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VAT treatment of financial services

2021

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Background

As part of its efforts to simplify the EU VAT rules, the European Commission has launched an initiative to revise the EU VAT rules for financial services and insurance (FSI). These rules are criticized for being complex, difficult to apply and not having kept pace with the development of new (digital) services.

The public consultation which was launched in this regard closed in May 2021. In response to this consultation a Point of View has been submitted on behalf of Deloitte's EMEA FSI Indirect tax network. Below we have included our contribution.

Our Deloitte EMEA FSI Indirect Tax network is set to contribute to the current debate on the revision of the EU VAT rules for financial services and insurance. Please do not hesitate to contact us in case of any questions. Contact details can be found on the last page.

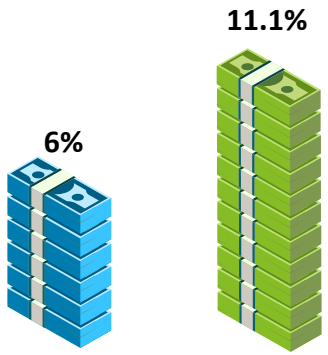
Introduction

We have taken notice of the public consultation on the ongoing review of the VAT treatment of financial and insurance services in the EU with much interest. As a complement to our responses to the questionnaire, we are happy to provide some viewpoints for consideration. These comments result from the common reflections on this topic by our global team of Financial Service and Insurance (FSI) VAT practitioners, who on a daily basis help a wide range of financial services and insurance providers in being compliant with the indirect tax framework that applies to their European and global activities.

Issues: reasons for reform

The current reform agenda has been pushed forward as a result of a number of shortcomings with the present EU VAT system as it applies to financial and insurance services. Here we have summarized a selection of these shortcomings to serve as key attention points in providing a solution to these.

The system of exemption lacks transparency regarding the amount of VAT included in the price of financial products. Neither business customers nor consumers see how much VAT is 'hidden' in the prices they pay, even though this appears to be a substantial amount.



A Dutch study of VAT exemptions by the Dutch Central Planning Bureau has shown that in 2010, the effective VAT rate in the financial services industry in the Netherlands was estimated at 11.1%, higher than the reduced rate (of 6% at the time).

Moreover, the difficulty of applying the current VAT rules leads to increased costs for service providers, which are passed on to consumers.

Other issues have effects that mainly affect taxable persons in the EU (not just FSI companies, but also other companies). The amount of VAT included in the price of financial services is not only opaque, but as a result it is also non-recoverable for business customers in sectors where VAT should be fully deductible. In addition, the sometimes divergent application of exemptions and options to tax by Member States, and various complex partial input tax recovery systems lead to a non-level playing field within the EU and therefore the effective price for financial services differs from Member State to Member State.

Certain issues are experienced throughout the FSI industry. We would particularly like to highlight the difficulties in dealing with internal transactions, legal certainty issues in determining the exact scope of exemptions as a result of present complexities and the added cost of cooperating across financial services groups and ecosystems, and of outsourcing functions and processes. In this respect we would also emphasize the added cost of VAT as a result of cross-border intra-group trading, especially when operating through fixed establishments, partly as a result of case law from the Court of Justice of the European Union (CJEU)[1]

[1]We mention here CJEU 17 September 2014, C-7/13, (Skandia America Corporation), CJEU 24 January 2019, C-165/17, (Morgan Stanley) and CJEU 11 March 2021, C-812/19, (Danske Bank).

[2]See a.o. CJEU 4 May 2006, C-169/04 (Abbey National), CJEU 28 June 2007, C-363/05, (Claverhouse), CJEU 19 July 2012, C-44/11, (Deutsche Bank), CJEU 7 March 2013, C-275/11, (GfbK), CJEU 7 March 2013, C-424/11, (Wheels Common Investment Fund Trustees Ltd), CJEU 14 March 2014, C-464/12 (ATP PensionService A/S), CJEU 9 December 2015, C-595/13 (Fiscale eenheid X), and CJEU 2 July 2020, C-231/19 (Blackrock Investment Management (UK))

[3]CJEU 7 March 2013, C-424/11, (Wheels Common Investment Fund Trustees Ltd), CJEU 14 March 2014, C-464/12 (ATP PensionService A/S)

Issues: reasons for reform

Other issues are more specific to certain FSI sub-sectors:

- Banking: innovation and product development in the payment area, competing with new entrants to the market; and the non-level playing field between full-service banks and niche operators;
- Insurance: the interaction and sometimes misalignment between VAT and Insurance Premium Tax (IPT); the cost of intercompany charges as a result of a regulatory split between various types of insurance and other services, especially when VAT grouping is not available; and the restrictive application of the exemption on insurance distribution models;
- Asset Management: the heavily debated scope of the collective asset management exemption[2], the increased price of pension fund management because defined benefit schemes are excluded from the scope[3]; and the inconsistent treatment of fund management in various Member States as a result of current regulations and their interpretation;
- Capital Markets: problems in determining the right to VAT recovery when trading on financial markets inside and outside the EU; the potential interplay with proposals around, amongst other things, an EU-wide financial transaction tax (FTT) and the implementation of national FTTs in a number of Member States, certain Digital Services Taxes (DST) and other existing indirect taxes such as IPTs

[1]We mention here CJEU 17 September 2014, C-7/13, (Skandia America Corporation), CJEU 24 January 2019, C-165/17, (Morgan Stanley) and CJEU 11 March 2021, C-812/19, (Danske Bank).

