17 January 1984

PANEL ON VALUE-ADDED TAX AND THRESHOLD

Report of the Panel adopted by the Committee on Government Procurement
on 16 May 1984
(GPR/21 - 31S/247)

I. INTRODUCTION

1. At the request of the United States delegation the Committee on Government Procurement established the Panel under Article VII:7 of the Agreement on Government Procurement, on 23 February 1983, with the following terms of reference:

> "To examine, in the light of the relevant provisions of this Agreement the matter referred to the Committee by the United States in GPR/Spec/18; to consult regularly with the parties to the dispute and give full opportunity for them to develop a mutually satisfactory solution; and to make a statement concerning the facts of the matter as they relate to application of the Agreement and make such findings as will assist the Committee in making recommendations or giving rulings on the matter." (GPR/M/7, paragraph 67).

The composition of the Panel was as follows:

Chairman:	Mr. K. Berger
Members:	Mr. E. Contestabile
	Mr. S. Sivam

2. The Panel met on 27 April, 1 June, 13 July, 15 September, 5 and 31 October, 24, 29 and 30 November and 6 December 1983.

3. In the course of its work the Panel consulted with the delegations of the European Economic Community and the United States. Arguments and relevant information submitted by the parties, replies to questions put by the Panel as well as all relevant Committee documentation formed the basis for its examination of the matter.

4. During the proceedings the Panel provided the parties adequate opportunity to develop a mutually satisfactory solution.

5. The Panel urged the parties to respect the need for confidentiality and requested them not to release any papers nor make any statements in public regarding the dispute.

II. FACTUAL ASPECTS

6. The matter referred to in paragraph 1 above was:
"… the European Communities' practice of excluding the value-added tax (VAT) from the contract price of EC member State government purchases in relation to the determination of whether such purchases fall under the Agreement …" (GPR/Spec/18).

The EEC practice in question was established in Council Directive 77/62/EEC of 21 December 1976 "co-ordinating procedures for the award of public supply contracts". This Directive applied to "public supply contracts whose estimated value net of VAT is not less than 200,000 European units of account" (Article 5:1(a)). Council Directive 80/767/EEC of 22 July 1980 adapted and supplemented the original Directive, inter alia, by reducing the applicable threshold to the EUA equivalent of SDR 150,000. This threshold continued to be net of VAT (Article 2).

7. The question of the treatment of taxes in relation to the threshold was taken up by the United States delegation at the first meeting of the Committee in January 1981 and the issue remained on the agenda of all regular meetings until and including that of February 1982. (GPR/M/1, paragraphs 58-62; GPR/M/2, paragraphs 67-76; GPR/M/3, paragraphs 85-91; GPR/M/4, paragraphs 59-62; GPR/M/5, paragraphs 65-66).

8. On 23 October 1981 the United States requested consultations on the matter with the European Economic Community, pursuant to Article VII:4 of the Agreement. Consultations were held on 3 December 1981, but no solution was reached.

9. The Committee, meeting in restricted session, investigated the matter on 6 July and 15 December 1982 with a view to facilitating a mutually satisfactory solution. Again, no such solution was reached.

III. MAIN ARGUMENTS

10. The United States argued that the EEC practice of deducting payable VAT charges in determining whether contracts met or exceeded the Agreement's threshold for coverage was contrary to the obligations of the Agreement. Article I:1(b) provided that the Agreement applied to "any procurement contract of a value of SDR 150,000 or more …" and Parties were obligated to ensure that all purchases of goods by the entities subject to the Agreement having a contract value of this amount or more were advertised and awarded in accordance with the Agreement's requirements. It was important to note that the SDR 150,000 threshold was for value of the contract and that this was a uniform threshold for all Parties. The Agreement provided for no deduction from the value of the contract. Nevertheless, the EEC, i.e. in practice the Member States, made this deduction even though VAT was paid on the contract in question. Nothing in the language of the Agreement nor in its negotiating history, indicated that the drafters had intended to permit any such deductions from contract value in determining whether a contract met or exceeded the specified threshold.

