pays VAT on its purchases - known as input tax, and charges VAT on its sales - known as output tax. It will settle up with the tax authorities for the difference between the two. In the end the cost of the tax is borne by the final consumer. Exempt supplies should be distinguished from those charged a zero rate of VAT. In the latter case, these supplies are technically taxable, and though no actual tax is paid on them, they still count as part of a business' taxable turnover. VAT charged on inputs relating to zero-rated activities can be reclaimed, unlike the VAT incurred by a business in the course of an exempt activity.

European VAT law plays a major part in determining the goods and services which can be tax free and the rates which can be charged. Though the first steps toward harmonising the VAT systems of Member States were taken in the late 1960s, it was the sixth VAT directive (77/388/EEC), adopted on 17 May 1977, which marked a turning point in establishing common criteria for the VAT base across the EU (ie, specifying those goods and services which could be exempted from tax). Article 13 to the directive set out a series of supplies which Member States were *required* to exempt from VAT, including public postal services.<sup>8</sup> Agreement on harmonising VAT rates was reached in 1991, though it remains a contentious issue.<sup>9</sup> It should be noted that any amendment to these rules – as with any VAT directive – must be agreed *unanimously* between the Member States.<sup>10</sup>

In November 2006 a new principal EC VAT directive (2006/112/EC) consolidated these provisions; Article 132 of the directive establishes that certain activities in the public interest will be VAT-exempt, including, “the supply by the public postal services of services other than passenger transport and telecommunications services, and the supply of goods incidental thereto.” This provision is incorporated in UK law under group 3, schedule 9 of *VATA 1994*, as amended.<sup>11</sup>

## 2 EU proposals for VAT on postal services

The current EU VAT-exemption for postal services does not cover the provision of postal services by private companies. In recent years postal services across the EU – the UK included – have seen some degree of market liberalisation, with a number of private

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<sup>7</sup> principally, the supply of domestic fuel and power, the installation of energy saving materials, women's sanitary products, children's car seats and certain types of construction work. HM Revenue & Customs' site has a basic description of the tax at: <http://www.hmrc.gov.uk/vat/start/introduction.htm>

<sup>8</sup> The provisions for exempting certain supplies from VAT are transposed into UK law by schedule 9 of the *VAT Act (VATA) 1994*.

<sup>9</sup> Only minor amendments to this agreement have been agreed subsequently. For details see, *VAT : European law on VAT rates*, Library standard note SN2683, 9 October 2012.

<sup>10</sup> The Treaty base for all proposals to harmonise excise duties and turnover taxes is Article 113 of the Treaty.

companies providing competing services to traditional national suppliers.<sup>12</sup> It was in this context that the European Commission first proposed removing the exemption for public post authorities, as part of a wider strategy to improve the VAT system published in June 2000:

Public postal authorities are increasingly operating in competitive markets and competition would inevitably be distorted if only the public sector were exempted from VAT. This situation is hardly justifiable, and regular complaints have been received from operators. Some Member States have already opted to tax their postal services which are now privatised and this has led to problems with other countries whose public postal services are still exempt. This shows that the principle of neutrality, which is at the heart of the common VAT system, is no longer being observed in this sector. Amending the Sixth Directive to make postal services liable to VAT would therefore help to modernise the taxation system. The Commission will present a proposal for a Directive on postal services by the end of June.<sup>13</sup>

However, the Commission did not publish a formal proposal until May 2003; a press notice issued at this time gave some background to the Commission's decision to do so:

Postal services were made VAT exempt from the introduction of the VAT system in the 1970s for two reasons. First, they were seen as part of the state-funded activities in the public interest for which the VAT system has always included a series of exemptions. Furthermore, when the VAT system was established, the postal sector was characterised by monopolies and a limited range of services that were not subject to any competition.

A basic principle of the European Community VAT system set out in the Sixth VAT Directive (77/388/EEC) is that each business in the chain charges the tax on the supply that he makes and deducts the tax on the supply that he receives. This means that a business that is exempt from VAT charges no VAT on its supplies but cannot deduct VAT on its costs. Since national postal operators now conduct business in markets that are subject to competition, the fact that the VAT exemption is limited solely to them inevitably distorts that competition. This situation, which is increasingly hard to justify, regularly gives rise to complaints on the part of both private and national operators. Increasing liberalisation in the sector increases the incidences of distortion.

It went on to summarise the content of this proposal as follows:

Under present VAT rules, traditional national suppliers of postal services are exempt from VAT. Consequently, these operators cannot deduct the VAT that they incur on their expenses such as vehicles, fuel and equipment. These expenses must then be passed on to their customers as part of the price charged for their services in the form of "hidden VAT". Meanwhile, the postal services provided by private operators are liable to VAT so the operators can deduct any VAT incurred on their expenses. Business consumers of postal services can deduct the VAT charged by the private operators but cannot deduct the "hidden" VAT included in the national suppliers' prices. This situation causes distortions in a market in which the two types of operators are increasingly in competition. At present approximately 80% of the total postal services provided in the EU are to the business sector.

