Response to the European Commission Green Paper on the Future of VAT

A response by the Association for Financial Markets in Europe

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The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the European Commission's *Green Paper on the Future of VAT*. We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised in the Paper.

Executive Summary

While we welcome the proposals to simplify and update the EU VAT system, we believe it is important that any reforms are developed with consistency and clarity, and that they do not introduce overbearing administration or hurdles which might adversely affect the single market. Simplicity is also a key requirement so that the system does not lend itself to abuse and fraud.

All initiatives to streamline administration and enhance relationships between businesses and tax authorities are welcomed, particularly those that lead to more effective compliance and a proper focus on risk, while also avoiding a formulaic and prescriptive approach to the relationship.

Whilst the adoption of the origin system would have certain benefits for taxpayers and tax authorities alike, we recognise that in practical terms it is unlikely to be achieved in the near term, so current improvements should be focused on making the destination system more effective. In the long-term though, in answer to Q33 we have put forward a number of ideas for how VAT could look from 2025. Although these ideas do not represent the agreed views of all our members, they are an attempt to take a fresh look at what could be achieved with a clean sheet of paper.

Q1. Do you think that the current VAT arrangements for intra-EU trade are suitable enough for the single market or are they an obstacle to maximizing its benefits?

The system is predicated on the concept of a supplier in one country and customer in another. Although there are administrative burdens in terms of statistical reporting and documentation, the system generally works for goods and for services. There are however a number of obstacles around each type of supply.

- For goods: once there are more than two parties in a chain, the need for workarounds leads to complexity.
- For goods: it can be easier to export goods to, or import goods from, outside the Member States rather than make a dispatch or acquisition. Taxable persons who are involved in intra community trade in goods only infrequently can find it difficult to maintain appropriate records and details to enable them to complete the necessary statistical declarations. This is because the information required is additional to normal commercial documentation.

- For services: differences in VAT liability between Member States results in complexity.

- For services: submission of European Sales Lists has to take into account all the different treatments in the Member States.

- For services: the concept of intervention interpreted differently across Member States gives complexity which is onerous and unnecessary. It does not affect tax yield. This also requires a determination of all the different treatments in the Member States. It may also cause double taxation and distortion of competition. A taxpayer may not be able to recover VAT but will still be required to account for VAT in the place of his fixed establishment. The fixed establishment may not have the regulatory permission to carry out that service locally.

The current system means that Member States can retain different VAT rates without distortion of competition arising. This is because the tax is collected in the Member State of the customer.

Q2. If the latter, what would you consider the most suitable VAT arrangements for intra-EU supplies? In particular, do you think that taxation in the Member State of origin is still a relevant and achievable objective?

In order for the origin concept to operate it would require Member States to agree on either a single VAT rate or VAT rates within a small band. Failure to do this would lead to distortions in the operation of the internal market.

The advantages of the origin system are that it would substantially reduce the administrative burden on tax payers, in terms of reporting intra-EU transactions, and would substantially reduce the risk of cross border fraud. Taxpayers would however still be obliged to operate a destination based model for supplies from outside the EU and would therefore be operating both origin and destination models.

In order to achieve a properly functioning origin system it would be necessary to agree common exemptions and reduced rates. Outside the single market tax payers would still be required to operate a destination system; but it would mean that they would have to apply just the rules of one Member State rather than considering the rules of all 27.

The origin system would involve taxpayers potentially incurring input tax from 27 Member States, and we understand that technology has already been developed to enable Tax Authorities to operate a central clearing house system for payments/credits between Tax Authorities in different territories. Taxpayers could add a country identifier to systems to allow them to identify where suppliers/customers are located to enable accurate reporting based on counterparty location.

Q3. Do you think that the current VAT rules for public authorities and holding companies are acceptable, particularly in terms of tax neutrality, and if not, why not?

In respect of holding companies alone we believe that:

- Some holding companies do undertake taxable activities, consisting either of supplies to third parties or the management of subsidiaries, and hence are normal taxable persons and entitled to recover VAT according to the normal rules.

- A commercial holding company that only holds shares, either directly or indirectly, in a number of companies in its own territory is also a commercial organisation and should in principle be entitled to be registered for VAT purposes, and recover input tax in the normal way.