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[3]CJEU 7 March 2013, C-424/11, (Wheels Common Investment Fund Trustees Ltd), CJEU 14 March 2014, C-464/12 (ATP PensionService A/S)

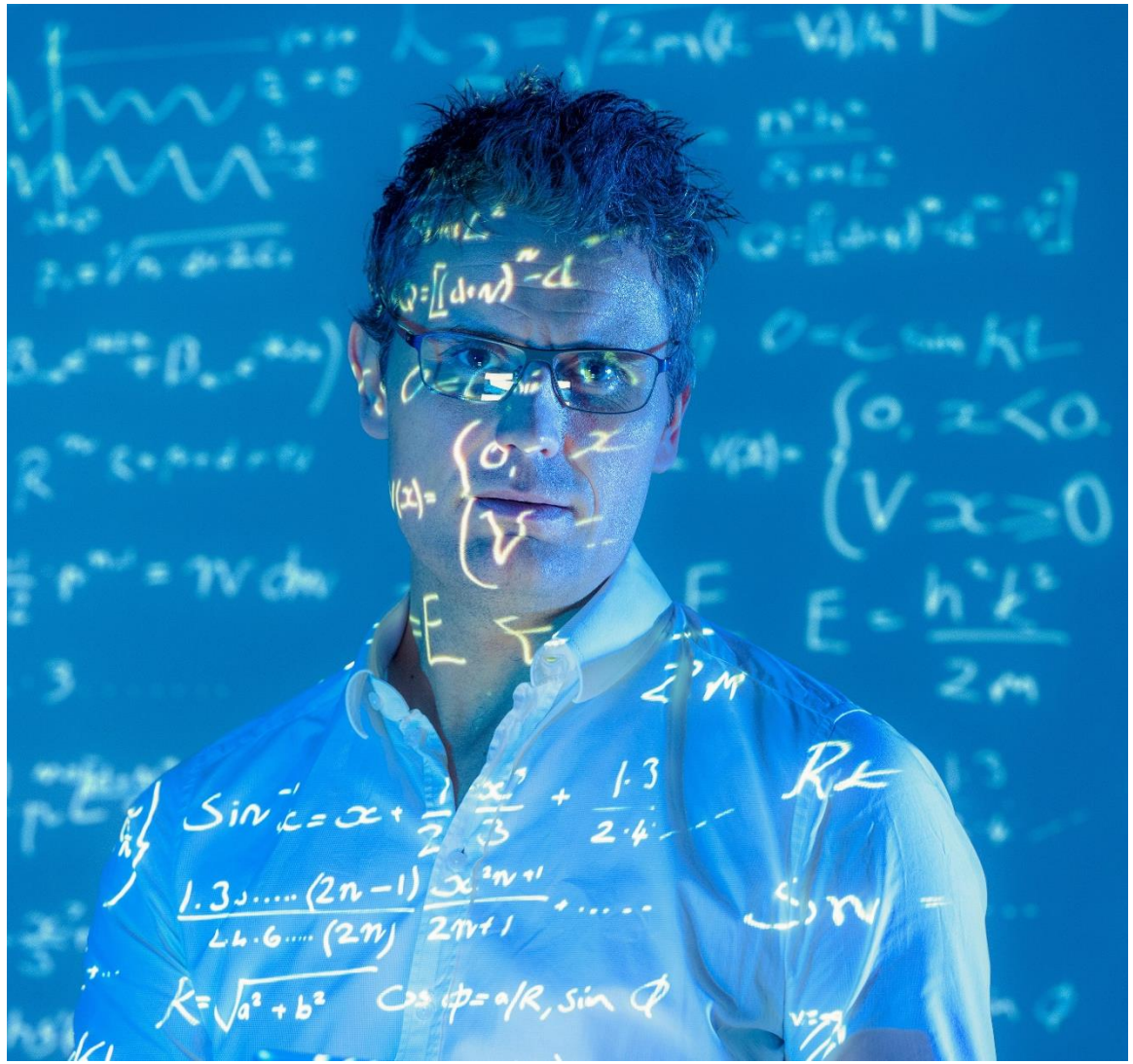
Purpose

With this paper, we intend to contribute to the ongoing debate around the future of the VAT treatment of financial services in the EU. It is explicitly not our intention to provide a blueprint for a future directive, but to present our thoughts on the strategic direction of the reform. We do this taking into account the attention points outlined above, and using the framework which we will set forth in the next section.

Conceptual framework

Introduction

It is not our aim in this contribution to comment on the question of how big the contribution of FSI to the national budgets should be, or to comment on the broader tax reform agenda and tax reform currently being considered in context of the COVID-19 crisis. We intend to contribute to the discussion of how (1.) VAT regulations can be designed in such a way that the internal market can operate as efficiently as possible, whilst (2.) observing as much as possible the OECD tax policy principles.



The internal market: taking away barriers

We have examined in this paper how to create an internal market that is as efficient as possible. Over the past years, the internal market has developed as a result of changes in the FSI industry and ongoing case law from the CJEU.

