



EUROPEAN COMMISSION
DIRECTORATE GENERAL
TAXATION AND CUSTOMS UNION
INDIRECT TAXATION AND TAX ADMINISTRATION
VAT and other turnover taxes

Consultation Paper on modernising Value Added Tax obligations for financial services and insurances

Note

This paper is intended as a basis for open consultation of all parties interested in the VAT treatment of financial services and insurances.

The sole purpose of the consultation exercise is to generate feedback on possible options for changing the existing provisions in the Sixth VAT Directive and to provide input for discussions with stakeholders which might assist the Commission in developing its thinking on the subject.

This document does not necessarily reflect the views of the Commission of the European Communities, nor does it signify that the Commission is committed to any legislative initiative in this area. The examples used to explain perceived problems are purely illustrative in nature.

Comments are invited on this paper by 9 June 2006 at the latest.

Submissions may be made in writing to

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1. INTRODUCTION - THE HISTORY OF FINANCIAL SERVICES AND INSURANCES IN THE SIXTH VAT DIRECTIVE

1.1. Since their implementation, the provisions in the Sixth VAT Directive which govern the treatment of financial services and insurances have never been re-visited legislatively. The Commission now intends to look critically at how they function today and the purpose of this consultation exercise is to seek the views of all stakeholders.

Although the measures came into force in 1977¹, the preparatory work leading to a political decision on the current rules is generally of an earlier date and, not unexpectedly, reflects an environment which was markedly different from that which prevails. The 1973 Hutchings Report was a broad consultation on VAT and financial services undertaken by the tax authorities in the then 6 Member States in close liaison with the industry. It came to the conclusion that the most serious objections to the introduction of VAT on financial services and insurances were the absence of a readily identifiable mechanism for so doing and the resultant increase in consumer credit. Nevertheless it recommended that if these obstacles could be overcome and if a decision were taken to apply VAT to financial services, any exemptions should be discouraged and kept to the strictest minimum.

In the event, the decision of the Council (which by 1977 consisted of ministers from 9 Member States) was to exempt financial services and insurances, mainly for pragmatic reasons since the technical difficulties could not be readily overcome. These consisted mainly in the impossibility of establishing taxable amounts and the amounts of deductible VAT without generating unacceptable administrative charges and without creating legal and accounting complexity for both economic operators and Member States' fiscal authorities. The perceived political sensitivities associated with imposing VAT on consumers were also an issue. Nevertheless, there was a widespread perception at the time that a technical solution allowing the introduction of full taxation on insurance and financial services, which was seen as the best option to rectify the breach in neutrality, would duly be identified.

1.2. In the subsequent years however, the focus of VAT legislative change was directed elsewhere (mainly towards establishing the circumstances necessary for the creation of the internal market in 1992) and it was not until the 1990's that financial services and insurances again attracted a level of attention.

In those years the Commission set about finding a technical methodology to allow full taxation and input credit on insurance and financial services. Some of this work was undertaken in conjunction with the OECD. Among the potential solutions identified, the possibility of applying an advanced cash flow method of charging VAT on financial services, known as the truncated cash flow method (TCA) seemed at the time to be the most promising. It envisaged a general zero rating of VAT on B2B (business-to-business) transactions whilst VAT on B2C (business-to-consumer) would be reflected in the customers' charges in a manner not to prejudice banks' margins. It demonstrated that a cash flow based system could successfully bring financial service transactions, including interest, within VAT. The technical feasibility of the system was confirmed by field testing it across a range of financial institutions but the perceived complexity of the system was seen as a strong negative factor by both administrations and business. The

¹ If not otherwise mentioned all articles cited in this document refer to the Sixth VAT Directive

general consensus was that the resultant benefits could not justify such a profound system change.

1.3. The difficulties in establishing taxable amounts and the level of deductible VAT without generating unacceptable administrative charges and legal complexity persist. However, the evolution of accounting and reporting systems driven by more powerful IT-solutions accessible even to smaller economic operators has probably had a significant impact.

In financial services and insurance services all economic operators are striving to improve their competitiveness since they are increasingly exposed to competition both between themselves on account of the trend towards a single pan-European market place as well as from economic operators established outside the EU. Consolidation within the sector has been driven by the need for efficiency but cost reduction strategies manifest themselves in various ways. These developments are accelerated by the emerging of a wider regulatory framework for an integrated European financial services market as a result of the successful completion in legal terms of the Financial Services Action Plan and related new initiatives recently announced by the Commission in its White Paper on Financial Services Policy (2005-2010).² This liberalising regulatory framework increases the competition between suppliers of insurance and financial services through the steady dismantling of barriers of a legal nature but also through the examination of other barriers such as those resulting from tax arrangements in the area of Clearing and Settlement³.

In this environment, unintended VAT consequences and in particular the generation of non-recoverable input VAT have become important factors in the decision making process on where and how an operator supplies financial or insurance services. In December 2004 the Commission services organised a Fiscalis seminar in Dublin with Member States and economic operators to consider experiences with the existing system and where points of tension arose. The general consensus here was that there is currently little interest in revisiting the issue of a general introduction of taxation. The complexity introduced by any such change was seen as strong negative factor and a fundamental move from a system which, whatever its shortcomings, had now been in place for three decades would be disruptive to a disproportionate degree.

Accordingly, the Commission's starting point has been to look at legislative measures in the context of three deliverable objectives:

- reducing the administrative costs for administrations in exercising fiscal supervision and for economic operators in achieving fiscal compliance,
- creating budgetary security for Member States and legal certainty for economic operators,
- addressing inconsistencies between the 1977 VAT provisions and more recent regulatory and legal provisions such as those falling under the Financial Services Action Plan.

² See the "White Paper on Financial Services Policy (2005-2010)" at http://europa.eu.int/comm/internal_market/finances/policy/index_en.htm

³ For more details on the EU clearing and Settlement Fiscal Compliance Experts' Group see http://europa.eu.int/comm/internal_market/financial-markets/clearing/compliance_en.htm

The present working document starts from a position which respects these objectives. It is however inescapable that any changes which increases the level of deductibility will, in the absence of compensating measures, result in a reduction in VAT receipts for Member States. A cost neutral approach might for instance have to balance increased deduction by taking more of the services supplied by financial institutions outside the scope of the exemption (in effect, narrowing the definition of exempt services). If such an approach were to be contemplated, it raises two basic issues. In the first instance, different financial services compete with each other and an unbalanced change in VAT would have an impact on consumer choice between different investment options (e.g., between life assurance and other investment vehicles).

