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GROUP ON THE FUTURE OF VAT

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**VAT treatment of financial services - a reflection on
possible options for review**

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1. INTRODUCTION

Working document GFV N°87, presented at the 26th meeting of the Group on the Future of VAT of 5 April 2019, sets out the current VAT treatment of financial and insurance services and the resulting issues. It explains previous attempts to review the current rules and announces the launch of the study to be carried out by an external consultant, which would provide a factual basis for a possible future review. The present paper shortly recalls the conclusions of the working document while adding some data collected by the contractor working on the study, provides an update on the state of works on the study and summarises the contractor's attempts to model the options for review and tentatively assess their possible impacts.

The VAT Directive¹ lays down the rules on the VAT treatment of financial and insurance services. These rules were introduced in 1977 and provide for an exemption of financial and insurance services which is not linked to a right to deduct the VAT paid on goods and services purchased (input VAT) in order to carry out the supply of such services. For this reason, VAT often constitutes a cost for operators in that field and, in turn, their customers.

Financial institutions have often attempted to alleviate this cost by means of existing instruments such as VAT groups (Article 11 of the VAT Directive) or – up until recently – cost-sharing arrangements (Article 132(1)(f) of the VAT Directive). VAT groups allow several closely bound persons to form a single taxable person for VAT purposes (leaving supplies between such entities untaxed). Cost-sharing arrangements allow persons with exempt or non-taxable output supplies to reduce the VAT incurred on expenses by creating a common structure (cost-sharing group) from which they receive exempt input supplies (they share costs among them). The characteristics of both instruments therefore vary; in particular, VAT groups offer a less targeted solution to the problem of the so-called sticking VAT (non-deductible VAT included in the price of the inputs) and cannot be cross-border.

Cost-sharing arrangements had been widely used by financial and insurance operators to offset the impact of their input VAT burden. This practice, allowed by most Member States, was, however, overruled by the Court of Justice of the European Union (CJEU)². Against the interpretation and application of Article 132(1)(f) of the VAT Directive by most Member States³, the CJEU found that cost-sharing arrangements are not applicable to the financial and insurance sectors.

Apart from the implications of the recent jurisprudence referred to above, the VAT treatment of financial and insurance services raises many other problems. The current rules are believed to be complex and difficult to apply in practice, notably given that they have not kept pace with the developments of new services in the financial industry. This seems to have led to increasing litigation before the CJEU, legal uncertainty, and high administrative and

¹ Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (OJ L 347, 11.12.2006, p. 1).

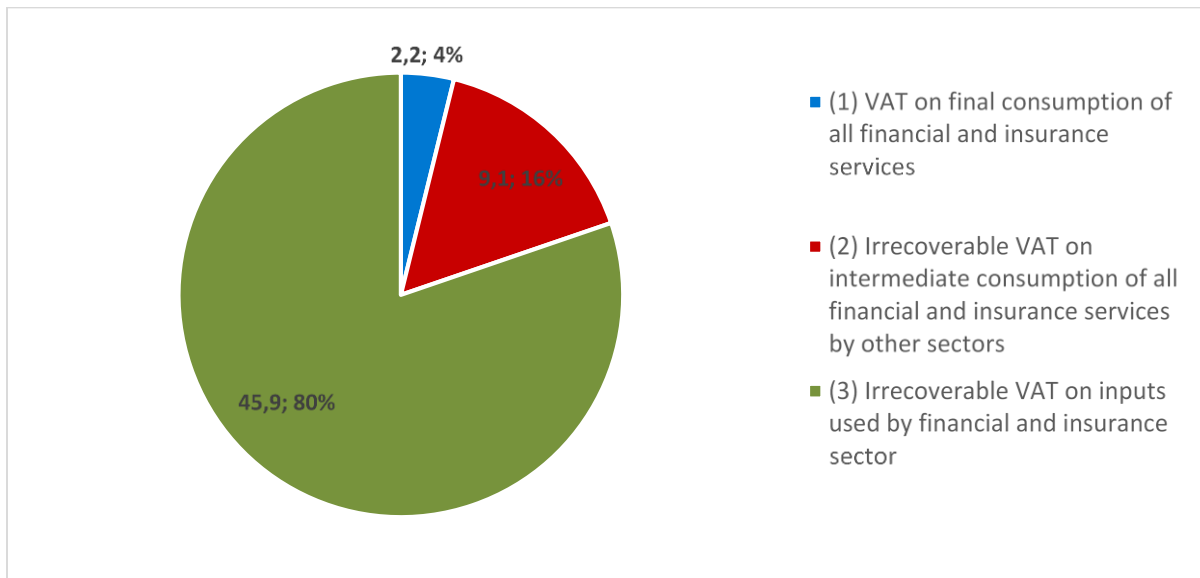
² CJEU, judgment of 4 May 2017, *Commission v Luxembourg*, C-274/15, EU:C:2017:333; CJEU, judgment of 21 September 2017, *DNB Banka*, C-326/15, EU:C:2017:719; CJEU, judgment of 21 September 2017, *Aviva*, C-605/15, EU:C:2017:718; and CJEU, judgment of 21 September 2017, C-616/15, *Commission v Germany*, EU:C:2017:721.