As a result of some of these developments, new barriers within the internal market have been introduced and existing barriers have increased. The most striking trends introducing or increasing barriers in the internal market in intercompany transactions, cross-border arrangements or obtaining economies of scale are

- The limited scope of the exemption, especially with regard to outsourcing and intermediation (a trend visible in Arthur Andersen[4], Nordea[5], Cardpoint[6], Q[7] and many others);
- The limitation placed on the application of the Cost Sharing Exemption to Art. 132 VAT Directive (introduced in Aviva[8] and DNB Banka[9]);
- The territorial interpretation of a VAT Group as a taxable person (seen in Skandia America[10] and Danske Bank[11]).

Coupled with divergent interpretations by Member States, these developments have increased the amount of legal uncertainty in the application of EU VAT law and as a result have given rise to new situations of double or non-taxation. More often than not, this has led to increased costs (both in terms of tax and increased administration) for financial services providers and therefore their customers.

The central aim of the efforts to reform EU VAT in the financial sector should, in our view, be to facilitate an internal market for financial services that is as efficient as possible, not only for FSI businesses but also for their customers, both businesses and consumers.

[4]CJEU 3 March 2005, C-472/03, (Arthur Andersen)
[5]CJEU 28 July 2011, C-350/10, (Nordea).
[6]CJEU 3 October 2019, C-42/18, (Cardpoint)
[7]CJEU 25 March 2021, C-907/19 (Q GmbH)
[8]CJEU 21 September 2017, C-605/15, (Aviva)
[9]CJEU 21 September 2017, C-326/15, (DNB Banka)
[10]CJEU 17 September 2014, C-7/13, (Skandia America Corporation)
[11]CJEU 11 March 2021, C-812/19, (Danske Bank)

OECD policy principles

The OECD has identified the following five generally accepted tax policy principles that legislators should consider when developing new (VAT) legislation[12]:

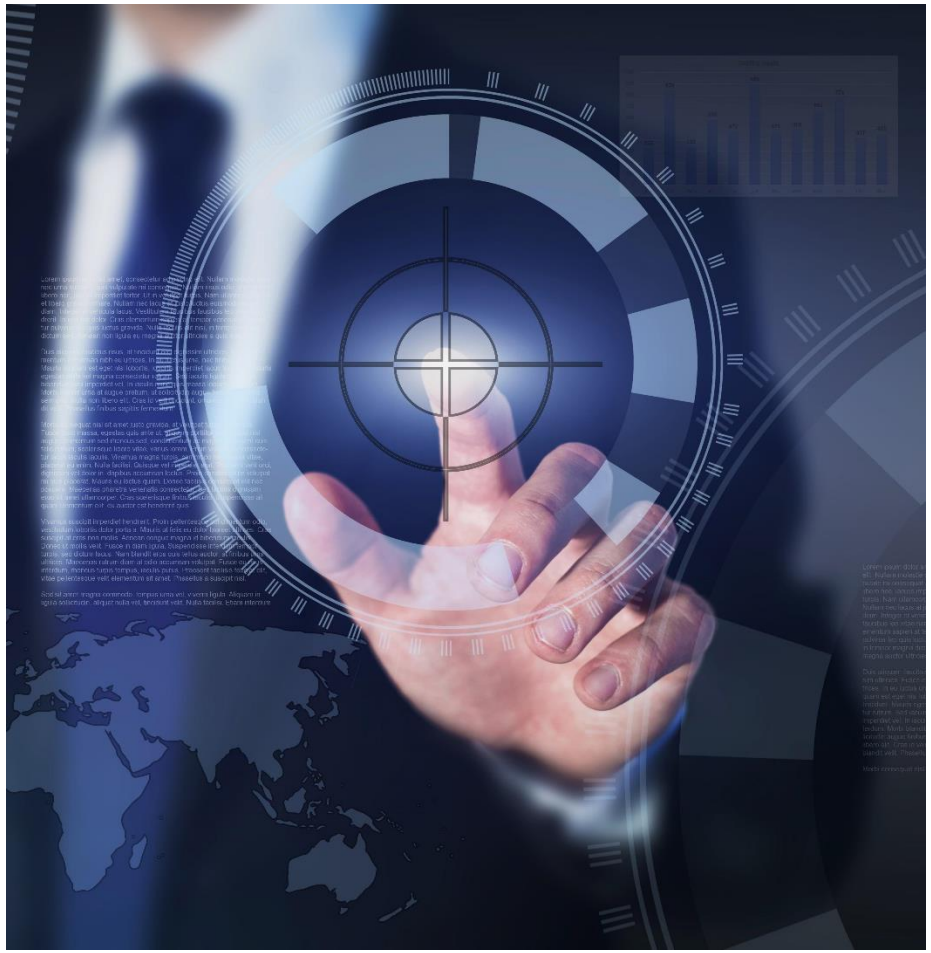
1. **Neutrality:** Taxation should seek to be neutral and equitable between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

2. **Efficiency:** Compliance costs for businesses and administrative costs for the tax authorities should be minimised as far as possible.

3. **Certainty and simplicity:** The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where, and how the tax is to be accounted.

4. **Effectiveness and fairness:** Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved.

5. **Flexibility:** The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.



[12]OECD (2017), International VAT/GST Guidelines, OECD Publishing, Paris.