Efficient and functioning markets for financial services and insurances will benefit European businesses and consumers. The Lisbon strategy recognises the benefits of financial integration in contributing to Europe's future growth in prosperity and employment. Significant achievements have been made in recent years in delivering the legislative and regulatory framework to underpin progress towards an integrated, open, efficient and competitive market for these products. VAT should not generate unnecessary obstacles to the achievement of agreed public policy objectives. Market considerations also require that VAT is applied in a manner consistent with a level playing field and accordingly any review of the existing provisions must address the elimination of VAT attributable competitive distortions.

It should also be mentioned that particular circumstances apply to insurance services where the role of VAT must be seen in the in the context of other national taxes which effect the sector such as insurance premium taxes. The interplay between VAT and other such taxes is not directly addressed in this paper but has to be taken into account in any changes having an impact on this sector. In order however to keep this paper within manageable length, it does not go into all of the sector specific issues here.

It will also be necessary to consider the VAT issues associated with importations from 3rd countries in so far as these are not already being addressed elsewhere in the legislative programme. The treatment of services imported into Community within the same legal entity may be such an example.

2. ANALYSIS OF PROBLEM AREAS

Against this background the Commission services looked in the first instance at the behaviour of the economic operators in improving their own competitiveness and the problems they encounter in that process. This has involved extensive informal contact with a wide range of operators. Approaches vary considerably between institutions but some of the more common basic techniques include the following:

- **outsourcing** of functions (with the intention of lowering administrative and labour costs, e.g.: depository activities, back-office administrative tasks etc.);
- **pooling** of activities (with a cost-sharing intention, e.g.: the common development of computer systems and software for several banks, the creation of credit factories which may either be associated with consolidation or be undertaken on a free-standing shared cost basis);
- **sub-contracting** (insertion of a supplementary distribution level for the financial products or insurances)
- **off-shoring** (sourcing in third countries, e.g.: computerisation or other back office support where technical or regulatory constraints allow this).

In taking these measures to improve competitiveness, the financial and insurance operators encountered four major areas of tension where their strategies were in conflict with the VAT rules in force:

- the definition of exempt services;
- hidden VAT in supplies between taxable persons (business-to-business (B2B));
- calculation of the amount of deductible input VAT;
- interests involved and approach to the problems by markets and by individual Member States.

2.1. Definition of exempt services

The definition of exempt services in article 13 B (a) and the (d) of the Sixth Directive date from 1977 and the legislation and its terminology reflects only the services commonly supplied at that time. Since then, the services available on the insurance and financial markets have developed to the extent that even the interpretation of classic terms like credit give rise to difficulties. The Commission services have been confronted with an increasing number of cases where economic operators and Member States had problems in interpreting the definitions of exempt services in article 13 B (a) and (d). These cases often reflect the complexity of financial and insurance products, extending to questions such as whether there is a taxable supply under Article 6 (e.g., exchange of creditors) and where the place of supply is located in accordance under Article 9.

Example 1: The lessee of immovable property sells the option to buy at the end of the lease period prescribed in the contract to a third person. Is this cession a taxable supply and a credit covered by article 13 (B) (d) (1) or (2) and if so, by which indent?

Example 2: A bank structures certain activities to comply with the precepts of Sharia law with the consequence that the economic act of making a charge for credit (which is in conflict with Islamic belief) is presented as a series of supplies of goods and services which may not in themselves be exempt. For reasons of equality of treatment, should this package be regarded as the granting of a credit under Article 13 (B) (d) (1)?⁴

Example 3: Several banks have pooled the entire handling of credit granting in one "credit factory" (a separate single enterprise). Only the acquisition of the clients and the decision to grant or to refuse the credit remain with the banks. Are the services supplied by this credit factory to the banks covered by article 13 (B) (d) (1) or (2)?

Example 4: An investment company sells the financial and insurance services of several banks and insurances as their contract agent. The company sells these products to its customers via specially trained sub-contract- agents. The final contract will be concluded between the customer and the bank or insurance company. Are the services supplied by the sub-contract- agents to the investment company and the services supplied by the latter to the banks and insurance companies covered by article 13 (B) (a) and (d) (1) or (2)?

2.2. Hidden VAT in B2B supplies

Where a bank or an insurance company supplies services in the Community which are exempt under article 13 (B) (a) or (d), these operators cannot recover input VAT on costs which are related to these exempt supplies since article 17 grants a right to deduct only

⁴ Sharia or Islamic finance accounts for a significant market share in some parts of the world. The IMF has been instrumental in setting up the Islamic Financial Services Board to coordinate the management of regulatory issues for this type of banking. It is difficult to estimate the size of the market or its potential in the EU. There are a number of specialist institutions operating in the area but, perhaps more significantly, several major European retail banks now offer Sharia compliant products such as mortgages, car financing and current accounts. Islamic law precludes the charging of interest so other mechanisms are used ensure the bank can take a profit on the operation. It would appear that many of these transaction are not covered by the current version of Article 13B (a) or (d).

for goods and services used for the purpose of taxable transactions. The higher the VAT rate of the input supplies, the higher is the hidden VAT in the supplies of services by the bank or the insurance company.

Example 5: Reinsurance company A only supplies reinsurance contracts to other insurance companies in the EU which are exempt under Article 13 (B) (a). The VAT which company A paid to company B when it buys a computer system from B, cannot be deducted by A. The insurance companies who receive reinsurance services from A also supplying exempt insurance services under Article 13 (B) (a) cannot recover VAT on expenditure. In this way hidden non-deductible VAT accumulates in the supply chain.

