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Opinion Statement

on Modernising Value Added Tax Obligations for

Financial Services and Insurances

Commission Consultation Paper

**Paper submitted by the
Confédération Fiscale Européenne
to the Council, the European Commission
and the Parliament
in 2006**

This is an Opinion Statement on the Commission Consultation Paper on Modernising Value Added Tax Obligations for Financial Services and Insurances, prepared by the Fiscal Committee of the Confédération Fiscale Européenne (CFE). The CFE is the leading European association of 29 national tax advisory organisations representing over 150,000 tax advisers.

The CFE welcomes the consultation of the European Commission on VAT on financial services and insurances. The CFE is aware that the most appropriate alternative does not exclusively depend upon pure tax aspects. Consequently, the purpose of the present opinion is only to try to clarify the debate raised by the consultation paper in the light of the system of which European VAT on financial services is a part.

1 VAT rules on financial services are part of an existing legal system

Any change should be compatible with higher rules. If not, any business could require a tribunal to declare that the inferior rules are not applicable, or should be interpreted in another way. This would create a permanent legal uncertainty that is not compatible with the purpose of the changes contemplated. It is therefore extremely important to place a possible proposal in its general context. Therefore, any change should:

- comply with the basic freedoms granted by the European Treaties;
- totally or partly relieve input VAT on costs and therefore it should be part of the VAT system;
- comply with the basic principle of the European VAT, in particular the First VAT Directive, and tax only final consumption, regardless of the number of the participants in the production chain;
- not impose additional administrative burdens on business. This would suggest as few exceptions to normal VAT rules as possible;
- be formulated in a simple way in order to avoid any future difficulty of interpretation;
- take into account specific characteristics of the various categories of financial services and insurances.

2 Why a VAT exemption of some financial services?

The CFE recalls that historically, the VAT exemptions on financial services had been introduced in order to avoid consumers suffering VAT twice on credit operations, the first time on the acquisition of goods and, a second time, on the granting of a credit by financial institutions.

Since the adoption of different systems for non taxable persons and business would have been complex, the option had been taken to exempt all financial operations. This pragmatic solution presented the disadvantage that VAT on costs incurred by the financial services providers was not recoverable. At that time, this non recoverability of VAT did not matter that much since the investment in materials and outsourcing were much less important and costly than they are today.

Until now, the absence of empirical studies on the micro economic and macro economic costs of VAT on financial services and insurances made any in-depth discussion on the most efficient alternatives difficult. Maurice Lauré, the inventor of VAT, estimated that the cost of VAT exemptions for banks in France was equivalent to an increase of interest rate from 0,3 to 0,4 % (*Science Fiscale*, p. 271) and that this had an influence on the competitiveness of the overall economy.

The opposition to the adoption of VAT on Financial Services in the early 70's seems to have been motivated by the strong opposition of the smaller financial institutions, in particular those who are dealing mainly with private individuals. Difficulties in determination of the taxable base of financial services played also an important role. But the VAT exemptions do not allow this difficulty to be avoided. It already exists in the case of the determination of the pro-rata deduction of input VAT, as well as in the case of supplies of financial services to customers established in third countries.

3 Why VAT on financial services?

From an economic point of view, taxation of financial services and insurances would definitively solve the problem of increased cost of outsourcing, of trade diversions and distortions of economic decisions, because it allows a full recovery of input VAT.

From a legal point of view, taxation reduces the chances that taxpayers would challenge the adopted procedures on the basis of the general principles of the Treaties.

Furthermore, the existence of VAT exemptions combined with the absence of taxation on operations between various establishments of the same legal entities but located in different countries (ECJ, 23 March 2006, FCE Bank plc, Case C-210/04) should logically lead to the adoption of a world-wide method of recovery of input VAT for financial institutions. However this is impossible because of the different methods applicable within and outside the EU which cannot be harmonized. For example how is one to determine the right of recovery of input VAT of an entity established in one country where only the general pro rata is accepted and another country where the entrepreneur can calculate the non recoverable partial amount by fair estimations? This is probably impossible. Similar remarks may be made about recovery of foreign input VAT, with the application of the 8th and 13th VAT Directives.

4 Review of the possible alternatives

An optimal alternative should comply with the requirements of:

- limited impact on cost of credit for business and households,
- reduced cost of outsourcing for the financial sector ,and finally
- neutral budgetary consequences for the Member States and the European Institutions.

The fundamental assumption of the European VAT as designed by the First VAT Directive is that neutrality of taxation increases the economic efficiency, that it reduces the costs of doing business (and therefore it could possibly reduce the interest rates) and increases the Member States revenue (by increasing the global economic activity).

From a technical point of view, the various alternatives discussed in the consultation paper of the European Commission are actually limited to three, with some variations:

- ✓ zero rating,
- ✓ taxation and
- ✓ option to zero rate or to tax.