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<sup>11</sup> For a basic description see, HMRC, *VAT Notice 700/24: Postage and delivery charges*, April 2003.

<sup>12</sup> Details on EU-wide developments to liberalise postal markets are collated on the Commission's site at: [http://ec.europa.eu/internal\\_market/post/legislation\\_en.htm](http://ec.europa.eu/internal_market/post/legislation_en.htm)

<sup>13</sup> *A strategy to improve the operation of the VAT system within the context of the internal market* COM(2000) 348 final, June 2000 p9.

The proposal would, first, remove the current VAT exemption for postal services and postage stamps supplied by traditional national operators. This would mean that VAT would be charged on the value added by a national operator when making a supply of postal services but it would also mean that a national operator could for the first time deduct the VAT incurred on his costs. Thus, while customers would in future pay VAT on the value added by the postal services operators, they would no longer pay the "hidden" VAT incurred on the operators' costs. The fact that the operators would be able to deduct their costs should mitigate price increases as far as private consumers are concerned. The proposed change would be advantageous for business consumers because they would be able to deduct the VAT incurred on postal services supplied by traditional national operators.

Second, in order to minimise further any possible impact that the removal of the VAT exemption for public postal services might have on postal costs for private consumers, the proposed Directive would give Member States the option of applying a reduced VAT rate to the standard postal services. These standard postal services (addressed letters and packets no heavier than 2 kg.) comprise the services most frequently used by private consumers and include regular and first class/priority mail as well as recorded and registered items. They would also include direct mail, books, catalogues, newspapers and so on, provided that they have been addressed to a named person. The total VAT levied on a postal operator's sales at a reduced rate would not be significantly different from the VAT at the standard rate recouped on his costs. Packages greater than 2 kgs. and nonstandard services (such as express mail and courier services) would be subject to the standard VAT rate.<sup>14</sup>

The Commission also published a list of 'frequently asked questions', in which it argued that the end of this VAT-exemption would *not* lead to an increase in prices:

**If VAT is added to postal services, would prices go up?**

No, there should be no major price increases. First, if traditional national operators are required to charge VAT on their sales they would also have the right to reclaim VAT on their expenses such as equipment, fuel and vehicles. Operating costs would therefore decrease. Increasing use of technology in the postal sector, in particular, means that postal operators currently pay large sums of VAT so the benefit of being able to deduct those costs would be great and they would no longer have to pass them on to consumers as hidden VAT.

Second, the proposed Directive would give Member States the option to introduce a reduced VAT rate for the standard postal services used by private consumers. The amount of VAT charged on a postal operator's sales at a reduced rate would not be significantly different to the amount of VAT at the standard rate reclaimed on his expenses which is currently passed on to consumers. Third, as far as businesses are concerned, most businesses can reclaim VAT paid so they would be better off as a result of the proposal. In principle prices should come down for them because there would be no more hidden VAT.<sup>15</sup>

In response, Postcomm – the independent regulator of the Post Office at this time – issued a short press notice, which also suggested this change would not necessarily lead to the price of stamps going up:

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<sup>14</sup> European Commission press notice IP/03/633, 6 May 2003

<sup>15</sup> European Commission, *VAT on postal services: frequently asked questions Memo/03/98*, 6 May 2003

The European Commission has published a draft directive which, if agreed by member states, would require VAT to be charged on mail services. However, it is important to remember that Royal Mail cannot currently reclaim VAT that it pays on the services it buys from other companies. Also, the draft directive allows VAT to be charged at a reduced rate. Therefore, if the UK were to charge VAT at around 5%, we believe that this would largely cover the VAT that is currently paid by Royal Mail, so, contrary to the initial press reports, it should not be assumed that stamp prices would have to rise. It seems most unlikely that the UK Government will agree to impose VAT at the full 17.5% and so increase stamp prices by several pence and this is not a course of action that we consider would be in the customers' best interests.<sup>16</sup>

However, the Labour Government strongly opposed removing the exemption; it set out its view of the draft directive in an explanatory memorandum published HM Customs & Excise:

The Government is opposed to VAT on stamps, and will make this clear on negotiations on the proposals. The Government is fully committed to further opening of the postal services market, in the interests of consumers, and supports the fair tax treatment of all players in the market. At the same time, it is important to recognise the important social role played by the universal service (provided exclusively by Royal Mail), and it is justifiable for the tax system to reflect this.<sup>17</sup>

The Government's opposition to VAT on stamps was also set out by the then Prime Minister, Tony Blair, at this time.<sup>18</sup>

In October 2003 the European Scrutiny Committee considered the draft text, and an impact assessment prepared by the department:

This Regulatory Impact Assessment notes that "Accurate and detailed estimates of the potential financial implications of the proposal for postal operators and customers are not possible at this time given the number of variables, including the optional basis of some of the proposed provisions."