Example 6: A bank grants credits exempt under Article 13 (B) (d) (1) to taxable persons (business clients) as well as to non taxable persons (private consumers). The VAT which the bank pays on fiscal consultancy for developing the structure of the credit cannot be deducted by the bank and become part of its costs. The price for the credit services which the bank supplies to private consumers (business to consumer – "B2C") reflects this VAT; however this disadvantage is more than compensated by the fact that the bank's services (which include of course a profit margin) are also supplied without VAT. The price for the credit services which the bank supplies to business consumers (business to business – "B2B") also contains this VAT; however were these credit services to be supplied with VAT, the business client could normally deduct this VAT. As a result the non-deductible VAT contained in the price for the credit service be an operating cost for the bank's business client with the consequence that the business will invoice VAT on VAT when it supplies goods or services. The following scheme based on a VAT rate of 20% shows how VAT is paid on VAT in practice:

| | | | | | | | |
|----------|---------------------|-------------|--------------------------|-----------------|----------------|--|---------------|
| C | 100 + 20 VAT | Bank | <u>200</u> | Business | product | 400 + 80 VAT (480) | Client |
| | | | 100 + 80 profit + 20 VAT | | | 100 + 20 VAT + 80 Profit A + 100 own costs + 100 own profit + 80 VAT (20% on 400) | |

The result of the exemption is that C pays **20 VAT** to the tax authority. For the bank the VAT is non-deductible. Therefore it becomes a cost factor for the business, which has to charge **80 VAT** to its clients, because the taxable amount of 400 includes 20 VAT. The final amount of VAT paid to the tax authority is **100 VAT** (20 VAT by C and 80 VAT by the business).

Had the 20 VAT been deductible, the final amount of VAT paid would have been only **76 VAT**:

| | | | | | | | |
|----------|---------------------|-------------|--------------------------|-----------------|----------------|---|---------------|
| C | 100 + 20 VAT | Bank | <u>216</u> | Business | product | 380 + 76 VAT (476) | Client |
| | | | 100 + 80 profit + 36 VAT | | | 100 + 80 Profit A + 100 own costs + 100 own profit + 76 VAT (20% on 380) | |

2.3. Calculation of the deductible amount of input VAT

Another problem consists in establishing the amount of deductible tax in cases where the taxable person carries out taxable and non-taxable transactions. For financial institutions, this is not an unusual set of circumstances. In such cases the amount of deductible tax depends in accordance with article 17 (2), on goods and services supplied to him and used for the purpose of his own taxable transactions. There are numerous ways to determine the proportion of deductible input VAT under article 17 (5) and article 19. Member States could for example directly allocate services and goods supplied to a taxable person, to the taxable transactions carried out by this taxable person (article 17 (5) (b)) for the purpose of determining the amount of deductible VAT. Member States could also establish the amount of deductible VAT in accordance with the simpler pro-rata method in article 19, where a percentage of taxable and non-taxable business is used for the purpose of determining the percentage of deductible VAT. In either case the principal process of establishing the deductible amount of input VAT involves three steps:

- the taxable or non-taxable activities of the economic operator must be established (see above point 2);
- the taxable amount of taxable and non-taxable services must be established in accordance with Article 11 of the Sixth Directive;
- the costs and input VAT on these costs must be allocated to the taxable and non-taxable business.

This process generates considerable administrative charges for economic operators and fiscal authorities and is a continuous source of litigation, creating an atmosphere which reduces the level of legal certainty for businesses and increases budgetary insecurity for Member States.

Example 7: A bank grants long-term credits exempt under Article 16 (B) (d) (1) which the bank re-finances itself at another bank. It also supplies taxable debt collection services to another bank. For each debt collection process it receives a fixed amount plus a percentage of the recovered interests for the collected credit. The bank has invested in office equipment, computers, software and client furniture and wants to calculate the deductible amount of VAT on these expenditures. As regards the calculation of the taxable amount of its long-term credits exempt under Article 16 (B) (d) (1), the bank does not know whether the taxable amounts consists in the gross profit generated for these credits (interests and costs charged to its clients minus the costs for re-financing) or in the interests and costs charged to its clients or only in the interests. It is also unsure over which periods these amounts have to be calculated. In practice Member States administrative rules vary considerably. As to the debt collection activity the fixed amount for each factoring process is fully taxable because debt collection is excluded from the exemption in Article 13 (B) (d) (3). However, it may be uncertain whether the partial transfer of interests is a taxable transaction. In a next step the bank has to allocate the expenditures and the input VAT on them to its taxable and non-taxable business. This allocation depends on the method used by the Member State concerned and may thus vary considerably.

Example 8: A bank specialises in selling and transferring options online to business clients and private consumers; these options representing a right to buy shares at a fixed price within a defined period of time. This activity accounts for 60% of the bank's business and is exclusively carried out by a specialised online sector in the bank. Over the years the bank has developed a second business sector which consists in the safekeeping and administration of titles where the option to buy was exercised. These services may include the collection of interest and dividend papers, the production of deposit files as well as information about exchange developments. Sometimes these activities are paid for by the deposit holder, sometimes by the seller of the titles. Some of these services appear to be taxable under Article 13 (B) (d) (5). In an increasing number of cases, sales and transfers are accompanied by safekeeping and administration of titles in package-solutions where both sectors must work together. The bank faces uncertainty on how to compute the taxable amount for safekeeping and administration for the purpose of calculating the deductible amount of VAT on expenditure. It also faces uncertainty on whether the other services for the collection of interest and dividend papers, the production of deposit files as well as information about exchange developments are accidental to the sale and transfer of the options and/ or shares or taxable as separate services.

2.4. Interests involved and approach to the problems by markets and Member States

A second step was to analyse the importance of these problems and the areas of common interest for Member States and economic operators.

2.4.1. In particular where financial services and insurance operators out-source, pool or sub-contract certain services, unless they fall within the definition of exempt services these services are invoiced by the supplier with VAT which is not deductible for the businesses concerned and enters into their costs. These additional VAT costs diminish the cost savings efforts of the operators concerned and counteract to the operators' strategies to improve their competitiveness. This is perceived as a major impediment to efficiency for the operators concerned.

2.4.2. The nature of financial and insurance services supplied by the operators concerned has become much more complex than that of services supplied in 1977, when Article 13 (B) (a) and (d) was introduced. Many of the financing instruments simply did not exist at that time or are nowadays "mixed bags" (e.g.: financial products containing insurance and other elements like options to limit the risk for the client). This creates the legal uncertainty for the operators whether the services they supply, can still be subsumed within one of the exemptions of Article 13 (B) (a) and (d). This uncertainty conflicts with the need of operators for longer term legal security for their business models and hampers investment decisions.

