

AFME Feedback in Response to the European Commission's Inception Impact Assessment : Review of VAT Rules for Financial and Insurance Services

November 2020

Thank you for the opportunity to respond to the European Commission's Inception Impact Assessment for the review of VAT rules for financial and insurance services¹ ('EC Roadmap'), regarding the future of the Financial Services and Insurance VAT exemption.² We welcome this initiative. As you may be aware, the Association for Financial Markets in Europe ('AFME') represents leading global and European banks and other large financial services organisations.³

AFME's response covers three main themes, namely:

- The need for an ongoing dialogue which includes industry representatives;
- FS VAT exemption design principles which need to be explored; and
- Specific suggestions and themes to be considered.

Each of these themes will, of course, need to be analysed in detail to design and implement an updated exemption which is fit-for-purpose both today and in the future.

1. Active participation of FS VAT subject matter experts

The financial markets have been transformed greatly since the current VAT rules governing Financial Services were framed. The technological developments have reshaped the Financial Markets globally and continue to do so. We now have a range of financial products that are complex and the current rules do not necessarily accommodate. In addition, financial services products are now delivered to the end consumers (business or retail) in many cases using electronic means. How customers take delivery of these services equally has changed and they now have a variety of avenues in how they conduct and manage their financial affairs rather than the traditional options which were previously available. In addition, the supply chain typically involves multiple parties across various jurisdictions, both within and outside the EU.

Given this, we would ask that any process for redesigning the VAT exemption includes active participation of relevant subject matter experts from the Financial Services sector. This will drive positive change, which will ultimately benefit the European Union and ensure a competitive financial sector is not only maintained but also flourishes.

Measures such as an FS-focused VAT Expert Group or specific committee would, in our view, be most welcome and recommended

¹ Accessed electronically via www.ec.europa.eu

² Principal VAT Directive [2006/112/EC] Article 135

³ Please see AFME's website www.afme.eu for further details

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2. Updating the FS VAT exemption – design principles

We note that the EC Roadmap proposes two principal propositions, being:

- Removal of the FS VAT exemption; or
- Modifying its scope to tax certain services.

As mentioned in the EC Roadmap, there is a wide range of issues and options which any review needs to address. Based on extensive consultation with our AFME members, we set out below a list of key themes based on our members' experiences.

2.1. Assessing the financial impact of removing or modifying the FS VAT exemption

It is not necessarily clear that removing or modifying the FS VAT exemption would automatically lead to a smoother functioning VAT system and / or the collection of additional VAT amounts. There are a series of practical and economic points which need to be assessed before any meaningful progress can be made.

2.2. Economic impact of taxing financial services

We strongly recommend that any proposal to modify the terms of the VAT exemption is supported by a detailed economic analysis, not only from a tax point of view, but also the macro implications on the capital market. Modelling the economic impact of taxing financial services is critical. If financial services provided to retail clients are taxed, this will result in a significant shift in the tax burden. The original drivers for having financial products exempt, particularly in the retail sector, continue to be appropriate today as demonstrated by the fact that a lot of the new countries that have implemented an indirect tax regime mirror the current EU financial services VAT rules.

Applying a lower VAT rate to specific supplies could limit the impact on retail clients whilst maintaining a certain level of VAT income from financial services.

2.3. Better definition of exempt financial services

As recognised in the EC Roadmap, European law has not been able to keep up with market or technological developments. The lack of detail in the Principal VAT Directive ('PVD') exacerbates this, generating a significant amount of litigation at both the national and European level. This should be addressed either by expanding the text of Article 135, PVD, or by issuing binding implementing regulations or similar to assist Member States' Tax Authorities and businesses.

2.4. Interactions with other taxes

If the VAT regime is amended, its interaction with other taxes would need to be considered, for example the French Salary Tax regime and financial transaction taxes. Any over taxation could

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create a burden to the sector and, at its widest, could reduce the attraction and competitiveness of Europe as a Financial Services hub.

2.5. Valuing financial services

It is well recognised that determining the value of certain financial services is highly complex. For example, a derivative contract may last a number of months / years and, at any given reference point, counterparties may need to pay or receive amounts. Determining when the supply is treated as made (e.g. at its outset, end date or points in between) and ultimately how to value that supply (i.e. the capital amount, the turn or commission) is, in our view, likely to impede the sensible application of VAT.