But it gives some indication of likely consequences, noting that:

- Royal Mail might be able to recover VAT sufficient to allow a net price reduction of between 2.1 and 2.6% without affecting its margin;
- on the same assumptions currently exempt customers able to recover VAT would pay less for postal services, whilst those unable to do so would pay more; and
- tax revenues could increase by between £34 million and £375 million.

The Regulatory Impact Assessment also says that the Government is receiving comments on the draft Directive from stakeholders and the option of a formal consultation is being kept open in the light of possible alternative proposals, and that the effect of the draft Directive on competition in the UK cannot yet be assessed.<sup>19</sup>

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<sup>16</sup> Postcomm press notice, *VAT on Stamps?*, 7 May 2003

<sup>17</sup> HM Customs & Excise, *Commission proposal COM(2003)234*, 19 May 2004 paras 9-10. See also, HC Deb 12 June 2003 c 984W. In 2005 Customs merged with the Inland Revenue to form HMRC.

<sup>18</sup> HC Deb 25 June 2003 c1048; HC Deb 7 January 2004 c258

<sup>19</sup> *Thirty-fourth report*, 6 November 2003 HC 63-xxxiv 2002-03 para 3.4-3.6

### 3 Postcomm consultation on Royal Mail's special privileges

In January 2004 Postcomm, which regulated the Post Office at this time, published a consultation document on the special privileges enjoyed by Royal Mail. (Regulation of Postal Services was transferred to Ofcom under the *Postal Services Act 2011*.<sup>20</sup>) The regulator took the view that the most significant of these was VAT exemption, which, it argued, distorted competition in postal services. Simply extending VAT at the standard rate would not, it suggested, “be in the best interests of postal users.” However, “if the VAT playing field was levelled in a way which would not result in such significant price increases to Royal Mail's services or put Royal Mail at a financial disadvantage, it would remove the current market distortion thus giving greater choice to many postal users.”<sup>21</sup>

The report gave a short description of how VAT exemption affected Royal Mail:

Royal Mail does not charge VAT on the services that it provides to its customers. In contrast, other postal operators, including those licensed to provide competing postal services are required to charge VAT at 17.5%. Where a customer is a business registered for VAT it can reclaim this VAT. Where a customer cannot reclaim VAT, the 17.5% VAT charged by private operators amounts to an additional cost. Those customers that cannot reclaim all the VAT charged include financial institutions such as banks and insurance companies, charities and educational establishments. Additionally, private individuals are not able to reclaim VAT.

As a result of Royal Mail's VAT exemption it cannot reclaim all of the VAT charged to it for goods or services supplied to it, for example, when it buys vans for delivering and collecting mail. As Royal Mail cannot reclaim VAT charged to it, this irrecoverable VAT forms part of the costs to Royal Mail and is taken into account in setting the price of its services. Postcomm estimates that irrecoverable VAT leads to Royal Mail's prices being on average around 2.5% higher than they would be if Royal Mail did not incur this cost.<sup>22</sup>

In Postcomm's view VAT exemption played little part in keeping postal prices down for its universal postal service, and that there was a strong case for its removal:

Given the current level of postal prices and that the average household spend on mail is only 56 pence per week, Postcomm does not consider that there is now a strong case for saying that exemption from VAT is necessary in order to keep universal service postal prices affordable and does not believe that there is a sound reason – on universal service ground alone – for continuing to exempt postal services provided by Royal Mail from VAT ...

In the case of those customers who are unable to reclaim all the VAT charged to them, faced with a choice of purchasing Royal Mail's VAT exempt services or choosing a private postal operator charging VAT at 17.5%, other things being equal, the customer may not choose the competing operator. For business customers who can reclaim all the VAT charged, the choice is more evenly balanced. They may choose either one of Royal Mail's competitors, as they can reclaim all the VAT back or they may choose Royal Mail and pay the marginally increased price reflecting the irrecoverable VAT

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<sup>20</sup> For more details see, *Postal Services: the Postal Services Act 2011 and recent developments*, Library standard note SN6131, 20 July 2012

<sup>21</sup> Postcomm, *A review of Royal Mail's special privileges*, January 2004 para S.9

<sup>22</sup> *A review of Royal Mail's special privileges*, January 2004 para 3.4-7

cost. Considering these two effects together, there is little doubt that Royal Mail's VAT exemption outweighs any nominal advantage private operators might have with customers that can fully reclaim VAT.<sup>23</sup>

Respondents' views to this issue were summarised in the regulator's 'competitive market review' published in September 2004.<sup>24</sup> On the whole Postcomm found that user groups felt that VAT exemption distorted competition and should be removed:

A major user group said that some of its members would like to see VAT at 0% applied to all core products and services. This would allow Royal Mail to reclaim its input VAT, relieving pressure on future price rises (assuming Royal Mail passed on the benefit of its recovered input VAT to customers through lower prices). This would also protect overall mail volumes. Other members of this user group were content with a reduced rate, providing assurances could be given that this would have little impact on Royal Mail's prices. One operator argued that Royal Mail's VAT exemption created a distortion in the market and was contrary to European law. While it argued that a reduced rate of VAT would be desirable, this operator argued that the key objective should be a level playing field. It pointed out that a reduced VAT rate would require a new Directive to be approved unanimously among all member states. If this were not successful, this operator supported applying the full rate of VAT on all postal services.