Possible directions of developments

A number of alterations to the current exemption of FSI, as well as some alternatives to it have been discussed. We have classified them broadly into three categories (maintaining the exemption, abolishing the exemption and partly maintaining the exemption) and benchmarked these against the current exemption, bearing in mind the OECD policy principles detailed above. Where appropriate, we have compared them to systems in use outside the EU.

Option 1: Maintain exemption with a similar scope, draft guidelines with definition of exempt financial services

Possibly the least invasive 'alternative' to the current system is the option to maintain the current broad exemption, but to provide more uniform guidance in the form of consistent legal definitions of financial services to which the VAT exemption applies and provide targeted relief where appropriate.

There are a number of benefits to be expected from this approach, the most important one being that it will solve economic distortions as a result of differing national interpretations that occur when companies compete on an international level. It also addresses some issues on the point of legal certainty.

However, a significant number of core issues around the current exemption are not solved by taking this approach. The first issue is that legal definitions will always be out of date, as no sooner will legal definitions be agreed and written, than new technology will come in and disrupt it.

The second issue is that, in principle, the added VAT cost of outsourcing is not solved by the solution. Only when targeted relief is provided in the form of the introduction of a Cost Sharing Exemption (CSE) and VAT grouping can this be (partly) mitigated. In order to be effective, this CSE should be applicable cross-border and in a broad sense. Even then, outsourcing of activities by financial service providers is still expected to add VAT to their cost base while at the same time not leading to an increase in consumption of financial services. This means that financial service providers are disadvantaged if they outsource to third parties, where other businesses are not. This leads to significant issues in terms of neutrality and efficiency (principles 1 and 2 above). It also limits flexibility (principle 5 above) as financial service providers are likely to be less encouraged to use outsource providers to keep pace with digital advancements. This runs contrary to the objective of taking away barriers to cross-border expansion and cooperation within the internal market.

The same holds true for the added cost of expanding operations across different Member States. Where personnel expenses (which do not carry VAT) are charged to fixed establishments or group companies in other EU Member States, the added non-recoverable VAT increases the cost of services for a multinational company when compared to a local operator. The introduction of cross-border VAT grouping in the EU could alleviate this.

As long as a broad exemption is applied, the cost of financial services will always include an amount of irrecoverable VAT. When financial services are provided to VAT taxable persons, this is fundamentally problematic as it runs contrary to the principle of neutrality[13]. Tax cascading will occur where the financial supply is an intermediate step in the supply chain, and therefore the VAT levied until then becomes a hidden cost (as it cannot be deducted). This could potentially be resolved by introducing an option to tax.

With a number of targeted solutions, like the CSE, cross-border VAT grouping, a broader and more consistent application of the exemption to outsource services and the option to tax, some adverse effects of the exemption can be somewhat mitigated. However, the question arises whether a more fundamental solution might bring more benefits for all.

[13] We refer to the text of Art. 1(2) VAT Directive.