2.4.3. Where financial and insurance operators supply exempt as well as taxable services the establishing of the deductible amount of input VAT generates high administrative charges for the operators concerned. These charges counteract to their efforts to reduce costs and become more competitive.

2.4.4. Although VAT difficulties may not be the predominant driver for business decisions of financial and insurance companies, they seem to play a significant role. This is confirmed by the energy which the operators concerned apply to convincing Member States' governments and the Commission to resolve these tax problems.

2.4.5. The reaction of Member States reflect two different perspectives:

- a focus on VAT collection as a priority (where Member States give priority to budget problems or perceive a low risk of mobility in the sector);
- a macro-economic driven interest in attracting or retaining key industry sectors (which may be most pronounced in Member States where cost factors are high or the risk of displacement outweighs budgetary concerns).

Depending on the primary interest of the Member States concerned, economic operators achieved can avail of specific solutions for their business models (e.g.: certain re-financing transactions are not considered as taxable where creditors are exchanged, the use of Article 13(A)(1)(f), etc.). In other cases a hands-off approach to fiscal control has lead to similar results. Where economic operators were unable to achieve such solutions with the Member State concerned and where the business model of the operator allowed mobility, there is evidence that activities gravitate to a more facilitating environment.

Example 9: A bank in the EU supplies financial products exempt under Article 13(B)(d) to a second bank established in Switzerland, from where they are supplied to final consumers in the EU. Under Article 17(3) the bank established in the EU can recover input VAT on investments. The second bank supplies the same financial products to final consumers in the EU at a price which does not reflect any VAT.

2.4.6. Although Member States have diverging approaches in dealing with the problems encountered by financial and insurance operators, the evidence to hand confirms that they retain a common interest in budgetary security and in a reduction of administrative costs for the financial supervision of the application of VAT rules by the

operators concerned. It would appear that a key interest of Member States consists in reducing the complexity of

- the methods for calculating deductible input VAT in cases where the taxable person supplies taxable and non-taxable services and of
- the definitions of exempt services because simpler or clearer definitions would also reduce the administrative costs of fiscal control and improve budgetary security.

2.4.7. The Commission services conclude from this that the interest of Member States in reducing the complexity of the calculation of deductible input VAT is partly consistent with the interest of economic operators in avoiding hidden VAT in the services they supply to other taxable persons (B2B supplies); although budgetary interests involved may be diverging. It would also appear that the interest of Member States in more secure definitions for reducing administrative costs and improving budgetary security is partly concurrent with the interest of economic operators in knowing whether services they supply are exempt, giving them the legal certainty they require for long term business planning. On the other hand Member States and economic operators were overwhelmingly of the view at the 2004 Dublin seminar that there is currently no interest in revisiting the generalised introduction of taxation. This means that the room for legislative amendments of the Sixth Directive in particular for supplies to non-taxable persons (B2C supplies) will be rather small. It also means that many of the basic principles developed by the jurisprudence of the European Court of Justice (ECJ) for financial and insurance services cannot easily be changed by legislative measures and will thus retain their validity. Therefore it will not be sufficient to explore the areas of common interest between Member States and economic operators; also the basic principles developed by the ECJ have to be taken into account when exploring possible solutions.

3. JURISPRUDENCE OF THE EUROPEAN COURT OF JUSTICE (ECJ)

A third aspect considered by the Commission services as critical to this review was to look at the basic structure of the ECJ jurisprudence on the exemption of insurance and financial services. This has to be taken into account in identifying in a subsequent step, the measures which could meet the needs of both economic operators and Member States' fiscal authorities within the objectives mentioned above. For the exemptions covered by Article 13, the ECJ has developed an extensive jurisprudence which is based on three main pillars which are deeply embedded in the Court's consistent stance on other services and on the place of supply of these services; it is not limited to the financial and insurance services:

- The terms used to specify the exemptions under Article 13 of the Sixth Directive are to be interpreted strictly, as they constitute exceptions to the general principle that every service provided by a taxable person for consideration is subject to VAT⁵.
- The nature of the service is important. It does not matter who supplies the service, or how it is supplied. It is also not important to which other services the service in question contributes or of which it is a necessary component part⁶.

⁵ (see Case C-359/97 *Commission v United Kingdom*, judgement of 12 September 2000, point 63)

⁶ see Case C-281/91 *Muys' en De Winter's Bouw- en Aannemingsbedrijf* [1993] ECR I-5405, paragraph 13, with respect to Article 13B(d)(1) of the Sixth Directive, Case C-2/95 *SDC* [1997] ECR I-3017, paragraph 32

- The interpretation must meet the requirements of the principle of fiscal neutrality on which the entire system of VAT is based.⁷

This jurisprudence applies for all Article 13 exemptions including those for financial and insurance services under Article 13(B)(a) and (d).

The 3 main pillars described above are supported by three additional pillars, which emerge from the specific jurisprudence of the ECJ on financial and insurance services:

- According to settled case-law, the exemptions provided for in Article 13 of the Sixth Directive have their own independent meaning in Community law and must therefore be given a Community definition; the purpose of the Sixth Directive is to approximate the national provisions on value added tax. In order to avoid distortions of competition, it must be ensured in particular that exemptions are applied throughout the Community in a uniform manner. That objective is jeopardised if the exemptions are complemented by concepts of national law which may diverge from each other. It would appear that this is often the case where Member States have been entrusted with the definition of certain terms like "management" in applying the exemption of Article 13 (B) (d) (6) of the Sixth Directive⁸.
- The exemptions are to be interpreted by reference to the context and the purpose of the rules of which they form part and in doing so the ECJ analysis the intention of the legislator at the time when the rules were introduced in 1977.⁹
- The third pillar is still under construction and contains two basic construction elements: Firstly the ECJ is confronted with the challenge to establish consistency between the various exemptions of Article 13 (B) (a) and (d) (1) – (6) and secondly the ECJ must decide which impact the developing horizontal Community rules for the insurance and financial services will have on the interpretation of the VAT exemptions.