- A commercial holding company will only be able to recover VAT if it can register as part of a VAT group or similar. Therefore VAT grouping or fiscal unity would need to be permitted in all Member States.

Q4. What other problems have you encountered in relation to the scope of VAT?

In addition to previous comments (Q1-3), there are situations where VAT is applied both by the supplier and by the recipient of the service under the reverse charge. This can still arise on intra-EU services despite the introduction of the VAT package as well as being a common issue with third country suppliers.

There is a lack of clarity in the definition of "economic activity" across Member States, with different interpretations applied.

Q5. What should be done to overcome these problems?

The Commission should engage with the respective Member States to ensure the VAT package is properly and consistently implemented. For non-EU countries, the Commission should seek engagement with supranational organisations to attempt to achieve greater consistency.

Clarification is needed in terms of the definition of economic activity as there are still inconsistencies across Member States.

Q6. Which of the current VAT exemptions should no longer be kept? Please explain why you consider them problematic. Are there any exemptions which should be kept and, if so, why?

The existing VAT exemptions have their origins in social, economic and political decisions. Therefore, any review of exemptions needs to be taken in the light of those original decisions to consider the extent to which any change is needed.

Specifically regarding the finance and insurance VAT exemptions, these are currently being considered in the Insurance and Financial Services Review and there seems little advantage in addressing this again as part of this consultation.

Q7. Do you think that the current system of taxation of passenger transport creates problems either in terms of tax neutrality or for other reasons? Should VAT be applied to passenger transport irrespective of the means of transport used?

No comment on this.

Q8. What should be done to overcome these problems?

No comment on this.

Q9. What do you consider to be the main problems with the right of deduction?

Our members find many differences in interpretation across the Member States which lead to unnecessary complexity and can result in distortions of trade.

- Lack of consistency of approach by Member States in the rules governing the right of deduction for taxable persons who are partly exempt, for example:
    - In some cases the right to deduct is determined by the nature of the business and not by the supplies made.
    - Many tax authorities assume that the VAT recovery rates of financial institutions must be inherently low or even zero.
    - Failure of tax authorities to acknowledge that business accounting systems are far more sophisticated now than they were in 1977 and can support more detailed calculations.
- Adjustment of the deductible proportion in respect of capital goods is ineffective. It causes a huge administrative burden for little benefit to the tax take. For example, last year an AFME member adjusted for a total of €38,110 on assets whose purchase cost was €165,348,188.
- The revised 8th and 13th Directive rules have done nothing to simplify the varying recovery rules in each Member State
    - Member States have not fully taken on board increased business use of e-invoicing and e-storage of invoices and insist on original documentation being forwarded with claims. Most invoice processing systems scan original invoices and it is those scanned invoices that are retained. Businesses find that installing an efficient invoice processing system effectively prevents them from submitting refund claims to other Member States.
    - In our view this is incorrect. Business efficiency should not be penalised in this way. In addition, Member States do not always adhere to repayment deadlines.
- Cash flow issues arise when tax payers have to account for VAT but do not have the right to deduct at the same time.
- Widely differing requirements for recovery and limitations on recoverable costs across Member States.
- Not cost effective to recover VAT on low value expenses eg staff expenses: high cost of processing for individual, low value reclaims, but overall value of many small claims is high for a large business. An estimated method could be one solution but few Member States allow this.

- Businesses are expected to check that their suppliers have correctly charged VAT, but have very little support to carry out effective checks.
- The intervention rules are distortive as they can lead to a tax payer charging VAT but not being given the right to deduct associated input tax.

As a specific example, consider the supply of an emissions allowance (EUA) by an AFME member to a bank, which is selling that certificate to its own client. That client will use the EUA against its own requirements. In this example, suppose that member state A allows direct attribution of input tax, whereas member state B does not:

(a) the certificate is traded on an exchange established in member state A and VAT is charged;

(b) it is purchased by bank 1, also established in member state A, which recovers the VAT in full (based on the assumption that member state A allows direct attribution of input tax);

(c) bank 1 sells the certificate to bank 2 which is established in member state B; bank 2 is required to account for VAT under the reverse charge procedure, but (based on the assumption that member state B does not allow direct attribution of input VAT) can only pro rata the VAT and therefore suffers an irrecoverable VAT cost;

(d) bank 2 in member state B sells the certificate to its client also in member state B and charges VAT;

(e) the client in member state B recovers the VAT charged to it in full.

