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Accompanying document to the

Proposal for a

COUNCIL DIRECTIVE

amending Directive 2006/112/EC on the common system of value added tax, as regards the treatment of insurance and financial services

IMPACT ASSESSMENT

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EXECUTIVE SUMMARY

Lead Directorate-General: DG TAXUD

Other Involved Services: SG, MARKT, ECFIN, ENTR.

Agenda Planning/Work Programme reference: 2006/TAXUD/008

The VAT Directive exempts most main-stream financial services and insurances. In consequence, these industries are not required to charge tax on the services which they supply but they are also generally unable to recover the VAT they pay on the goods and services which they acquire to operate their businesses. This non-recoverable tax is a significant source of revenue to the tax administrations of the Member States. It is also one which automatically increases as financial and insurance institutions increase their use of specialist third party service providers (outsourcers) or consolidate their operations on across-border basis (such as through shared cost centres).

The legislation has never been revisited since it was adopted in 1977 and has been showing its age in recent time. The work undertaken by DG Taxud in the preparation of this impact assessment has demonstrated that there are growing problems in ensuring a clear and consistent application of the exemption across the Community. This is mainly attributable to the way in which the industries have become more sophisticated and complex over the last thirty years but also in how the move towards a single market has highlighted inconsistencies. New products have been developed as well as new ways of delivering these products to consumers. Institutions build up operational relationships, sometimes with companies who would not normally be considered to be financial or insurance institutions and it is not always easy to see whether these activities should be treated as exempt financial services.

This uncertainty has lead to a significant growth in litigation with the ECJ being asked to interpret the legislation with increasing frequency. This process can be initiated by either businesses or tax administrations, both of whom are faced with ambiguity and uncertainty. It is a slow and cumbersome way of delivering clarity and the outcome is often uncertain. For tax administrations, they see risks to revenue here and attach importance to re-establishing long-term certainty. For businesses, uncertainty also inhibits long term planning and causes the diversion of significant resources to the resolution of tax problems. DG Taxud has concluded that modernising the definitions should therefore be regarded as a priority. Ideally, this should be achieved as far as is reasonably possible in a tax neutral way that respects both the general limits of the current exemption and the relevant jurisprudence of the ECJ.

The preparatory work has also shown that the EU's financial services and insurances industries are less efficient than their international competitors, particularly US institutions. As a consequence, EU industry in general faces higher costs for financial services and insurances.

There are many factors which contribute to this and VAT is probably some way down the list. Nevertheless, embedded or non-recoverable VAT plays at least some contributory role and certainly increases the cost of financial services to business.

Because of the revenue implications, the room for manoeuvre in dealing with the efficiency issue is limited. It will not be easy to persuade the national tax administrations that keeping and encouraging a vibrant financial services industry in and across the EU should be worth limited VAT revenue trade-offs.

Even in the absence of any legislative change however, the development of a pan-European market for financial services will have an impact on the pattern of existing tax revenues. DG Taxud is consequently minded to consider some measures which would mitigate the

unintended effect of VAT on business efficiency. These should take particular account to disincentives to cross-border consolidation and could include more extensive cost sharing exemptions or, in limited instances, a wider access to the option to tax.

The Impact Assessment has been amended to take account of the comments received from the Impact Assessment Board in its opinion of 17 July 2007. These changes cover, *inter alia*:

- A section summarising the main problems.
- A summary of the objectives which are in turn related to the evaluation of specific policy options.
- Inclusion of some selective data, collected by interviewing commercial operators, on the costs occasioned by problems in the existing legislation which are intended to be reduced or eliminated. (This does not totally overcome the issue in relation to quantification of problems and options where enormous difficulties remain in sourcing reliable data.)
- Additional explanations reinforcing the link to the Financial Services Action Plan and the Single Market Review.
- Further analysis of the administrative costs and burdens associated with the tax. In the context of the EU Standard Cost Model, specific administrative burdens on business are not mandated in the VAT Directive but remain the responsibility of Member States. Nevertheless, the proposal could over time produce some costs savings under headings which fall outside the Standard Cost Model but this will continue to depend on how Member States apply the legislation and accordingly it is not possible to assess what, if any, savings might be achieved.
- A summary of policy options has been added.
- The arguments on why the *status quo* is not sustainable have been further developed.
- The supportive arguments for why the particular policy options have recommended are developed further.

1. PROCEDURAL ISSUES AND CONSULTATIONS OF INTERESTED PARTIES

1.1. Why is there an issue with VAT on financial services and insurances?

Since the adoption of the Sixth VAT Directive in 1977[1], the EU's common value added tax system has exempted most main stream financial services including insurances and investment fund management. The precise reasons for the exemption have never been set out but whilst it has been variously attributed to economic or social policy considerations, the main one seems to be the technical complexity inherent in taxing financial services. To some extent the Directive reflects an uncertain approach in that it also allows Member States to grant taxable persons the option of taxing these services. Nevertheless, the general practice of the last thirty years has been exemption. Since VAT is a Community tax which functions on a common legal base set out in Community legislation, any changes can only take place at that level.

Intermediation lies at the heart of most financial services and it is not easy to allocate the margin to individual transactions under the normal VAT system (unlike measurement of profit for corporation tax or financial reporting purposes which aggregates the difference between interest received and interest paid by the financial institution). This is an essential requirement if businesses who pay for financial services are to be able to recover the VAT included in the price they pay.

The growing sophistication of the industry has not made it any more amenable to the normal VAT system. In some complex transactions, it may even be difficult to identify who is the recipient of the service for tax purposes. VAT normally functions as a transaction based tax where taxing decisions must be made at the point where the transaction takes place. This requires a high level of certainty on the nature of the transaction.

Difficulties caused by intermediation also present problems in applying VAT to the activities of insurance companies. Additional technical VAT problems would occur in the treatment of claims settlement for private consumers and the existence of insurance premium taxes or other equivalent charges in some Member States is also a potential source of problems for the introduction of another tax.

Whatever about its origin, a significant consequence of exemption is that a business is unable to recover the VAT it bears on its inputs (or purchases) of goods and services. Instead, it becomes a charge which must be absorbed by the business.

The generally held view at the time of adoption of the common VAT system saw exemption as a transient solution to be replaced eventually by a methodology for applying VAT when the technical problems were overcome. This perception of transience allowed for an acceptance of some manifest shortcomings on the basis that they would be rectified in time. Exemptions of this nature (without the right to

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[1] The legal base for the Sixth VAT Directive is in Article 93 of the Treaty establishing the European Community. It requires that the Council "*adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market*." On 28 November 2006 the Council adopted a recast directive incorporating the provisions of the Sixth Directive as well as other VAT legislation. Council Directive 2006/112/EC of on the common system of value added tax is now habitually referred to as the VAT Directive and in the rest of this note, is referred to as such.

deduct) are alien to the VAT system because they interfere with the neutrality of the tax and the cascading effect caused by the non-recoverable tax distorts competition. Exemption with deduction (effectively zero rating), whilst resolving the cascading problem, would have been equally alien to VAT.

The Commission services however persisted with the objective of developing a full taxation model which would deal with these shortcomings. A series of reports on this work were published in the late 1990's[2] on what became known as the TCA method (tax calculation account). The methodology was generally accepted as delivering technically on the objective of full taxation, a conclusion confirmed by extensive field testing.

This field testing also confirmed that what was being contemplated was extremely complex, with significantly increased administrative charges and perhaps even reduced transparency. Moreover, the various reports contained rather little to re-assure stakeholders that the benefits of the system could outweigh its costs, in particular the costs of implementing change. The political sensitivities associated with applying VAT to consumer credit, including mortgages, did little to make TCA any more palatable.

Given a uniformly negative reaction from stakeholders, the Commission never took the step of making a legislative proposal to introduce full taxation. Notwithstanding the significant amount of work that had been undertaken, the issue was effectively shelved for the time being. Some further reflections have confirmed the perceived shortcomings in the TCA method. These include difficulties in coping with some more recent market developments such as the delivery of financial services by operators who do not conform to the more traditional models of financial institutions.

To complete this opening picture, it should also be said that no other jurisdiction has found a suitable and straightforward way to tax financial services. All major economies (with the notable exception of the US) have a VAT system[3] but struggle with how to tax financial services. In general, they exempt most supplies whilst trying to incorporate mechanisms to deal with some of the more serious shortcomings[4] where these might have a negative effect on international competitivity. Although it may not pass uncontested, there is a broad professional consensus that exemption is the only workable option at least until something better comes along.

1.2. Situation today.

Since then, the evolution of the environment is which these industries operate has meant that the sources of stress inherent in the exemption model for both businesses and tax administrations have become more apparent. The EU is not unique in treating

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2 http://ec.europa.eu/taxation_customs/taxation/vat/key_documents/reports_published/index_en.htm

3 In some parts of the world, VAT is referred to as a goods and services tax (GST) but this is simply a variation in the nomenclature.

4 The limited use of zero rated taxation of financial services with full recovery adopted in New Zealand is not readily transposable to the EU and, apart from the special case of Hong Kong, has not been replicated elsewhere. The Australian GST on insurances works effectively in that country, overcoming the problem with settlements involving non-taxable persons or final consumers by requiring the insurer to make an adjustment to their GST accounts to reflect final consumption. Although conceivable, the introduction of such a model here would be difficult and disruptive, particularly in the light of existing national insurance premium taxes and other equivalent taxes where Article 401 of the VAT Directive allows Member States a free hand.

financial services and insurances in this fashion and many of the practical difficulties entailed in interacting with VAT are well known. Here however VAT produces a particular range of problems in its implementation across 27 Member States whose ambitions include the establishment of a single pan-European market. In this respect the application of VAT gives rise to tension points which are not found elsewhere in applying a consumption tax to financial services and insurances.

The existing tax arrangements generate revenues for tax administrations which have grown significantly over the years. Any option for change has to respect this important reality.

VAT rates have moved upwards since 1977 when they averaged 14.5% (across 9 Member States) to today's average of around 19.5% (27 Member States). The real increase in tax yield has however been produced from the increase in the tax base. In 1977 financial and insurance institutions managed most of their own back office and support activities. Institutional structures were nationally based, focusing in the main on supplying domestic markets.

The growth in outsourcing and the trend towards cross-border consolidation within the Community have become important sources of tax revenue for national treasuries. The counter-part of this is of course that the evolution of the industries since 1977, as well as changes in the legal and regulatory environment, has increased exposure to non-recoverable tax. For them, increased tax charges absorb the first benefits from any efficiency gains from cross-border consolidation and outsourcing.

Maximising economic welfare demands a high-performance and efficient financial system. These are ‘special’ industries due to their fiduciary nature, their role as enablers in the wider economy and the imbedded systemic risk in their activities. Public policy decisions, such as those relating to tax, have a role to play in enabling them to deliver. Balancing economic efficiency against stability and fairness in the tax system is not easy, particularly here where the task in hand includes reconciling single market objectives with appropriate taxation of the financial services and insurance sectors.

Given their legitimate expectations of tax revenue, it will be necessary to establish to Member States that it may not be possible to maintain total budgetary neutrality if a viable solution to the VAT problem is to be found. Keeping and further developing a vibrant financial services industry in and across the EU should be worth limited VAT revenue trade-offs.

1.3. Dialogue with national tax administrations of Member States

In aftermath of the TCA exercise, Member States showed little appetite to revisit the VAT treatment of financial services and insurances. Concerns about an impact disproportionate to any problem left many Member States cautious of change. For them, perhaps the best approach was to carry on with the 1977 model, despite all its imperfections, and to deal with any more urgent problems on an *ad hoc* basis as they arose.

Nevertheless, The Commission was of the opinion that, given the economic importance of the sectors, the issues could not be ignored. The disappointing outcome to the earlier work notwithstanding, the need for reform was becoming obvious. Other options, perhaps less ambitious, needed to be considered.

1.3.1. First Fiscalis seminar.

The Commission services first step was to convince Member States of the need to re-visit the issue and to start a fresh examination of the problems and possible solutions. This was initiated through a Fiscalis[5] seminar held in December 2004.

Apart from the already established issues of lack of neutrality and distortion, the seminar identified concerns about consistency with FSAP objectives (with participation from DG Markt) and the manner in which the legislative vacuum was being filled by the ECJ (with input from the Commission's Legal Service).

The seminar successfully addressed the reluctance of Member States to engage on the VAT issue by demonstrating that modernisation was overdue. As a consequence, the Commission services could commit themselves to further work on problems and potential solutions on the basis of an overwhelming conclusion among Member States that the existing situation was unsatisfactory[6].

1.3.2. Next steps

Given that there was no desire or advocacy for a root and branch overhaul (such as the TCA method), a pragmatic approach dictated that work should focus on identifying the shortcomings in the exemption model, analysing their impact, and then considering what options were realistically available for reform.

During 2005 dialogue with the main stakeholders was intensified. Regular contacts were established with representative groups such as the European Banking Federation (FBE), the Comité Européenne d'Assurance (CEA) and The European Fund and Asset Management Association (EFAMA) as well as professional advisors and other interested parties.

The issues were also discussed bilaterally with a number of Member States, largely at their initiative. These tended to be rather unstructured and general, given that the frontiers of the working space were still being defined.

Consequent to the first Fiscalis seminar, it had been the intention to present an analytical paper to Member States in the VAT No.1 Working Party during the course of 2005. However the complexity of the issues and the need for further investigatory work precluded this. Apart from a developing dialogue with the industry, the case for seeking independent expertise was soon apparent. Accordingly a tender was launched for a study to establish the major problem areas and their impact as well as some options for remedying them.

The contract for this work was awarded to PwC after a competitive tender procedure[7]. The report details are set out in paragraph 2.2.2 below.

A first working meeting with Member States was eventually held in February of 2006. The purpose was to inform Member States of the Commission services thinking. The analytic working paper which was the basis for discussion broadly

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5 Fiscalis 2003-2007 is a Community Action Programme intended to improve the operation of the tax system in the internal market. Seminars can consider a range of issue including shortcomings in the operation of existing legislation. In order to encourage free discussion, there are no binding conclusions and individual views are not identified in the final report.

6 Only two Member States dissented from the (informal) conclusion that the Commission should re-open the issue – one on the basis of having no instructions, the other that it was unnecessary.

7 Tender No Taxud/2005/AO-006.

presaged the consultation paper subsequently released on 14 March 2006 (see 2.2.1 below). For the most part reactions at this initial meeting were muted with most participants simply noting the work of the Commission. A few drew attention to what they saw as the priority of revenue security.

In so far as Member States have expressed their opinions, they have a preference for limiting the current exercise to a modernisation of the definitions of exempt financial and insurance services. They are at best lukewarm, but perhaps even antagonistic to wider structural change which they see as involving revenue losses. Even where there is an openness to debate these issues, they would prefer to treat them separately allowing the Council to handle the definitions issue expeditiously.

1.3.3. Second Fiscalis seminar

A second Fiscalis seminar was held in March 2007 with the objectives of familiarising concerned officials from the national tax administrations with the policies driving change in the general regulatory framework for these industries, and the economic drivers for cross-border financial integration. The programme also covered practical implementation issues in the current legislation.

Contributions from DG Markt confirmed that cross border delivery of financial services and, to a lesser extent, insurances is a reality which can only increase. Cross border consolidation is not driven by tax considerations. It rather has tax consequences although in some configurations (branches as opposed to subsidiaries) these consequences may be reduced. It is more developed in some area than others with investment products ahead of the general curve.

A side effect of cross-border marketing is that the tax revenue generated by VAT on inputs will mainly accrue in the Member State where the service is created as opposed to the Member State where the consumer (business or private) of the service is established. It is not clear if Member States are focused on this phenomenon but its effects will become more pronounced as a pan-European market develops.