For the exemption of Article 13(B)(d)(3) and (5) the Court held in particular in SDC¹⁰ that the transactions in question must be distinct in character in the sense of forming a distinct whole and be specific to and essential for the exempt transactions.¹¹ In the Abbey National Plc and Inscape Investment Fund case¹², the Advocate General has proposed to the ECJ not to transpose the interpretation developed for Article 13(B)(d)(3) and (5) to Article 13(B)(d)(6).¹³ The Advocate General comes to the conclusion that the aspect of change in the legal and financial situation, which the Court developed in connection with

⁷ Case C-45/01 *Christoph-Dornier-Stiftung* [2003] ECR I-12911, paragraph 42

⁸ (see Case C-169/04 *Abbey National Plc and Inscape Investment Fund v Commissioners of Customs & Excise*, OPINION OF ADVOCATE GENERAL

KOKOTT delivered on 8 September 2005, points 36, 40 - 44, Case 348/87 *Stichting Uitvoering Financiële Acties* [1989] ECR 1737, paragraph 13, Case C-358/97 *Commission v Ireland* [2000] ECR I-6301, paragraph 51, and Case C-428/02 *Fonden Marselisborg Lystbådehavn* [2005] ECR I-0000, paragraph 27)

⁹ Case C-372/88 *Cricket St. Thomas* [1990] ECR I-1345, paragraph 19, Case C-2/95 *SDC* [1997] ECR I-3017, paragraph 22, and Case C-384/98 *D* [2000] ECR I-6795, paragraph 16, Case C-169/04 *Abbey National Plc and Inscape Investment Fund v Commissioners of Customs & Excise*, OPINION OF ADVOCATE GENERAL KOKOTT delivered on 8 September 2005, paragraph 58

¹⁰ Case C-2/95 *Sparekassernes Datacenter (SDC) v Skatteministeriet*

¹¹ *SDC*, cited in footnote 5, paragraphs 53, 66 and 73, and Case C-235/00 *CSC Financial Services* [2001] ECR I-10237, paragraphs 26 to 28.

¹² Case C-169/04 (see footnote 7)

transactions within the meaning of points 3 and 5, is not decisive for determining whether a transaction is exempt under point 6 and then develops a specific interpretation for Article 13(B)(d)(6). If the ECJ follows that proposal, this will lead to a specific interpretation of the different exempt services in Article 13 (B)(a) and (d)(1)-(6) where these services are distinct and specific enough.

In the Abbey National Plc and Inscap Investment Fund case, the Advocate General has also proposed to the ECJ to consider other horizontal EU provisions where they provide a description of the typical functions of the supplier of the services¹⁴ and has come to the conclusion that the horizontal EU provisions should be taken into account in answering the question as to which the operations in question are specific to and essential for the management of a common fund under Article 13 (B) (d) (6).

It would appear that the ECJ will be able to deepen these questions, because the number of preliminary questions where similar issues are to be solved is increasing.¹⁵

4. ADVANTAGES AND DISADVANTAGES OF POSSIBLE TECHNICAL SOLUTIONS

Against this background, it would appear that a possible modernisation must address the following issues:

- it should allow that insurance and financial services suppliers are not left with non-deductible input VAT on supplies which can be allocated to their taxable output supplies whilst,
 - maintaining at the same time budgetary security for Member States,
 - reducing the administrative charges for the economic operators concerned and
 - avoiding distortions in competition;
- it should improve the definition of exempt services, creating more legal security for Member States and economic operators and be sufficiently robust to keep pace with the development of new insurance and financial services;
- it should remove potential or actual competitive distortions between supplies of insurance and financial services across different Member States or between places outside the EU and supplies of those services in the EU.

4.1. Point of departure

In addressing these issues, it is essential to consider the point of departure for the Commission services. Three basic constraints or framework conditions can be identified.

The first is that neither Member States nor economic operators have shown an appetite to revisit the question of full taxation. Although this could still be considered as a theoretical option, in the light of experience to date it is not intended to pursue it further in this paper. As a consequence, some of the basic inconsistencies inherent in exemption are likely to remain in place. Within that constraint, it is however possible to identify options that can ameliorate or resolve particular distortive effects but it will be difficult to resolve all the fundamental inconsistencies created by the exemption itself. The

¹³ Case C-169/04 (see footnote 7), paragraphs 62-63

¹⁴ Case C-169/04 (see footnote 7) paragraph 79

¹⁵ Pending case C-363/05

difficulties in establishing taxable amounts and the correct deductible input VAT remains the basic problem to be overcome.

A further consequence of the exemption model remaining in place is that the basic principles developed by the ECJ for these exemptions remain valid and that any measures contemplated must reflect these principles although there is room for amending definitions as well as other modifications which respect this constraint.

A second condition is that in order to address the need of economic operators for long term planning security and to avoid double or unnecessary investments, an approach to modernising VAT should be fully consistent with the Commission's White Paper on the strategic plans and policy objectives for the integration of financial markets.¹⁶ and in particular with the evolution of legislative and regulatory objectives for the industries, as endorsed by Member States

The third point of departure is to analyse the possible solutions for dealing with at least some of the negative consequences of non-deductible VAT first before addressing the issue of definitions. Any approach proposed by the Commission which Member States may eventually accept for dealing with the definition of exempt services will be influenced considerably by the structural or technical choices made. In fact, some of the solutions examined which appear to reduce administrative charges in exercising fiscal supervision will have budgetary implications which effect the definition of exempt services. If, for example, none of the structural options are considered practical for Member States, the consequent dilemmas associated with updating the definitions of exempt services which will have budgetary consequences and may create an even more complex legal situation.

Common to all of these framework conditions is that whatever is proposed by the Commission should be in conformity with the basic structure and principles of the VAT system.