11. The European Economic Community argued that no reference was made in Article I:1(b) or indeed subsequently in the Agreement or in the Notes of the Annexes thereto to the inclusion or exclusion of VAT in the calculation of the value of a procurement contract. On the central point at issue, namely the US assertion that a procurement contract must be considered as inclusive of local taxes, the EEC held that, in the absence of any provision in Article I:1(b) regarding the treatment of such taxes for the purpose of determining contract values there could be no presumption that local taxes must be

included.[1] The US approach assumed that the value of the contract for the purpose of Article I:1(b) was equivalent to the full cost to the buyer.[2] The Agreement contained no definition of what was meant by the term "value of the contract"; and in the EEC view there were at least two possible interpretations which were different from that of the United States: first, that "value of the contract" was to be understood in a sense that was sufficiently broad as to permit deduction of taxes - or secondly, that it might be understood as quite simply exclusive of tax, so that the issue of deduction of taxes was in reality a non-issue. The European Community position on the exclusion of VAT in the calculation of the threshold was well known through the existence of Directive 77/62/EEC. The EEC believed that it was the responsibility of other Parties to have made clear during the negotiations what their intentions were on Value Added Taxes, so that this could have been incorporated in the Agreement. However, there was no evidence that this point relating to taxes was raised during the negotiations or that a uniform practice by all Parties had been expected. The EEC had an established practice, known to other Parties to the Agreement, and in the absence of any explicit request to modify this practice, it was reasonable to assume that other Parties expected it to continue.

12. The United States maintained that there was no negotiating history to suggest ambiguity, uncertainty or an interpretation different from its own. The interpretation of Article I:1(b) must be uniform for all Parties. The United States interpretation concurred with the principle of international law that the terms of a treaty be interpreted in accordance with their ordinary meaning in the context of the treaty and in light of its object and purpose. Other Parties were entitled to expect the EEC to conform its practice to the Agreement and had no responsibility to examine previous practices of the EEC under EC internal arrangements. The EEC in previous discussions in the Committee on Government Procurement had said that the Community's previous internal arrangements for government procurement among Member States always involved deduction of the VAT from contract value in making threshold determinations, however, the pertinent EC regulations specifically qualified the standard of contract value with the words "net of VAT". Article I:1(b) did not provide that contract value should be net of VAT, and the EEC would not have explicitly qualified contract value with the term "net of VAT" if, as the EEC now seemed to contend, netting out VAT was implicit in the term contract value in the Agreement. The United States did not doubt that rationales could be constructed for different threshold rules in the Agreement, including that now espoused by the EEC. If one were constructing a new Agreement it could be argued that it was inequitable, for example, that large countries or entities with centralized purchasing practices were at a disadvantage with a uniform threshold because they would normally make proportionately more purchases above the threshold than smaller countries or entities with relatively decentralized purchasing practices. It could be argued that product specific thresholds would be more equitable than a threshold based on contract value, since the same quantity of the same merchandise varies in cost as among Parties because of differences in protection, taxation, conditions of competition and other factors. It could be argued that taxes and or customs duties should

[1]As for Article V:12(h), this provision also did not give a reply to the question. It was dealing with another problem, and although taxes were referred to in this paragraph, the context (related only to foreign products) suggested that the negotiators did not have in mind a tax such as VAT which applied equally to domestic and foreign products.

[2]The EEC explained, inter alia, that the VAT was a tax imposed on end consumption and at the earliest calculated at the point of delivery. An entity putting out a notice for an intermediary product, for instance, could not determine the effective rate of VAT at the moment of award or even not at the point of delivery because payments of VAT on purchases were offset against VAT on outgoing transactions by that entity, the result being a net sum.

all be netted out because this in the end was money paid by the entity but recovered by the government.[1] These and other arguments could all be put forward for different rules. But the fact remained that the rule agreed upon was a uniform threshold for contract value, without deductions or adjustment (except that contracts might not be divided to avoid application of the Agreement). With a fixed uniform threshold, the negotiators could then seek an equitable balance of rights and obligations in the negotiations on entity coverage.