4.1 Zero rating

In B2B relations, VAT is payable to the competent tax authorities by the supplier or/and by the customer, but at the end, VAT is not a cost for both the supplier and the customer. In

B2B relations, taxation or zero rate have the same economic result except for the effect on cash flow in the case of taxation.

Zero rating allowing relief from the input VAT could take various forms:

- full right of deduction of input VAT by the customer of the VAT charged by the supplier;
- partial right of deduction of input VAT by the customer of the VAT charged by the supplier;
- no VAT charged by the supplier of financial or insurances services and this supplier has a full right to deduct input VAT on costs;
- no VAT charged by the supplier on some services to financial institutions, but no right of deduction on costs incurred by this supplier (example article 13(A)(f) of the Sixth VAT Directive).

In practice, most of the zero rating alternatives are complex and they could possibly be subject to serious criticisms in the light of the Treaty Principles. In order to meet the requirements of compatibility with the Community law and the First VAT Directive, it should be clear that other methods cannot be applicable (general principle of proportionality).

4.1.1 Broaden the scope of VAT exemption to suppliers of financial institutions

This is a VAT relief that has the same impact as a zero rate: instead of giving a right of deduction of input VAT to the recipient, the supplier could exempt with credit his operations to financial institutions. It differs from the full zero rating since its scope is narrower.

This would not allow attainment of the objectives of the contemplated changes, such as increase of legal certainty, because the scope of the VAT exemptions could be subject to permanent disputes and this increases the cost of monitoring by the tax authorities.

4.1.2 Introduce cross-border VAT bodies, including groups, cost sharing arrangements or other structures.

This solution is a kind of zero rating, but it is restricted to some categories of suppliers and to some operations.

4.1.3 Introduce a special input VAT deduction rule on the basis of a fixed percentage for specified services to address the vertical integration bias, as is the case with Australia's Reduced Input Tax Credit;

This solution is a kind of partial zero-rating, but the method of deducting input VAT is calculated on a lump sum basis. This system already exists in Australia, but it has proven to be complex.

4.1.4 Zero rate the supply of financial services and insurance to other taxable persons (B2B-supplies) as is the case with New Zealand's GST;

A similar system already exists in Europe regarding supplies of financial services to third countries' residents and it is largely implemented in order to combat fraud on internal operations (such as immovable property).

Such system:

- ✓ is compatible with the overall integrity of the system since it ensures a full neutrality of the VAT on production;
- ✓ prevents distortions of economic decisions and enforces the neutrality of the VAT system;
- ✓ is easy to implement because it is easy to make a distinction between the various kinds of clients on the basis of their VAT ID number;
- ✓ does not increase the administrative charge of business.

4.2 Taxation

4.2.1 Broaden the taxation for B2B supplies with a corresponding deduction for input VAT

This has the same impact as a pure zero-rating, but only in B2B transactions whilst maintaining the VAT exemptions for transactions to non-business customers. A similar alternative is already adopted by some Member States on operations for which a commission fee is requested and it has proven to function efficiently.

This solution does not solve the situation faced by the great majority of financial institutions performing both taxable and VAT exempt operations. It also requires that the issue of the determination of the taxable base would be solved. The CFE observes that the TCA method

was probably not the only method of determination of the taxable base of financial services and the taxation of the gross intermediation fees should be considered.

4.2.2 Reduced rate for regulated financial institutions

All financial services provided by regulated financial institutions and, under conditions yet to be determined, by non regulated financial institutions, could be subject to a uniform VAT rate of, for example, 2 or 3 %.

This supposes that the issue of the determination of taxable base would be solved and its impact on the cost of credit to households should be clarified.

4.3 Option to tax or to zero-rate

Another suggestion is an option exclusively granted to regulated operators and, under conditions yet to be determined, to some non regulated operators:

- to tax at a uniform reduced VAT rate ; or
- to zero-rate the services rendered to business identified for VAT.

5 For a common definition of the taxable base for financial services

In a VAT system, the determination of the taxable base is less of a method to tax (and to collect revenue) than a method of monitoring the collection of the tax at final consumers stage and to ensure the neutrality of the tax on business.

A practical consequence of this observation is that the taxable base should only be disclosed to the customers when it is strictly necessary to deduct input VAT in the chain of production of taxable supplies. In B2C, the taxable base has only to be disclosed to the tax authorities for the purpose of the monitoring of the correct application of the tax (compare with ECJ, 24 October 1996, Argos, Case C-288/94).

Any solution other than zero-rating or taxation of B2B operations does not bring satisfactory solutions to situations such as:

- refund of foreign VAT on the base of 8th or 13th VAT directive to taxable persons supplying both taxable and VAT exempt operations;
- right of deduction of input VAT by financial institutions structured as branches located within or outside of the EC.

In such a context, it is extremely important to adopt uniform methods of determination of the taxable base. Different solutions could probably be adopted, depending on the nature of the activities of banks and financial intermediaries, insurance companies and brokers, funds and mortgage providers.

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