4.2. Non-deductible input VAT

Within the above parameters, the Commission services have identified five possible technical options with the capacity to address the distortive effect of non-deductible input VAT for insurance and financial services suppliers:

- zero-rating the supply of insurance and financial services to other taxable persons (B2B-supplies);
- extending the scope of exemptions to services supplied by other taxable persons to insurance and financial services suppliers;
- uniform limited input credit option on the basis of a fixed percentage on a designated list of acquired services, constructed in a manner to neutralise the distortive impact of the bias towards vertical integration in the current rules;
- allowing economic operators to opt to tax their supplies of insurance and financial services to other taxable persons (in general limited to B2B supplies) subject to precise conditions allowing to match taxable output with deductible input VAT (e.g.: a product specific cost management);
- the creation of cross-border VAT bodies (groups, cost sharing arrangements or other structures), where they realise taxable supplies, in a manner which does not have

¹⁶ See above footnote 2

negative consequences for either administrative charges or budgetary security of Member States.

In the Commission's opinion, these options merit further analysis and consideration. It is possible that other options may emerge in a consultation process but these refinements of the exemption model will be the focus of this paper.

It should however be stressed that suggesting these options for consideration carries no implication that they reflect any preferences or priorities of the Commission. From the outset, many of the scenarios involved are mutually exclusive and should be seen merely as an *ex-ante* positing of all reasonable options for discussion. Perceived advantages and disadvantages are identified merely for the purpose of assisting discussion.

4.2.1. Zero-rating

Advantages:

- Zero-rating the supply of insurance and financial services to other taxable persons (for example for B2B-supplies) would solve the problem of non-deductible VAT for the economic sector concerned; zero-rating would give the economic operators concerned the full right to deduct input VAT and not generate output VAT. It would thus allow them fully to exploit their strategies (outsourcing, pooling, sub-contracting) to increase their competitiveness. Extending it to B2C might have a certain popular appeal.
- Zero-rating has the advantage of being a clear and transparent solution¹⁷ which would be easy to implement.

Disadvantages:

- The reality is that zero-rating is not really compatible with the overall integrity of the VAT system. It is inconsistent the notion of VAT being a general consumption tax and it offends the principle of fiscal neutrality as defined by the ECJ. Accepting zero-rating on a continuous basis for an entire economic sector would be a significant breach in the VAT system.
- Zero-rating is fundamentally distortive and conducive to economic inefficiencies. It would lead to unequal treatment between suppliers of insurance and financial services on the one hand and other business operators who could not benefit from zero-rating, discriminating against the latter.
- There are some additional accounting and reporting obligations associated with zero rating which may give rise to control risks and would certainly add to complexity. For non-financial activities involving zero rating, tools for dealing with such accounting procedures are already addressed in standard accounting software packages but the more complex issues associated with financial services and insurances require further investigation. With the exception of intra-Community transactions, the general VAT system does not provide for a distinction on the basis of the capacity of a client to deduct input tax and remedying measures would need to be introduced. With the point

¹⁷ The only significant recent instance of introduction of a zero rate for financial services was in New Zealand. This was undertaken as part of a general restructuring of the system for taxing these services with several revenue compensating aspects and in circumstances of budgetary buoyancy.

of departure being the current exemption based system, the tax base will not always be obvious. The institution would have to identify the tax base to allow a customer who has acquired the service for other than a fully taxable purpose to account properly for VAT.

- Zero-rating would also have negative budgetary effects for Member States. The effect of significantly increased recovery for operators availing of zero rates would be difficult to estimate. Ensuring the correct application of zero rating would increase administrative charges for fiscal authorities. Member States would be facing the difficulty of estimating or calculating the deductible amounts for budgetary purposes which they cannot foresee because input VAT generally would be deductible for suppliers of insurance and financial services. The combination of deductible input VAT and zero-rated output is also susceptible to manipulation and misuse. Even worse, transferring the problem of establishing the taxable amount to the recipient businesses of financial and insurance services means spreading the basic unresolved problem to a multitude of economic operators instead of addressing it within a limited sector.

4.2.2. Extending the scope of exemptions

Advantages:

- Extending the scope of the exemptions could immediately solve some of the problems of non-deductible VAT for the economic sector concerned. For certain economic operators, it carries the assurance that their services when supplied to financial and insurance operators are covered by the exemption from VAT. This would reduce the problem of hidden VAT in the exempt supplies of insurance and financial services. It would thus allow the operators concerned to exploit some of their strategies (outsourcing, pooling) to increase their competitiveness.
- It permits addressing specific problems immediately and could be incorporated in a modernisation of the definition of exempt services. The objective here would be to reflect better the reality of the industry today rather than the 1970's perspective in the current legislation.

Disadvantages:

- It is difficult if not impossible to address all relevant outsourcing or pooling of activities by extending the application of exemptions to services supplied by other taxable persons to insurance and financial services suppliers. In fact these activities could cover all sorts of services which insurance or financial services providers buy in. Defining the limits and borders of the exemptions becomes therefore almost impossible to achieve. This makes it very difficult to draw up legislation consistent with the jurisprudence of the ECJ that the nature of a service determines whether it is covered by the exemption, that it does not matter who supplies the service or how it is supplied and neither is it important to which other services the service in question contributes or of which it is a necessary component part.¹⁸
- It will be impossible to resolve all sub-contracting scenarios satisfactorily by extending the scope of the exemptions. Sub-contracting structures often reflect national private law provisions which diverge considerably from Member State to Member State. Integrating these different approaches in one single system would be

¹⁸ See above footnote 2

difficult to achieve although a limited clarification based for instance on the interpretation of the Court in the SDC case might be practicable.

- Any system which is based on the approach of extending the application of exemptions may be difficult to manage for the fiscal authorities if it basically means resolving many different scenarios on a case-by-case basis. Unless linked to significant clarification of definitions, this could lead to complex resolution issues with extremely high administrative charges for Member States. Achieving budgetary security in such a complex environment will thus become more difficult for Member States.
- There is a risk that the main consequence for operators would simply be high administrative charges for the suppliers of insurance and financial services. Any resultant legal uncertainty would be costly and adversely affect long-term planning. The experiences of economic operators with current administrative practises in several Member States and the increasing number of cases arriving at the ECJ confirm this.
- It may lead to increased difficulty in assuring equal treatment between the economic operators, a constraint which needs to be seen in the light of the objectives of the Financial Services Action Plan.
- There is always the risk in attempting to bring a wider range of outsourced activities within the ambit of exemption, the problems associated with unrecoverable VAT are simply being shifted elsewhere.