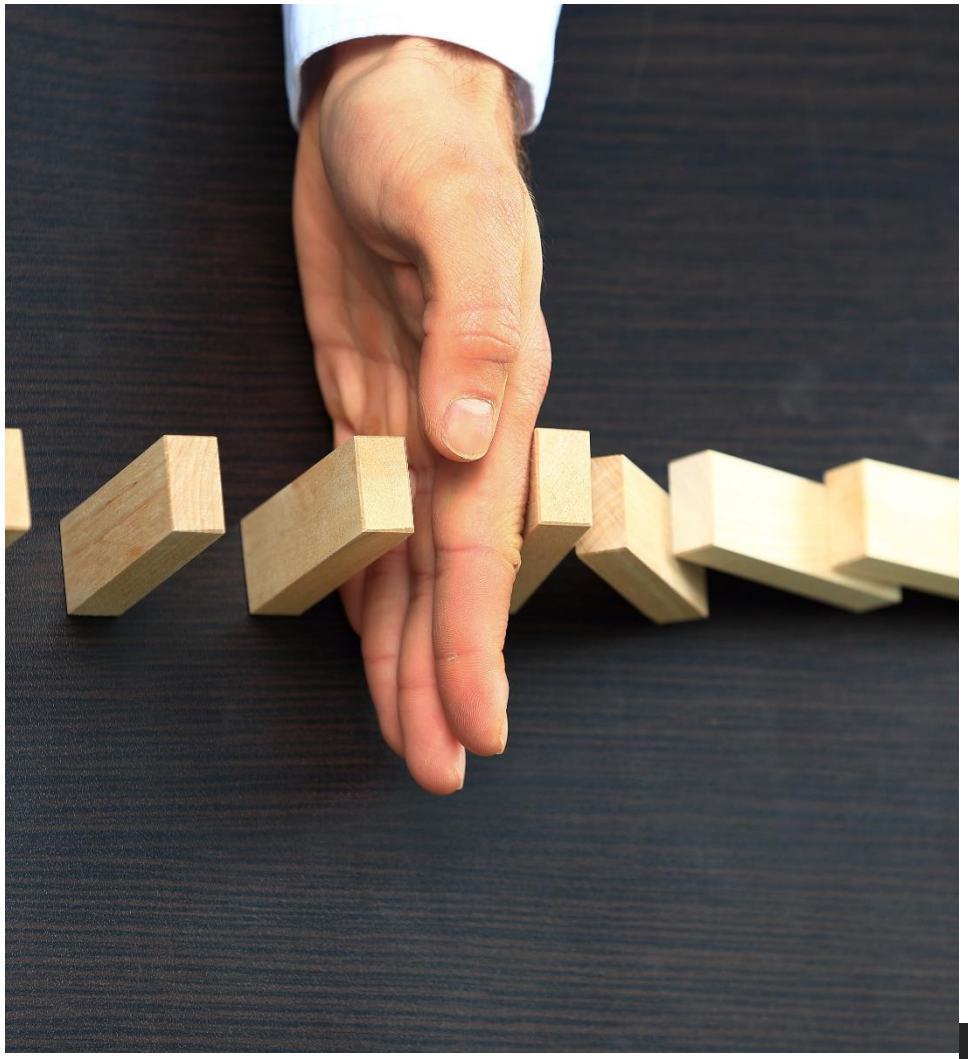
Option 2: Abolish the exemption

If VAT exemptions would be (partly – see option 3 below) abolished, this would solve the core issue of neutrality as the hidden VAT cost in the supply chain caused by tax cascading would not exist due to taxation and deduction for taxable persons. The preference of taxation over exemption was already flagged in the 1962 ABC-report laying the groundwork for what would become EU VAT. There the objective was already stated: exemptions should be kept to a bare minimum and, where possible, replaced by moderate rates set with the aim of neutralizing VAT in the earlier stages of the supply chain[14].

If VAT would also be levied on supplies to final consumers at the standard rate, the VAT burden on financial services will in the end be higher, making financial services more expensive. This could lead to financial exclusion of low- and mid-income consumers. Abolishing the exemption could arguably also impact the competitiveness of the financial services sector in the EU.

We also note that the potential overlap with other taxes such as IPTs and FTTs which are levied on a national level should be taken into consideration. Application of these taxes next to VAT could lead to high additional costs for end consumers.

Conceptually further thought should also be given to the fundamentals of the VAT system when analysing the consequences of abolishing the exemption. Assuming financial services (including insurance) itself will remain unchanged, there will need to be a detailed focus on (1.) the place of supply, (2.) the taxable amount and (3.) the VAT rate. These three elements will significantly impact the effectiveness and efficiency of taxing financial services.



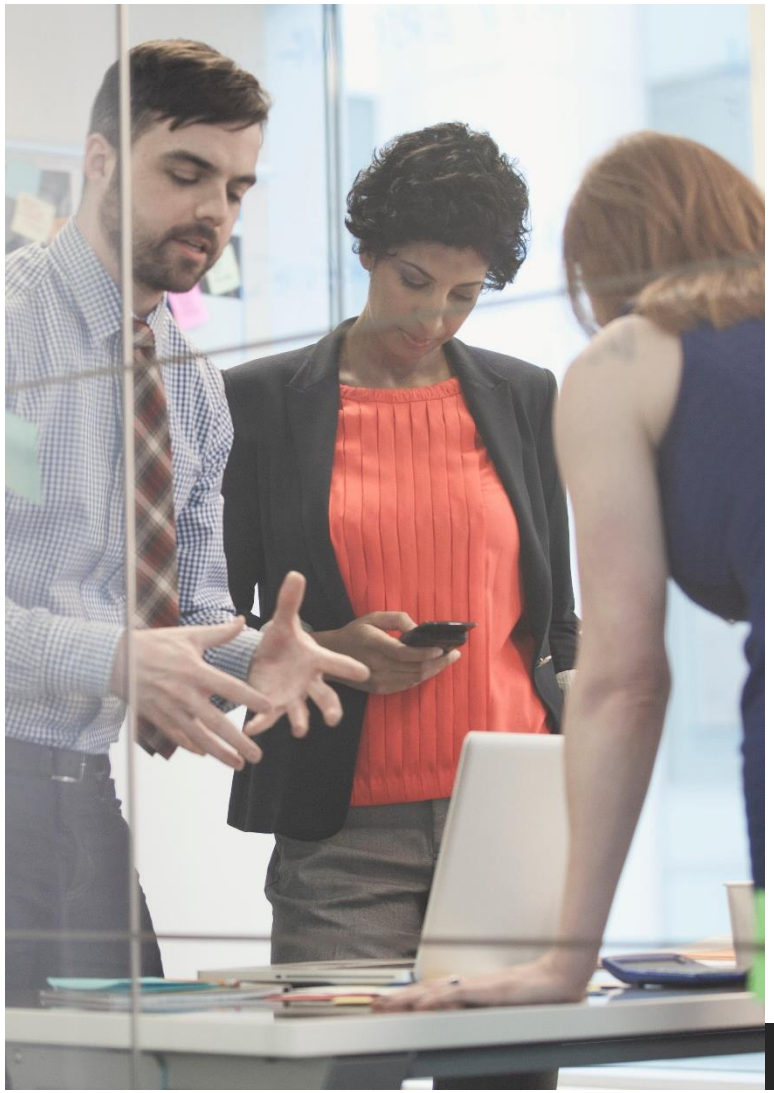
[14]Communaute Economique Europeenne, Rapport General des Sous-Groupes A, B, et C créés pour examiner différentes possibilités en vue d'une harmonisations des taxes sur le chiffre d'affaires, Brussels: EEG 1962, p. 113.