³ The CJEU itself acknowledged that some Member States exempt services supplied by cost-sharing groups to entities such as insurance companies, for instance, in paragraph 34 of *Aviva*.

regulatory costs. Moreover, such rules are interpreted and applied inconsistently by Member States and this has resulted in tax competition and distortion within the EU. Furthermore, they give rise to distortions of competition with third countries, which might become an issue of growing concern especially if some of these transactions are being zero-rated and therefore the right of deduction is allowed.

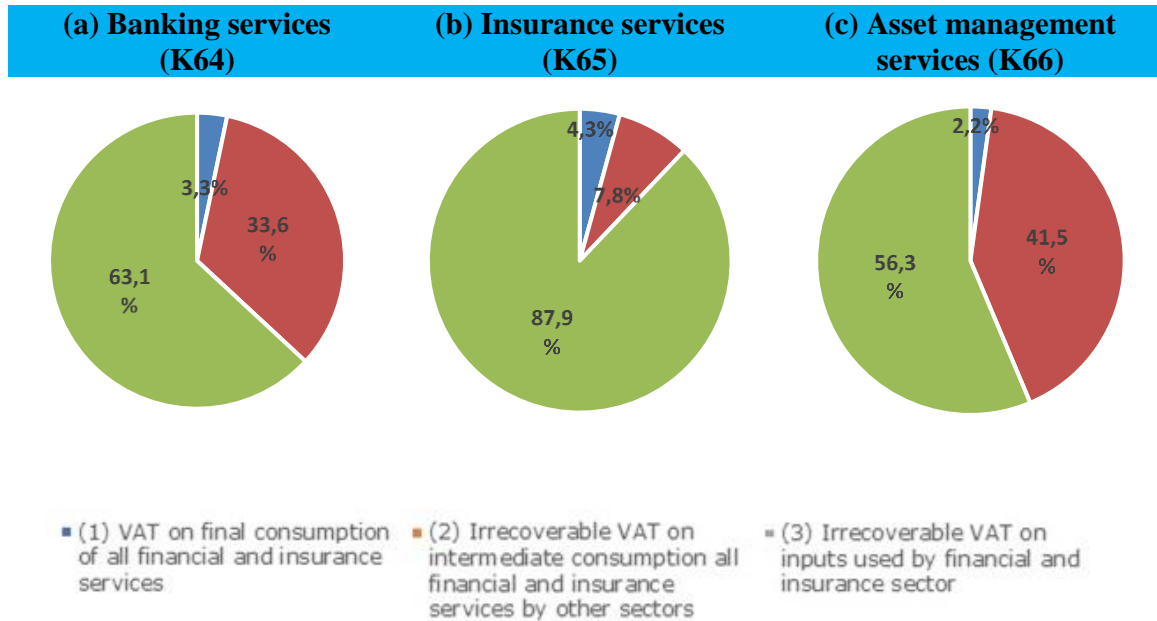
The figures below give an idea of the magnitude of the problem of the so-called sticking VAT. They show the structure of VAT liability on all financial and insurance services and on their subsectors. They clearly show that the largest contribution to the VAT liability is from irrecoverable VAT on inputs used by the financial and insurance sector, which in 2017 amounted to ca. EUR 45.9 billion (80.2%).

Figure 1. Structure of VAT liability on all financial and insurance services (all EU MS, 2017, EUR billion and %)



Source: *Economisti Associati*, analysis in the *First Interim Report*, based on national accounts, data from fiscal registers and own resources submissions (ORS).

Figure 2. Structure of VAT liability on financial and insurance services subsectors (all EU MS, 2017)⁴



Source: *Economisti Associati*, analysis in the First Interim Report, based on national accounts, data from fiscal registers and ORS.

The last element which has to be recalled is that other taxes apply to this sector which largely escapes VAT (taxes on insurance premium, payroll taxes and also financial transaction taxes in some Member States).