The application of VAT to capital amounts (rather than the profit element derived) complicates this further and may limit the attractiveness and opportunity to add VAT. This could lead to differing interpretations across Member States and consequently further ambiguity and uncertainty. Any approach should be pragmatic. For instance, adopting a portfolio level calculation on margin based services, as advocated by economists, is in practice unworkable as shown by the fact that countries have not adopted them.

This being said, we recognise that the taxation of fee based products is simpler and indeed that this approach has been implemented in other VAT / GST systems.

3. Additional areas to explore

In addition to updated wording to the FS VAT exemption, there are a number of areas which could help to ensure any new exemption is fit-for-purpose. We list below a non-exhaustive list of points we recommend exploring.

3.1. Expanding use of the 'option to tax'

Certain Member States have already introduced an option to tax provisions for financial services. A more consistently-applied and straightforward application of this across the EU would be welcome. Making the option to tax mandatory for Member States to implement and give taxpayers the ability to use it on a transaction by transaction basis would be our recommendation. More flexibility in the financial services sector will give financial institutions and their clients the option of applying taxation where they consider this to be most appropriate. This could help reduce current market distortions (e.g. in the payments sector where similar services provided by FinTechs and 'traditional' banks may attract a different VAT liability). Allowing businesses to opt to tax services could provide them with a smooth opportunity to manage these mismatches without compromising the value chain.

3.2. Cost sharing exemption and VAT grouping

We also recommend reviewing the use of VAT grouping across Member States and/or the introduction of a new cost sharing provision which can be accessed by all sectors including Financial Services.

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Harmonising VAT grouping rules is critical to ensuring neutrality and equal treatment across the EU. Consistency is critical in relation to:

- Implementation by Member States (making the implementation by Member States mandatory rather than optional);
- VAT grouping eligibility criteria;
- The process by which VAT groups are created and maintained; and
- The treatment of cross-border supplies, particularly in response to recent CJEU litigation⁴.

3.3. Complex intercompany supply chains

The impact of complex supply chains must be explored as part of any review. In particular, the VAT treatment of outsourced or offshored services is important: a review which focuses only on supplies to end customers creates a risk that existing VAT costs are not addressed.

Under current rules, the exemption is very narrowly construed. This means that outsourced and offshored financial services are in a majority of cases subject to VAT. This disadvantages businesses (global or domestic focussed only) – with operations in centres of excellence across the globe. It is our view that a smooth-functioning VAT system must reduce the VAT impact of outsourcing financial services if the EU is to remain competitive. Should VAT exemptions on financial services be retained, this can be done in several ways, such as expanding the application of VAT exemptions to outsourced financial service. However, if broadening the exemptions is considered not acceptable, the impact of taxing outsourcing can be reduced by applying additional rates of VAT recovery on outsourced functions (as currently applied in Australia – see 3.4 below).

3.4. Fix rate recovery of input tax

We note that certain jurisdictions (e.g. Singapore and Australia) have included fixed recovery rates or specific rules around deduction of VAT on costs. We would welcome discussions on this but note that care must be taken to ensure that any new deduction system does not give rise to irrational or distortive recovery positions for EU businesses. It may be that a global investment banking group has an entirely different product and geographical profile from another which is focused on an EU or domestic market. To grant them the same recovery right may not be an accurate reflection of their use of costs and could deny a business a recovery right under PVD Article 169(c).

In light of these complexities and in recognising potential complications in relation to complex supply chains per 3.3, we would also recommend whether an Australian-style recovery approach could apply to intercompany / outsourced services such that these are given a specified level of recovery even before the general pro rata or alternative fixed rate is applied.

3.5 Partial exemption recovery methodologies

How partial exemption recovery rates are determined across the EU is currently inconsistent. This is an area that needs to be addressed by the European Commission as part of this review. In

⁴ E.g. CJEU decisions in Cases C-7/13 - Skandia America, C-165/17 – Morgan Stanley & Co International, C-812/19 – Danske Bank

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addition to the fixed rate deductions applicable to outsourcing as suggested in 3.4 above, we suggest exploring whether mandatory requirements by Member States to allow financial services firms to use 'sectorised' or 'use-based' recovery approaches under PVD Article 173(c) should be more appropriate.

4. Conclusion

We trust the above is helpful in framing some of the key points which will need to be raised by this review. Further, and as noted above, AFME and its members would welcome the opportunity to actively participate in these important ongoing discussions.

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