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GROUP ON THE FUTURE OF VAT

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**Update on the state of play of financial and insurance services and their
VAT treatment**

1. INTRODUCTION

Directive 2006/112/EC¹ (hereinafter: [VAT Directive](#)) lays down rules on the VAT treatment of financial and insurance services. These rules were firstly introduced in 1977 and provide for an exemption of financial and insurance services. According to the Court of Justice of the European Union (hereinafter: CJEU), the purpose of the exemption for financial transactions is to *‘to alleviate the difficulties connected with determining the tax base and the amount of VAT deductible and to avoid an increase in the cost of consumer credit’*².

Because this exemption from VAT, different to other exempt supplies (e.g. medical services), is not linked to a right to deduct the VAT paid on goods and services purchased (input VAT) in order carry out the supply of financial and insurance services, VAT often constitutes a cost for operators in that field.

Recent case law of the CJEU³ overruling cost-sharing arrangements⁴ but also the rise of the digital economy and the increase in the outsourcing of input services by financial and insurance operators could be reason enough to reflect on how the VAT rules on financial and insurance services could be clarified and modernised.

The purpose of this paper is to provide delegates with an outline of the current VAT treatment of financial and insurance services (section 2), the issues arising therefrom (section 3), the steps that have been taken in the past to counter these issues (section 4) and the current state of play of the Commission services’ work with regard thereto (section 5).

2. CURRENT VAT TREATMENT OF FINANCIAL AND INSURANCE SERVICES

The current VAT rules governing financial and insurance services have already been discussed in the context of the 20th meeting of the Group on the future of VAT held on 9 February 2018⁵, though the discussion focussed on the cost-sharing exemption under Article 132(1)(f) of the VAT Directive and recent CJEU case law in this regard.

Most financial and insurance services are exempt from VAT under Article 135(1)(a)-(g) of the VAT Directive. Taxable persons supplying such services cannot deduct their input VAT, which consequently becomes a cost for them. Article 137(1)(a) does provide for an option to

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 19 April 2007, *Velvet & Steel Immobilien*, C-455/05, EU:C:2007:232, paragraph 24.

³ 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.

⁴ An instrument traditionally used by operators in the field of financial and insurance services as a way to partly alleviate the VAT cost, see section 2 of this document.

⁵ GVF No 66, Implications of the CJEU judgments on cost-sharing for the financial and insurance sectors, taxud.c.1(2018)623416, p. 4.

tax, however, it used at the discretion of Member States. According to the knowledge of the Commission services, only few Member States made use of that option in a very limited manner.

The exemption under Article 135(1)(a)-(g) of the VAT Directive dates back to when VAT legislation was first put into place in 1977 and, although the reasons behind the VAT exemption in the law are difficult to pinpoint, it probably stems from the fact that it was found too difficult to apply VAT to financial and insurance services.

Various explanations are possible, including economic and policy considerations, as well as the practical and administrative complexity of taxing financial services. In particular, there seemed to be a problem in identifying the value of supplies, and hence the tax base, in relation to lending and borrowing, where the consideration forms an integral part of the interest charged or “spread” on the transaction. Because of these difficulties, exempting financial and insurance transactions seemed a pragmatic solution at the time. The exemption, however, reflects the way that Member States treated financial services prior to the Sixth VAT Directive⁶.

Since the VAT paid on goods and services purchased in order to supply the financial and insurance services may not be deducted, it represents a cost item for the service providers. This could lead to two negative impacts. Firstly, by artificially increasing the cost of *inter alia* investment goods and outsourcing, the taxation of inputs limits the choice of production techniques, and thus reduces the efficiency of the financial sector. Secondly, it puts EU financial institutions at a competitive disadvantage compared to institutions residing in countries where VAT is not levied or is levied at a lower rate.

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), although the characteristics of these provisions vary (for instance, VAT groups cannot be cross-border).

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). It should be noted, however, that these instruments only treat the symptom (VAT as a cost for financial and insurance operators) rather than dealing with the cause of the problem (the exemption from VAT itself).

Cost-sharing arrangements are widely used by financial and insurance operators to offset the impact of their input VAT burden. This practice, allowed by most Member States, has,

⁶ See Article 13B(a) and (d) of the Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment (OJ L 145, 13.6.1977, p. 1).

however, been recently overruled by the CJEU⁷. Different to the interpretation and application of Article 132(1)(f) of the VAT Directive by most Member States⁸, the CJEU found that cost-sharing arrangements are not applicable to the financial and insurance sectors. The CJEU's main reasoning is based on the notion that cost-sharing groups are restricted to the category of operators engaged in activities in the public interest listed in Chapter 2 of Title IX of the VAT Directive (*'Exemptions for certain activities in the public interest'*). Financial and insurance activities, however, are exempt based on rules laid down in Chapter 3 of Title IX of the VAT Directive (*'Exemptions for other activities'*) and hence do not fall within that category.

3. ISSUES RESULTING FROM THE CURRENT VAT TREATMENT OF FINANCIAL AND INSURANCE SERVICES

Apart from the recent jurisprudence laid out above, overruling the application of cost-sharing arrangements in order to remedy the operators' VAT input burden, the VAT treatment of financial and insurance services raises many other problems.

The current rules date back to 1977 and 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 has led to increasing litigation before the CJEU, legal uncertainty, and high administrative and 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.

Due to the rise of the digital economy and the increase in the outsourcing of input services by financial and insurance operators, in part driven by regulatory changes, the problems linked to the VAT treatment of financial and insurance services keep worsening.