4.2.3. Uniform limited input credit option

Under certain circumstances, it is possible to envisage a refinement of the exemption based VAT model whereby providers of financial supplies or insurances may not be entitled to claim input tax credits, but could be entitled to reduced input tax credits in respect of specified acquisitions. The purpose of this is to allow the VAT exempt business to recover part of the VAT so that it again finds itself in a similar position as if it had undertaken the contract in-house. The proportion of VAT recoverable is linked to the estimated wage element in the underlying outsourcing contracts.

Advantages:

- Simple to apply in principle and has worked in practice elsewhere, Australia being the best known example
- Avoids any need for case-by-case consideration.
- Can be structured in a manner which aimed at ensuring that outsourcing decisions are not distorted by the generation of extra VAT by linking the percentage of non-recoverable to the average non-labour content of specified outsourced services.

Disadvantages:

- Could give rise to complex apportionment and characterisation issues.
- Raises issues of consistency with fiscal neutrality (although there may be a balancing argument that it would simply restore the economic neutrality which is absent from the exemption model).
- As recovery rates vary significantly between Member States, it could be extremely difficult to arrive at a common recovery rate. The reasons for variations in recovery

rates are not always evident. Furthermore, the range of standard VAT rates prevailing in the Community is not going to make it any easier to reach a common level. The Commission services may need to investigate this issue further to ensure that differences in recovery rates are consistent with neutrality.

4.2.4. Option to tax for B2B supplies

Giving economic operators the option to render their supplies of insurance and financial services to other taxable persons (B2B supplies) taxable, subject to precise conditions allowing to match taxable output with deductible input VAT (e.g.: a product specific cost management) without increasing the administrative charges, could be a realistic means to address the problem.

Advantages:

- Where the option is exercised by the economic operator concerned, all approaches pursued by business operators to increase their competitiveness, in particular those focussing on the reduction of costs would lead to tax neutrality, allowing them to exercise the right to deduct input VAT.
- It is a fair solution, because it grants insurance and financial services suppliers the same rights as other economic operators subject to the condition that they render fiscal control possible. Where they comply with that condition, they will no longer depend on Member States using the option to tax but have themselves a right to opt for taxation in respect of B2B supplies.
- It is fully consistent with the jurisprudence of the ECJ; the terms used to specify the exemptions under Article 13 of the Sixth Directive can continue to be interpreted strictly, the nature of the service will continue to play the dominating role in establishing whether a service is exempt. The principle of fiscal neutrality on which the entire system of VAT is based, is respected. It can be ensured that uniform exemptions apply throughout the Community. The exemptions can continue to be interpreted by reference to the context and the purpose of the rules of which they form part and in doing so the ECJ analysis the intention of the legislator at the time when the rules were introduced in 1977.
- The solution is consistent with all objectives of the White Paper on Financial Services Policy (2005-2010),¹⁹ in particular with the developments in accounting, supervision and actuarial science and with important developments in the banking area under Basel II²⁰.
- The conditions for the option will give the economic operators concerned a clear perspective and an incentive encouraging them to develop and introduce product specific cost management tools which allow the operators to establish a specific and reliable link between taxable input and output and thus an efficient way of establishing deductible input VAT. These tools will enable fiscal authorities and economic operators to establish deductible input VAT with a minimum of resources and thus reduce the administrative charges of both and increase Member States' budgetary security.

¹⁹ See footnote 11

²⁰ The updated version of International Convergence of Capital Measurement and Capital Standards as issued by the Basel Committee on Banking Supervision – see <http://www.bis.org/publ/bcbsca.htm>

- In the regulatory framework described in the White Paper on Financial Services Policy the economic operators will inevitably have to move towards product specific cost management tools to measure their competitiveness in business and to verify whether they comply with the rules (e.g.: Basel II). Therefore the additional incentive of being able to deduct input VAT on the basis of these management tools (and potentially even the VAT on the costs for developing these tools), represents an additional incentive and contributes to the competitiveness of the operators concerned.
- At the same time the option will generate legal certainty for the economic operators concerned and give them a long-term perspective, securing their investments.

Disadvantages:

- Using the option will require some time and considerable investments by economic operators, particularly in those Member States where the option is not currently available in national law.
- Where for cross-border supplies the reverse-charge mechanism (not the supplier but the recipient of the service is the person liable for VAT)²¹ is used, there is a need to communicate that the supplier has opted for taxation to make sure that the fiscal authorities in the Member State of establishment of the recipient can exercise fiscal control. This communication will generate administrative charges for economic operators and fiscal authorities. In mitigation, since the option to tax is already available and exercised in some Member States this is not a new or fundamental problem but rather one of an increase in the platform.
- In order to ensure neutrality and a level playing field, it will be necessary to reach agreement on a mechanism for charging VAT. This however is not an insurmountable difficulty and, particularly if limited to B2B, should not lead to the same complexity as might be the case for a more universal application of VAT.
- The burden of distinguishing between B2B and B2C operations is cited as an obligation which would be cumbersome for the institutions involved.
- Particular issues arise in the insurance sector where insurances premium taxes and other similar fiscal charges apply. These fall outside the scope of the Sixth VAT Directive and so are not addressed here. Any solution should not however lead to double taxation.
- Since much of the output VAT charged by the operators to B2B customers will be recovered by them, the budgetary consequences for Member States remain uncertain.

4.3. Cross-border VAT bodies

The VAT implications of the Societas Europaea (SE) are only now being fully absorbed. The approach of commercial operators to the SE has so far been rather tentative and the role of VAT as a driver for adopting this model of corporate structure seems to be been limited. In certain circumstances, the SE may allow an institution to restructure pan-European operations in a manner which does not generate unintended sticking VAT. As a result, an operator may arrive at some of the advantages associated with a wider application of grouping provisions in a manner consistent with existing VAT rules. The

²¹ See Article 9 (1) of the Commission proposal on the place of supply COM (2003) 822 of 23 December 2003

implications of the SE for VAT on financial services and insurances is however a relatively recent development and but it does promise possibilities for dealing with at least some the issues which currently cause concerns.