Case studies based on actual examples from the financial services industries involving the place of supply of financial services for VAT purposes and whether services were exempt or taxable were discussed by mixed groups of national administrators in workshops. These confirmed the range of diversity in how the current VAT legislation is seen. All but the simplest scenarios showed divergence in interpretation on which services were exempt and which were taxable. It was difficult not to see this as other than confirmation of shortcomings in the definitions of exempt financial services.

The seminar also heard evidence[8] of how financial channels are dynamic and can respond rapidly to competitive distortions (this can include taxes). Business efficiency is the key driver – competitive distortions can retard this process but they usually extract significant economic costs and may divert financial flows into other venues, either domestically or elsewhere. The industry is regulation sensitive and reacts to distortion such as those resulting from non-neutrality in the tax system. An optimum regulatory and tax regime maximises competitive neutrality so that financial activities are driven by the underlying economics.

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[8] The basis for this was a presentation from Professor Ingo Walters of the New York University's Stern Business School, New York University.

Other factors which affected the competitive efficiency of the market included a lack of diversity and possible barriers to new entrants. Here the EU markets seemed less vibrant than the US but no evidence was adduced that could attribute this to VAT beyond the more general issue of lack of tax neutrality.

1.4. Public consultation and conference

The industries affected by the VAT issue are numerous, disparate and spread across the Community. There are a number of pan-European organisations which represent effectively the views of many of the different sectors and The Commission has established constructive working relationships with them. As already mentioned, there is an ongoing dialogue which has generated essential technical input and which functioned as a sounding board for potential change.

Nevertheless, none of these organisations give a total coverage of the industries and it cannot be excluded that a consensus among their member does not reflect all views. The industries are extremely competitive and are likely to shelter divergent views on key strategic issues. In order to build up a comprehensive view on stakeholder views, the Commission organised an on-line public consultation of business on its intention to modernise the rules for the VAT exemption for financial and insurance services. This was done on the basis of a comprehensive options paper which analysed the difficulties which had been identified in the current system and looked at choices which might lead to their resolution.

This was published on 14 March 2006 with a closing date for responses of 9 June 2006. In response to a number of requests for extensions, replies were accepted until late August.

The consultation paper contained views on the current legal framework and on options for change. It explained why there is a need to review Community legislation. In particular, it looked at why there is a need to ensure that it reflects the world as it is today, taking account of the changes that have occurred in the intervening 30 years. The paper was addressed to stakeholders in the financial services industry generally, including insurance, their professional advisors and indeed to consumers of these services generally. The purpose of consulting the public on this issue was to provide input to the discussion, gather relevant feedback and assist Commission services in developing their thinking on the subject.

In the event, 82 contributions were received – a record for a tax consultation.

The main thrust of the views expressed was that were of the view that the Commission had correctly identified the priorities and options in its consultation paper. Cross border groupings and modernisation of definitions were seen as priorities followed by option to tax with other options attracting less support. There was a notable range of sectoral diversity in the responses, particularly between the banking and insurance industries.

The public consultation document itself and a more detailed summary of the views expressed by respondent's can be found at http://ec.europa.eu/taxation_customs/common/consultations/tax/index_en.htm . These should be considered as annexes to this Impact Assessment. A CD with all the responses received is also available.

As part of the consultation process, DG Taxud organised a public conference held in Brussels on 11 May 2006 in Brussels in conjunction with European Banking

Federation. This drew over 400 participants, reinforcing the open dialogue with stakeholders.

The speeches and presentations from the event can be found at http://ec.europa.eu/taxation_customs/common/archive/news/2006/article_2541_en.htm

1.5. PwC Study

The study undertaken by PwC into the economic effects of the VAT exemption of financial services and insurances in the EU25 required that they provide evidence of the distortions caused by the current VAT arrangements and that they identify options to remove these distortions.

The final report was eventually presented to the Commission in November 2006 and concluded as follows:

- EU financial institutions are less profitable than their equivalents in other highly developed economic regions including the US. They suffer significantly more embedded (non-recoverable and cascading) VAT which increases their costs. There is however no clear proven link between embedded VAT and profitability but there must be at least some contributory element. It does however increase the cost of financial services to business[9].
- In so far as service providers require a physical presence in the market in which they wish to operate, VAT based competition was not very strong within the EU. Certain investment management services, which are provided relatively easily on a cross-border basis as a result of their nature and/or regulatory factors, were found to be an exception to this. Given longer term trends however towards borderless markets, the report cautions against complacency as operations become more flexible in terms of where they are located. For the moment, non-VAT constraints on the cross-border provision of financial services draws attention away from the less than level playing field for tax purposes.
- There is some evidence that, in comparison with the US in particular, EU financial institutions use of outsourcing and shared cost centres is at least partially constrained by VAT.
- Because of divergences between Member States in interpreting the VAT Directive on what constitutes exempt or non-exempt financial services, operators face considerable legal uncertainty in making what should be purely commercial decisions. This would appear to be a significant issue in deciding what is outsourced.
- There is evidence that certain FS institutions were suffering relatively high rates of non recoverable VAT as a result of corporate structures based around subsidiaries whilst others were required to put in place structures which might otherwise be considered as less than optimal from a regulatory or corporate tax perspective in order to minimise intra-group VAT charges. Here in effect the report was drawing attention to the lack of neutrality for VAT purposes between

[9] Because of the well known problems in sourcing evidence, the report did not attempt to quantify the level of embedded VAT involved.

institutions which are structured on a holding/subsidiary basis and those on a head office/branch basis.

- Unevenness in the interpretation of the decisions of the ECJ and differences in the calculation of recovery rates were also seen as sources of distortion, contributing to a lack of neutrality.
- To some extent, the VAT issue is overshadowed by more immediate regulatory concerns. In cross-border consolidation and restructuring, supervisory and economic issues emerged in the study as the predominant constraint. However, as these are resolved and absorbed by business, then VAT issues will come to the forefront.

In terms of identified options for change, the report stressed the need for clarity, consistency and certainty in the services which were covered by the exemption. With one exception, the options proposed by the consultants for structural changes in the system which responded to its shortcomings were along the same lines as those mentioned in the Commission's consultation paper. (They are analysed below in paragraph 5.3.)

Pan-European guidance on the correct interpretation of the Community VAT legislation (and also perhaps ECJ decisions) was seen as a possible alternative that would not require any legislative change. Where inconsistencies in application could not be attributed to discretion expressly allowed to Member States, guidance should be given which would lead to their elimination. The report however also acknowledged that guidance alone, without any substantive legislative change would not address all the shortcomings identified.

The full report is annexed to this Impact Assessment.

1.6. IBFD Survey

As part of the preparatory work, in late 2006 The Commission asked the International Bureau for Fiscal Documentation to carry out a survey on the methods of deduction of input VAT applied by the Member States on goods and services used by taxable persons operating in the financial services and insurances industries. The finding in the PwC report had been that recovery rates[10] varied from 0% to 74%, notwithstanding that the VAT Directive seems to foresee a degree of harmonisation[11].

The Commission needed to understand better the factors which might affect the rate of input VAT recovery and accordingly asked the IBFD to provide information on the way in which the Member States had transposed the rules in Community legislation. Notwithstanding the aspiration to harmonisation, the Directive also allows Member States a considerable degree of leeway in the methodologies which may be used or enforced for the calculation of the rate of recovery. Similarly, although the Directive also foresees in principle that recovery of input VAT should

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[10] The recovery rate is the percentage of input VAT for which a business can claim repayment, generally on the basis of taxable activities but also on supplies of exempt activities to third countries or transactions directly linked to goods to be exported outside the Community or as otherwise allowed in the Directive.

[11] The preamble to the VAT Directive (Whereas no. 39) says that "T*he rules governing deduction should be harmonised to the extent that they affect the actual amounts collected. The deductible proportion should be calculated in a similar manner in all Member States*".

be linked to the level of taxable transaction[12], it also allows for a range of other circumstances where entitlement to deduct input VAT may arise[13].

The report confirmed that a review of national legislation demonstrated that there were wide variations in the way in which Member States applied the legislation. In addition many have significant concessional practices not reflected in the legislation which effect the eventual right of financial institutions to deduct input VAT.

Several Member States allow financial institutions to waive the exemption and opt to tax their supplies of exempt financial services[14]. The effect of this depends to some extent on the way in which the option is exercised but can lead to a relatively high rate of recovery, including as permitted by the Directive recovery where no taxed supply has taken place.

Variations can also be explained on the basis of the composition of the institution's client base. Where allowed under the Directive, the place of establishment of the institution's customers may have a significant increase in recovery rates. These will increase as the number of clients established outside the EU increases (or in certain circumstances, established in another Member States) as a proportion of the total client base. Unfortunately, the report was unable to source detailed data on this effect, much of it seemingly being protected by commercial confidentiality.

Variations in recovery rates could also be explained by differences in the way in which Member States interpret the scope of the exemption. The report gives some examples of how this can occur. This evidence adds weight to the arguments for modernising the definitions of exempt services so as to ensure consistency and certainty.

Concessional arrangements in some Member States are also likely to be a contributory factor.

The most consistent reason for differences in recovery rates however springs from the ways in which Member States make use of the flexibility which the Directive allows in the ways in which recovery can be computed.

The full report is annexed to this Impact Assessment

1.7. Difficulties in sourcing data.

Accessing data has been a recurrent problem in this exercise.

In assessing the impact of the VAT exemption, there are two sets of figures which, if available, would form a vital input to this process. The first is the value of VAT foregone through exempting financial services and insurances and the second is the value of actual VAT receipts which can be attributed to non-recoverable VAT borne by these industries.

This information is not generally available from official published statistics. Member States were asked by The Commissionto supply this information for use in the preparation of this impact assessment. The response has been disappointing. Some Member States have replied to the effect that for a variety of reasons they do not have the data requested. Useable data has been received from a number of Member

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12 Article 167 of the VAT Directive.

13 Article 168 *ibid*.

14 Belgium, Estonia, France, Germany and Lithuania.

States although in some cases this is partial and there is a lack of consistency in the manner in which the data is assembled and presented. In asking for data, an undertaking was given that issues of confidentiality would be fully respected. The main facts which can be gathered from the replies received are summarised in an annex to this document but which is not intended for publication..

A check with DG Budg confirms that, despite some efforts in the past, their efforts to capture this data (for Own Resources purposes) have had similarly limited success. Their experience has been that some MSS do not calculate VAT figures for the financial sector, or else make a rough estimate that Budg must accept for want of any better information. In some cases the estimates lump together financial services and other exempt sectors with some taxed activities (e.g. certain public authorities or the property sector). This output adds little to what it available.

Efforts to source useful data from the business sector have not been any more successful. The normal accounting practice for non-recoverable VAT is to subsume it in the general cost structure of an enterprise and, no matter how significant the figures are, there is no practice or requirement which would give rise to their appearance in published reports. In comparison with income taxes, where reporting standards mandate rules for the computation and disclosure of the consequences of the tax[15], VAT is not transparent. Companies such as financial and insurance institutions are however acutely aware of and sensitive to their VAT recovery rates[16] In discussions with these companies, it became very clear the these figures are generally considered as a commercial secret to be closely guarded.

At one point in the PwC study[17] on the economic effects of the VAT exemption for financial and insurance services, reference is made to an unpublished report compiled for the Hundred Group[18] where approximate figures for the United Kingdom indicate that unrecoverable VAT accounts for roughly 20.3% of the total UK taxes paid by the FS sector. The full report is considered confidential and could not be made available to the Commission, making it impossible to put this figure in any context. No similar surveys in other Member States have been identified.

The PWC study showed that unrecoverable VAT increases the cost of financial services to business by up to 4%. This figure came from a fairly small sample of institutions but it can probably be accepted as representative.

Some very limited data on the cost of unrecoverable VAT was made available by individual companies. It tends to confirm that this has become a significant cost for business. Unrecoverable VAT running at 50% and upwards of the corporation tax charge was mentioned as typical, with insurance companies at the higher end. Even on a purely indicative basis, it would be difficult to draw any conclusions as the source base is tiny (less than 10 institutions). The figures were proffered informally

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15 International Accounting Standard No 12 sets down rules on the disclosure of income tax in financial statements. There are no corresponding rules for the treatment of VAT or GST.

16 The percentage of input VAT for which they can claim repayment, generally on the basis of taxable activities or supplies of exempt activities to third countries or transactions directly linked to goods to be exported outside the Community.

17 http://ec.europa.eu/taxation_customs/common/publications/studies/index_en.htm page 162.

18 The Hundred Group is an ad-hoc lobbying who act as a mouthpiece of FTSE-100 companies in the UK on finance issues. Participation in the group is by invitation only. Numbers are thought to fluctuate between 130 and 150 members, including representatives from multinationals and other major companies in important industries that are not part of the FTSE-100.

and in confidence. Moreover, they possibly came in some cases from sources who felt their VAT costs were unduly high and accordingly should not be considered as representative.

This difficulty with statistical data is a well know problem internationally. In 1999, the OECD undertook a study[19] (with funding from the Commission) which had the objective, *inter alia,* of quantifying the economic effects of VAT (or GST) exemption on financial services and insurances. Because of limited data availability, this was not a success and the report concluded that "*given these uncertainties (due to lack of data), member countries have agreed to await a further report from the European Commission to evaluate the likely economic and revenue effects of any move to taxation before undertaking any further work.*" This does not seem to have happened, presumably due to the Commission's subsequent decision not to pursue the TCA model of taxation.

As already mentioned above, The Commission asked the International Bureau for Fiscal Documentation to produce a survey of the recovery of input VAT in the FS industry. Whilst it sets out the rules applicable in the 27 Member States, the authors were unable to furnish any information on tax flows or recovery rates which they admit may be influenced by factors which are not readily identifiable from information in the public domain. The authors conclude that "*it should be noted that statistical information on the actual average rate of VAT deduction for institutions operating in the financial sectors of the individual Member States is generally not available. From a perspective of competition, the financial institutions generally consider that type of information as confidential*."

At the beginning of April 2007, The Commissionwrote to Member States asking for data on the impact of the exemption on VAT receipts to be used in preparing the impact assessment. Specific questions were asked in respect of:

- The value of VAT foregone though exempting financial services and insurances.
- The value of actual VAT receipts which can be attributable to non-recoverable VAT borne by these industries.
- Average VAT recovery rates for these industries, where possible broken down by nature of activity.

14 responses were received. 3 Member States were able to provide the data more or less as requested; a further 5 gave partial answers and the others indicated that for various reasons they were unable to supply the information requested. A number of others confirmed orally that they were having difficulty procuring the data in reasonable time. Given the very limited data and the restricted conditions under which it was made available[20], it was not possible to draw any meaningful conclusions.

As in many problems with seemingly straightforward answers, there is a paradox in that it is not certain that ending the exemption for financial services would have any dramatic effect on the revenue collected through VAT. If the current exemptions

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19 Indirect Tax Treatment of Financial Services and Instruments – OECD 1999, available at www.oecd.org/dataoecd/9/26/1915300.pdf

20 One of the Member States who furnished a full reply stipulated that the data supplied could only be used when merged with figures for the other 26 Member States.

were replaced by a full taxation model, much of the revenues generated today would be lost because financial institutions would recover input VAT. Tax charged on outputs would produce revenue increases only in so far as it was borne by final consumers or other exempt operators. If final consumers were left untaxed (say for social reasons), there would certainly be a net loss for national exchequers. In the absence of any reliable and consistent statistics however, it will be difficult to convince governments of the potential benefits of any change. Their inability, or unwillingness, to share data is probably a major contributory factor to the difficulty in establishing bench marks against which to measure the effects of potential change.

2. PROBLEM DEFINITION

2.1. Summary of the main problems to be resolved

The existing legislation is out of date and deals poorly with the complexity of modern business. It creates uncertainty for tax administrations in their dealings with financial and insurance institutions leading to excessive costs. This uncertainty also produces differences in interpretation and practice across Member States which are both distortive in themselves and impose undue burdens on businesses seeking to operate across several Member States.