Option 2: Abolish the exemption

3.2.1 Place of supply

One of the drivers to consider in the taxation of financial services should be to tax the added value of these services where they are used. This is in line with the effectiveness and fairness policy principles of the OECD.

For Business to Consumer ('B2C') services, it could be considered to change the place of supply rules. In the current system, the main rule is followed (i.e. place of supply is the place of establishment of the supplier). The place of residence of the customer may better reflect the purpose of taxing consumption to align this better with the destination principle. This would also prevent possible distortion of competition (between Member States) and would ensure that financial services rendered by non-EU providers would also be considered taxable in the EU if used by EU customers.



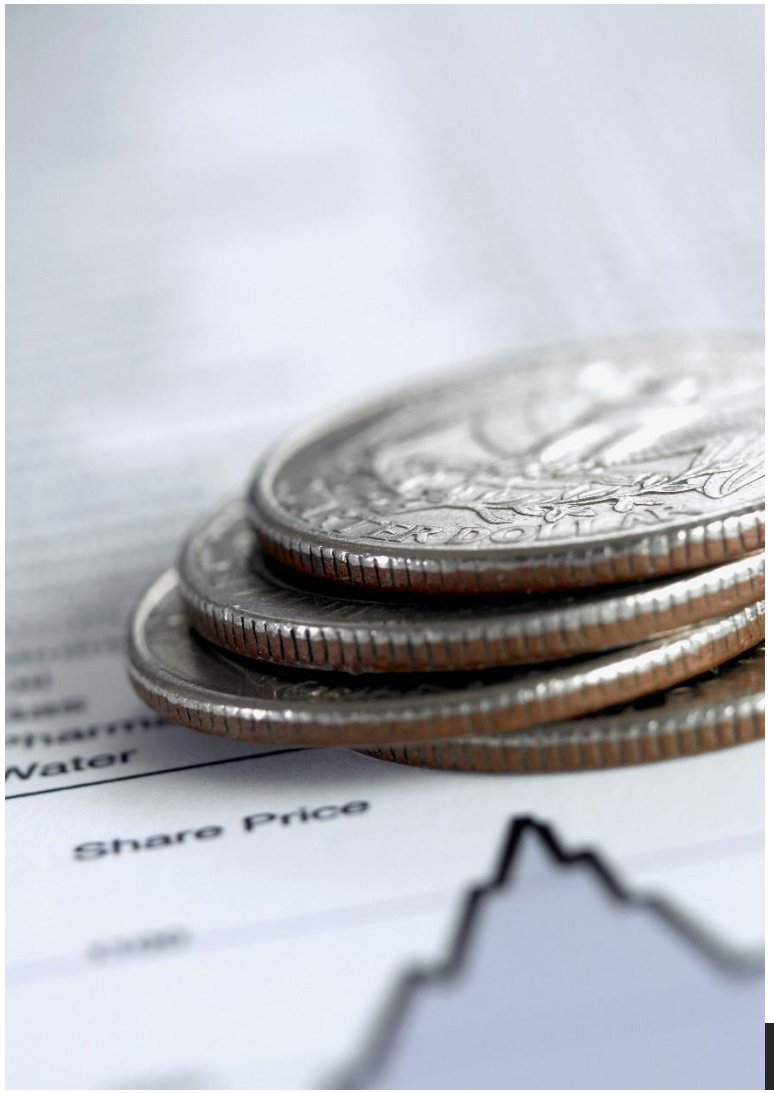
Option 2: Abolish the exemption

3.2.2 Taxable amount

In order to achieve the goals of the certainty and simplicity principle, but also that of effectiveness and fairness, taxpayers should be able to clearly determine the taxable amount (i.e. the value of the consideration).

Due to the complex nature of financial services determining the appropriate taxable amount could be administratively burdensome. Determining the taxable amount would be very complex, not to say impossible, for transactions such as high frequency transactions and derivatives. In this respect, we note that the CJEU in First National Bank of Chicago accepted that the taxable amount to be included in the proportional deduction could be the net margin of transactions on currencies[15]. This “old” case illustrates the complexity of the question while the volume and the complexity of transactions have certainly massively increased since that period.

Technology has made it easier for taxpayers to report and manage supplies of financial services. However, for a number of businesses, especially non-FSI businesses that supply financial services, the quality of data produced by the systems in respect of both invoicing and reporting could still make it very difficult to correctly determine the taxable amount of financial services. Various studies prove that the easier a tax system works, the more voluntary compliance increases.



[15]CJEU, C-176/92, (First National Bank of Chicago)

Option 2: Abolish the exemption

3.2.3 Tax rate

When the place of supply and the taxable amount are clear, the applicable VAT rate should be determined. In various studies and proposals in relation to the review of the VAT rules for financial and insurance services, the standard rate, one or more reduced rates and even a zero rate have been put forward.

Reduced rates are often socially and/or politically motivated and serve to stimulate the consumption of goods or services covered. Broadly, the aim is to alleviate the burden of tax due to a targeted relief that keeps prices low and therefore accessible to a large group of consumers.

While this is well motivated, it sometimes does achieve the objectives. An example would be to apply a reduced rate to all foodstuffs as introduced in many EU member states and other countries with a VAT system. While this makes basic needs such as food more accessible to a large group of consumers and arguably also provides for a redistribution of income (as consumers with a lower income will spend a larger proportion of their income on food), it also means that the reduced rate can apply equally to luxury items like caviar as it does to essentials like a can of beans.