13. The European Economic Community questioned the relevancy to the present dispute of the various theoretical arguments the United States had admitted could be put forward for different rules. Concerning the argument that the language of the Agreement was clear and that it was incumbent upon the Community to seek a derogation from it or to introduce a reservation if it wished to continue this practice unchanged, the EEC replied that the corollary to this was that the Community practice was clear and that other Parties had no reasonable expectation of any change, nor of any benefits which would flow from such a change, in the absence of specific requests during the negotiations for a modification to this established practice. It added that the United States' interpretation of why the Community regulations had "explicitly qualified contract value … net of VAT" carried no general implications for the meaning of the Agreement. The EEC went on to state that on the subsidiary point ("only one threshold"), although the Agreement sought to establish a level of value which resulted in the same obligation for each Party, it clearly did not establish a uniform value in any literal sense. The figure of SDR 150,000 had, in any case, to be converted into national currencies and, for the purposes of the Agreement, this was done on an annual basis. But with the considerable fluctuation of exchange rates which was now common, the equivalent value of SDR 150,000 in real terms in national currencies could be over or understated by 10 per cent or more at any given moment. There was thus a certain degree of imprecision in the figure itself. Moreover, the present EEC position led to a uniform threshold figure throughout the European Community. If VAT were to be included, there would be different thresholds in different Member States because there was no uniformity of VAT rates. Furthermore, the concept of a uniform value for a procurement contract in terms of Article I was, in any case, fairly unclear. The normal practice was for an entity intending to put a purchase out to contract to make an estimate of the price of this contract. This estimate might be based, for example, on past experience with similar purchases, the experience of other entities in the same field, etc. At all events, it was no more than an estimate, on the basis of which the entity would proceed to its tendering procedures. It was not until a later stage, when the tenders were submitted and opened, that a more precise figure for the value of the contract - however this was defined - would become available; and even then there could be a wide difference between the lowest and the highest tenders submitted. Bearing this in mind, it was clear that the figure of SDR 150,000, as it related to the particular point of prior publication, had to be considered as no more than a broad and general indication of the value of the contract. Here again, therefore, there was a certain degree of imprecision relating to the figure of SDR 150,000, since the accuracy of the estimate and its relationship to the final contract figure agreed would depend on the skill and experience of the officials responsible.

[1]It was the understanding of the United States, that EEC entities sometimes included and sometimes excluded value added taxes as a cost element in tender documentation, though such taxes were always paid. Since value added taxes did not affect the relative competitiveness of tenders for any given contract, either practice was permissible under Article V:12(h), and EEC practice under that provision was therefore not at issue. However, even if the EEC never included value added taxes as a cost element under Article V:12(h), the US would consider exclusion of those taxes for purposes of threshold determinations to be inconsistent with Article I:1(b). It added that, viewing the Agreement as a whole, it would be odd to consider taxes as a cost element of tender prices in one portion of the Agreement while at the same time excluding taxes in determining the value of the contract under Article I:1(b).