It cannot be the intention of the Directive for irrecoverable VAT to arise in these circumstances. The commercial solution adopted is that bank 2 assigns the benefit of the contract to a subsidiary in another member state that allows direct attribution. The subsidiary then completes the sale to the client. All VAT is now recovered in full.

It is wrong that businesses are compelled to restructure transactions so that they are commercially viable solely to avoid differences in interpretation of VAT Directives between Member States.

Q10. What changes would you like to see to improve the neutrality and fairness of the rules on deduction of input tax?

- Taxable persons should have a statutory right to use a recovery formula other than the pro rata method where they can demonstrate that their accounting systems can support such a method. The principles of use based attribution to supplies or business sectors should be made mandatory before any method based on pro rata is applied.

  For example the value for VAT purposes of equity transactions is calculated by reference to the face value of the instruments. However this part of a bank's business has a tiny profit margin and it is difficult to understand how including these amounts in a single pro rata calculation could lead to a fair recovery of input tax when other supplies, say advisory services, have a much lower value

for VAT purposes, but commercially may produce as much profit. The purpose of attribution or sectorisation is to treat like with like and prevent this type of distortion. If the businesses were conducted in separate companies they would each have their own recovery rates reflecting their respective businesses. The same treatment should be available to all taxpayers.

In practice the existing arrangements result in some Member States restricting tax payers' right to deduct input tax incurred that relates to taxable supplies. In addition some Member States assume that certain types of business should all have the same or very similar VAT recovery rates, and it is our view that the use of industry "standard" deduction rates should be abolished.

- Adjustments for capital items should be abolished, or at least small value items excluded and the calculations simplified. Consideration should be given to a de minimis limit.

- Standardisation of rules governing claims by non-resident entrepreneurs so that there is consistency on what costs are allowable and disallowable

- Abolition of the rule that prevents such claims if the taxable person has a fixed establishment in the country of travel. Such claims to be allowed in the VAT recovery calculation of the fixed establishment concerned.

- Removal of necessity to submit original invoices.

- Adopt a common list of excluded items across EU.

- Standardise reclaim requirements across EU.

Q11. What are the main problems with the current VAT rules for international services, in terms of competition and tax neutrality or other factors?

- It can be very difficult to identify what supply has been received, for example there may be little narrative or description, or a supplier may issue several invoices for different elements of one supply.

- Cross border recharges on inter-company transactions or between companies collaborating on a commercial enterprise, development or project can result in additional VAT costs arising because of the lack of a common approach between Member States.

The way a business is organised can create significant differences in its VAT costs. VAT should be a tax on consumption and should not be allowed to impede inter-company transactions. This can result in competition issues for EU businesses where they have to potentially account for VAT when centralising functions.

Q12. What should be done to overcome these problems? Do you think that more coordination is needed at international level?

- As we have indicated above in Q9, greater dialogue with international organisations could assist in ensuring that proper tax neutrality for businesses is achieved.
- To achieve neutrality, all intra-company transactions should be disregarded for VAT purposes. Disallowance of input tax (if appropriate) would incur in the member state in which the expense was incurred, and double taxation would not arise
- The Commission should re open discussions on cross border VAT grouping as this would relieve many taxpayers from the burden of double taxation which distorts the operation of the internal market
- The Commission should also consider whether the existing provisions of Article 132(1)(f) can be enhanced to achieve the same or a similar objective

Q13. Which, if any provisions of EU VAT law should be laid down in a Council regulation instead of a directive?

The use of regulations can bring considerable clarity, and generally has a positive impact on the administration of VAT. However the use of words such as 'intervention' which are open to different interpretation across the Member States is unhelpful for businesses.

Q14. Do you consider that implementing rules should be laid down in a Commission decision?

We consider that once the Member States have unanimously agreed on a proposal this could be helpful, particularly if it sets out the rule to be applied, how it should be applied, and what mischief it is intended to prevent. Taxable persons would have additional information with which to challenge unusual or individual decisions by tax authorities in Member States, as well as greater understanding of the legislative purpose.

Q15. If this is not achievable, might guidance on new EU VAT legislation be useful even if it is not legally binding on the Member States? Do you see any disadvantages to issuing such guidance?