There are inherent inefficiencies in exempting these industries from VAT which can only be totally overcome by fundamental changes in the tax model. Given political and technical obstacles which in practice seem insurmountable, it will be necessary to identify possible structural changes which reduce these inefficiencies. This will be difficult without impinging on the revenue raising capacity of the tax.

Some further problems have been identified in the analytical process or in the stakeholder consultation. They are set out towards the end of this section but are considered as having a lower priority than the two abovementioned problems for the purposes of this exercise. In consequence, although recognised, they will probably not be taken up in the current proposal.

2.2. Uncertainty and inconsistency in the definitions of exempt financial services and insurances

The VAT Directive provides that financial services and insurances as defined under Article 135.1(a) to (g)[21] are exempt. Since an exemption is an exception to the general rule of VAT, it must be interpreted restrictively. Beyond what is in the Directive, no detailed definitions of the services covered is provided nor or are any explicit references made to definitions used elsewhere in Community legislation or by regulatory bodies.

This lack of precision has been a source of difficulty for both tax authorities and for businesses in defining the scope and application of the exemption. Evidence of this can be found in the growing volume of litigation at national level but, more particularly, in the number of referrals to the ECJ.

The quantative increase in case load caused by more frequent recourse to ECJ aside, the resultant judgements have frequently had a significant impact on the interpretation of the law and on the practical application of the tax. The quest for

[21] Formerly articles 13(B)(a) and (d) of the Sixth VAT Directive.

certainty and legal security has not been helped by national differences in applying these judgements.

In 1977, there seems to have been a reasonable level of concordance between the definitions adopted in the directive and those employed for regulatory purposes in the Member States. The gradual broadening and increased complexity of the range of services and the general evolution of regulatory provisions mean that this is no longer the case.

Financial services and products have become more complex over the last thirty years. Derivative products, securitisation products and structured financing are all examples of products which did not exist in 1977.

Outsourcing has grown in size and complexity and is now crucial to the operations of most financial institutions. The question of what precisely constitutes a financial service in its own right as opposed to a service which is merely an input to a financial service is one which frequently proves contentious. Interpretation issues of this nature arise with regulatory as data handling and control systems within institutions are now heavily dependent on bought-in support. Competitive pressures encourage the pursuit of cost reduction strategies and a trend away from vertical integration towards greater dependence on outsourcing – all of these add to the need for greater clarity.

The increasingly sophisticated nature of financial services in particular has increased the trend to specialisation in core functions with other activities being entrusted to third parties. Where these outsourced services are purely administrative, there is little difficulty in interpreting the provisions of the Directive. However, the obligation to interpret the exemption strictly puts the emphasis on the nature of the service being performed rather than the person performing it. In consequence the possibility arises that the outsourced service itself may benefit from the VAT exemption. The answer to this can be a constant source of tension and uncertainty in the administration of the tax. In its decisions the Court has cast some light in holding that, to qualify for the exemption, the service should meet certain tests. These include services which bring a change in the legal and financial relationship or the parties or services which are considered to be essential and specific to the primary exempt service.

In more developed cases, outsourcing can now extend to the totality of the activities of an institution. The outsourced service provider effectively "stands in the shoes" of the bank or insurance company which itself functions as little more than a shell. Such an arrangement is generally accepted as the supply of an exempt financial or insurance service even though not specifically envisaged in the legislation. The absence of a clear provision in the legislation covering such increasingly common arrangements can be a source of uncertainty for both businesses and tax administrations.

Since the adoption of the Sixth VAT Directive, 379 VAT[22] cases have been decided by the ECJ. 44 of these decisions were handed down in the 14 months between January 2006 and February 2007. In overall terms, VAT cases are currently running at between two and three per month whilst for the first 15 years after 1977, that was about the annual rate.

[22] Supplementary data received from PwC (not in the main study).

Only 6% of these cases (24) involve the definitions of exempt financial services and insurances[23]. (19 of these are for financial services or investments and 5 involve issues related to insurances.) The trend however is upwards with just 4 decisions being handed down up to 1990 and in the next decade 8. Since the turn of the century however the Court has addressed these issues in 12 separate instances. The effect of these judgements can be wide-ranging, particularly where the effect is to draw attention to inconsistencies between Member States. It is not however possible to say whether the increase in litigation is attributable mainly to the state of the legislation (where the defined exempt services are not representative of current complexity in financial services) or to the growth in non-recoverable VAT (seen either as a revenue source for governments or a cost to business). Both are equally plausible as contributory factors.

The accepted wisdom in the industries and indeed in national tax administrations is that the level of litigation is on an upward curve. This perception is largely fuelled by an identifiable growth at national level which will generate more referrals to the ECJ. The question then arises as to whether, because of legislative neglect, the Court is effectively being asked to determine tax policy. What is clear is that the ECJ is being forced to make judgements on complex modern industries on the basis of outdated legislation and, in the absence of modernising legislation, this will continue.

Notwithstanding the difficulties in sourcing of data mentioned in Section 1.7 above, some information on the cost of uncertainty and inconsistency in the legislation has been made available by operators. Although the data could not be independently verified and may even be selective, there is a degree of consistency which merits its introduction here.

For operators who supply specialised support to financial or insurance institutions (e.g., payment processing, card settlement, etc) and offer a similar package of services across the Community, set-up costs seem to involve a high level of outlay on local VAT compliance advice. A number of operators interviewed in the course of the preparatory work were able to justify costs ranging between €150,000 (for smaller contracts) to over €500,000 (for larger contracts) as being typical for each contract to ensure that it can be treated as a VAT exempt supply of financial services. Most of this is attributable to the VAT Directive being interpreted differently in different Member States and commercial models which qualify for exemption in one part of the Community are not readily transportable but need to be re-validated on every occasion. Similar costs are probably also incurred by their customers (banks and insurance companies) who will need to ensure their own conformity with complex VAT requirements when entering into outsourcing arrangements.

Litigation costs, if difficult to quantify, are also high and, so far, probably largely attributable to the poor state of the legislation.

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[23] See Annex 1 attached. For this purpose, those cases primarily involving Articles 132(1)(f) and 135(1)(a) to (g).

2.3. Tension between distortive effects of the exemption and the need to secure tax revenue

2.3.1. General

Financial and insurance institutions, because of unrecoverable VAT have an embedded tax cost which leads to overall higher costs. The impact of these higher costs varies according to whether the recipient is a business or a private individual.

A business will in normal circumstances recover the VAT it suffers on its inputs but where these services are exempt, non-recoverable VAT must be absorbed in its overall cost structure or passed on to customers. The process whereby non-recoverable VAT accumulates in the chain of business is referred to as cascading. This is accentuated when financial institutions deal with each other and hidden VAT (tax on tax) accumulates through a network of complex inter-bank transactions. In consequence the tax embodied in any financial service will depend on the number of "production stages" (perhaps better expressed in this case as the degrees of intermediation) that it passes through. For a financial institution cascading results either in reduced profitability or higher charges (e.g., increased interest rates) which in turn have negative effects on other businesses.

For private individuals on the other hand, the cascading VAT results in a lower cost for financial services than would be the case if the tax was applied in the normal way to the final retail price of the service where the final consumer must carry the full cost.

Therefore, the exemption of financial services and insurances means that these services are more expensive for business and less so for consumers than would otherwise be the case[24].

By admitting tax cascading, exemption creates incentives to avoid tax by opting for vertical integration (or self-supply). Financial and insurance institutions will thus be more inclined to supply potentially taxable services in-house (*e.g.,* back office services) rather than from a specialist supplier of outsourced services where non-recoverable VAT would be generated. Because of the effect of tax (non-neutrality), the resultant choice may not be the optimal one in terms of its contribution to overall efficiency.

2.3.2. Implications for VAT of growth in cross-border delivery of financial services and insurances.

By their nature global financial markets have a unique degree of mobility and, when establishing the location of business, an important factor will always be whether the regulatory and tax regime is considerate. Market economics suggest that structural evolution will follow the dictates of institutional comparative advantage. If there are significant economies of scale which can be exploited in the Internal Market, this will in time be reflected in the size of the institutions which develop though consolidation. Opportunities for other economic benefits, either in costs or in revenues, will be reflected in the range of activities they offer. If the creation of a pan-European market leads to commercial linkages can be exploited for profit, then

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[24] Since VAT is to some extent a regressive tax, a case could be made that the exemption of financial services has, in the case of households, a corrective effect. It is however most unlikely that this influenced the decision leading to the current exemption.

these will be reflected in activities and choice of location of the most successful institutions.

If experience in the EU follows that in the US, market changes will enhance customer choice with the outcome that most financial services can be obtained in one form or another from a wide range of institutions, each of whom in turn will be involved in a broad array of financial intermediation services. Eventually this process of market adaptation will be reflected in consumer choices across a wider geographic area than is the case today – in other words some services will not necessarily be produced and consumed in the same Member State. When the final provision of the service to a consumer is VAT exempt and the service provider is unable to recover input VAT, this has implications for the distribution of VAT receipts.

The PwC report indicates that this process of delocalisation, based on consolidation and market driven development, is not yet at a very advanced stage but will certainly develop over time. Some sectors are likely to adapt more rapidly than others. Early evidence of this trend can be found in certain investment management services, which are provided relatively easily on a cross-border basis as a result of their nature and/or regulatory factors. In time, this process can be expected to feed through to the consumer market for a wide range of banking and insurance products, via the development of cross-border platforms and aggressive cross-selling to take full advantage of consolidation. Because of its relative level of development, investment funds provide a good illustration of the effect on VAT of cross-border market development.

In the marketing of investment funds, the process of consolidation and market driven development will only increase as regulatory changes increasingly facilitate cross-border funds mergers and enable pooling of assets from different funds.

Both tax efficiency (broadly defined, as VAT is not the only tax involved) and the general regulatory environment are significant factors which fund managers consider when selecting a domicile for a new fund. However taxation (including VAT recovery possibilities) is of increasing importance for managers launching alternative and progressive funds where the tax treatment is often less established and more fluid. For such funds, the manager's belief in the ability of a location to offer a clear and certain approach and a stable fiscal environment is of critical importance in arriving at a decision.

The following table illustrates changes in the volume of assets under management by Member States of domicile of the fund in 2006[25].

Member State	**Non UCITS € billion - 2006**	**UCITS € billion - 2006**	**Total € billion - 2006**	**Annual % increase 2001 - 2005**	**Market Share %**
Luxembourg	138	1387	1525	11.8%	23.2%
France	116	1155	1271	8.3%	19.3%

[25] Source – Fact Book for 2006, published by the European Fund and Asset Management Association.

Germany	705	262	967	3.5%	14.7%
United Kingdom	131	513	644	2.7%	9.8%
Ireland	121	463	584	22.9%	8.9%
Italy	32	382	414	-2.1%	6.3%
Spain	6	269	275	8.4%	4.2%
Austria	48	108	156	11.3%	2.4%
Belgium	6	110	116	5.4%	1.8%
Denmark	42	64	106	25.6%	1.6%
Sweden	1	104	105	4.9%	1.6%
Netherlands	16	80	96	-2.4%	1.5%
All others (market share below 1%)	24	120	144	n/a	4.7%
TOTAL	**1386**	**5017**	**6403**	**7.6%**	**100%**

In terms of the overall rate of growth, investment fund assets in Europe have quadrupled in size over the past decade, an average annual growth rate of 15.7%. This growth has not been evenly distributed.

It is probable that some of the changes illustrated can be attributed to the health of domestic demand for investment products or to growth in funds attracted from third countries but this hardly explains the concentration of almost one third of total funds in Luxembourg and Ireland. A significant part of the increase has to be on the basis of funds whose ultimate customers are located in other Member States but where the management of the fund choose not to domicile it there. As such, the figures are simply evidence of a market driven process which can only grow as the remaining obstacles to cross-border marketing of funds are resolved.

By way of illustration, investment in funds (as opposed to the domicile of the fund) is highest in France, Germany and Italy. In the case of the latter two Member States, what is striking is that the figures indicate investment in funds domiciled abroad but promoted by national providers are growing at a multiple of the rate of investment in funds domiciled in the Member State[26].

[26] In the case of Italy, an apparent decline in market share in recent years masks an increase in volume of activity among Italian investors in funds domiciled in other Member States but promoted by Italian

Whatever about the reasons for choice of domicile (and there is really only slight evidence of VAT being a factor), there are consequences for the VAT revenues received by an individual Member States. Where an investment fund remains domiciled and managed in the same Member State as where the consumer of its services is located (regardless of whether these are institutional or retail customers), there is some assurance that the non-recoverable VAT created in the course of the underlying financial and management operations will generally accrue to that Member State.

This however will not follow automatically when the investment fund is domiciled and managed in one Member State and the customers (investors) are located elsewhere. The tax revenue generated by the non-recoverable VAT on bought-in goods and services will for the most part accrue to the Member State where their recipient is established rather than where the ultimate consumer of the exempt service is established.

Further complexity is added by the growing trend to delegate or outsource all or part of the management function to yet another Member State. This may be driven by capacity pressures in the main financial services centres but, whatever the reason, reduces even more the likelihood that tax revenue from embedded VAT will accrue where the consumer (the investor) is located.

This is a logical and unavoidable consequence of the removal of barriers to the cross-border provision of financial services and the drive of financial institutions to seek efficiencies within a single pan-European market. It will become more in evidence as Community financial services policy over the next five years achieves its objectives and barriers to retail integration and cross-border distribution of retail financial services are dismantled. The commitment to enabling consumers to shop around all over Europe for the best savings plans, for mortgages, insurances and pensions carries long term implications for national VAT receipts.

It is however a process which produces winners and losers in that tax revenues attributable to non-recoverable VAT shift to the Member State where the exempt financial service is generated from the Member State where it is consumed. Today, the evidence indicates that the pace of change is relatively slow except in certain areas such as investment management (where the effects are illustrated above). There are nevertheless other emerging areas of cross border integration in financial services such as for the integrated retail payment markets within the SEPA project. Here, the search for economies of scale in the development of payment processing "factories" will probably mean that the market is serviced from a limited number of locations. Over time, increasing disjunction between Member States where the retained tax accrues and the Member State where the consumption of the service takes place is likely to be a growing consequence of any increase in cross border marketing of financial services.

As long as the exemption model continues to be the norm, there will be implications for tax flows. The place of taxation for VAT generated by an outsourced service or one provided via a cost sharing centre will generally be the place where the business recipient of the service is located. However, the location of the ultimate customer,

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financial institutions (so-called round-trip funds) as well as such funds promoted by foreign providers in Italy. The effect is less pronounced in Germany but is real nevertheless.

who receives and consumes an exempt service, is of no consequence as far as VAT is concerned. In the longer run, the only mechanism which will ensure a neutral outcome and that tax accrues where the recipient of a financial service is located would be to move away from exemption towards more general taxation.

2.3.3. Distortive effect of VAT - conclusions

The work done in preparing the Impact Assessment came to the conclusion that the only definitive way of dealing with all aspects of this distortive impact would be through the introduction of full taxation. This applies both in the case of the distortive consequences of exemption for the business itself as well as the distortive effect on the tax flows received by individual national tax administrations. As already explained however, the technical and political obstacles to such a step cannot be easily overcome and accordingly this option is not being pursued.

The distortive economic effect of VAT exemptions in general has been well documented[27]. Nevertheless, the political and practical reality is that exemptions, either in the public interest or for other reasons, will always be a feature of the VAT system.

There may be a case to be made that the problem is not so much the overall level of tax (VAT, corporation taxes, payroll taxes, premium taxes, etc) which is borne by the industry but rather the way in which VAT specifically falls at a point which may inhibit business choices on steps to efficiency. If the same total tax revenue is collected through more general charges, this effect may not be as pronounced.