The Commission proposed to review the rules on the VAT treatment of insurance and financial services already in 2007 through a legislative package which comprised a proposal for a Council Directive and a proposal for a Council Implementing Regulation⁵. However, the discussions in the Council ended up in a standstill and the proposals were withdrawn in 2016⁶.

⁴ Field 2 in the figure refers to providers of financial and insurance services consuming other financial and insurance services. For example, asset management services are primarily used as intermediate inputs for banking and insurance services. For this reason, 41.5% of the liability on these services is associated with other sectors that cannot recover the “sticking” VAT on their use of taxed asset management services, while 56.3% of VAT liability relates to irrecoverable inputs. The trend is similar for banking, but with much greater share irrecoverable input VAT, which is due to the fact that a larger share of asset management services is taxed. For insurance, the largest portion of liability is associated with irrecoverable VAT on the sector’s inputs (87.9%). This results from the highest ratio of exempt output across three types of analysed groups of services.

⁵ 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 ([COM\(2007\) 747](#)); and Proposal for a Council Regulation laying down implementing measures for Directive 2006/112/EC on the common system of value added tax, as regards the treatment of insurance and financial services ([COM\(2007\) 746](#)). The proposals were based on the following elements:

- 1) clarification of the rules governing the exemptions;
- 2) broadening the existing option for taxation (right to opt for taxation transferred from Member States to economic operators); and
- 3) introduction of a cost-sharing group targeting financial entities.

Elements 2 and 3 of the proposals were left aside in Council, and discussions mainly focused on element 1.

⁶ OJ C 155, 30.4.2016, p. 3.

Even though - when recently back on the agenda - the discussion on the VAT treatment of financial and insurance services has been triggered by the limitation of the cost-sharing exemption, emphasis was on the need for a broader review⁷. In order to prepare it, the Commission launched in June 2019 a study for the review of the VAT rules for financial and insurance services in light of the existing regulatory and other indirect taxation rules. Following the discussion at the 20th GFV meeting⁸ on the implications of the CJEU judgments on cost-sharing for the financial and insurance sectors, the scope of the study is very broad. It covers functioning of the VAT rules impacting financial and insurance services at the level of the Member States and at the level of the EU, takes into account both input and output side, and sets the problem in the wider context of regulatory developments in banking, financial and insurance services and markets and other indirect taxation rules.

2. SUPPORTING STUDY FOR THE REVIEW OF THE VAT RULES FOR FINANCIAL AND INSURANCE SERVICES

The contract for the study was signed in June 2019.

The study has three main objectives:

- Evaluation of the functioning of the current VAT rules impacting the financial and insurance services at the level of the Member States and at the level of the EU as a whole, while putting them in context of all other relevant legislative developments in the financial and insurance sectors;
- Development of the options for the review of the relevant provisions of the VAT Directive;
- Analysis of benefits and costs, opportunities and risks, as well as impacts, in respect of each of the options for review, with the expectation that the analysis will feed into preparations for a possible future legislative proposal on the VAT treatment of financial and insurance services.

2.1. State of play

The contractor recently submitted the Second Interim Report which, together with numerical estimates previously delivered, broadly covers all of the tasks of the study. The Final Report is due in September.

The study will provide the basis for the impact assessment to accompany a possible future legislative proposal if such is decided. It is designed in a way to also provide data necessary to carry out an evaluation of the existing rules.

2.2. Options for review modelled by the contractor

As mentioned above, the scope of the study and, as a result, the range of the options for review considered, is broader than in the 2007 exercise. The study analyses both input and

⁷ See statement by the Commission and the Council inserted into the minutes of the Council meeting at which the Council adopted the Quick Fixes (Council Directive (EU) 2018/1910) (ST 12564/18 FISC 380 ECOFIN 849).

⁸ Meeting of 9 February 2018; see GFV No 066.

output side and proposes the elements of options and then composite policy options for review designed to address the problems on both sides.

The contractor will provide an assessment of the impacts of different elements of policy options grouped in five areas of intervention as presented below:

Areas of intervention	Elements of Policy Options	Analysis
<i>A. Service definitions</i>	A1. Status quo A2. Legislative revision of definitions A3. Introduce definitions for innovative services A4. Provide non-binding guidelines on the application of the current definitions	Targeted
<i>B. Removal of the exemption</i>	B1. Status quo B2. Remove exemption for all financial and insurance services B2a. Standard rate B2b. Reduced rate B3. Remove exemption for all financial services B3a. Standard rate B3b. Reduced rate	Systemic
<i>C. Cost-Sharing Arrangements</i>	C1. Status quo (including full implementation of the CJEU judgments) C2. Introduce CSAs for providers of financial and insurance services	Likely targeted
<i>D. Option to Tax</i>	D1. Status quo D2. Obligation for Member States to introduce the option to tax	Unclear
<i>E. Fixed rate of deduction</i>	E1. Status quo E2. Mandatory fixed rate of deduction E3. Optional fixed rate of deduction	Targeted

At the same time, the impact of more complex options, consisting of a combination of different elements, is likely to go beyond a pure sum of impacts of separate elements. That is why the Commission services have tentatively proposed to the consultant five combined options, composed of several different elements and asked the contractor to assess their impact. These options may be adapted following feedback.