Experience has shown that Member States have limited enthusiasm for the fiscal grouping option in Article 4.4 of the Sixth VAT Directive. The extension of this provision to include cross-border VAT bodies (whatever structure they have, groups or other) to facilitate exchanges must be seen against concerns of loss in VAT income for Member States, risks of manipulation and increased administrative charges. However, the creation of cross-border VAT bodies might – in a limited sector and subject to specific conditions – merit further consideration. In fact, where these VAT bodies realise taxable transactions, the authorisation of such bodies could reduce the administrative charges of Member States and increase the quality of their fiscal supervision. At the same time it could reduce the administrative charges of the recipient of services within such a body.

Example 10: An insurance company (A) in the UK has opted for taxation and supplies insurance services to a related bank (B) established in France having also opted for taxation, from where financial services are supplied with French VAT to French economic operators (taxable persons). Under the reverse charge mechanism²²(A) invoices (B) without VAT. (B) becomes the person liable, declares VAT on the supply to the French fiscus and exercises its right to deduct at the same time. In that system (A) needs to inform (B) that it has opted for taxation and provides a taxable supply. (A) also needs to inform the UK authorities that it has supplied an intra-Community services which comes under the reverse charge mechanism. There must also be information to the French authorities so that they can make sure that (B) declares the supply.

Advantages:

- A VAT body encompassing (A) and (B) in the circumstances described above and having a reporting mechanism for the UK and French authorities would reduce the administrative charges of both Member States for processing information under the reverse charge system and also reduce the tax declaration obligations of (B).
- Alternatively, in an environment of a "Societas Europea" where no taxable supply is carried out between the branches established in various Member States with no VAT specific fiscal control on services carried out between them, a controlled environment of a VAT body would appear to become a more interesting vehicle for Member States.

Disadvantages:

- This concept is new and will require that reporting standards and procedures be agreed upon.
- The linkage with the SE requires further investigation.

In any event, further analysis of the use of Article 13(A)(1)(f) as a quasi-grouping provision is required. Although it is a mandatory provision, it has not yet been implemented by all Member States. As currently constituted, it provides exemption to cost-sharing arrangements by entities carrying on exempt or non-taxable activities in the public interest. The application of this provision to financial services has not yet been considered by the

²² See above 2.3. **Disadvantages** – second indent

Court²³ and it is unclear just how widely this provision can be applied but there may be a case for clarifying the legislation. Since not all Member States have yet implemented this provision and the extent to which it has been applied to financial services and insurances is uneven, further study needs to be given to its use on a pan-European level. It does however have some promise as a mechanism for aligning the application of VAT to cost sharing arrangements in line with the evolution of the industries. In addition, where cross border transactions are involved, transfer pricing rules for direct taxes purposes create certain unintended complication. Some mechanism for addressing this will need to be considered.

4.4. Definition of exempt services

In modernising the definitions of exempt services in Article 13 (B)(a) and (d), there are some basic parameters to be seen:

- Currently the exemptions are limited to the following services:
 - insurance or reinsurance transactions;
 - granting, negotiation and management of credits;
- dealings and management in credit guarantees or other securities for money;
- transactions concerning deposit and current accounts (excluding debt collection and factoring);
- transactions concerning currency, bank notes and coins used as legal tender;
- transactions in shares, interests, debentures and other securities;
- management of special investment funds.

Where the basic system of exemptions for financial and insurance services remains in place, and depending on the structural changes which may be envisaged, any widening of the scope of these definitions will necessarily lead to budgetary losses and other disadvantages for Member States. Consequently the extent to which Member States are ready to accept change will have a major influence on how the definition of exempt services must be addressed.

While the legislator is free in re-defining the exempt service; the jurisprudence of the ECJ remains valid in that the nature of the service is decisive in deciding whether it falls under the definition of the exempt service. To avoid distortions of competition, it must also be ensured that

²³ The Court had occasion to consider the measure in *Stichting Uitvoering Financiële Acties v Staatssecretaris von Financien* [1989] ECR I737 but this case related to social and cultural institutions.

uniform exemptions apply throughout the Community, the purpose of the Sixth Directive being to approximate the national provisions on value added tax. The exempt service must therefore be given a Community definition.

There are several examples of where such clarification is needed. The definition in Article 13(B)(d)(6) currently allows Member States to specify what constitutes a "fund". If a more consistent application of definitions by Member States is the objective, a Community definition becomes unavoidable. Currently Member States apply their own interpretation to what constitutes an investment funds for exemption purposes and their position on a common definition would be a pre-condition for re-defining the concept of a "fund".

Against this background there are three basic methods of re-defining the exempt services: -

- using an economic definition of the service and possibly combining it with a measurable criterion (e.g.: credit means "temporary loan of money against compensation, where the costs of included taxable services do not allocate for more than 20% of the agreed compensation.)
- using extensive descriptions of financial and insurance products (e.g.: related services in Article 13 (B) (a) are: "...." or "Transactions concerning other negotiable instruments" in Article 13 (B) (d) (3) are swaps, futures, ...");
- or using the basic purpose and the functions of an exempt service (e.g.: credit granting: "is a service where the main purpose is the temporary making available of money against compensation");

On a more general level, bringing clarity and certainty to the definitions may be at the cost of a significant increase in the level of detail. Given the complexity of the modern industry, this may be inevitable. It also opens issues in relation to the supply of services which might traditionally have been considered as financial or insurance services by other operators. One approach here would be to complement the high level definitions in the Directive with the use of Regulation under Article 29a. This would be consistent with the methodology applied under the Financial Services Action Plan and has proven acceptable to both business and Member States.

5. COMMENTS AND OBSERVATIONS INVITED

The above analysis is by no means a comprehensive catalogue of all the VAT issues which have an impact on financial services and insurances. Additional questions may need attention such as those relating to possible competitive distortions between supplies of insurance and financial services from outside the EU and supplies of those services from within the EU. This leads in turn to ask whether there is a need to re-define rules on the application of deduction under Article 17(3) and for 13th Directive refunds in this sector.

Against this background the Commission is therefore asking stakeholders to respond to this open consultation by providing comments on the paper and to suggest other areas of concern or options for change. Wherever possible, such comments or

suggestions should be supported by details of experience or other supportive evidence.

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