In accepting that replacing the exemption by full taxation is not a deliverable outcome, the range of realistic options becomes clearer. The best that can be reasonably expected is to make the existing exemption model work better by addressing at least some of its imperfections.

2.4. Other problems identified.

In the course of the public consultation and the dialogue with stakeholders, a number of other areas of concern were raised. Some of these could only be considered as peripheral or their resolution would require changes which are disproportionate to the scale of any problem identified.

Two of these however deserve a mention in this part of the Impact Assessment even though, for the reasons stated in each case, they raise issues which are not being taken up in the current legislative proposal.

2.4.1. Tax recovery methodologies

As evidenced in the IBDF survey there are currently significant differences in the VAT recovery methodologies permitted by Member States. This seems to be particularly an issue for financial institutions in the new Member States or for institutions based in the older Member States who expand their business there. The majority of Member States favour the use of simple output value based methods with a pro-rata calculation along the lines set out Article 174 of the VAT Directive (at its simplest, a "single pot" method). Other Member States do however permit the use of

[27] Much of the analytical work establishing the negative economic effects of exemption was originally developed by Maurice Lauré who is generally considered the father of VAT. See, for instance, "*Les Impôts gaspilleurs"* by Lauré, Louit and Babeau, published by Presses Universitaires de France October 2001.

direct cost allocation methods which more accurately apportion the actual use of VAT incurred to the specific activities which they support. These may involve the use of floor space, headcount, transaction count, etc as proxies for actual use. These methods are sometimes referred to as "actual use" (the term is used in the IBFD report) but all are to some extent arbitrary.

The ability to use such methodologies, perhaps on a negotiated basis, is seen by many businesses (and indeed a number of national tax administrations) to produce a more accurate VAT recovery rate, particularly in complex businesses, delivering a fair result for all concerned. They also reduce the compliance cost burden in the views of business.

More accurate tax recovery results could also be assured where it is possible to negotiate pro-rata calculations for sectors of a particular business which have discrete activities where relevant accounting data in relation to attributable inputs and outputs can be "ring-fenced".

This is linked to concerns in the industries that the limited methodologies imposed by some Member States (when direct cost allocation is precluded) in this area cause distortion of competition. They also cause significant administrative costs and uncertainties for financial institutions that operate across a number of Member States and it is difficult to see who benefits from the complexity.

In responding to the case for more widespread use of bespoke methods of direct allocation, realistically this could only be considered if it were possible to establish a number of minimal guiding principles at a Community level, which should include *inter alia*;

- data to operate the adopted methodology is supported by robust accounting/information systems (notwithstanding that financial or cost accounting is not primarily aimed at determining the correct tax base),
- the methodology employed is readily understandable,
- the methodology is readily verifiable by relevant tax authorities,
- the methodology is readily adaptable to changes in the business, market place, legislation etc,
- it produces a fair and reasonable recovery of input VAT acceptable to both the business and relevant tax authority.

Even reaching agreement on this level of standardisation in methodologies would not however deliver a consistent result although it might assist with moderating excessive compliance costs.

Apart from inconsistencies in computation methods, differences in the acceptable proxies for calculating direct cost allocation are endemic, even among those Member States who prefer an actual use approach in allocating input VAT.

It is not difficult to find examples in practice but one will suffice to illustrate the point. Most Member States will allow an institution to recover VAT incurred on the costs associated with investment funds to the extent that these are considered to relate to non-EU turnover. In some cases the specified proxy is the domicile of the fund – if an EU institution is managing a fund domiciled in for example the Channel Islands, it will be able to recover any input VAT incurred in the process. Other Member States however consider that the correct proxy is the domicile of the

investments made by the fund. Under this interpretation, if the EU institution is managing a fund domiciled in a Member State which invests in for example NASDAQ shares, then it will be able to recover input VAT.

Depending on which of these proxies for actual use is applied, the outcome will be two different results for input VAT recovery, even where a direct allocation method is used in each case.

It would seem in consequence that fully harmonising VAT recovery would require a level of detailed guidance in Community legislation which would be difficult to deliver. Even a relatively high level harmonisation of the methodologies allowed would seem to be an unrealistic objective, at least at this stage.

This conclusion is reinforced by discussions with Member States on options for more consistency in recovery rules. Their general view was that this was not to be regarded as a priority and they would prefer to retain the room for manoeuvre which in their view the Directive currently allows them.

There are issues here however which cannot be left to one side indefinitely. Although it is not the intention to address them in the current proposal, the Commission intends to examine further the matter of consistency and transparency in the computation of recoverable VAT, not least since the Directive foresees a harmonised treatment here.

2.4.2. Sharia compliant banking and insurances

VAT issues associated with Sharia[28] compliant financial services and insurances were mentioned tangentially in the Consultation Paper and taken up by a small number of financial institutions in their comments to the Commission. Their objective is to seek exemption for transactions involving the provision of goods and services carried out under Sharia law to the extent that there is equivalence (economically and intent) to transaction falling under the exemption in Article 135.1(a) to (g).

Without going into detail here, it is by no means clear whether this is possible under the existing VAT rules.

However, notwithstanding some evidence of political commitment at national level to resolve these problems and to ensure that this niche activity can prosper within the Community, it is not intended to address this issue now. This is a specialist area and the market is still relatively underdeveloped, limited to a small number of Member States. The VAT consequences, if any, require further study and rather than delay the current exercise, The Commission will in the very near future consider what steps need to be taken in conjunction with the Member States concerned.

3. OBJECTIVES

3.1. What are the identified objectives?

In the consultation paper of March 2006, the Commission's starting point was to set out three objectives for the current exercise. They remain valid and any possible legislative measures should be considered against this background:

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[28] Here the term is being used generally to describe the provision of banking and insurance services in a manner with Islamic law (*Sharia*) principles which, *inter alia,* prohibits the collection and payment of interest.

- **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.**

It was not considered appropriate or practical to establish a hierarchy of objectives. From an early stage in the work, it was clear that the emerging options for change could deliver solutions which met some, or some part of, these objectives. In consequence, a pragmatic approach was to consider each of the identified policy options in terms of what it would contribute to achieving the aforementioned objectives.

3.1.1. Reducing the administrative costs for administrations in exercising fiscal supervision and for economic operators in achieving fiscal compliance.

In tax literature, a common understanding of what constitutes administrative and compliance costs has achieved widespread acceptance[29]. Here administrative costs are the costs incurred by the tax administrations of Member States in collecting VAT and enforcing tax regulations, including collecting, administering, and managing the tax system. Apart from these direct costs they also include indirect costs incurred by judicial and quasi-judicial bodies responsible for settling disputes between taxpayers and the government up to and including the ECJ.

The total array of costs for business is usually described as compliance costs. For financial and insurance institutions, these are the expenses incurred by them to comply with tax regulations. These include the time and expenses to maintain proper records (particularly where these are not aligned with normal business accounting procedures), tax planning costs, reporting and remittance costs, etc. In the course of the public consultation, stakeholders put most stress on the legal and consultancy costs, including litigated solutions, occasioned by the uneven and uncertain nature of the current legislation.

For business, this broad notion of "compliance costs" goes much wider than the concept of administrative costs considered in the EU common methodology foe assessing administrative costs imposed by legislation[30]. The intended proposal will not impose any new obligations on enterprises or create any new legal obligations for them to provide information on their activities, either within the broader or more restrictive understanding of the concepts.

VAT does of course impose costs on enterprises in meeting their legal obligations. These however are not set out in Community law but rather determined in national legislation where such choices, reflecting a subsidiarity based approach, are left to Member States. The results here are unfortunately a very real source of concern for pan-European businesses faced with different administrative obligations wherever

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29 See for instance, "The Modern VAT" Ebrill, Keen and others, IMF Washington 2001.

30 As set down in a Communication from the Commission COM(2005) 518 of 21.10.2005.

they have a business presence but this is a horizontal issue, not specific to financial services and insurances and is not addressed here[31].

In assessing the costs or savings associated with modifying tax systems, the accepted methodology among tax administrations is that compliance costs for business should be weighted rather less heavily than administration costs. The main reason for this is that this perception of compliance costs includes expenditure on tax planning which is often open ended and notoriously difficult to monitor.

A significant objective in cost reduction however is to achieve a reduction in the level of litigation caused by disputes or uncertainty in the interpretation of the VAT provisions. This will undoubtedly benefit both tax administrations and businesses and stands out as a win-win achievable outcome. Achieving a significant decrease in litigation remains the paramount objective in modernising the definitions of exempt financial services and insurances.

The process of meeting some of the other objectives (listed below) may however give rise to additional administrative requirements as there are inherent tension points between the two objectives which follow and which need to be balanced. These however are essentially at the discretion of Member States and it would be impossible to put a cost on them in advance of knowing what is entailed.

Reconciling the VAT system (with its focus on national tax revenue) with the broader objectives of a single market for financial services can only be achieved if the integrity of the tax collection system is secure. It is possible that this may involve additional record-keeping and reporting obligation, highlighting the lack of compatibility between those imposed by Member States at national level. The responsibility for administering any additional administrative burden falls however to the Member States. Although this seems at odds with the objective of reducing administrative costs, it may be the cost which has to be paid in delivering on the remaining two objectives.

Any wider approach therefore may impose fresh compliance costs, although it should be stressed that the measures being contemplated are optional. To some extent it may be possible to leverage these obligations off the existing accounting and compliance systems but this will need to start with a detailed description of what any additional reporting requirements would entail.

Such opportunities may in any event be limited as standard financial and cost accounting techniques serve other priorities. Views expressed by the main suppliers of business accounting and reporting software to the FS industries, confirm that tax compliance and reporting requirements are seldom integrated within the end-to-end data and management information platforms which are increasingly used in financial institutions.

As far as EU VAT is concerned, this incompatibility can be largely attributed to 27 different sets of reporting and compliance obligations across Member States. In addition, there are no established norms for internal cost management systems off which a standard set of tax reporting obligations could be leveraged. The result is

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[31] More details on the Commission's approach to remedying the obstacles created by divergent administrative obligations for VAT can be found in COM (2004) 728 Proposal for a COUNCIL DIRECTIVE amending Directive 77/388/EEC with a view to simplifying value added tax obligations. Moreover, common rules for VAT purposes for invoicing are already in place in the VAT Directive.

that different networks or software applications are required for tax purposes, often resulting in expensive errors or omissions in tax returns and difficulties in reconciling them with financial statements, all of which create practical difficulties in keeping compliance costs under control. It will not be easy to generate much improvement but, as mentioned, this is not an aspect specific to the activities under consideration here.

3.1.2. Creating budgetary security for Member States and legal certainty for economic operators.

As indicated above (Section 3.4), it is not easy to put a figure on the budgetary receipts generated by VAT from the financial services and insurance industries. It is clear however that the tax administrations of Member States regards these receipts as an important source of revenue and will legitimately expect that Community legislation does not put them at risk.

Here it is necessary to draw a distinction between budgetary security and absolute budgetary neutrality. It may not be possible to maintain the latter if a viable solution to the VAT problems is to be found. Keeping and further developing a vibrant financial services industry within the EU should however be worth limited VAT revenue trade-offs that will be compensated by increases in other taxes and contributions. Ensuring that financial services and insurances remain EU based and thus continue to generate tax revenue must be a key contribution to achieving this objective.

Significantly, the status quo is by no means secure because of the potential for budgetary risks associated with leaving the interpretation of legislation to the ECJ in circumstances where the likely outcome is not always sure. Certain recent decisions of the Court have been a source of discomfort to some Member States and, given the potential budgetary significance, retaining the present situation cannot be considered a robust long term strategy for budgetary security. Moreover, internal market developments *(see Section 2.2.2)* will also lead to re-distribution of existing tax revenues between Member States.

There is a direct linkage between budgetary security and legal certainty for businesses. The current legislation often leaves them in a position where the absence of a clear and consistent understanding of the legal provisions in the Directive is a constraint on long term planning, particularly in pan-European projects. Increased legal certainty and uniformity in interpretation has been a consistent demand in the dialogue with stakeholder.

3.1.3. Addressing inconsistencies between the 1977 VAT provisions and more recent regulatory and legal provisions such as those falling under the Financial Services Action Plan.

The Community VAT system should, "eliminate, as far as possible, factors which may distort conditions of competition, whether at national or Community level"[32]. It should consequently be compatible with the objectives of the FSAP and the Lisbon Agenda which hold that a single market for financial services is essential for the EU's global competitiveness.

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[32] Preamble to the VAT Directive, fifth "whereas".

Better regulation is an important element of the renewed Lisbon strategy. In the area of VAT, the Commission has already made several proposals aimed at improving the regulatory framework so as to remove obstacles to market functioning and to introduce more competition.[33] The current proposal will seek to build on this.

However some of the more intuitive steps which might affect the financial services and insurances sectors – *i.e.,* by bringing more neutrality to the VAT consequences of cross-border consolidation – will have budgetary consequences for some Member States. Nevertheless, when VAT creates obstacle for institutions or groups which operate across several Member States, thus inhibiting the growth of a single market for financial services, reasonable efforts should be made to rectify this.

A major challenge for the current proposal will be to reconcile the legitimate aims of tax administrations with Community policies which are based on the premise that the more integrated EU financial markets become, the more efficient will be the allocation of capital and long term economic performance. Enhancing competitiveness should not be restricted by the tax system as the long term consequences would only be detrimental to both the industries and the public purse.

4. POLICY OPTIONS

Within the established and identified constraints, the policy options available for consideration can be summarised under the following headings:

- Leaving the existing situation unchanged.
- Modernising the definitions of exempt financial services and insurances in a manner which ensures their consistent application across the Community.
- Proposing one or more targeted structural changes to the way in which the current tax system operates in offset the largely unintended negative economic consequences and barriers to efficiency.

These options are set out in more detail in the following sections which point the way towards a balanced set of legislative changes, drawing on the second and third of these options.

4.1. Doing nothing – why this is not an option

One outcome of the transparent manner in which this issue has been treated is the near-total consensus that has developed on the need for change. The existing situation is unstable in that it inevitably leads to an increased reliance on litigated solutions.

The legislation which has been in place for 30 years, its provenance is even older and it was never seen as a long term fix. Neither was it intended to handle a complex and sophisticated industry which spreads across 27 Member States and works within a radically re-focused regulatory system.

The external pressures on the tax system are developed elsewhere in this document and there is every indication that they will grow over time. The well documented increase in litigation is a continual destabilising factor, bringing uncertainty to

[33] Implementation of the community Lisbon programme - Communication from the Commission to the Council and the European Parliament - The Contribution of Taxation and Customs Policies to the Lisbon Strategy - COM(2005) 532.

existing interpretations and practices in many areas. Even a decision to retain the status quo would in all probability require legislative intervention.

A more intensive and systematic policy of infringement proceedings on the Commission's part would do little in the longer term other than to highlight further the shortcomings in the legislation.

There is inevitability about change and the only real decisions which remain are about what the nature of the changes should be. The choice is between a *laissez faire* stance, leaving the future to the courts and to market forces, or to embrace the process constructively on the basis of clear and ambitious policy objectives.

Reliance on the courts as the sole or main instrument for developing the application of tax law in this area carries the risk of future crises. The decisions of the ECJ have sometimes favoured taxpayers and sometimes tax collectors. It is far from inconceivable that a future decision of the Court might put in question the revenue raising process in a fundamental way. The Community legislative process is not attuned to dealing with emergencies and it would be negligent in the extreme to wait until one arises before addressing the underlying issue.

In so far as the objectives set out in Section 3 are concerned, the effects would be as follows:

- **Reducing administrative costs**. The uncertainty inherent in outdated legislation will continue to create excessive costs for both tax administrations and businesses. This will particularly apply to businesses with a presence in more than on Member State.
- **Budgetary security and legal certainty**. In an increasingly litigation-based environment, Court decisions will continue to generate unpredictable consequences for Member States' budgets and for business.
- **Addressing inconsistencies**. Leaving things as they are will do nothing to further other Community objectives such as those of the Lisbon Agenda and the FSAP.