First of all, there is a high level of uncertainty on how to treat new forms of financial and insurance transactions, usually carried out electronically (e.g. crowdfunding, use of cryptocurrencies such as "Bitcoin", or peer-to-peer money transfers made outside the banking system). As a result, it is often not clear what the scope of the exemption is. Secondly, outsourcing (as opposed to services generated in-house) increases the VAT costs of the sector. As a result, VAT may further constitute a source of competitive distortion and an obstacle for innovation, in particular for small financial and insurance institutions as well as new entrants vis-à-vis established institutions. The availability of online banking and, more generally, financial globalisation may also have been increasing the competitive handicap from irrecoverable input VAT by making it significantly easier to provide financial services from abroad than was the case in the 1970s.

⁷ 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.

⁸ 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*.

4. PREVIOUS ATTEMPTS TO REVIEW THE CURRENT RULES

In order to address these concerns, the Commission proposed already in 2007 new legislation as regards the VAT treatment of insurance and financial services, which comprised a proposal for a Council Directive and a proposal for a Council Implementing Regulation⁹. The proposals mainly aimed at clarifying and modernising the scope of the exemption, but they were not focused on more fundamental issues (that is, the fact that supplies of financial operators are exempt and, as a result, input VAT constitutes a cost for them). In particular, the proposals were based on the following three pillars:

- 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.

The discussion of the proposals had come to a standstill in Council, where it was last discussed under the Polish Presidency in 2011. This was mainly due to the inability of Member States to reach an agreement on several politically sensitive issues (notably, as regards the application of the VAT exemption for the management of investment funds and pension funds; and also transactions concerning commodity derivatives and outsourced services).

Consequently, the 2007 VAT proposals on financial services were withdrawn in 2016¹⁰.

5. STATE OF PLAY OF THE COMMISSION SERVICES' WORK

Though the discussion on the VAT treatment of financial and insurance services has been recently very much triggered by the loss of the cost-sharing exemption, it has a broader context and relates to problems that have affected the taxpayers and national tax administrations for a longer while¹¹. This discussion emphasises the need for a broader review, which could also build on the experience gained from the work done on the 2007 proposals. In addition, it is worth noting that recent changes in the rules regarding markets in financial instruments¹² improved the transparency and oversight of financial markets¹³. The

⁹ 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](#)).

¹⁰ OJ C 155, 30.4.2016, p. 3.

¹¹ See section 3 of this document.

¹² Notably Directive 2014/65/EU (MiFID II) of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L 173, 12.6.2014, p. 349).

¹³ In particular, as regards intermediation services, further requirements were introduced related to the protection of investors, including transparency on costs of services provided.

original reasons for including the VAT exemption for the supply of financial and insurance services in the VAT Directive should be reassessed in light of these developments.

In the context of the adoption of the Commission’s VAT quick-fix proposal¹⁴, the Council and the Commission agreed the following statement to the minutes¹⁵:

‘The Commission and the Council are aware of a certain divergence in the VAT treatment of independent groups of persons that pool their services and share costs between their members. The Council and the Commission recognize the need to clarify such VAT rules on independent groups of persons.

The Commission will analyse this matter in detail in a study to be launched shortly with a view, subject to its right of initiative, to a possible proposal.’

In this statement, the Commission committed to carrying out a study with regard to the cost-sharing exemption. However, given the need of a broader review as explained above, the Commission services consider it timely not only to focus on the aspect of cost-sharing but to carry out a study on the functioning of the VAT rules for financial and insurance services as such with a special emphasis on their cross-border dimension. This is also consistent with the overall conclusions drawn from discussions at the 20th meeting¹⁶. The study should analyse the functioning of the provisions of the VAT Directive across the EU, their advantages and flaws and the main elements and options to consider for the future review of the relevant provisions of the VAT Directive.

At this stage, the Commission services are currently evaluating offers received by several potential tenderers. If one of the offers is considered to be sufficient to fulfil the purpose of the study, the study will be launched shortly and the results could be expected within about one year, i.e. by summer 2020.

The main objective of the study is to evaluate the functioning of the current VAT rules on financial and insurance services, while putting them in the context of all other relevant legislative developments in those sectors; in particular, by taking into account new regulations on financial and insurance markets developed after the 2008 financial crisis and other relevant taxes at national level (e.g. national FTTs, insurance premium taxes, or bank levies). In order to limit the scope of the exercise, the study is in principle not supposed to take into account corporate income taxation, unless it becomes clear that this plays an important role.

¹⁴ Proposal for a Council Directive amending Directive 2006/112/EC as regards harmonising and simplifying certain rules in the value added tax system and introducing the definitive system for the taxation of trade between Member States ([COM\(2017\) 569](#)); and Proposal for a Council Implementing Regulation amending Implementing Regulation (EU) No 282/2011 as regards certain exemptions for intra-Community transactions ([COM\(2017\) 249](#)); and Proposal for a Council Regulation amending Regulation (EU) No 904/2010 as regards the certified taxable person ([COM\(2017\) 567](#)).

¹⁵ See Annex II of the [Council Presidency note of 28 September 2018](#).

¹⁶ GVF No 69, Minutes – 20th meeting – 9 February 2018, taxud.c.1(2018)1127105, section 3.4 (p. 5).

Based on that evaluation, the study should also develop possible options for the review of the provisions in the VAT Directive and prepare an analysis of impacts in respect of each one. Those options would, amongst other, look at ways in which financial and insurance services could be taxed.

Such an assessment will help the next Commission decide whether EU action is needed and, if so, which is the best way forward.

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