A major user group believed Royal Mail's VAT exemption was one of the most significant barriers to entry and that it was not necessary for the provision of a universal service, as Royal Mail's price control ensured prices reflect cost. It believed, however, that removing this exemption would lead to price increases for some customers. Therefore, this user group called for the application of a reduced VAT rate of around 5%, believing this would ensure no price rises and a level playing field. There would also need to be special provision on reimbursing financial service providers, charities etc, for the fact that they would experience price rises due to their inability to recover the VAT charged to them. Without these provisions, or something similar, this user group would not support removing the VAT exemption.

Another major user group said the overwhelming majority of its members were VAT recovering, and so would not be disadvantaged if Royal Mail charged VAT. Given that there would be considerable extra cost to residential and non-VAT recovering customers, it believed it would be desirable if VAT were levied at a lower rate. This user group supported removing the exemption provided it took account of the cash flow impact of delays in VAT recovery, and there was no significant extra cost for residential and non-VAT recovering customers.<sup>25</sup>

For its part the Royal Mail was opposed to removing its VAT exemption, and was supported by several other respondents, including a number of charities:

Royal Mail did not support the removal of its VAT exemption. It said imposing VAT at the standard rate would lead to a 15% price rise, while a reduced VAT rate of 5% would mean a 2.5% price rise. It argued this would impact those least able to afford the increase, the elderly, charities and small businesses. Royal Mail said a 2.5% rate of VAT would make it possible to protect its customers from a price rise, however a 2.5% rate of VAT was not permitted under EC law. While it agreed that creating a level

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<sup>23</sup> *op.cit.* para 3.9-10

<sup>24</sup> Postcomm, *Competitive market review: proposals for consultation*, September 2004

<sup>25</sup> *Competitive market review: proposals for consultation*, September 2004 paras 4.34-39

playing field was reasonable, Royal Mail argued this would contradict Postcomm's obligation to protect customers.

Royal Mail also questioned whether VAT would be a significant factor in opening up the market. It argued VAT appeared to have had minimal significance in the development of competition in the parcels market. If Royal Mail was to absorb the imposition of VAT and not pass on the cost to its customers, at the standard rate of 17.5% it would cost it £500m per year, or £150m at a VAT rate of 5%. Royal Mail believed that the social purpose of the universal service should continue to be recognised and supported by the current exemption.

The CWU and Amicus supported Royal Mail in opposing the removal of Royal Mail's VAT exemption. The CWU and Amicus argued that even a lower level of VAT would have a serious impact on Royal Mail's social customers. If VAT were applied at its current standard rate and Royal Mail passed on the savings from reclaiming VAT, this would mean a price rise of 15%, equivalent to an 8p rise in postage costs per household per week (assuming they spend 56p a week). Small businesses that were not VAT registered would also suffer from postage price rises. Charities, educational establishments and financial institutions would also be worse off as they would not be able to recover the VAT charged to them.

Responses were also received from a number of charities arguing against removing the VAT exemption. One (non-postal) trade union said they would only be able to claim back a small proportion of any VAT charged to it. If Royal Mail's exemption were ended the union would (as a not for profit organisation) expect to be reimbursed for any additional costs. A number of charities argued that post was a significant proportion of their overheads, and that removing the VAT exemption would impact small, medium and large charities. One charity believed if the proposal went ahead it could lead to charities switching away from post and towards other media. This charity also said that if the proposal went ahead the Government should ensure the price of stamps in the UK did not increase. If Royal Mail did lose its exempt status, then charities should be compensated for their financial loss.<sup>26</sup>

However, the regulator went on to argue that VAT-exemption was clearly a major barrier to businesses who wished to enter this market:

Research by Postcomm assisted by consultants Arthur D. Little (ADL), confirmed Postcomm's previous analysis that around 50% of customers by value cannot reclaim all the VAT charged to them ... Some of the largest bulk mail customers are VAT exempt, including banks and financial institutions, charities, and some government departments. ADL believed that for competitors to win market share from Royal Mail, they would need to offer average discounts of around 20% to persuade customers to switch. Given operators need to overcome an approximate 13% price disadvantage against Royal Mail for customers that are not VAT recovering before offering a discount, this implies Royal Mail's VAT exemption is a significant barrier to entry.<sup>27</sup>