14. The United States stated that the EEC practice impaired the Agreement's balance of rights and obligations and undercut its objectives. First, the threshold set in the Agreement had had an important impact in limiting the number of contracts to which the EEC had accorded the benefits of the Agreement. In 1981, 49.8 per cent of EEC purchases by entities covered by the Agreement were below the threshold level. A portion of these "below-threshold" purchases would undoubtedly have been covered by the Agreement in the absence of the EEC practice. The effects of the EEC practice could be substantial. By netting out the VAT, the EEC Member States applied a threshold which was higher by the amount of VAT payable than that mandated by the Agreement. As a result, other Parties to the Agreement were denied legitimately-expected benefits of the Agreement vis-à-vis these purchases. The systematic application of a higher threshold through deduction of VAT was distinct from the variations to which the EEC referred concerning exchange rate conversions and the practice of estimating contract values in advance. The Committee's agreed procedures for conversion of SDR's to national currencies could result in a higher or lower threshold for contracts at various times in any country, a risk borne by all Parties by agreement. Good faith prior estimates of contract value might also be too low or too high in particular cases, though the United States believed that deliberate or systematic underestimates of contract value would breach Article I:1(b). These variations thus might benefit or harm different Parties at different times, but the EEC's practice of deducting VAT resulted only in the application of a systematically higher threshold, to the detriment of other Parties. Secondly, as VAT rates varied among products, the EEC practice resulted in not only different thresholds in different Member States but also product-specific thresholds. The balance negotiated in the Parties' offers of entity coverage was determined on the basis of one uniform threshold based on contract value, rather than a series of product thresholds. Parties accepted or acceded to the Agreement on the basis of the rights they would receive and the obligations they would incur under a uniform contract value threshold. The EEC practice destroyed this uniformity and thus impaired the Agreement's balance of rights and obligations.

15. According to the European Economic Community its practice did not result in different member State thresholds and even product-specific thresholds. On the contrary, if the EEC were to include VAT in the contract value for threshold purposes, then there would certainly be a multiplicity of different thresholds, not only member State/product specific but also probably entity/product specific.

16. The United States stated that the matter had been of longstanding concern. The US still hoped the EEC would voluntarily remedy its practice in the face of the concern expressed by the US and others without the need for a formal Panel judgement and without further delay. In the absence thereof, the United States requested the Panel to determine that the subtraction of estimated VAT payable by the EEC and its Member States in threshold determinations was inconsistent with the EEC's obligations under the Agreement.

17. The European Economic Community reiterated that the uniformity of the threshold did not exist in the literal and precise sense that the United States authorities would imply; that the threshold was an estimate and not a precise calculation and thus was subject to the imprecision that this implied; and it also stated that it had never during the existence of the Agreement raised any expectation that it would change its present practice. The EEC further submitted, without prejudice to its argument that the Agreement did not provide for the inclusion of VAT in determining which procurement contracts were subject to the Agreement, that the effect of VAT exclusion was likely to be in any case de minimis. Given the lack of precision inherent in the value figure as set out in the Agreement it was questionable that inclusion or exclusion of VAT would in itself be significant enough to upset the balance of rights and obligations of the Parties. It was an entirely reasonable interpretation to take the value of the procurement contract as the value of the goods supplied without the addition of the tax. The EEC believed that the onus was on those who held a different opinion to demonstrate that this view was inconsistent with the Agreement.

IV. FINDINGS AND CONCLUSIONS

18. The Panel examined whether the European Economic Community's practice of excluding the value-added tax (VAT) from the contract price in relation to the determination of whether government purchases fall under the Agreement was in conformity with Article I:1(b) of the Agreement, according to which this Agreement applies to "any procurement contract of a value of SDR 150,000 or more".

19. The Panel noted that the case before it dealt with the value of contracts as estimated for the purpose of determining whether a procurement contract would fall above or below the threshold of the Agreement on Government Procurement or, in other words, whether a contract was to be advertised and subsequently awarded under the terms of the Agreement.

20. The Panel noted that no reference was made in Article I:1(b) or elsewhere in the Agreement to the inclusion or exclusion of value-added taxes in the calculation of the value of a procurement contract for the purpose of threshold determinations.

21. The Panel considered the case before it in the light of the drafting background of Article I:1(b). The Panel noted that the question of how the VAT should be treated in the calculation of the contract value had not been specifically raised in the negotiations.