4.2. Modernisation of definitions

There would seem to be no doubt about the universal consensus on the need for a significant re-write of the 1977 definitions of exempt financial services and insurances.

This modernisation should address the shortcomings in the existing legislation – these include lack of clarity, failure to keep abreast of commercial developments, unevenness in application and the already mentioned need for more frequent recourse to the Court for clarification.

The modernisation should take due account of the interpretative jurisprudence of the Court which has given good guidance in many instances.

Some measure of selectiveness is however needed. Whilst some decisions bring useful clarification (e.g., the SDC[34] case, by focusing on the essential and specific nature of bought-in services which qualify as exempt) others have served to highlight the problems caused by deficiencies in the legislation and need a different reaction. .

[34] Case C-2/95 Sparekassernes Datacenter (SDC) v Skatteministeriet.

This has happened where wording generally considered as helpful in the 1970's in achieving its objective cannot always be seen as such in today's context. An example here is the Andersen[35] case where for insurances the specific mention of brokers and agents has led to what many Member States (as well as business) consider to be the wrong result for intermediation by highlighting inconsistencies that were never intended. There would seem to a strong case that intermediation in insurances was never intended by legislators to be any different to intermediation in financial services generally.

The approach identified as optimal by The Commissionhas been to modernise the definitions of exempt services within the boundaries of the existing exemption framework with the objective of making them more robust and reflecting modern business practice. A considerable increase in the level of specific detail is warranted by the need for consistency. This is being achieved through a combination of an updated directive augmented by implementing regulation.

Although the broad intention should be a revenue neutral solution, lack of uniformity in the implementing measures is likely to mean that achieving conformity will be at the cost of some changes in tax flows.

This point is dealt with in Section 5.

In so far as the objectives set out in Section 3 are concerned, the effects would be as follows:

- **Reducing administrative costs**. Both tax administrations and businesses incur significant costs in dealing with the current legislation. Modernising the definitions of exempt services, both by amending the Directive and by putting implementing regulations in place, could have a positive impact on these costs.
- **Budgetary security and legal certainty**. The current legislation is both unpredictable and unstable. The effect of ECJ decisions cannot be known in advance and the reality is that they are an increasing factor in the application of the tax. Their outcome can have significant effects on tax flows – in either direction. Both administration and businesses are at one in calling for greater certainty in the system.
- **Addressing inconsistencies**. In so far as the definitions of exempted services remain within the same broad boundaries, it will do little to redress lack of neutrality in the exemption model. However, the mere fact of greater consistency should not be discounted as a significant contribution to single market objectives.

4.3. Structural options identified in public consultation.

4.3.1. Zero rating

There are a limited number of examples of zero rating within the existing EU VAT system, all of which are seen as aberrations which should disappear in time. For the most part, whatever limited justification can be found for their continued existence is invariably linked to social policy considerations. Introducing a fresh range of zero rating into what is the most mainstream of all commercial activities would require exceptional justification.

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[35] Case C-2/95 Staatssecretaris van Financiën v Arthur Andersen & Co. Accountants c.s.

Although it gets rid of the problem of input tax not being deductible, it is difficult to find arguments in favour of an option which effectively singles out the financial services and insurance industries for a general subsidy.

The zero rating of financial services in New Zealand and Hong Kong[36] cannot be seen as a serious option for the EU. In both of these cases, zero rating is placed in the context of a significant fiscal re-engineering exercise which is not on any agenda here and which deals with factors specific to relatively small "special case" economies.

Zero rating would be an expensive step for Member States, replacing one set of distortive consequences with something probably worse. It would subsidise business as well as household consumers of financial services. As a relatively general undiscriminating measure, it would be difficult to identify specific efficiency gains which might justify other more targeted changes. In the absence of demonstrable and significant buoyancy in wider tax receipts, there is a risk that any revenue shortfall having to be made good by increased taxes on other goods and services.

Accordingly, this option will not be pursued any further.

In so far as the objectives set out in Section 3 are concerned, the effects would be as follows:

- **Reducing administrative costs**. It is not clear that zero rating would lead to any improvement in administrative burdens. The introduction of additional VAT rates is usually seen as imposing burden on business and it is unlikely that the outcome would be any different here.
- **Budgetary security and legal certainty**. Zero rating would lead to major revenue losses for Member States. It would also lead to demands for more zero rates in other, perhaps perceived as more deserving, fields.
- **Addressing inconsistencies**. There are no convincing arguments that subsidising the financial services and insurance industries (which would be the outcome of zero rating) would assist other policy objectives such as those of the FSAP or the Lisbon Agenda.

4.3.2. Extending the scope of exempted services.

In general, the existing exemption extends to mainstream financial and insurance services but also such additional outsourced services as are considered to be essential and specific to generating the main exempt service.

Other outsourced services, which do not fall within these categories, will incur VAT which may not be recoverable in many or most cases. Widening the scope of the exemption would be one way of bringing such services within the scope of the exemption and eliminating or reducing embedded VAT.

Although there would seem to be a superficial benefit for the industries in reducing such non-recoverable VAT, the borderline definitional problems would still remain. In reality it would spread the problems associated with exemption to other

[36] Zero rating in New Zealand was introduced as part of a general revenue-neutral re-balancing of taxes on financial services. The Hong Kong measures however were mooted with the specific intent of positioning their FS industries in a more competitive and advantageous position in relation to their international counterparts.

businesses, creating further complexity and increasing the number of entities which have to deal with the administrative complexities of partial exemption. The problems associated with the cascade effect would not disappear but rather acquire extra layers.

The range of potential additional qualifying services is large and it would be difficult to discriminate between them. Their inclusion would also have effects which are difficult to quantify on existing limited recovery possibilities.

Because of the lack of clearly identifiable benefits and the potential for increasing both uncertainty and complexity, this option for change is not being pursued any further.

In so far as the objectives set out in Section 3 are concerned, the effects would be as follows:

- **Reducing administrative costs**. Simply shifting the boundary of the exemption will do little in itself to ease administrative burdens.
- **Budgetary security and legal certainty**. Determining the exempt and non-exempt would remain an issue and thus little contribution would be made to security or certainty. Widening the exemption would increase the range of transactions not subject to tax but would also reduce recovery possibilities on inputs.
- **Addressing inconsistencies**. This would have little effect here.

4.3.3. Uniform limited input tax deduction

The uniform limited input deduction model has its basis in a system designed by the Australian tax authorities to ensure a degree of neutrality in outsourcing decisions. The so-called RITC (reduced input tax credit) method allows providers financial services in that country to recover a fixed 75% of the input tax incurred on certain back office services.

This percentage was arrived at on the basis of an estimation of that part of the cost of a representative bundle of outsourced service which related to salary costs plus the service supplier's added value. The residual figure is considered to be that part of the operation which would in any event have attracted tax had it been performed in-house. It is designed as a means of levelling the playing field between larger businesses that are able to undertake functions in-house, whereby non-recoverable VAT is not incurred on labour costs, and smaller operators that have to use external suppliers where they inevitably incur higher levels of non-recoverable VAT.

A more refined version of this system is used in Singapore[37] intended to reflect the variation in labour content in different kinds of financial services. In both cases however it is linked to a significant narrowing of the range of exempt services compared with the EU legislation.

[37] In Singapore most retail banks qualify for a 75% input tax credit, wholesale banks and merchant banks 96%, and offshore banks 96%.

This narrowing of the exemption when combined with RITC leads to higher recovery rates for institutions[38]. There is also a general perception that the system has also eliminated much of the legal argument that might otherwise have arisen on the scope of the exemption for financial services in relation to service providers who are not themselves financial institutions and thus contributing a significant reduction in compliance and administrative costs.

Notwithstanding the ostensible benefits (at least for businesses) that it seems to have created in these two countries, the conclusion was that this method of containing non-recoverable input VAT is not readily transferable to the EU.

In both these cases, there is a homogenous domestic labour market with negligible variation in labour costs. This allows for the establishment of reasonable accurate percentages of the labour cost elements in typical financial services without which the RITC type model would not work.

This essential pre-requisite does not however exist in the EU and there are significant differences in unit labour costs between Member States. A composite recovery rate would be unworkable in these conditions.

It could be conceivable in principle to develop sector specific recovery rates (along Singapore lines). However rates which accurately reflect differences in labour cost (which are in themselves a significant competitive factor in the outsourcing market) would be so difficult to compile in practice as to make the system impossible to administer at Community level.

Although this option registered a degree of support among some respondents to the public consultation, none of the respondents could identify a way to handle unit labour cost variations within a uniform deduction system.

A further concern here is that permitting such a formula for financial services and insurances might lead to pressure to extend it to other exempt services with consequential risks of revenue losses, although this is not confirmed by experiences elsewhere.

Against the background of practical difficulties, there seems to be no point in pursuing this option.

In so far as the objectives set out in Section 3 are concerned, the effects would be as follows:

- **Reducing administrative costs**. The technical concerns mentioned above would be very difficult to overcome, leading to high set-up costs. Ongoing costs would however probably be reduced.
- **Budgetary security and legal certainty**. Would reduce tax receipts from non-recoverable VAT on financial services and insurances as well as risk possible knock-on effects in other exempt or partially-exempt sectors.
- **Addressing inconsistencies**. Would restore some measure of neutrality in so far as labour costs would be treated in an equal manner for VAT, whether in-house or out-sourced.

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[38] The Australian Tax Office was unable to give any indication on the effect on overall tax receipts. In addition to insurances, there are more taxable services in Australia than in the EU but it is not clear without significant additional work to what extent higher recovery offsets this.

4.3.4. Option to tax

As already mentioned, the Directive allows Member States to implement an option to tax financial services[39]. In the Member States concerned, this allows financial institutions to waive the exemption and opt to tax their supplies of exempt financial services[40]. This option does not currently extend to insurances.

Option to tax for B2B allows the financial institution to charge VAT to customers who will then generally reclaim the tax under normal VAT rules. The institution itself, to the extent that it supplies taxed services will be able to claim back more VAT, increasing its recovery rate. Clearly the use of the option is intended to create a taxed supply to allow for recovery in full of any directly related input tax, notwithstanding that it adds legal and economic complexity in the relationship of the two parties in a business transaction. In many cases it would only generate partial recovery of VAT, with some limited reduction in administrative complexity. In Member States such as Germany where the option can be exercised on a case-by-case basis, the financial institution will use the option to tax for customers entitled to deduct input VAT.

Several practical problems arise. An immediate problem is in trying to identify what are B2B transactions. Grey areas arise in transactions with governments or public bodies, non-VAT registered businesses, other exempt entities such as schools and hospitals etc and possibly even other financial institutions.

The economic outcome may not always be so clear. Although the financial institution will be able to reclaim an increased proportion of the input tax it incurs, there is no way, apart from relying on competition, to ensure that this saving will be passed on to business customers in the form of reduced costs. There is always a risk that commercial constraints will spread the cost saving unevenly across the entire client base with business customers still carrying a part of the cost of non-deductible VAT.

In practice however there is confirmation that higher recovery for the financial institution and lower costs for the business customer are the usual outcome. As the supplier has to generate a VAT invoice, this inevitably creates expectations of a cost saving on the part of the customer. Effectively, the benefits for both participants are financed by the exchequer – when the option to tax is exercised, it seems that the outcome will ever be thus.

Experience with the option to tax in the property area has not been uniformly positive but rather is seen as having created the need for a considerable body of anti-avoidance legislation at national level. In some cases this even leads to requests for derogations from the provisions of the Directive itself in order to combat potentially serious avoidance of VAT. This may colour the perception of certain Member States when considering the wider application of the option to financial services although there is no evidence of similar experiences in the Member States where the option to tax financial services is currently available.

An option to tax limited to B2B might also be seen distortive and offends neutrality in that it treats similar transaction (*e.g.*, supplies to final consumers) in a different way. In some cases it may effectively be the same thing as zero rating since no tax would be collected (as business customers would reclaim any VAT they incur) and

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[39] Article 137(a)

[40] Belgium, Estonia, France, Germany and Lithuania.

the financial institution will increase their recovery rate in line with their percentage of business customers. Where the supplier of a financial service whose customers are all fully taxable businesses opts to tax these supplies, the effect is the same as zero rating.

One of the technical issues associated with a wider use of the option to tax for suppliers of financial services is that it raises the question of what is the correct taxable base. In those Member States who allow the option, it is in some instances it is only used for a very restrictive range of services where the charge is a purely fee based one and there are no margin related aspects to the operation. An example of such a service would be the provision of payment processing services.

Where the option to tax is applied today in more complex circumstances, the tax computation may be on the basis of crude or ad-hoc methods which side step the problem of identifying the correct taxable base. Since this only arises for B2B supplies where the recipient will normally be in a position to recover the invoiced tax amount, it does not cause any practical problems between the parties to the transaction. An example would be where VAT is added to the gross interest charged to a business borrower – in effect dealing with difficulties posed by the intermediation nature of the service provided by the financial institution through the expedient of ignoring it[41].

This is unlikely to be acceptable on a wider scale. As it is, accounting for VAT on this basis in circumstances where no real tax is generated from the taxed transaction, leaves the impression of a forced solution undertaken with the intention of increasing recovery.

Any use of the option to tax will need a clear and consistent approach to the definition of the taxable base which is consistent across the market and which ensures neutrality in tax treatment. Even in the most restricted circumstances, the taxable base has a major impact on the recovery of tax. For a very wide range of financial services where the charge combines fee and margin elements, institutions retain a wide degree of discretion in determining how they are balanced. Without appropriate clarification in Community legislation, there is a risk of triggering a shift from margin to fee based charges which would not be inhibited by other regulatory constraints or commercial limitations.

There might be some initial set-up costs associated with the wider use of the option to tax, particularly if they involve fresh reporting burdens for cross-border transactions. The costs however should be proportionate to the extent that the business is willing to apply the option to tax to individual transactions. For the most part, the correct use of the VIES[42] system would be sufficient to ensure adequate fiscal security. Under current rules, when a taxable cross-border service is generated the supplier should already make a declaration so that the authorities in the Member

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41 Identification of a taxable base for complex transactions has received some attention internationally although none of this has brought a successful implementation of taxation any nearer – see for instance Howell Zee, International Monetary Fund, Washington: *A new approach to taxing financial intermediation services under a value added tax.* Published in National Tax Journal March 2005.

42 The VAT Information Exchange System is a computerised system run by the Commission which, *inter alia,* which manages intra-Community data flows to enables VAT administrations to monitor and control the flow of intra-Community trade and to detect irregularities. It is currently being extended to cover intra-Community trade in taxed services.

State where the recipient is established are informed and can exercise appropriate control. Where charges are invoiced, this is mostly done electronically so additional costs should not be excessive.

On the balance of the analysis, The Commission considers that a wider use of the option to tax can resolve some of the problems identified as giving rise to concerns, particularly those associated with cascading tax. In some specific fields – such as innovative payment and transfer services which are not linked to bank accounts and may be provided by non-traditional operators – the only obvious way to deal with the issues of neutrality and competitivity is through a more general access to the option to tax in such cases.

There are however a number of choices to be made in how to structure and control any wider use of the option to tax. Any solution should minimise the risk of "cream skimming" and should not entail disproportionate administrative burdens for either administrations or businesses.

These are dealt with in Section 5 under analysis of impact.