The reason the difference is 13% and not 17.5% is because Royal Mail's prices implicitly include its input VAT, which it cannot itself reclaim. If Royal Mail services become subject to VAT then it would be able to reclaim all its input VAT ... Postcomm has undertaken further analysis of the potential impact of this barrier on new entrants. This is summarised in Annex 2 [of this report] and suggests that VAT could prevent an

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<sup>26</sup> *op.cit.* paras 4.40-43

<sup>27</sup> [VAT is less of an issue in the parcels market in part because only about 20% of Parcelforce's business is with VAT exempt customers: *op.cit.* para 4.49.]



extra 4% of total market volumes being captured by new entrants (or 1bn items per year by 2010/11). Given the present scale of entry is less than 1% of the market, this represents a significant lost opportunity for new entrants. The effect is likely to be understated because VAT exempt volumes from customers such as banks and financial institutions are very advantageous to building critical mass and scale to compared to other market segments, such as single piece items.<sup>28</sup>

Postcomm reiterated its views in its final paper on barriers to entry, published in March 2005 – although this did not see any change in the Government's position; an extract is given below:

Postcomm reaffirms its recommendation to Government that a solution ought to be found that achieves two principal objectives. First, there should be a level playing field for all postal operators. Second, the solution should not lead to significant price rises for postal users. Postcomm considers that a uniform rate of 5% being applied to postal services is one solution (on the basis that a total exemption is unlikely, albeit acceptable) that is consistent with Postcomm's two principal objectives. Postcomm will continue to pursue this with Government.<sup>29</sup>

#### **4 Legal challenges to the scope of the VAT exemption**

In July 2004 the Commission published an amended draft, following scrutiny by the European Parliament.<sup>30</sup> The Scrutiny Committee reported on this amended text, which the UK continued to oppose because it would result in stamps being charged VAT:

In March 2004 the European Parliament asked the Commission to make 12 amendments to the draft Directive. The Commission has accepted four of the suggestions and the amended draft Directive reflects these.

The main modifications proposed by the Commission are:

- the proposed special place of supply arrangements and optional reduced rate of VAT would apply for non-express addressed mail items that are not heavier than ten kilograms, rather than the two kilograms in the original proposal, so that the volume of items that would be eligible for the special place of supply rule and the optional reduced rate would be increased. Ten kilograms is suggested as a natural weight borderline which is already established within the postal sector in connection with Member States' responsibilities to ensure the provision of a universal postal service; and
- Member States would not be required to implement any new Directive until 1 January 2007. This deadline recognises that postal operators would need time to adapt their systems to enable them to implement any VAT changes.

##### **The Government's view**

The Paymaster General (Dawn Primarolo) says: "The amendments to the proposal do not alter the fact that the Commission proposal would impose VAT on postal services. The Government is opposed to VAT on stamps, and will continue to make this clear in negotiations on the proposal." The Minister adds: "The Government will continue to

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<sup>28</sup> *op.cit.* paras 4.44-48

<sup>29</sup> *Tackling barriers to entry in postal services: Final decisions and recommendations*, March 2005 paras S29-30

<sup>30</sup> COM(2004) 468 final, 8 July 2004

maintain its present regular, flexible and open-ended dialogue with affected parties, including postal operators, customers and the postal regulator.”<sup>31</sup>

At the time several Member States took the same position, and negotiation on the draft text ground to a halt.<sup>32</sup> Continued opposition from several Member States, including the UK and Germany, saw the Commission officially withdraw the draft directive in late 2012.<sup>33</sup>

In July 2007 the Commission indicated that, in its view, the way that both the British and German authorities had applied the VAT exemption for their respective public service providers hindered competition.<sup>34</sup> The Commission proposed taking infringement proceedings against the UK & Germany, as well as Sweden, which did not exempt postal supplies at all:

[The Commission] is aware that these three Member States are not the only ones where similar problems exist and regards these as test cases which show in stark relief the devastating effects non-harmonised application of VAT rules has for the internal market ... Perhaps the single most important obstacle to achieve effective competition in this sector is the VAT exemption as applied in several Member States. In transposing article 132 of the VAT Directive [formerly article 13 of Directive 77/388/EEC "the Sixth VAT Directive"] (which exempts supplies by "the public postal services"), those Member States have exempted from VAT all (the UK) or most (Germany) postal services provided by their former postal monopolies. They do so on the grounds that those operators have been assigned particular obligations with regards to the provision of the universal postal service. Other postal operators are required to charge VAT on their services.

Paradoxically, some of the operators (former monopolies) who benefit from this tax advantage at home are now expanding across Europe and facing and complaining about unequal tax treatment in these new markets.

The Commission is arguing that in the context of competitive postal markets, different tax liabilities are bound to distort competition and can only be justified as regards the strict discharge of the universal service obligation. Where for commercial reasons – namely to fend off competition from other operators – former monopolies offer to some high volume clients pricing and quality conditions which are not available to the general public, their supplies should be subject to the same tax liability as their competitors ...