Arguably, other rates than the standard rate are complex as they trigger questions on demarcation and generally increase the cost of compliance.

Taking into account budget neutrality, that is very likely to be high on the agenda of any tax reform in the next few years, applying a reduced rate, (possibly combined with a zero rate) to (some) financial services would also mean that this reduced rate will need to be relatively high. Although consumers to a large extent already pay for embedded VAT in the prices of financial services, replacing an exemption with taxation could impact social acceptance. As indicated above, as an example, in 2010 the effective VAT rate in the (exempt) financial services industry in the Netherlands was estimated at 11.1%, higher than the reduced rate at the time.

Option 2: Abolish the exemption

3.2.3 Tax rate

This impact will vary based on the activities of the financial services industry in the country. The main driver here will be whether the financial services sector broadly provides services on a local level or is a net exporter of services.

It should therefore also be considered, when determining a revenue neutral (reduced) VAT rate, whether this should be done on a national level or on a uniform EU level where there will likely be ‘winners’ and ‘losers’. Accordingly, allowing flexibility for the (reduced) rate (i.e. within an EU prescribed range) should be considered.

An alternative could be to introduce the zero rate for (selected) financial services. The zero rate is already in place for different goods and services in some Member States and the United Kingdom. Moreover, in the United Kingdom, since 1 January 2021, financial services rendered to foreign clients generally allow VAT recovery of input tax, which creates a “de facto” zero rate. Applying a zero rate would solve issues such as the hidden VAT for business without creating an additional VAT costs for individuals and would enforce the competitiveness of the EU financial services sector. The obvious downside of applying a zero rate to financial services, however, is that it will have by far the highest negative impact on tax revenues.

Option 3: Partly maintain the exemption, tax more services

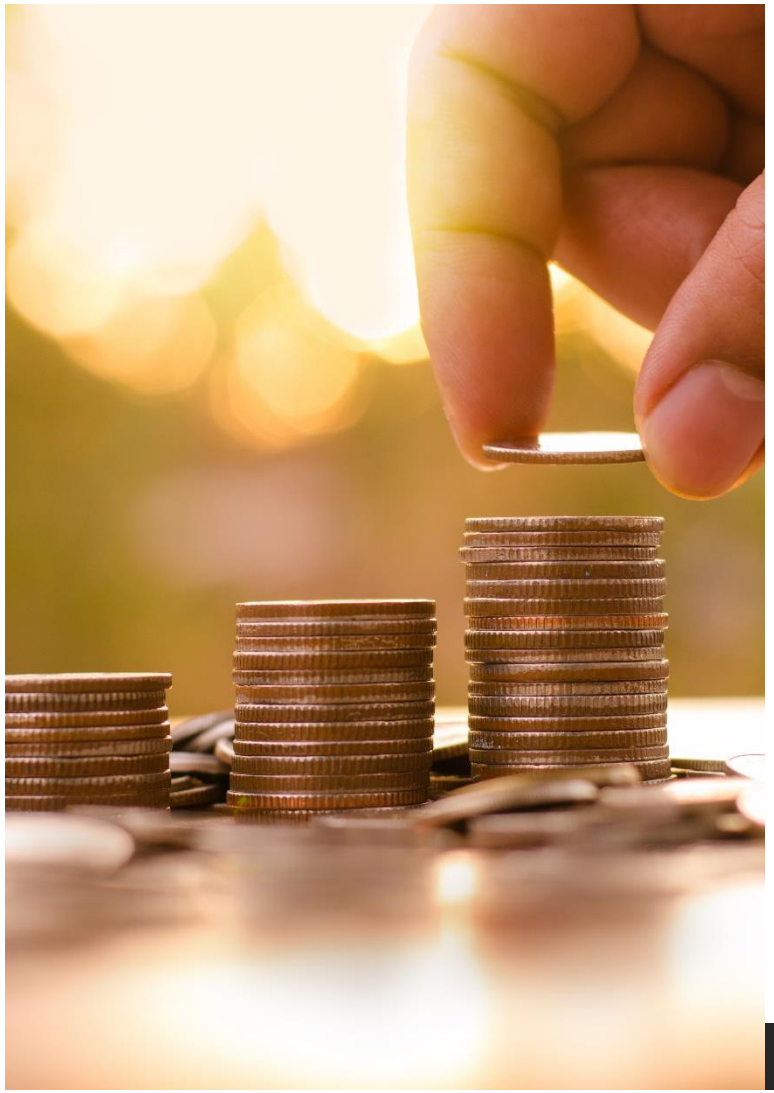
Option 3 is to partly maintain the exemption, while taxing more services. Taking into account the taxation of financial services in other regions and countries (e.g. the Gulf Cooperation Council States, New Zealand and South Africa), this third option involves taxing fee-based financial and insurance services, while maintaining the exemption for margin-based financial services (products which offer a spread as a return on investment or interest income).

This approach acknowledges the complex nature of financial services meaning that for certain (margin-based) financial services, determining an appropriate method of taxation would be too administratively burdensome and therefore where this is the case, an exception is made, so that some services are treated as VAT exempt. Such an approach limits the disadvantages of VAT exemptions generally.