In so far as the objectives set out in Section 3 are concerned, the effects would be as follows:

- **Reducing administrative costs**. A significant shift in the way VAT is applied, such as wider use of the option to tax, will certainly entail some once-off costs for both businesses and administrations. In the longer run however it should be easy and less costly to administer as charging VAT, rather than exempting, is the norm for VAT. In any event, it is not to be expected that financial and insurance institutions that opt would face administrative obligations any different from main-stream business who apply VAT in the usual fashion.
- **Budgetary security and legal certainty**. As this measure is an optional one for business, the actual effect will depend upon the rate of take-up. Over time, the end result is likely to be a net outflow of tax. This will particularly be the result if the option is restricted to B2B transactions.
- **Addressing inconsistencies**. Increases in neutrality will be generated by wider application of taxation – the overall outcome will depend on the precise details of the implementing measures and the rate of take-up. The distortive effects of VAT, which are the principal source of inconsistency with other policy objectives, will be reduced accordingly. In its normal application (*i.e*., when transactions are fully taxable), VAT operates as a neutral tax without distortive consequences for business.

4.3.5. Cross border VAT bodies

4.3.5.1. Single legal entities and cross-border transactions.

The VAT Directive does not consider transactions between different parts of the same legal entity to be taxable. However a number of Member States were uncertain about how this should be interpreted correctly and it required the intervention of the ECJ[43] to confirm that a fixed establishment which is not a legal entity distinct from the company of which it forms part (*i.e.,* a branch) established in another Member

[43] Case C-210/04 FCE Bank plc.

State and to which the company supplies services, should not be treated as receiving a taxable supply.

This means that a financial or insurance institution with business interests in several Member States which uses a head-office/branch structure can affect transactions between the different establishments without creating potentially non-recoverable VAT. Thus IT services or other back office services can be centralised efficiently and made available to branches in other Member States without VAT. It also allows an institution to consider the acquisition of bought-in services on the basis of what is economically the most attractive economic location.

In consequence, the legal form through which a banking or insurance group operates becomes critical in determining how much VAT it pays. An institution which is structured on a head-office/branch basis can achieve a more favourable result in terms of VAT than a company structured on a parent/subsidiary basis. There is some perception that this may reflect a division between institutions which grow organically and those which grow through consolidation or acquisition but this is probably a tenuous conclusion.

A Societas Europea structure will also deliver this result. Confirmation was received in the course of the preparatory work that a number of European institutions are considering or are at an advanced stage of transforming their structure to an SE. Although this is not VAT-driven, they are aware of the potential for reducing non-recoverable VAT. However it also appears that other legal and regulatory uncertainties act as a brake on this trend.

Given the resultant lack of neutrality between different forms of corporate structures, one of the objective criteria for assessing any proposed change in the treatment of cross-border bodies is whether it improves neutrality of treatment between different cross-border structures.

There are however a number of residual areas of opacity which where Member States have concerns about the correct application of the tax and which, in consequence, create uncertainty for business. One is how recovery should be calculated across the various establishments in a cross-border body of this nature. Given the diversity in practices for the computation of recoverable VAT between Member States (see 4.3.1 above), this will not be easy and it is not being addressed in the current exercise. Another source of uncertainty is where a branch (or the head-office) form part of a VAT group or other cross-border structure. This issue is currently being examined by The Commissionin conjunction with the Legal Service to see whether a non-legislative solution is possible.

Regulatory changes in certain areas also seem to favour institution operating though a branch structure. An example is the single European insurance licence allows insurers established with the EU to set up branches in and provide cross-border services into other Member States, advertising and selling their products subject only to home state control and certain notification procedures.

Neutrality should mean that VAT does not determine the corporate structure of a financial or insurance institution.

It is not however proposed, in the context of the current initiative, to make any changes to the existing provisions.

4.3.5.2. VAT grouping

About half of the Member States currently allow or are contemplating the introduction of domestic VAT grouping. This is a facilitation measure provided in Article 11 of the Directive whereby a Member State "*may regard as a single taxable person any person established in the territory of the Member State who, while legally independent, are closely bound together by financial, economic and organisational links."*

These conditions are interpreted in different ways in the Member States where grouping is available. Their approaches are summarised in the following table:

MEMBER STATE	**Conditions to be fulfilled**.
Austria	- 75% shareholding
Belgium	- control, usually considered 50% direct or indirect shareholding
Cyprus	- control, 50% accepted
Denmark	- full control, seemingly 100% in some cases.
Estonia	-at least 50% of the shares
Finland	- at discretion of VAT authorities
Germany	- control plus additional conditions
Hungary	- can include third party service providers to financial or insurance institution, which in itself stand out as a marked difference to the approach elsewhere.
Ireland	- control, usually 50%
Netherlands	- 50% or more of shares
Spain	– 50% of shares
Sweden	– must be bound by financial, economic and organisational links (all three needed)
United Kingdom	- control, majority voting rights

On the basis of the information available to the Commission, at least three further Member States are currently contemplating the introduction of domestic VAT grouping.

The main practical consequence of VAT grouping is that it shelters transactions between members of the group for VAT purposes. Group registration is particularly attractive for partially exempt companies who fulfil the degree of relationship required in legislation and who have substantial levels of cross-charges involving taxable services (such as back office support services) where they wish to minimise

the amount of irrecoverable VAT. For intra-group cross-border transactions in main stream financial services (which are generally exempt anyway), no such concerns arise.

As far as the right to deduct input VAT within a group is concerned, there are no detailed rules laid down in the Directive but obviously the general principles for computing deductible tax should apply. However there is considerable variation in how Member States handle this. In some instances the right to deduct must be exercised at group level and in others at entry level (at the level of individual group members). As with recovery methodologies in general, for groups this also varies from either general pro-rata or direct attribution methods, depending on the Member State.

There is also a lack of consistency in the practices on the admission of branches, whether domestic or in other Member States, to national grouping arrangements.

There is some evidence that the availability of VAT grouping has an influence on where certain taxable support operations are centralised.

The existing domestic grouping provisions were conceived as a way of simplifying the administrative burden for both tax authorities and business. Although the detailed arrangements vary, their basic effect is to create a single taxable person comprising all the legally distinct members of the group. Thus "internal" supplies between members of the group are ignored for VAT purposes and the group accounts for VAT only on taxed supplies made to third parties outside the group and deducts input VAT only on supplies made to it by third parties which can be attributed to the former. Such treatment may, as suggested by the Explanatory Memorandum to the Sixth VAT Directive, serve the interests of efficient tax administration. Tax saving seems at least as important a factor in the eyes of the operators concerned.

The Commission has previously contemplated a more extensive use of these provisions in the interest of facilitating a more efficient single market[44]. However, the general feeling among Member States at the time (1989) was that it would be very difficult to determine adequate legal criteria for eligibility. In the event, the Commission did not at the time pursue this issue and other priorities took precedent.

The table above shows how Member States have different perceptions of what constitute “financial, economic and organisational links″ which would seem difficult to reconcile the legal criteria for eligibility. Cross-border grouping would require a common understanding of what constitutes a VAT group.

However, even if consensus could be achieved on this point, there are a range of other differences in the way in which Member States implement grouping which would seem to preclude any form of cross-border grouping based on an extension of existing arrangements.

Nevertheless, there is a strong demand from the industry for cross-border structures which allow for VAT neutral transactions in services where exemption is not available between independent entities which have links of a financial, economic and organisational nature. Although representative groups such as the EBF and the CEA

[44] Communication from the Commission to the Council and to the European Parliament: Completion of the Internal Market and Approximation of Indirect Taxes - COM(89) 260.

are realistic about the prospects, they push the case for equivalence with the facilities available to branch based structures described in Section 6.3.5.1.

Given the mixed views on existing domestic grouping arrangements, Member States will need convincing on cross-border grouping. As with the option to tax, choices are needed to be made in how to structure and control any wider use of cross-border grouping the option to tax and should not entail disproportionate administrative burdens for either administrations or businesses.

These are dealt with in Section 5 under analysis of impact.

In so far as the objectives set out in Section 3 are concerned, the effects would be as follows:

- **Reducing administrative costs**. The existing provisions on VAT grouping were introduced with the intention of saving administrative costs for both businesses and administrations. Whilst it is clear that there would be cost saving for business in their further extension, this perspective is not generally shared by the administrations who see control issues which would increase their costs.
- **Budgetary security and legal certainty**. Domestically, VAT grouping produces results that tend towards revenue neutrality. This cannot however be assured in the case of cross-border structures where differences in recovery rates in particular would contribute to revenue displacement. Existing grouping rules are already a source of uncertainty and there are many issues to be resolved (*e.g.,* branches) before a wider application can be concerned.
- **Addressing inconsistencies**. Cross-border VAT grouping will assist consolidation in the industries as well as the creation of economies of scale.

4.3.5.3. Cost sharing arrangements.

Article 132(f) of the Directive allows an exemption from VAT for cost sharing arrangements in providing that "*the supply of services by independent groups of persons, who are carrying on an activity which is exempt from VAT or in relation to which they are not taxable persons, for the purpose of rendering their members the services directly necessary for the exercise of that activity, where those groups merely claim from their members exact reimbursement of their share of the joint expenses, provided that such exemption is not likely to cause distortion of competition*."

In practice this means that services the group supplies to the group's members do not attract VAT and if they are used by them for own tax exempt activities. Significantly, this arrangement should not give rise to competitive distortions, possibly when seen against the supply of a similar service by an independent supplier but this is not clear.

Where available for financial services and insurances (the provision has not been uniformly implemented) its focus is presumably on those services which would not otherwise be treated as exempt services. In the context of the modernisation of the definitions of these exempt services, it must focus on those services which are not defined as being "essential and specific" which would cause them to be exempt in any event.

The manner in which this provision is applied varies from Member State to Member State. In some cases, it has not even been transposed into national law, even though it

is a mandatory provision allowing Member States no choice in the matter. This in itself shows the need for harmonisation in the application of Community law.

Although its application is not limited to the financial services and insurances industries, it is the case that this exemption was introduced to provide smaller operators with some measure of equity in their economic treatment. While larger institutions may be well equipped to handle problems that are technically demanding or demanding on resources in a manner which avoids the creation of unintended VAT between the different parts of an enterprise, smaller institutions or new entrants often do not have the capacity to provide essential support services from their own internal resources. For them, access to cost sharing arrangements as envisaged in Article 132(f) allows them to sustain competitiveness in a VAT neutral way.

This view of the legislators' intention is confirmed in the comments of the Advocate General in the Taksatorringen case[45]. A typical example in practice might be where a group of independent smaller institutions can achieve a measure of efficiency of scale by managing a support service through the sharing of staff resources. Since 1977, smaller insurance companies have been among the most consistent users of cost sharing arrangements where this is permitted. Access to Article 132(f) allows them to do that without creating a fresh VAT charge.

Under a strict interpretation, the exemption is generally seen as being limited to arrangements where the group merely claim from its members an exact reimbursement of their share of the joint expenses in a manner which is self liquidating. When this is on a cross-border basis, this requirement is sometimes seen as creating a source of tension with transfer pricing guidelines for direct taxes where an open-market mark-up is required. Reconciling these seemingly contrary rules is however not technically impossible and has been resolved, at least on an *ad-hoc* basis in those Member States where it is already an issue. The point should nevertheless be taken into account in any restructuring of the exemption.

It is important that these groupings do not enter into direct competition with enterprises which are not exempt. But even this precondition may be already met since only services rendered to the members of the arrangement are tax exempt and, were the possibility to supply outside it to be contemplated, such supplies would have to be taxed.

This stipulation in the legislation, whereby such an arrangement must not produce distortion of competition, is not particularly clear and it is questionable whether the arrangement involving mere recovery of costs can ever really produce distortion of competition. Nevertheless, the Court in Taksatorringen[46] considered this to be a significant factor. Clarification is required in any modernisation of the provision, perhaps against the perspective that the cost-sharing grouping constitutes a closed entity, and that transactions between the group members and other undertakings not belonging to the grouping are subject to VAT in the normal manner.

From the experiences in those Member States where the cost sharing exemption has been fully implemented and from the analysis undertaken, The Commission is of the view that a more extensive use of this provision is of value in achieving the objectives set out in Section 3 above. At the very least, since the existing provision is

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45 See comments of Advocate General Mischo in ECJ Case C-8/01, para 118 and 119.

46 Ob cit.

mandatory, steps should be taken to ensure its consistent application in all Member States. This should also be the occasion to deal with some of its less clear aspects which have been adduced as reasons for less than full implementation.

However the policy options which can deliver on the stated objectives (in this case, inconsistency with FSAP objectives on cross border consolidation) go further than what is envisaged in the current legislation. Here there are a range of possibilities which extend to restructuring the provision in a way which better accommodates the process of cross-border consolidation which was not in the minds of the original legislators. In some Member States, a practice has developed whereby access to relief on cost sharing arrangements is predicated on the existence of a European Economic Interest Group (EEIG)[47] with the possibility (in the case of France) that up to 50% of the turnover can be supplied (with VAT charged) to non-Members. Such variation in the implementation of Article 132(f) currently causes problems in cross-border scenarios, effectively limiting to usefulness of cost sharing in cross border consolidation[48], an aspect which could well usefully be incorporated in any future clarification of the legislation since, by definition, it allows already for arrangements with participants from different Member States.

A modernisation and widening of the provision could, in addition to the areas mentioned as requiring clarification, take account of the following:

- The extent to which the activities of members of the cost sharing group can include non-exempt activities. In practice, a restrictive interpretation of the existing requirement that a group member must be "*carrying on an activity which is exempt from VAT*" is regarded as unrealistic and in practice a level of non-exempt of up to 30% is regarded as permissible. The legislation should be changed to reflect this.
- Common rules on supplies (with VAT) to non-members may be needed.
- As a consequence of this, in cases where a right of deduction arises (*e.g.,* for such non-exempt activities) it might be necessary to clarify that Members of the group should have a right to deduct the group's input taxes proportionally.
- Clarity would be required for conditions of membership – is it open to legal persons, partnerships, natural persons, branches, members of other VAT groups, etc?
- Can a member of the cost sharing arrangement (independently) exercise the option to tax?
- If provision is to be made for more complex cost-sharing arrangements, such as those extending to more than one Member State or third part service providers,

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47 EEIGs are groupings authorised under Council Regulation (EEC) No 2137/85 to facilitate or develop the economic activities of its members by a pooling of resources, activities or skills. It is not intended that the grouping should make profits for itself. There is however a perception that EEIGs are not so easy to manage for smaller operators.

48 This can happen when Member State A implements Article 132(f) in a manner significantly different to Member B. One result in practice may be that the authorities in the latter will consider as taxable any services received under a cost sharing arrangement set up in Member State A simply because it does not fulfil the conditions of the legislation in Member State B implementing Article 132(f). The options open to the institution if it wishes to persist are either to absorb the additional tax cost or to seek a consistent interpretation of the legislation through litigation.

what specific conditions need to be laid down to ensure correct administration of the tax. This could involve channelling the arrangement through an obligatory special purpose vehicle (such as an EEIG) but would have to be weighed against the extra administrative burdens for both tax administration and businesses. There are also legal and administrative obstacles (particularly in employment law) which might make this a burdensome obligation and which will need to be assessed.

- Additional reporting and record-keeping requirements might have to be considered for cross-border cost-sharing structures. Since this would involve a Community obligation rather than a strictly national one, these would have to be set out in detail and their value accessed against the additional administrative burdens being imposed on tax administrations and businesses.
- What invoicing requirements arise, if any?

In addition, the feasibility of including third party service suppliers within the cost-sharing arrangement needs to be considered. This could be envisaged on a very limited basis within the following framework:

- As the main objective is to serve neutrality and to assist smaller operators by avoiding the creation of VAT on labour costs, it might be necessary to have minimum labour cost element in any cost sharing arrangement. (60% is suggested.) Current commercial practices in any case generally require transparency on the allocation of exact labour costs to cost sharing arrangements, usually on the basis of full-time equivalent (FTE) jobs to demonstrate that no profit is being made on the arrangement.
- The participating outsourced service provider's profit margin should be excluded from any VAT relief. If for commercial reasons a sufficient degree of transparency cannot be obtained, the exclusion of the profit element could be achieved either on the basis of a standard percentage or by the supplier self-assessing for profit element under Article 27. (This latter mechanism is fully auditable by the supplier's own home tax administration.)