22. The Panel found that the case before it depended on an interpretation of the term contract value. In view of the silence of the Agreement and the absence of a negotiating history concerning this term, the Panel analysed the meaning of the term contract value. The Panel first noted that the value of a contract, as signed between a procuring entity and a winning supplier, might or might not include the element of indirect taxes, depending on how the procurement was carried out. However, for the purchasing entity, what counted was the total price which the entity would have to pay in order to obtain the product in question. If the entity was to pay the VAT, this element would form part of the total price whether it was included in the supplier's bill or whether it would be paid in another way by the entity. Against this background and as Article I:1(b) did not expressly provide for the deduction of any taxes, the Panel found that the natural interpretation of the term contract value would be the full cost to the entity, taking into account all the elements that would normally enter into the final price, and would therefore include any VAT payable, unless the entity was exempted from paying VAT.

23. In this context, the Panel also noted that most Parties to the Agreement had, from the outset, included indirect taxes such as VAT when making threshold determinations.

24. The Panel asked itself what the intentions of the drafters had been with regard to the question before it in the light of the objectives of the Agreement. Whether any VAT payable was included or excluded in the context of threshold determination would, in the view of the Panel, make a clear difference to the number of contracts to which the Agreement would be applied. The Panel believed that it must have been the intention of the drafters that the obligations should be interpreted in a uniform way by all Parties with respect to this question.

25. The fact that the present EEC legislation excluding VAT for threshold determinations had already existed at the time of the negotiations was, in the Panel's view, not a decisive argument. Although the negotiating partners might have been aware of this particular element in the EEC's legislation, the Panel did not consider it reasonable to presume that it was in fact known to all negotiating partners nor that these partners foresaw and accepted that the EEC would exclude the VAT for the purpose of threshold determinations under the Agreement. The Panel further noted that, while Article I:1(b) was silent on the question of how to treat value-added taxes for this purpose, the corresponding part of the relevant EEC Directive had explicitly excluded the VAT. The Panel considered that the EEC legislation on this point could be taken as an indication that the term contract value in Article I:1(b) did not automatically exclude the VAT element.

26. The Panel also considered the argument that threshold determinations had to be based on estimates which by their nature were imprecise and that several erratic factors would be at play which lead to variations in the threshold. The figure of SDR 150,000 was, for instance, converted into national currencies once a year, whereas exchange rates could fluctuate considerably over the year. Furthermore, the accuracy of the estimate would depend on the skill and experience of the officials responsible. The Panel was of the opinion that the acceptance of certain erratic factors which applied to all Parties and which could affect the threshold in both directions, could not mean that Parties might make a unilateral deduction of certain cost elements like VAT, which would have the effect of raising the threshold for the Party in question. The inevitable uncertainty resulting from the need to estimate the contract value and from currency variations was no reason to create this further difference. Regarding the currency conversions, the Panel also noted that the Committee had decided, at its January 1981 meeting, to examine any significant problem with regard to the application of the Agreement due to a major currency change in the course of the year.

27. The Panel considered the argument that the inclusion of the VAT would lead to differences among the various EC Member States, caused by the absence of uniform VAT rates within the Community, and recognized that the Community considered this to be a problem. The Panel also recognized that arguments could be made for a net of VAT rule, in particular in the context of a common market such as the European Community which aimed at harmonizing conditions of competition. The Panel did not go further into a discussion of the merits or demerits of such a rule as it found that this would not change its interpretation of Article I:1(b). The Panel also considered that the existence of different VAT rates in the Community was not of decisive relevance for the interpretation of the provisions of the Agreement applying between the Parties to it. The Panel noted in this context that VAT rates as well as other elements that went into the total contract price differed between the Parties to the Agreement other than the EEC. The Panel considered that the fact that elements which went into the total contract price differed from Party to Party was no justification for excluding particular cost elements in the absence of provisions specifically excluding them.

28. Considering these various aspects and arguments, the Panel found that the term contract value in Article I:1(b) should be interpreted to be the full cost to the entity, taking into account all the elements that would normally enter into the final price, and would therefore include any VAT payable, unless the entity was exempted from paying VAT. The Panel concluded, therefore, that the present EEC practice of excluding the VAT was not in conformity with this interpretation of the existing Agreement when the entity was not exempted from paying VAT.