Contrary to the United Kingdom and Germany, Sweden does not exempt postal services. All operators including the one entrusted with the provision of the universal service - Posten AB - must charge VAT for all services. While in so doing Sweden has ensured that VAT does not distort competition, it has nevertheless failed to apply an exemption which remains in Community legislation and must be applied in a harmonised manner across the Community.<sup>35</sup>

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<sup>31</sup> European Scrutiny Committee, *Thirtieth report*, 22 September 2004 HC 42-xxx 2003-04 pp 6-7

<sup>32</sup> The legislative history of this proposal is set out on the Commission's PreLex database at: [http://ec.europa.eu/prelex/detail\\_dossier\\_real.cfm?CL=en&DosId=182512](http://ec.europa.eu/prelex/detail_dossier_real.cfm?CL=en&DosId=182512)

<sup>33</sup> European Scrutiny Committee, *Forty-first report*, 22 September 2011 HC 428-xxxvi 2010-12 pp50-52; *Thirteenth report*, 2 November 2012, HC 86-xiii 2012-13 pp193-4

<sup>34</sup> "Threat to scrap Royal Mail's tax exemption", *Financial Times*, 25 July 2007

<sup>35</sup> European Commission press notice IP/07/1164, 24 July 2007

Following this announcement the Commission did not publish any more details.<sup>36</sup> However, alongside the Commission's concerns, the private mail company TNT made a request for judicial review of the way the UK had applied the scope of this VAT-exemption, on the grounds that some of Royal Mail's activities could not be regarded as 'public postal services'. In April 2009 the European Court of Justice ruled that the EU-wide VAT exemption applied to the universal postal service provided by Royal Mail, even though services being provided by other operators were subject to VAT, but that the exemption *did not* extend to supplies of services for which terms had been individually negotiated.<sup>37</sup>

The consequences of the Court's decision were set out by the Financial Secretary in a letter to the Scrutiny Committee, which the Committee summarised in January 2010:

- the decision caused a few Member States, including Sweden, which tax such postal services, difficulties;
- it also meant that some postal services supplied by Royal Mail, which have, in the past, been treated as exempt will become liable to VAT;
- to address this HM Revenue and Customs will implement some changes to domestic VAT legislation, as described in Business Brief 64/09;
- the Swedish Presidency scheduled a discussion on the amended draft Directive by officials in July 2009, but failed to persuade the majority of Member States that the proposal warranted further discussion;
- it therefore took the matter to an ECOFIN Council meeting on 2 December 2009, when Ministers agreed to ask officials to examine the interaction between the VAT Directive and the Postal Liberalisation Directive and to report back no later than December 2010;
- the extent to which the proposal will be discussed over the course of 2010 is unclear; and
- any change would have to be agreed unanimously, many Member States, including the UK, strongly object to VAT on public postal services and, importantly, the two Presidencies in waiting, Spain and Belgium, have not indicated that this is a priority for them.<sup>38</sup>

In the 2010 Budget the Labour Government confirmed that VAT would be extended to cover certain postal services, to take account of the Court's judgement, with effect from 31 January 2011. Legislation would be included in a Finance Bill, *after* the General Election. (Given the relatively short amount of time between the Budget and the Dissolution of the House before the Election, the Labour Government introduced a shortened Finance Bill, with Opposition support, leaving many measures announced in the Budget to be introduced at a later date.) Social mail, including stamped mail, would remain exempt from VAT, so private individuals should largely be unaffected by the change.<sup>39</sup> The incoming Coalition Government introduced

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<sup>36</sup> A 2010 survey commissioned by the EC noted, "The proceedings were still ongoing as of mid-2010, and no information is publicly available as to the state of play of the Commission's analysis. Only when that examination is concluded and a final decision on the issue is taken will the Commission be in a position as to make public its findings" (Copenhagen Economics, *Main developments in the postal sector (2008–2010)*, EC November 2010 p198).

<sup>37</sup> *TNT Post UK Ltd v HMRC*, C-357/07, 23 April 2009

<sup>38</sup> *Fifth report*, 15 January 2010 HC 5-v 2009-10 p15. See also, HMRC, *Revenue & Customs Brief 64/09: VAT treatment of postal services*, 15 October 2009

<sup>39</sup> HM Revenue & Customs Budget Note BN48, 24 March 2010. See also, HMRC, *VAT – postal services: technical note*, 24 March 2010.

a short Finance Bill in June 2010 to implement its key priorities, and a second Bill in the autumn to clear these inherited measures, including this change.<sup>40</sup>

In Public Committee when this provision was scrutinised, the Exchequer Secretary, David Gauke, noted that should the functions of the Royal Mail as a universal service provider be transferred to some other body – say, if Royal Mail were subject to wholesale privatisation – this would not, in itself, affect the VAT liability of stamps. He went on to emphasize that, “although the clause removes the zero-rating of some of Royal Mail’s services, everyday use by private individuals will remain largely unaffected.”<sup>41</sup> A longer extract from his speech is given below. First, the Exchequer Secretary set out the background to TNT’s legal challenge and the Court’s ruling:

Royal Mail, as the only public postal service provider in the UK, has historically been eligible to exempt from VAT all its postal services, including those provided by any of its wholly-owned subsidiaries. However, postal services provided by other postal operators, both before and after full deregulation of the postal sector in the UK on 1 January 2006, are liable to VAT at the standard rate. Following a challenge from one of Royal Mail’s competitors, the European Court of Justice confirmed in April 2009 that Royal Mail, as the operator providing the public postal service, is the only body in the UK that is eligible to exempt postal services from VAT. In drawing that conclusion, the Court recognised that many of Royal Mail’s services are subject to regulatory conditions and requirements that have been imposed only on Royal Mail under the terms of its licence, and not on any other postal operator.

... Provisions for the universal service provider exist in other European member states, and there is an opportunity for zero-rated arrangements in those areas. We anticipate that that will be the case, even if there is a change in structure ... there is no reason why the fact that VAT is not payable on stamps should change where there is a universal service obligation on Royal Mail.

It is worth pointing out that Royal Mail operates under a significantly different legal regime from that of its competitors, but the European Court of Justice ruled that the exemption does not apply to supplies made by Royal Mail for which the terms have been individually negotiated, or which can be dissociated from the service of the public interest. The Court’s ruling means that the exemption for postal services must be applied on a narrower basis, and the clause applies that from 31 January 2011. That date reflects the need to regularise the position as soon as possible while giving Royal Mail sufficient time to make the necessary IT changes.

The Minister went on to spell out which services would become liable to VAT, and underlined that the Government would keep the law under review, in relation to any future changes to the postal sector:

Most of Royal Mail’s services will remain free of VAT, including stamps and normal deliveries—so-called social mail—so private individuals will be largely unaffected. Those services provided by Royal Mail that are not subject to price and regulatory control in the public interest, or which are individually negotiated, will become liable to VAT at the standard rate. The principal services affected are Parcelforce, door-to-door mail—that is unaddressed mail—Mailroom and other contract services. The customers

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<sup>40</sup> This is now set out in s22 of *Finance (No 3) Act 2010*. The original Budget note published in March 2010 was reissued at the time of the Coalition Government’s first Budget: [Budget Note BN41, 22 June 2010](#).

<sup>41</sup> Public Bill Committee (*Finance (No.2) Bill*), *Fourth sitting*, 26 October 2010 c118. The provision proved uncontroversial and adopted without a vote.

who will be primarily affected will be those businesses and other bodies that purchase the affected services from Royal Mail and are unable to reclaim all the additional VAT incurred ...

The Government are mindful of the possible impact of proposed changes to the regulatory framework for postal services and have noted the comments made in response to the consultation, including by private operators. We will therefore review the VAT legislation in mid-2011, in line with any changes being made to the regulatory framework, and take action as appropriate to ensure that it supports the development of a fully competitive postal services market ... Retaining certain services within the exemption, pending their deregulation by the market regulator, is consistent with the court's decision and ensures that the VAT treatment does not give rise to any unwelcome distortive effects.

The Minister also noted that the wording of the VAT-exemption would be amended, ensuring that the Royal Mail's rural bus service would continue to be VAT-free:

I should like to say a word about Postbus. The clause also amends the law relating to the zero-rating of passenger transport by Royal Mail to replace an obsolete reference to the Post Office company with the designation "universal service provider". In practice, zero-rating applies to Postbus, which is a rural bus service that Royal Mail provides in conjunction with its postal services. The scope of the zero rate remains unchanged as a result of the amendment.<sup>42</sup>

The scope of the VAT-exemption was also set out in answer to a PQ at this time:

**Peter Bottomley:** To ask the Secretary of State for Business, Innovation and Skills what information his Department holds on the number of (a) organisations which provide business mail services and (b) such organisations which supply (i) services which are exempt from value added tax and (ii) only those services which are standard rated for value added tax purposes.

**Mr Davey:** I understand this question to refer to postal operators in the UK.

At present there are around 51 licensed postal operators in the UK, including Royal Mail.

VAT is a matter for HM Treasury and HM Revenue and Customs. I am however advised that under current UK VAT legislative provisions, all postal services provided by Royal Mail, as the universal service provider, are treated as exempt, including stamped, bulk and express mail. All other postal service providers are, in principle, required to charge VAT at the standard rate. However, other postal operators who make use of Royal Mail's facilities to deliver post for the 'final mile', can take advantage of special VAT arrangements to treat this element-which accounts for a significant proportion of the onward charge to their customer-as a 'disbursement' and only charge and account for VAT on the remaining amount.