We believe this could be of assistance. However, given that our members have seen instances of radically different interpretations of decisions of the European Court of Justice, we would have concerns that Member States might in practice disregard the guidance.

We consider that the VAT committee could be better used, and could provide additional guidance and insight into legislation.

Q16. More broadly, what should be done to improve the legislative process, its transparency and the role of stakeholders in the process, from the initial phase (drafting the proposal) to the final phase (national implementation)?

- The legislative process is lengthy and frequently by the time agreement is achieved the relevance of the decision has been lost.

- We consider it could be helpful if the Commission would consult with trade bodies at the beginning of the process in an effort to resolve issues at an early stage. Taxpayers, because of their day to day experience in the operation of VAT, can offer assistance in respect of the workability of proposals.
- Where appropriate, if definitions are already agreed in other EU legislation, VAT legislation should be aligned with those definitions. If, for example, Community legislation has defined insurance, taxpayers should be able to rely on that.
- There should be greater use of consultations**,** and the views of taxpayers should be recognised. Too often taxpayers are left feeling that their views have been ignored – the purpose of consultations is to make better informed decisions, not to use the consultation as a way of supporting decisions already taken.
- Proper and complete impact assessments should be made.

Q17. Have you encountered difficulties as a result of derogations granted to Member States? Please describe these difficulties.

No comment on this.

Q18. Do you think that the current procedure for granting individual derogations is satisfactory and, if not, how could it be improved?

No comment on this.

Q19. Do you think that the current rates structure creates major obstacles for the smooth functioning of the single market (distortion of competition), unequal treatment of comparable products, notably online services by comparison with products or services providing similar content or leads to major compliance costs for businesses? If yes, in what situations?

We consider that the VAT liability should not be dependent on the means of delivery.

Q20. Would you prefer to have no reduced rates (or a very short list), which might enable Member States to apply a lower standard VAT rate? Or would you support a compulsory and uniformly applied reduced VAT rates list in the EU notably in order to address specific policy objectives as laid out in particular in 'Europe 2020'?

This does not greatly affect our members. As a general observation however, the Member States have different issues and there should be some choice to reflect local and national circumstances.

Q21. What are the main problems you have experienced with the current rules on VAT obligations?

- The administrative burdens imposed on the tax payer in relation to intra-EU trade, particularly when documentation and submissions are required purely for VAT purposes. For example:

- EC Sales Lists / Intrastats - time consuming to prepare and very difficult to get complete accuracy. It does not always appear that the data collected is being used in any meaningful way.
- Wording for invoices - requirement to state reason for zero-rating/exemption creates additional compliance burden.

Q22. What should be done at EU level to overcome these problems?

- Standardising of intra-EU reporting requirements so that all Member States require the same return formats. These standards should not be a burden on taxpayers.
- Requests for information should be proportionate and geared towards the use for which the information is to be put.
- Cross border reporting should be restricted to a single VAT reporting requirement.
- Implement recommendations 6-15 in the Annex to Communication COM(2009) 544.
- Abolish local rules over and above reporting of taxable transactions eg rules on supplier and customer listing.

Q23. What are your views particularly on the feasibility and relevance of the suggested measures including those set out in the reduction plan for VAT (N° 6 to 15) and in the opinion of the High Level Group?

Broadly speaking, AFME is in agreement with the suggested measures (No 6-15 in the reduction plan for VAT) identified. In our view, any measures which successfully minimise the time and expense associated with VAT administration are, of course, of benefit. Whilst we are in agreement, we would make some observations. Any simplification should not be a detriment to the cash flow position of a business. This is recognised in Recommendation 7 which enables businesses to submit more frequent VAT returns if desired. We are supportive of Recommendation 11 - a move from invoice to payment date as a driver for accounting for VAT as this would benefit business cash flow.

In terms of Recommendation 14, we would be keen that processes for obtaining numbers are aligned. However, not all businesses are VAT registered and this could cause issues (especially for VIES etc). We fully support Recommendation 15 and please also see our comments relating to anti-fraud derogations and the application of these across the EU.

We also support a maximum list of standardised obligations in Art 273. Member States should not be able to impose additional requirements in respect of documentation.

This would enable greater consistency between Member States and clarity for traders.

