COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 28.11.2007
SEC(2007) 1555

COMMISSION STAFF WORKING DOCUMENT

accompanying 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 SUMMARY

(This condensed text merely summarises the analysis which is contained in the full text, which together with all mentioned annexes is available only in the original language version and accordingly presented only with the English language version of the proposal)

{COM(2007) 747 final}
{SEC(2007) 1554}

1. PROCEDURAL ISSUES AND CONSULTATIONS OF INTERESTED PARTIES

For largely pragmatic reasons, the VAT Directive exempts most main-stream financial services and insurances. To some extent however the Directive also reflects its uncertain approach in that it also allows Member States to grant taxable persons the option of taxing these services.

When supplying exempt services, these industries are not required to charge tax on such supplies but are also generally unable to recover the VAT they pay on the goods and services acquired for 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 work of the Commission in the preparation of this impact assessment has demonstrated that there are growing problems in ensuring clear and consistent application of the exemption across the Community. In some complex transactions, it may even be difficult to identify who is the recipient of the service for tax purposes.

Whatever about its origin and the difficulties in finding another solution, 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. The negative consequences of exemption remain however, notably the loss of neutrality in the tax. An additional issue for the EU is that the VAT system must function in 27 Member States in a manner which allows for 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 which have grown significantly. Any change has to respect this reality which is partly attributable to increased VAT rates but mostly to growth in tax base, notwithstanding the economic inefficiencies imposed on business.

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. Member States will require convincing that keeping and further developing a vibrant financial services industry in and across the EU should be worth limited VAT revenue trade-offs.

To this end, the Commission has engaged with Member States in order to identify a fresh way forward.

As part of the preparatory work with Member States, the Commission organised two seminars under the Fiscalis programme which dealt in the main with the identification of areas of stress in the existing legislation.

A consultation paper setting out views on the current legal framework and on options for change was published in March 2006 and generated a record level of responses for a tax consultation. Removal of barriers to cross border consolidation and modernisation of definitions were seen by respondents as priorities. To expedite matters, the Commission launched a study (by PwC) into the economic effects of the VAT exemption of financial services and insurances in the EU-25. The report (finalised in November 2006) concluded that embedded VAT increases costs for EU institutions and the cost of financial services to business. Divergences in interpreting the VAT Directive on exempt or non-exempt financial services, creates uncertainty in making what should be purely commercial decisions. Evidence was found that FS institutions were suffering relatively high rates of non recoverable VAT as a result of corporate structures or alternatively adopt 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.

In terms of identified options for change, the report stressed the need for clarity, consistency and certainty in defining exempt services. The report is annexed to the full Impact Assessment.

In addition, the Commission asked the International Bureau for Fiscal Documentation to survey the methods of deduction of input VAT in Member States for financial services and insurances. The PwC report found that rates varied from 0% to 74%, even if the VAT Directive foresees that these must be harmonised.

Notwithstanding this, the Directive also allows Member States a considerable leeway in methodologies for calculating recovery. There are variations in the way Member States apply the legislation and concessional practices not always reflected there.

Exercising the option to tax thus can lead to a high rate of recovery, including where no taxed supply has taken place.

It was impossible to get either dependable figures for the value of VAT foregone through exemption or the receipts attributed to non-recoverable VAT. The PwC study references an unpublished independent report where figures for one Member State (the UK) show unrecoverable VAT accounting for 20.3% of the taxes paid by the FS sector and increases the cost of financial services by up to 4%. From the restricted data available to the Commission, it was not clear if ending the exemption would have any effect on tax revenue collected. Potential tax gains would in all likelihood be absorbed by higher recovery rates.

2. PROBLEM DEFINITION

The existing legislation is out of date and deals poorly with the complexity of modern business, leading to excessive costs and is inherently inefficient. The Directive exempts a list of financial services and insurances which must be interpreted restrictively. Nevertheless only 6% of recent ECJ VAT cases (24) involve the definitions of exempt financial services and insurances although the effect can be wide-ranging. Litigation costs, if difficult to quantify, are also high and are probably largely attributable to the poor state of the legislation.

Financial and insurance institutions, because of embedded tax face overall higher costs. Institutions will be more inclined to supply taxable services in-house rather than from a specialist supplier of outsourced services where non-recoverable VAT would be generated. The non-neutrality of VAT is thus an obstacle to overall efficiency.

Inevitably, when the final provision to a consumer is VAT exempt, cross border provisions of services has implications for the distribution of VAT receipts.

The revenue from non-recoverable VAT will mostly accrue where their recipient is established rather than where the ultimate consumer of the exempt service is established.

It will increase as Community financial services policy achieves its objectives and barriers to retail integration and cross-border distribution are dismantled. In general, the work of the Commission in preparing the Impact Assessment concluded that the only sure way of dealing with this distortive impact is full taxation. The Commission also identified differences in the VAT recovery methodologies permitted or imposed by Member States. Probably the methodologies imposed by some Member States cause distortion of competition and increase costs. This conclusion is reinforced by discussions with Member States on more consistency in recovery rules. Among the secondary issues which were raised in the consultation process but which are not addressed by the Commission at this stage are the VAT treatment of Sharia compliant financial services and insurances.