Royal Mail's exemption from VAT for postal services in the UK is currently the subject of legislative amendment as part of the Finance Bill which is progressing through Parliament. This follows a European Court of Justice decision which confirmed that Royal Mail, as the sole operator providing the universal postal service, is the only postal body in the UK eligible to exempt postal services from VAT. However, it also

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<sup>42</sup> PBC, *Fourth sitting*, 26 October 2010 cc114-118

ruled that exemption does not apply to all Royal Mail's postal services and as such, those services which are either individually negotiated or not subject to price and regulatory control (such as Parcelforce and Mailmedia) will become liable to VAT at the standard rate. These changes are due to come into effect from 31 January 2011.<sup>43</sup>

One consequence of this change in the law was that in June 2011 the Commission decided to close its infraction proceedings against the UK.<sup>44</sup>

## 5 Recent developments

There has been one further, minor, change in the wording of the provision in UK VAT law for the exemption of public postal services. In June 2011 the *Public Postal Services Act (PSA) 2011* received Royal Assent. The Act replaced the existing licensing regime and to maintain the current VAT treatment of these supplies, HMRC confirmed in September that year that secondary legislation would be introduced:

*PSA 2011* ... provides for the introduction of a regulatory framework based on general authorisation to replace the licensing regime that was introduced under the *Postal Services Act 2000 (PSA 2000)*. As Group 3 (Postal Services) of Schedule 9 (Exemptions) to the *Value Added Tax Act 1994* refers to a licence duty that will no longer exist after the regulatory changes are made, HMRC are amending the legislation to maintain the scope of the VAT exemption for postal services. Similarly, HMRC are amending Group 8 (Transport) of Schedule 8 (Zero-Rating) to the Act to reflect the fact that *PSA 2011* has superseded *PSA 2000*.

The amendments to the VAT legislation are being made by the *Postal Services Act 2011 (Consequential Modifications and Amendments) Order 2011 (SI 2011/2085)*.<sup>45</sup>

As a consequence, the wording of group 3 to schedule 9, *VATA 1994*, is the following:

### Item No.

1. The supply of public postal services by a universal service provider.
2. The supply of goods by a universal service provider which is incidental to the supply of public postal services by that provider.

### Notes:

- (1) ...
- (2) Subject to the following Notes, "public postal services", in relation to a universal service provider, means any postal services which the provider is required to provide in the discharge of a specified condition.
- (3) Public postal services include postal services which a universal service provider provides to allow a person access to the provider's postal network (within the meaning of section 38 of the *Postal Services Act 2011*) and which are required to be provided by a specified condition.
- (4) Services are not "public postal services" if—
  - (a) the price is not controlled by or under a specified condition, or
  - (b) any of the other terms on which the services are provided are freely negotiated.

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<sup>43</sup> HC Deb 21 October 2010 c869W

<sup>44</sup> European Scrutiny Committee, *Forty-first report*, 22 September 2011 HC 428-xxxvi 2010-12 para 8.7

<sup>45</sup> HMRC, *VAT: postal and postbus services – Brief 34/11*, 15 September 2011

(5) But Note (4) does not apply if a specified condition requires the universal service provider to make the services available to persons generally—

(a) where the price is not controlled by or under the condition, at the same price, or (b) where terms are freely negotiated as mentioned in Note (4)(b), on those terms.

(6) In this Group “specified condition” means a designated USP condition, a USP access condition or a transitory condition under paragraph 5 of Schedule 9 to the Postal Services Act 2011 which is imposed only on a universal service provider.

(7) Any expression which is used in this Group and in Part 3 of the Postal Services Act 2011 has the same meaning in this Group as in that Part.

In response to public debate about the wider implications of the Government’s ambitions for privatising Royal Mail,<sup>46</sup> the Department for Business, Innovation & Skills has recently published a brief, addressing a number of specific concerns – including some assertions that have been made about the impact of a sale of Royal Mail shares on stamp prices and VAT:

***Stamp prices will go up***

Royal Mail’s stamp prices for the universal postal service will continue to be regulated by Ofcom which has a duty to ensure that they remain affordable. The prices of Royal Mail’s non-regulated services will be subject to competitive pressures.

***Businesses will be squeezed through price increases***

Royal Mail values all its customers and will want to keep them. Prices for services used by businesses will be regulated by Ofcom or subject to competitive pressures.

***VAT will apply to stamp prices when Royal Mail is privatised***

Royal Mail will continue to be the designated universal service provider regardless of its ownership. An ownership change would not, therefore, trigger a change in the current VAT exemption which applies to first and second class stamps as part of the one price, anywhere service.<sup>47</sup>

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<sup>46</sup> As noted above, the background to this issue is examined in, [Privatisation of Royal Mail](#), Library standard note SN6668, 21 June 2013. More recently the Secretary of State for Business set out the Government’s plans for a flotation of Royal Mail shares on the London stock exchange via an initial public offering in a statement to the House (HC Deb 10 July 2013 cc361-376).

<sup>47</sup> Department for Business, Innovation & Skills, [Royal Mail: Myth-Busters](#), Ref: BIS/13/756, 4 July 2013 p5