Q24. Should the current exemption scheme for small businesses be reviewed and what should the main elements of that reassessment?

No comment on this.

Q25. Should additional simplifications be considered and what should be their main elements?

No comment on this.

Q26. Do you think that the small business schemes sufficiently cover the needs of small farmers?

No comment on this.

Q27. Do you see the one stop shop concept as a relevant simplification measure? If so, what features should it have?

In principle we are of the view that this is a relevant simplification measure. However we see many practical obstacles. We believe that this concept would work best if we have adopted firstly, the origin system, that there is a facility for pan-European VAT grouping or fiscal unity, and that there are consistent rules across all Member States**.**

Q28. Do you think that the current VAT rules create difficulties for intra-company or intra-group cross-border transactions? How can these difficulties be resolved?

Yes we believe that the current rules do cause difficulties, particularly for the partly exempt financial and insurance services industries. Some of the specific problems and possible resolutions are as follows:

- The VAT Package has placed further administrative burdens on companies involved in cross border trade in terms of statistical reporting. This means that tax authorities need to understand:

    a) the VAT systems of the 27 different Member States; and

    b) how to interpret what is meant by "intervention" when many Member States have provided no explanation of how this is to be interpreted locally.

  The VAT Package should be amended to remove the administrative burdens it has introduced. Member States should have confidence in the general reverse charge provisions (which were operative for many services for many years prior to the VAT Package changes) irrespective of whether or not the supplier has a presence in the same country as the recipient of the services. The contractual position should be definitive.

- The fact that VAT grouping is permissive rather than mandatory discourages EU trade in the single market. The Commission's views on the position of overseas branches being separate legal entities from their parent company if they belong to a VAT group registration in another country is very unhelpful to business. Article 132 (1) (f) is largely ineffective since its primary requirements are that it covers independent groups of persons who are carrying on an activity which is exempt from VAT. By definition intra company/group transactions cannot involve "independent groups of persons." Neither does it provide for entities which are partly exempt for VAT purposes.

  These issues could be addressed by making VAT grouping compulsory across the EU. Where companies fulfill the requirements of being "…legally independent, are closely bound to one another by financial, economic and organisational links" then they should be allowed membership of a single VAT group irrespective of where they are physically located. In the absence of a pan-European VAT group facility then Article 132 (1) (f) should be amended to include partly exempt persons and to specifically include cost sharing agreements particularly where done for transfer pricing purposes.

Q29. In which areas of VAT legislation do synergies with other tax or customs legislation need to be promoted?

We believe that synergies need to be achieved in the following areas:

- The use of a common tax base value
- The removal of double taxation on supplies between Member States.

Q30. Which of these models looks most promising in your view and why, or would you suggest other alternatives?

We assume this question relates to the "VAT gap" and to VAT fraud. In this context AFME do not consider any of the four options to provide any advantages over the current system. While AFME recognises the benefits of the origin system, in practical terms it is unlikely to be achieved in the near term and current improvements need to focus on making the existing destination system more effective.

In expressing this view AFME would endorse the detailed comments of colleagues at the BBA on options 1 to 4 with the following additional comment:

Option 4: We see no advantage to this option as we believe that the people most likely to comply are those who are already compliant. The additional costs of this option fall not only on business, but also on the Tax Authorities as highlighted in the Green Paper (para 5.4.1 last bullet).

Q31. What are your views on the feasibility and relevance of an optional split payment?

AFME does not consider this approach to be feasible.

The tax payer is responsible for accounting for the tax on the supplies that he makes – there should be no changes which would move that obligation and bring any other person into the chain of responsibility.

The proposal for an optional split payment would introduce an additional layer of complexity which rather than reduce the opportunity for fraud would insert a new opportunity for customer triggered fraud. The proposal increases risk and administrative burdens for compliant traders. AFME is in agreement with BBA colleagues on their response on this issue.

Q32. Would you support these suggestions to improve the relationship between traders and tax authorities? Do you have other suggestions?

AFME welcomes all initiatives that streamline administration and enhance relationships between businesses and tax authorities. We particularly welcome initiatives that lead to more effective compliance effort, a proper focus on areas of risk and which steer away from formulaic and prescriptive approach to the relationship.