3. OBJECTIVES

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

Any options for change could deliver solutions which met some, or some part of, these objectives. Administrative and compliance costs are burdens for the tax administrations in collecting VAT and for business in meeting tax obligations. VAT compliance obligations are not however set out in Community law but rather determined in national legislation where such choices, reflecting a subsidiarity based approach, are left to Member States. Opportunities to reduce compliance costs by leveraging other reporting obligations are limited as standard financial and costing techniques serve other priorities. Tax compliance and reporting are seldom integrated within the 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.

Some Member States however will profit at the expense of others from cross-border consolidation. Ensuring that these industries remain EU based and thus continue to generate tax revenue may require limited VAT revenue trade-offs.

The VAT system should, "eliminate, as far as possible, factors which may distort conditions of competition, whether at national or Community level". The current proposal should build on this but some of the more obvious steps which might benefit the financial services and insurances sectors will have budgetary consequences for Member States.

4. POLICY OPTIONS

The policy options for serious consideration boil down to three - leaving the existing situation unchanged, modernising the definitions of exempt services in a way which ensures their consistent application and proposing one or more targeted structural changes to restore some measure of neutrality to the VAT system.

A second potential structural change was to widen the range of services exempted. In reality it would spread the problems of exemption to other businesses. To restore some neutrality, Australia and Singapore have adopted a simplified limited input deduction model based on estimated salary costs plus the service supplier's added value but this is not suitable for EU conditions. The Directive already allows Member States to implement an option to tax financial services and in the five Member States where this option is in place, financial institutions may waive the exemption and opt to tax their supplies of exempt financial services (but not insurances). The Commission also looked at the role of cross-border VAT structures in reducing distortion. Institutions which employ a branch/head-office structure within a single legal entity enjoy flexibility in affecting internal transactions without VAT. It achieves a more favourable result in terms of VAT than a company structured on a parent/subsidiary basis. An objective therefore for assessing any change in the treatment of cross-border bodies is whether it improves neutrality between different structures. VAT grouping can deliver similar results but it availability is restricted to domestic operations in about half of the Member States. The practical consequence of VAT grouping is that it shelters transactions between members of the group for VAT purposes.

The Directive already allows an exemption for cost sharing arrangements in certain circumstances. From the experiences where the cost sharing exemption has been fully implemented and from the wider analysis undertaken, the Commission sees benefit in more extensive use of this provision, including third party service providers and operators in different Member States.

Although suggested by a small number of respondents, reduced rates of VAT for financial services and insurances are not a serious option for consideration. Recent experiences with reduced rate issues for VAT on other types of transactions are anything but encouraging.

Only one further option for change was identified was the creation of a Blue Book or European VAT commentary, clarifying the definitions, interpreting the exemption and its scope as well as the implementation and application of ECJ case law. This may be taken up later.

5. ANALYSIS OF IMPACT

Examining the options leads to a recommendation to modernise the definitions of exempt services insurances. Structural changes should then focus on more general application of cost sharing relief and wider access to the option to tax for businesses. Cost sharing relief in particular can greatly reduce fragmentation in the market by allowing the different sectors of the industry to combine in cost reduction and to achieve neutrality in strategic business decisions.

The intention of the Commission here is 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.

The choice of exempting from VAT the expenditure on cost sharing arrangements on services which are not otherwise exempt which would resolve at least some of the problems. The Impact assessment sees two ways of achieving this.

A minimalist approach, based on clarifying the existing provisions requires a specific provision on cost sharing arrangements in the course of supplying exempt financial services and insurances – in effect an industry-specific measure but which would bring limited benefits.

A more dynamic approach would entail a more extensive access to cost sharing relief, to include cross border arrangements and 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 would best be achieved by clarifying the Directive. In analysing the impact of changes in the rules on the use of the option to tax, issues to be resolved include the correct treatment for intra-Community transactions and possibly additional reporting requirements.

As long option to tax is limited to B2B, no additional tax revenue is generated for the Member States but reducing the tax borne by the financial institutions should reduce the cost of financial services to business. There is however a potential for extra tax revenue will be generated through non-recoverable tax in certain circumstances. For pragmatic reasons, the option to tax may have to be exercised on a transaction-by-transaction basis or client-by-client basis rather than a "whole of business" basis. Undoubtedly, 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.

6. COMPARING THE OPTIONS

A more ambitious approach with enhanced neutrality in respect of the outsourcing of labour based services could have a potential impact on revenue depending 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).

Any more general use of the option to tax moves in the direction of uniform application of VAT. It should reduce distortion and increase neutrality but Member States are likely to face re-adjustments of tax burden as the cost of such benefits. The Commission envisages 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.