These are:

1. Taxation of financial services at a standard rate + optional fixed rate deduction + legislative revision of definitions⁹ (B3a + E3 + A2)
2. Taxation of financial services at a reduced rate + optional fixed rate deduction + legislative revision of definitions (B3b + E3 + A2)
3. Taxation of investment services at a standard rate + mandatory fixed rate deduction + legislative revision of definitions (new element + E3 + A2)
4. Taxation of investment services at a reduced rate + mandatory fixed rate deduction + legislative revision of definitions (new element + E2 + A2)

⁹ These definitions will still be needed even if the exemption is removed, because of the specific rules on deduction or because part of these financial services may technically not be taxed (still a need for an exemption or a suspension scheme).

5. Cost-sharing arrangements made available to financial and insurance service providers + legislative revision of definitions (C2 + A2)

The above options contain different elements of limitation of the scope of the exemption, by an introduction of taxation of financial (but not insurance) services or more specific – investment services only. In that context, at this stage, no simulation of the removal of the exemption of insurance services has been carried out. On the other hand, it is proposed to test the impact of a limitation of taxation to investment services (asset management and fund management) only, mainly in view of a seemingly more limited social impact. Fund management, which is explicitly mentioned in Article 135(1)(g) of the VAT Directive, consists of the setting up and operation of collective investment funds. Asset management consists of the definition and execution of investment strategies.

The proposed options also take into account the input side through an introduction of a mandatory or optional fixed rate for deduction.

In options 1 and 2, an optional fixed rate of deduction is foreseen to simplify the calculation for taxpayers having both taxed and exempt supplies (e.g. financial services + insurance services) while preserving their right to full input tax deduction in case they prefer it.

In options 3 and 4, it is proposed to introduce a more limited modification of the scope of exemption – i.e. taxation of investment services only – but then it should be combined with the mandatory fixed rate deduction to limit the possibilities of arbitration for the taxpayers. As pointed out in literature on the subject, a partial extension of the VAT base to only some categories of financial services can easily defeat its own purpose if the VAT deduction mechanism is not regulated and controlled by the tax authorities. Otherwise, it may only lead to greater administrative costs and no further tax revenue at all¹⁰. Therefore, under options 3 and 4, which introduce more limited modification of the scope of the exemption, the mandatory fixed rate deduction would be particularly important to have and possibly its effects would be easier to observe.

Finally, option 5 focuses on a more targeted review and on re-introduction of the cost-sharing arrangements for the financial and insurance sectors.

All of the above options contain an element of revision of definitions, which seems unavoidable in view of recent developments regarding the new forms of services in the financial and insurance sector and the resulting problems with interpretation of the existing definitions and the scope of the exemption.

The contractor has been asked to include in the analysis of impacts all the elements required by the Impact Assessment Guidelines. In particular, the contractor has been charged with covering the issue of competitiveness of the sector on a global market and the question of the impacts on the cost of financial and insurance services, such as banking, insurance, mortgages etc., for individual consumers. These elements will be of key importance for balancing the interests of different stakeholders and tax administrations.

It should be stressed here that the final options for the impact assessment will be selected by the Commission services at a later stage and will integrate the results of the study and the

¹⁰ See e.g. R. Schatan, *VAT on Banking Services: Mexico's Experience*, VAT Monitor, July/August 2003, p. 287.

feedback received from the stakeholders and the tax administrations as well as further work carried out on the basis of the study.

The analysis of possible impacts of different elements of the options and of combined options is ongoing. It is structured so as to cover impacts on (1) legal certainty and regulatory costs; (2) VAT revenue and demand (including for B2B and B2C market segments); (3) macroeconomic and social impacts; and (4) market impacts such as competition, innovation and trade in the Single Market. The contractor will present the main conclusions of this analysis at the meeting.

3. QUESTIONS TO THE DELEGATES

The delegates are invited to:

- express their views on the options for review and their possible impacts,
- provide any further suggestions as regards the avenues to explore, and
- submit any relevant data that might contribute to the assessment of the options.

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