Q33. Which issues, other than those already mentioned, should be addressed in considering the future of the EU VAT system? What solution would you recommend?

HOW CAN VAT LOOK IN 2025?

The questions raised in the Green Paper are designed to consider the individual issues we all encounter on a regular basis on VAT. Whilst it is good to consider the detail these questions raise, AFME believes we should also think "out of the box" and say, what would we do if we had a blank piece of paper.

Although we do have to maintain the revenue generation for the tax authorities we also have to consider a system that allows for easy VAT collection.

Thoughts could turn to VAT being completely changed (a sales tax type approach?) but the expectation is that the current structure of each transaction in a chain giving rise to VAT, with input tax deduction and output tax liability, will be maintained. On this basis, the suggestions outlined below are initial thoughts on what could happen to make VAT simple to operate but without significantly impacting the overall revenue generation for the tax authorities.

- **<u>VAT to be a "Simple Tax"</u>**

  The only way to make VAT a simple tax is to ensure the same rules must apply everywhere, and there is only a very limited scope for dispute on the treatment of specific supplies. VAT has become a "monster" as far as compliance and liability decisions are concerned and the cost of administering it is too high, both for business and the tax authorities. We should therefore be looking for a system that is easy to operate and maintains the revenue levels for the tax authorities.

- **<u>Origin system of VAT</u>**

There are many arguments as to why an origin system will be "difficult", but these are generally based upon different rates and the expectation that people will shop around for lowest rates.

The origin system should however bring a rate convergence as territories ensure they are competitive. The benefits of an origin system can be summarised as:

- Reduced complication
- Reduced filings (no ESL/Intrastat)
- Reduced scope for fraud

Previous discussion on an origin system has often failed due to the complication of different rules in different territories. If we adopted a simple approach to VAT legislation we should be able to see the benefits of an origin system.

The origin system will bring the need for some kind of central clearing house process between the Member States. This should not be beyond the capabilities of the Member State tax authorities.

- **Daily/Weekly electronic filing to the Tax Authorities**

Why do we have monthly/quarterly/annual returns? We have all seen significant IT system developments over the recent years and there is no doubt we will continue to see developments that overall will make data analysis easier and quicker.

These developments should make "real-time" reporting to the tax authorities possible. Providing transaction by transaction (or counterparty by counterparty) reporting on a daily (or at most weekly) basis is one option for consideration. Taxpayers could make such filings allowing the tax authorities to match output tax/input tax declarations. This would significantly reduce scope for fraud (MTIC for example).

- **VAT invoices not required**

We will certainly see a reduction in "paper" documents across businesses over the next few years with the majority of invoices becoming electronic, certainly for large taxpayers, in 10 years.

Why do we need VAT invoices? As proof of input tax deduction, but is it needed? If we adopted an electronic filing (as outlined in the previous bullet point) there will be no need for formal VAT invoices. Clearly some kind of documentation is needed between counterparties to support payments, but there should be no need for this to impact VAT.

- **Zero-Rating**

  Unlike exemptions, zero-rating will allow for tax free transactions without input tax restriction. Therefore zero-rating should be available for "public interest" transactions. In summary these can be summarised as follows:

  - Charities
  - Health
  - Housing
  - All food
  - Education

  Zero-rating will remove the "hidden VAT cost".

- **Exemption**

  There could be a significant reduction in exemptions. Exemption should not be considered as an answer on "public interest" but should merely apply where it is not possible to apply VAT due to difficulties in valuation. As a result it appears the exemption could be restricted to a limited population. And in doing so it should be a restrictive exemption to limit the scope for argument.

  Restricted exemptions will allow greater input tax deduction, therefore removing the hidden VAT cost in many transactions.

- **Inter-Company Transactions**

  We should consider treating transactions between associated or connected parties as outside the scope of VAT.

  For many transactions between connected parties there is no "value added", they are merely supplies arising from the way in which corporate groups are structured. Corporate groups develop for many different reasons. For example, it may be necessary for regulatory purposes to have local entities for various activities. For VAT to arise on transactions between these entities appears to create administrative requirements that bring no benefit to either taxpayer or tax authorities.

  Again, if we have limited exemptions, the exclusion of connected party transactions from VAT should not actually reduce tax revenues but will significantly reduce compliance burdens for taxpayers and tax authorities.