B. STATEMENTS MADE AT THE MEETING OF 16 MAY 1984

1. The following statements were made at the Committee's meeting on 16 May 1984 after the adoption of the report by the Committee.

2. The representative of the European Economic Community noted that the Panel recognized that its interpretation of the term "contract value" could give rise to problems for the Community, owing to the existence of differing VAT rates in the Community. He recalled that the Panel's approach would be that VAT or other indirect taxes should be included in the final price of any item and thus in the contract value, unless there was a tax exemption. However, the existence of different tax systems and practices affecting government purchasing, and particularly the application of differing tax rates both within the Community and in other countries, as well as different rules for tax exemptions, made it difficult, if not impossible, to see how the Panel's approach could lead to an equitable solution. He stated that, in these circumstances, there was a need to explore various avenues and formulae in addition to the interpretation of the Panel in order to arrive at a balance of advantages and commitments for all signatories to the Agreement.

3. The representative of the United States welcomed the adoption of the VAT Panel report which, in his delegation's view, was both well reasoned and equitable in its handling of the facts of this case. He particularly welcomed the clear finding that signatories might not unilaterally make deductions from contract value in determining whether purchases fell below the threshold of the Agreement. His delegation had listened with interest to the EEC's statement on the need for flexibility in implementing the findings of the Panel report. It noted in this regard, however, that it would view as unacceptable any suggestion that all signatories exclude VAT charges in making threshold determinations.

4. The representative of Canada recalled that his delegation had, in previous meetings, supported a proposal for the adoption of the report and a Committee recommendation that the EEC bring its practice into conformity with obligations of the Agreement. His delegation was pleased that the Committee had adopted the report but regretted that a recommendation had not been made. It nevertheless expected the European Economic Community to report to the Committee actions it was taking to change its practice of deducting VAT in threshold determinations and to implement the Panel conclusions. Canada also reserved its rights in the matter.

5. The representative of Finland, speaking on behalf also of Norway and Sweden, welcomed the adoption of the report and appreciated the efforts made by the parties to the dispute to bring about this result. These countries considered that by adopting the report, the Committee had at the same time also adopted the conclusions of the Panel, which they considered to be correct, clear and with which they agreed. It was therefore their expectation that appropriate action would follow this adoption. In the meantime, these countries reserved their rights under the Agreement, adding that they did not consider that any rights under the Agreement had been diminished by this decision. Having heard the statements by the parties to the dispute, he added that they would not consider it an acceptable avenue for Parties to exclude VAT charges in threshold determinations.

6. The representative of the European Economic Community stated that his delegation had in no way intended to put Parties' rights into doubt. On the contrary, in adopting the report, he had made it clear that the EEC was seeking to re-establish the equilibrium between rights and obligations of all Parties. It would do this in cooperation with other members of the Committee, so as to find the most adequate solution or formula which, in the EEC's view, was not the one the Panel had suggested. While his delegation would, of course, inform the Committee of any further action, he expected that consultations with other members would have to take place before such action could be defined and taken. He added that the matter was not easy to deal with as it affected EC legislation as well as legislation of the ten Member States.

7. The representative of Singapore noted with satisfaction that the Committee had been able to adopt the report, and recalled that his delegation's view had been stated previously. He expressed the hope that, with the adoption of the report, the Committee would be able to find a meaningful and lasting solution to this problem which it had had before it since its first meeting. In the interest of the maintenance of the credibility of, and confidence in, the dispute settlement mechanism embodied in the GATT, he stressed the importance of the Committee making a pronouncement so as to bring the case to a logical and definite conclusion.

8. The Committee took note of the statements made.

9. The Chairman indicated that at its next full meeting the Committee would be informed of the contents of the report and its adoption, and that the Committee would follow further developments with interest and take action as appropriate.