In VAT systems without exemption, the default position for insurance is that broadly general insurance products and insurance brokerage are treated as taxable, while life insurance premiums are exempt.

The impact and considerations of implementing this system with a partial exemption of financial and insurance services are broadly similar to those of option 2 (where exemptions are totally abolished).

The most important additional attention points for this option are (1.) the demarcation between margin-based and fee-based supplies and (2.) the tax rate for taxable services.



Option 3: Partly maintain the exemption, tax more services

3.3.1 Margin-based vs. fee-based

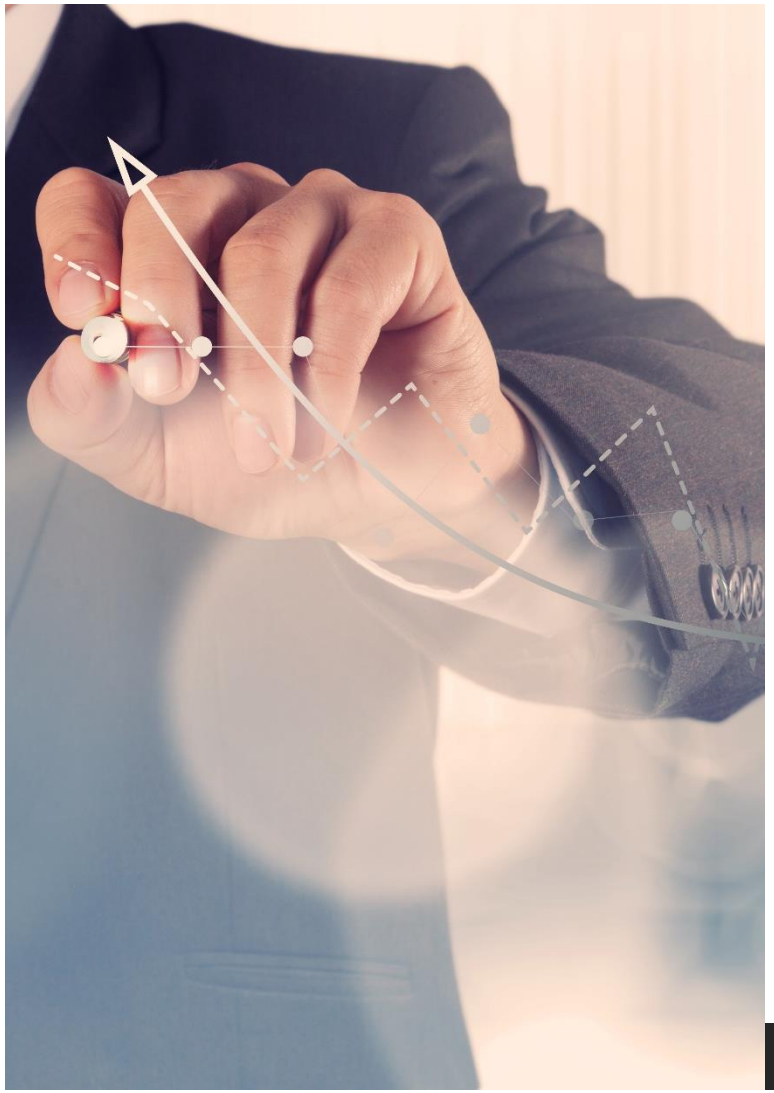
Although the distinction between margin-based services and fee-based services seems rather straightforward, in practice this distinction could lead to difficulties and as such creates a conflict with the aims of efficiency, certainty and simplicity (principles 2 and 3 above).

A result could also be that services which have the same use to the customer could be taxed differently solely on the basis of the way the consideration is calculated or charged, which is not in line with the effectiveness and fairness of taxation (principle 4 above). This may lead to (tax) planning by restructuring products to achieve the desired treatment for VAT purposes.

Another potential complication with the distinction is that a proportionate right to VAT recovery needs to be calculated by most financial service providers. Even though applying the exemption alleviates the problem of determining the taxable amount to calculate the VAT payable, it will likely be still relevant for the purposes of a partial exemption calculation. Additional guidance in this respect may be necessary to ensure the harmonized application of this system.

3.3.2 Tax rate

Again, assuming a revenue neutral reform of the VAT rules, maintaining the exemption for margin-based financial services (and life insurance premiums) will mean that the VAT rate for financial services subject to tax will need to be relatively high (also see 3.2.3 above). This may not align with the policy objective to make financial services accessible for all customers and other EU policies such as to diversifying and improving the financing of the EU capital markets.



Outline for policy review

Based on the above, in our view, there is merit in further investigating the extent to which some form of default taxability for financial services can be introduced alongside certain exceptions for exemption. Our initial view would be that it is recommended to apply exemptions where a targeted relief is achieved (i.e. in line with policy principles and the concept of exemption adds value to the policy as a whole). In other cases, taxation could conceptually be a better option.

It should be noted that the choice for (partial) taxation also means there needs to be detailed discussion on the place of supply, the taxable base and the VAT rate, as this will have an impact on the competitiveness of the financial services sector, the revenue impact for countries and the successful implementation of the new rules.

Given the practical challenges associated with this approach (relating to systems, reporting and invoicing), this could also work to reinforce the EU's ambition to become a digital leader in financial services.

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