In order to avoid distortion of competition, the exemption should not differentiate between different commercial structures and such systems as chain outsourcing might have to be accommodated.

The possibilities for achieving these results, at least to an extent, are considered in Section 5 under "analysis of impact".

In so far as the objectives set out in Section 3 are concerned, the effects would be as follows:

- **Reducing administrative costs**. No new administrative obligations are envisaged but neither is there any immediately identifiable reduction in the costs of current administrative obligations.
- **Budgetary security and legal certainty**. As the purpose of cost-sharing relief is to avoid creating VAT through such arrangements, it will lead to revenue losses. These are difficult to quantify as consequent changes in business behaviour is also likely to include reconsideration of arrangements which would otherwise have been foregone (and not just tax savings on existing arrangements). Any extension of existing relief measures would have to include increased legal certainty.

- **Addressing inconsistencies**. Cross-border cost sharing will assist consolidation in the industries as well as the creation of economies of scale

4.3.6. Reduced VAT rate for bought-in service

Although suggested by a small number of respondents in the consultation, this is not a serious option for consideration. It would be very difficult to operate in practice and would have only a limited impact in dealing with the non-neutrality in the VAT system.

Recent experiences with reduced rate issues for VAT on other types of transactions is anything but encouraging.

In so far as the objectives set out in Section 3 are concerned, the effects would be as follows:

- **Reducing administrative costs**. Likely to have no effect at all.
- **Budgetary security and legal certainty**. Will reduce tax receipts for Member States but, *per se*, will do nothing for legal certainty.
- **Addressing inconsistencies**. Will reduced impact of distortive effects (roughly in proportion to any reduction in tax rates) but will not be as effective as more focused options.

4.3.7. Other options

Only one further option for change was identified in the course of the consultation process (and also in the PwC report) in addition to those already covered in the consultation paper.

Accepting that uniform and strict application of the exemption is essential, the suggestion was put forward that part of any solution should involve the creation of a Blue Book[49] or European VAT commentary, clarifying the definitions, interpreting the exemption and its scope as well as the implementation and application of ECJ case law.

The proposed Community Blue Book could contain the detailed interpretation and application of the VAT Directive as it applies to specific transactions with the objective of eliminating national differences in implementation.

The PwC study suggested that this could be achieved though the creation of a VAT forum or working party with industry experts (such as the EBF, CEA, the Investment Management Association, the European Fund and Management Association, etc.), as well as the Commission and national tax authorities. As they saw it, the forum could be modelled on the EU Joint Transfer Pricing Forum.

The proposed guidelines would then be submitted to the VAT Committee leading eventually to proposals to the Council under article 397 of the VAT Directive.

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[49] The original VAT Blue Book is produced by the British Bankers Association and sets out the correct VAT treatment of over 6000 specific financial services ranging from fund management to energy trading. It is updated regularly and a key feature is that its contents have been reviewed and agreed by the UK tax authorities (HMRC). Its use has not however totally removed the need for litigation based resolution in the United Kingdom but it is generally accepted as making a significant contribution to easing compliance procedures.

The Commission services however already see the article 397 procedure (Council Regulation) as appropriate for inclusion in the updating of the definitions of exemption which it sees as an essential component in any option for change and is drawing up the legislative proposal on this basis. Work on draft legislation is already well advanced and has been undertaken in consultation with Member States.

The suggestion of an Advisory Committee is one which can be re-visited at a later stage.

5. ANALYSIS OF IMPACT

The foregoing examination of the policy options leads to the recommendation that the legislative proposal should address the modernisation of the definitions of exempt financial services and insurances.

In additions, as far as structural changes are concerned, these should be focus on more general application of cost sharing relief (including cross border) and wider access to the option to tax for businesses. Although basically stand-alone options, they are not mutually exclusive and it is recommended that they be considered together. Although they deliver on similar objectives – offsetting the bias against outsourcing which favours vertical integration – the probability is that an institution will focus on one or more of them. Cost sharing is perceived as being more interesting for small to medium sized operators who have difficulties in achieving economies of scale unless they combine without facing a VAT penalty. Option to tax is a more generalised horizontal measure and will function for a wide range of operators, including highly specialised ones such as payment service providers. Both of these options advance a more coherent approach to applying the tax, build on features which are already there and, taken together, have a reasonably wide focus of efficiency promoting benefits.

The reasons for these recommendations are set out in further detail in the following sections. In each case, there are points of precision which remain to be addressed in finalising legislation but the analysis looks at the broad lines of such choices and considers their impact.

These structural changes will also make a significant contribution to reducing the unintended obstacles created by VAT to the achievement of other Community objectives, notably those set pertaining to the Single Market Review and the FSAP. Cost sharing relief in particular can greatly reduce fragmentation in the market by allowing institutions to combine in cost reduction and product delivery schemes across national borders. Underlying the FSAP is a recognition that the more integrated financial markets are, the more efficient will be the allocation of economic resources and long term economic performance. Modernising VAT should reduce barriers to the completion of the single market in financial services and insurances, a key area for the EU's future growth and employment creation as well as being essential for international competitiveness. All of these are crucial parts of the Lisbon economic reform process.

There are no environmental or social aspects of any significance foreseen under this initiative.

Whatever changes are put in place, main stream consumer finance (mortgages, consumer finance, etc) and insurance products will remain exempt. The overall cost impact on the consumer investment market is likely to be beneficial (increasing the

range of funds qualifying for VAT relief). It is conceivable that some additional costs may arise for consumers on certain bank charges if institutions exercise the option to tax them but this may be offset by overall efficiency gains[50].

5.1. Modernising the definitions of exempt services.

One of the few things that can be said in favour of the existing definitions of exempt services in the VAT Directive is that the definitions are short – running to less than 200 words in total. This brevity however is far too conducive to variations in interpretation and leads to consequences which are not consistent with a uniform application of the law in all Member States.

Inevitably, the complexity of the modern industries, the need for clarity for both businesses and tax administrations as well as the requirement for a consistent application across 27 Member States will require a more detailed approach. The draft revised definitions which have been under discussion with Member States since late 2006 have shown that Member States are not opposed to a significant increase in the detailed description of the services which qualify for exemption.

The ultimate test of the efficacy of the revised definitions will be whether they succeed in reducing the volume of litigation created by uncertainty in the current legislation.

In drawing up the existing definitions of exempt services, legislators seem to have focused on compiling a descriptive list of the main activities of banks at the time. To this list, they added insurance and reinsurance transactions (including those of brokers and agents) and certain investment funds.

No attempt was made to take account of the essential economic nature of the exempt activity and there have been no attempts at Community level to update the list. Apart from inconsistent interpretation, there has been increasing evidence of stress caused by evolution in range of services provided by financial and insurance institutions and the increase in the provision of these services and related services by other operators.

The approach taken has been to restructure the definitions on the basis of the essential economic nature of the activity so that the question of exemption (or taxation) does not depend on who is supplying the service. Where considered necessary, the definitions will incorporate the descriptive terminology developed by the ECJ in establishing the correct interpretation of the limits of the existing exemption.

The revised definition would have the following structure:

Old Article Directive 2006/112/EEC	**New Article Directive 2006/112/EEC**
135 (1) (a) insurance and reinsurance	135 (1) (a) insurance
135 (1) (a) related services performed by insurance	135 (1) (i) mediation

[50] As is the case in Belgium where an option to tax payment services is generally exercised at little cost to consumers but with significant benefits in the quality of the service.

brokers and insurance agent	
135 (1) (b) credit and management of credit by person granting it	135 (1) (b) granting of credits
135 (1) (b)negotiation of credit	135 (1) (i) mediation
135 (1) (c) dealings in credit guarantees or any other security for money	135 (1) (c) financial collateralisation of credits
135 (1) (c) negotiation	135 (1) (i) mediation
135 (1) (d) transactions concerning deposit	135 (1) (d) deposit services
135 (1) (d) transactions concerning current accounts, payments, transfers, debts cheques and other negotiable instruments excluding debt collection	135 (1) (e) bank account operation services connected to a bank account
135 (1) (d) negotiation	135 (1) (i) mediation
135 (1) (e) transactions concerning currency, bank notes and coins used as legal tender	135 (1) (f) currency exchange and cash money services
135 (1) (e) negotiation	135 (1) (i) mediation
135 (1) (f) transactions in shares, interests in companies or associations, debentures and other securities	135 (1) (g) supply of securities
135 (1) (f) negotiation	135 (1) (i) mediation
135 (1) (g) management of special investment funds	135 (1) (h) management services for special investment funds

The revised definitions will in each case be complemented by more extensive descriptions to be set out in a Regulation as provided for under Article 397 of the Directive. These would extend to listing services which are to be specifically included or excluded from the exemption. The regulation will also delimit those related services which can be considered as specific to and essential for the provision of the main service (and hence qualify for exemption) as well as those which are not.

The intention is, as far as possible, to work within the limits of the existing exemption and not to alter the boundaries. The consequence should therefore be that any service which is currently exempt will remain exempt and any service which is currently taxable will remain so.

However, it will be difficult to guarantee this outcome in those areas where particular national interpretations have given rise to a tax treatment which diverges from that generally applied. This may have occurred because the Directive currently allows some leeway of interpretation to Member States (*e.g.,* in the treatment of investment funds) or because the actual national practice is not sufficiently transparent to identify an incorrect application of Community law.

Whichever is the case, the proposed new definitions of exempt services have the objective of eliminating differences in the way the law is applied. It cannot therefore be excluded that any consequential adjustments in national practice will have an impact in those Member States concerned.

5.2. Cost sharing arrangements

The choices for using cost sharing arrangements to exempt from VAT the expenditure on cost sharing arrangements on services which are not otherwise exempt and which would resolve at least some of the problems defined in Section 2 (mainly distortions) basically break down to two.

The first of these could be seen as a minimalist approach, based at its simplest on a clarification of the existing provisions, which as seen in 6.3.5.3 are either not implemented or not implemented to the full in many Member States.

This would require the following:

- Restate the mandatory nature of the provision.
- For clarity of implementation, create a specific provision focused on cost sharing arrangements entered into in the course of supplying exempt financial services and insurances – in effect an industry-specific measure.
- Acknowledging that very few institutions will always supply 100% exempt services, set a realistic threshold for non-exempt supplies.
- Although the exemption remains at national level, clarify that exemption remains applicable when the costs are incurred in another Member State. This can be achieved by allowing specifically for cost-border participation
- Resolve any inconsistencies with transfer pricing rules (for direct taxes) caused by the absence of any mark-up.
- The exemption should not lead to distortion of competition.

The impact of such an adjustment might be modest, given that it should be in any event available throughout the Community, on the basis of direct effect where it has not been implemented.

The second would be to propose a more extensive application of cost sharing, to include cross border arrangements and the inclusion of third party service providers who are not themselves financial or insurance institutions. These are features available in individual Member States today but their more general application, if desired, would best be achieved by clarifying the Directive to make specific

provision for this. In addition to the foregoing, any such wider use of cost sharing should:

- Create a specific provision focused on cost sharing arrangements entered into in the course of supplying exempt financial services and insurances. The obvious vehicle would involve the establishment of a European Economic Interest Grouping.
- Allow specifically for cost-border participation.
- Allow for the inclusion of suppliers of non-financial services up to a specified limit, subject to conditions that the substantial aim of the service is to displace in-house labour costs and that the service supplier's mark-up is excluded from any relief.
- The cross-border nature of the arrangement may require that it is channelled through a special purpose vehicle or service company. The record-keeping and reporting obligations may need to be specified in Community legislation.
- The exemption should not lead to distortion of competition.

In so far as this diverts activities from in-house to a cost sharing scheme, there will be no tax revenue effect. In comparison with direct outsourcing of the same service, part of any saving generated may entail a revenue cost for national tax administrations. For the institutions concerned, there is a potential in either case for increased economic efficiency and to increase opportunities for consolidation across the internal market in a tax neutral way.

5.3. Option to tax

In analysing the impact of changes in the rules on the use of the option to tax (which can be considered across several different scenarios, depending on the choices made) the following factors should be taken into account:

- If the option is generalised, what is the correct treatment for intra-Community transactions?
- What are the effects on tax flows?
- Is there a potential for tax risks?
- What additional reporting requirements will be required – what are the burdens for business and for administrations?
- Any other obligations which might be imposed as prerequisites for using the option?
- Are there identifiable wider macro-economic benefits?

Some impact effects of the option to tax are common to the different configurations and will have to be considered in any policy choice, particularly where cross-border transactions are involved.

- As long as its application is limited to B2B, no additional tax revenue is generated for the Member States but the effect of the exercise is to reduce the tax borne by the financial institutions and, although this cannot be absolutely guaranteed, reduce the cost of financial services to business.

- If tax is applied generally to B2B transactions which are currently exempt, there is a possibility that extra revenue will be generated through non-recoverable tax on financial services acquired by taxable persons who transact exempt activities (hospitals, educational establishments, public bodies and, perhaps other financial institutions). Whatever about the policy wisdom of such a result, it would probably be circumvented in practice when these institutions simply transfer their custom to financial institutions which do not exercise the option and thus can offer them services at a lower real price. Any change in the tax system which produced such a distortive outcome would be difficult to contemplate. The option to tax may therefore have to be exercised on a transaction-by-transaction basis or client-by-client basis rather than a "whole of business" basis.
- The additional reporting and record-keeping requirements (in particular for cross-border transactions) will have to be spelt out in Community legislation where Community obligations rather than national ones are envisaged. The costs of the additional administrative burdens being imposed on tax administrations and businesses can then be assessed as well as the opportunities to leverage off existing reporting or accounting obligations.
- If the option is to be applied consistently on a Community basis, some rules on what transactions qualify for the option. The obvious context would be where a clear charge or fee is involved. However this is not always clear-cut (see 6.3.4 above) and ad-hoc solutions have developed where the option is currently allowed. The choice is between allowing the parties to a transaction to find their own solution or to establish some Community guidance or rules.
- On a wider basis, the conditions for using the option to tax will have to be set out at a Community level to ensure consistent application. The responsibility for ensuring conformity with these conditions rests however with the Member States.

Variation 1 - Current rules.

The impact of the exemption to tax under the current legislation is set out as a bench mark against which to analyse the impact of other configurations.

Company A is a supplier of a financial service mentioned in Article 135.1(a) to (g) and is established in Member State 1. These supplies are made only to suppliers of taxed services or to other suppliers of financial and services. For this purpose, it is assumed that there is no difficulty in identifying the taxable base.

Company A has no other fixed establishment or branches in other Member States.

Member State 1 allows an option to tax for certain of these services, including those supplied by Company A.

Company A exercises the option to tax. In accordance with normal VAT rules, these will be taxed at the standard rate when supplied to customers established in the same Member State. An invoice will be required to allow the recipient of the service to exercise any right of deduction.

When the services are supplied to business customers in another Member State, the place of taxation is where the recipient is established and the tax rules of that Member State apply. On the basis of the current state of legislation, they will continue to be treated as exempt financial services in most other Member States where there will no further consequences.

Company A will recover VAT on its taxed inputs in accordance with the rules of the VAT Directive.

For the business, a direct effect will be a reduction in the tax charge and a corresponding increase in retainable profits. It may also prompt the institution concerned to invest in efficiency improving measures. The business customers (who in most cases will expect to recover the input VAT) will generally expect to see a reduction in the cost of financial services.

Since the option to tax will only be exercised in circumstances which increase recovery of VAT, there will be a consequential loss in tax revenue to the national treasury.

In this instance, there is a presumption that the decision by the national authorities to allow the use of the option is based on a calculation that there is a net overall benefit which compensates for the VAT foregone, either in other taxes generated perhaps on the basis of a more efficient or vibrant FS sector or in the attraction or retention of a strategic industry which might other wise locate in another Member State or in a third country.

Variation 2 – Changing the Directive to provide that the option to tax is available in all Member States and the option is to be exercised at the discretion of the taxable person.

This comes closest to treating financial institutions in the same manner as other taxable businesses – except to the extent that the technically difficult areas of the taxable base (for more complex transactions, particularly those which are margin based) and the political/social sensitivities associated with taxing consumers are left to one side.

Company B is a supplier of a financial service mentioned in Article 135.1(a) to (g) and is established in Member State 2. These supplies are made only to suppliers of taxed services or to other suppliers of financial and services.

Company B has no other fixed establishment or branches in other Member States.

In Member State 2 in accordance with normal VAT rules, these will be taxed at the standard rate when supplied to customers established in the same Member State. . As is normal, an invoice will be required to allow the recipient of the service to exercise any right of deduction.

When the services are supplied to business customers in another Member State, the place of taxation is where the recipient is established and the tax rules of that Member State apply. Two scenarios are possible here.

One is where the supplier's use of the option to tax automatically triggers the use of the option in the Member State where the recipient (the taxable person) is established.

The other is where the option is at the discretion of the recipient (the taxable person).

Company B, (like Company A in the first example) will recover VAT on its taxed inputs in accordance with the rules of the VAT Directive.

As a consequence of the more general access to the option to tax, Company B will have to issue an invoice indicating that a taxable service is being supplied. The modifications to the VIES reporting obligations and the VIES system currently nearing adoption in the Council will ensure that the tax authorities in the Member

States involved have sufficient information on cross-border transactions for control purposes[51]. Beyond this, no additional record-keeping or reporting requirements are envisaged and control of the recovery of input tax remains with the administration of the Member State where it is exercised.

The recipients of the taxed services will account for them and will recover taxes in accordance with the rules of the Member State where they are established (which may be overall pro-rata or direct cost allocation or some combined methodology – see Section 4.3.1).

Since the option to tax will only be exercised in circumstances which increase recovery of VAT, there will be a consequential loss in tax revenue to the national treasury. Its general availability would however ensure a measure of balance between Member States in the decision on where to locate a particular financial service activity - the selective access to increased recovery which seems to be a feature of the current restrictive access would be neutralised.

Tax losses could be mitigated to some extent if the legislation contains restrictive conditions which discourage "cherry picking". This could be done by requiring that the option be applied to the total turnover from fee-based activities. This variation would exclude margin operations and, for practical reasons, probably also certain more complex transactions where the taxable base is not always clear.

Variation 3 - Changing the Directive to provide that the option to tax is available more generally but only in to operators supplying financial services who qualify and to similar operators in other Member States with whom they have established a link. Transactions between group members are taxed but recovery opportunities may be available.

Currently, exempt financial services supplied between operators in different Member States do not give rise to any tax formalities. No VAT is generated and, in most circumstances, the transaction will give rise to no recovery of input VAT.

As it is a cross-border scheme, modalities for access to this variation would have to be established at Community level, with the discretion of national tax administrations limited to ensuring that the conditions have been met.

Company C is a supplier of a financial service mentioned in Article 135.1(a) to (g) and is established in Member State 3. These supplies are made only to suppliers of taxed services or to other suppliers of financial and services. It exercises the option to tax in respect of supplies to an authorised taxable person established in another Member State.

As the primary supplier, Company C will have to issue an invoice indicating that a taxable financial service is being supplied (as opposed to an exempt financial service which would otherwise be the case). The VIES obligations, which are currently being extended to cover intra-Community of taxable services, will ensure that the tax authorities in each of the Member States involved have sufficient information on these cross-border transactions for control purposes.

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[51] This will modify Article 262 so as to ensure that the periodic recapitulative statement, which taxable persons are required to submit, covers intra-Community supplies of services. When financial services are taxed, the supplier will be obliged to report details of each supply. The information will then be available to the tax authority where the recipient is located where it can be used to check that the correct tax procedures have been followed.

As the service is being supplied to a business recipient in another Member State, no output tax will be generated in Member State 3 but Company C will be able to recover input tax to the extent to which this is allowed. This will allow C either to increase its profits to the extent of any VAT recover or to offer the service at a lower cost.

Therefore, a revenue cost is foreseen in Member State 3 because of increased recovery.

(Where additional record-keeping or reporting requirements are envisaged for formal cross-border VAT bodies, these will have to be specified in Community legislation and will be in addition to (non-harmonised) national reporting obligations. Such additional administrative may be needed because of national differences in recovery rules and outcomes but would involve obligations different to and in addition to those imposed by the 27 Member States.)

The recipient of the service, Company D in Member State 4, will have to make a reverse charge assessment in respect of VAT on this. The opportunity to recover this input tax will only arise in so far as Company D itself makes taxable services.

This configuration probably only becomes attractive to participating operators to the extent when members make taxed supplies to third parties, opening up opportunities for enhanced recovery.

In the first instance, recovery would normally follow the rules of the Member State where the member receiving the service is established. If recovery in this case should be on the basis of direct cost allocation, such a measure could be foreseen but it would reconciled with the practice in those Member States where this is not currently the norm[52]. The effect would presumably be to exclude the application of the scheme in such Member States. It would probably also not hold any attractions in those Member States where the option to tax is already in place.

If Company D does not make any taxed supplies or other supplies which would generate recovery, then Member State 4 can expect an increase in tax receipts when the option to tax is exercised.

Since however this configuration will only be of interest in so far as it increases recovery of VAT as opposed to simply shifting of tax, it assumes that Company D will make taxed supplies and that the input tax is fully recoverable.

This variation would by definition exclude consumer financial services and probably also more complex cross-border transactions where the taxable base is not always clear. It would also not be workable for inputs which are general in nature and cannot be allocated to specific transactions or in those Member States where the general rules for recovery are based on the pro-rata calculation.

[52] Direct allocation methods and pure pro-rata methods of computing recovery yield different results and it is difficult to reconcile them.

6. COMPARING THE OPTIONS

6.1. Cost sharing arrangements

	Variation 1 (Clarifying and ensuring more general application of current provisions exempting cost sharing in an industry-specific manner)	Variation 2 (More extensive cost sharing exemption with managed inclusion of third party service providers)
Does it increase neutrality in the tax system?	In so far as exempt cost sharing arrangements substitute for in-house services, neutrality in VAT creation is assured.	Increased neutrality in VAT can only be assured though exclusion of the service suppliers profit element from exemption.
Neutrality of treatment between different corporate structures (*i.e.*, branch/head office v. holding/subsidiary)	No change to existing position. Legal form of institution will still be a factor in determining tax treatment of cross-border transactions.	No change to existing position.
What requirements arise in the case of intra-Community transactions?	Exemption is only available within the Member State where the recipient of the service is established.	Exemption only arises within the Member State where the recipient of the service is established. If a special purpose vehicle or service company is required, this may require cross-border reporting obligations. Revised VIES obligations may cover this but notification requirements may also apply. For arrangements involving third party service providers, some limitations may have to be put in place.
What are the effects on tax revenue flows?	If cost sharing is simply a more efficient way of undertaking activities which would otherwise be run in-house, there are no revenue	In so far as cost sharing is simply a more efficient way of undertaking activities which would otherwise be run in-house, there are no

	implications. In so far as this is largely a clarification of an already existing provision (albeit one which is not widely	revenue implications. Inclusion of services out-sourced to a third party can generate additional tax recovery. On the other hand, if the comparison is between running an activity in-house and running it via a cost-sharing arrangement, there would probably be no tax implications. In the absence of comprehensive data, it is not possible to quantify the consequential revenue losses for Member States. Moreover, as the provision would be optional, the actual outcome will depend on take-up.
Is there a potential for other tax risks?	If normal fiscal supervision is exercised, no particular risks should arise.	Cross border aspects should largely be covered by revised VIES obligations but additional notification requirements may also apply.
Any other obligations which might be imposed as prerequisites for using the option – are they commensurate with expected benefits?	Can be covered incorporating such transactions in existing reporting obligations, or within the updated VIES system.	Apart from existing reporting obligations, the need for a special purpose vehicle or service company may give rise to additional reporting obligations. The soon-to-be introduced VIES reporting obligations for services should cover most requirements. In any event, since cost-sharing is an option at the choice of operators, there is a built-in check against non-commensurate obligations.
Are there identifiable benefits, particularly to compete on a cross-border basis, for smaller enterprises or for new	An exemption for cost sharing arrangements is specifically targeted at smaller or medium sized	As with Variation 1, this is specifically targeted at smaller or medium sized institutions.

market entrants?	institutions.	The clear inclusion of cross-border cost sharing structures and the possibility of limited involvement of outsourcers such institutions to take greater advantage of Single Market opportunities.
Are there identifiable benefits for the functioning of the internal market?	A limited domestic cost sharing arrangement does not have any particular internal market focus but, in so far as it contributes to overall efficiency, should improve efficiency.	A wider cost-sharing exemption will enable smaller institutions to link up with institutions in other Member States, creating shared cost centres which enable them access support services on an economic basis where they can successfully compete with larger operators.
Are there identifiable wider macro-economic benefits?	In so far as embedded VAT is an inhibition on efficiency, any relief on cost sharing should facilitate efficiency-enhancing decisions.	The wider possibilities for avoiding the creation of embedded VAT should further facilitate efficiency-enhancing decisions.

Summary

- Variation 1

As this is for the most part a clarification of an existing mandatory provision (albeit one not universally implemented and also in need of clarification), it should not be difficult to implement and the overall effect should not be markedly different to that which might be achieved by a more consistent application of the existing rules.

- Variation 2

As Variation 1, but with enhanced neutrality in respect of the outsourcing of labour based services. Impact on revenue would be determined on whether the activities run within a cost-sharing arrangement substitute for in-house activities (little or no impact on revenue) or those outsourced to a third-party (reduction in VAT generated). If exempt activities are pooled in a cost sharing arrangement for enhanced efficiency, neither tax losses nor increases would result.

6.2. Option to tax

	Variation 1 **(Current rules continue - implementation at discretion of**	**Variation 2** **(Option to be exercised at discretion of taxable person)**	**Variation 3** **(Option restricted to operators supplying currently exempt FS and Insurance services,**

	Member States)		**linked in a group type arrangement with operators in other Member States)**
Does it increase neutrality in the tax system?	Any shift from exemption to taxation increases neutrality in VAT systems in the Member State concerned. However, the implementation of taxation in individual Member States damages neutrality vis-à-vis comparable operations in other Member States where the same transactions are exempted. The impact on neutrality is two-fold, firstly on the prices but more markedly on tax recovery rates where significant distortion may occur.	The existing use of the option is limited to 5 Member States. Where available, operators can achieve significant tax benefits which are not available to operators elsewhere in the Community. Wider access to the option, even if limited to B2B, would significantly increase overall neutrality. Because in practice it falls some way short of full taxation, there are some risks for competitive neutrality where similar transaction are taxed differently. This could be an issue for supplies of financial services to other exempt or partially exempt entities (such as government, hospitals, etc).	As in variations 1 and 2, any shift from exemption to taxation increases neutrality in VAT systems In so far however as here it is restricted to groups of cross-border operators who are linked, there is a lack of neutrality *vis-à-vis* other operators.
Neutrality of treatment between different corporate structures (*i.e.*, branch/head office v. holding/subsidiary)	No change (existing position remains). Legal form of institution will still be a factor in determining tax treatment of cross-border transactions.	No change to existing position.	No change to existing position but position of taxable person acting through a branch will require clarification.

Does it deliver a correct treatment for intra-Community transactions?	Impact purely within Member State's which authorise use of option. Treatment of services from a supplier in another Member State (other than the one which authorises use of option) is not clear in practice, notwithstanding actual place of supply.	Consistent rules across all Member States in respect of access to the option to tax will give facilitate cross-border operations.	Effects will be limited to participating operators.
What are the effects on tax flows?	Leads to tax reduced receipts, but primary option lies with tax administrations.	Leads to greater reduction in tax receipts than Variation 1, since primary option lies with operator. This effect could however be mitigated by the inclusion of fee-based B2C services (but not consumer finance).	Limited opportunities for increased recovery will make this option among the least disruptive attractive to Member States but will also lead to limited take-up.
Is there a potential for tax risks?	Current measures are at the discretion of Member States who exercise whatever risk management is needed.	In so far as a more extensive use of the option to tax puts the financial institution in the same situation as a normal supplier of taxed services, no particular extra risks should arise. Some measures to restrict manipulation of the fee/margin balance might be required.	In so far as a more extensive use of the option to tax puts the financial institution in the same situation as a normal supplier of taxed services, no particular extra risks should arise
What additional reporting requirements will be required – what are the burdens for business and for administrations?	Notification to Member States concerned largely covered by revised VIES requirement for intra-Community supplies of services which should lead to	Notification to Member States concerned largely covered by revised VIES requirement for intra-Community supplies of services	Notification to Member States concerned largely covered by revised VIES requirement for intra-Community supplies of services

	more consistent application of correct taxation.		
Any other obligations which might be imposed as prerequisites for using the option – are they commensurate with expected benefits?	Mainly covered by VIES revision.	Mainly covered by VIES revision.	Mainly covered by VIES revision.
Are there identifiable wider macro-economic benefits?	Likely that Member States currently using option to tax are, in some cases, motivated by national economic interests.	Reduces cascading tax with consequential gains in economic efficiency. Reduction in cost of financial services to business generally with consequential efficiency gains.	Similar potential economic benefits for participating operators.

Summary

- Variation 1

Confirmation of existing situation – no change.

- Variation 2

More general use of the option to tax moves in the direction of uniform application of VAT. It should also increase lead to wider economic benefits but Member States are likely to face re-adjustments of tax burden as the cost of such benefits. On balance, The Commission is of the view that model should be pursued, subject to adequate administrative safeguards in the legislation.

- Variation 3

This is the least disruptive option for Member States but attraction to operators may be limited. It may however be too restrictive and disproportionately complex.

7. MONITORING AND EVALUATION

It is envisaged that any legislative changes will be put in place though a combination of modification of the VAT Directive and implementing regulations under Article 397 of the same Directive.

The modernisation of the definitions of exempt financial services and insurances has as a primary and overriding objective, that there should be greater certainty, clarity and consistency in the manner in which VAT is applied to financial services and

insurances. The acid test for evaluating whether this has been achieved will be whether there is a reduction in the need for litigated solutions.

As already mentioned, this aspect of the Directive has not been revised since it was implemented in 1977. Given the complexity of the legislative process for tax issues, it is unlikely that there will be a further opportunity to revisit the primary legislation in the foreseeable future. This creates a significant pressure to make sure that any changes now being proposed are sufficiently robust to withstand any future challenge.

The provisions of the implementing regulation are slightly more amenable to change, albeit that this is something which should not be undertaken lightly. It does however provide a context within which the successful application of the changes in the definitions of exempt financial services and insurances can be monitored over time and where some limited corrective could be contemplated, if justified. An example of this might be where innovative and new services appear on the market and which, although seeming to fall within the primary exemption, require clarification or guidance to ensure consistent treatment. This could if necessary be achieved through modification of the Regulation.

It is not however possible to set a formal timetable for any such monitoring process. It is rather the case that such action would be considered in the context of future developments as and when they arise.

For other structural changes (such as changing the arrangements for the option to tax or for cost sharing), it has been a feature of VAT legislation the Commission will undertake a review of their operations and will issue a report on the outcome with, if considered necessary, proposals for change which might be needed. Changes of the nature now being contemplated require a certain amount of time for their implementation and both tax administration and business have a strong aversion to short term measures or frequent changes to administrative obligations. In the circumstances, it is suggested that a 5 year evaluation period is appropriate and that the Commission should prepare and issue report on the operations of the changes at the end of that time.