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POSITION PAPER

ESBG first draft response to the Commission's questionnaire on VAT rules for financial and insurance services

ESBG (European Savings and Retail Banking Group)

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Objective:

The objective of this public consultation is to obtain the views of stakeholders and public authorities of the Member States on the current VAT rules for financial and insurance services and their functioning as well as on possible changes to these rules. The answers provided will feed into the review of the relevant provisions of the VAT Directive and will contribute to a possible future legislative proposal.

Context:

The current VAT rules for financial and insurance services are criticised for being **complex, difficult to apply** and for **not having kept pace with the developments of new products and services**. This seems to have led to a lack of **VAT neutrality, legal uncertainty** and **high administrative and regulatory costs**.

VAT is a tax levied on the consumption of goods and services within the European Union. It is a multi-stage tax calculated, and thus charged, on each stage of the value chain. Operating businesses pay the VAT due on their supplies at regular intervals. This is the VAT due on their outputs – the output VAT – after deducting the VAT on their inputs – the input VAT. The system of deduction ensures that the tax is neutral, with respect to the length of the supply chain and the number of transactions therein. However, where the output supply is exceptionally not taxed because it is exempt or out of the scope of the application of VAT, the right to deduct does not hold.

Main issues under the current rules:

However, under the current rules, financial and insurance services constitute an exception to these principles: as listed in Article 135(1)(a)-(g) of the VAT Directive, most of them are exempt from VAT. The reasons behind the introduction of the exemption are multiple, but mostly related to the technical difficulty to calculate the tax amount. However, these rules were introduced in 1977 and have since become outdated.

Because of the exemption, the providers of financial and insurance services cannot deduct the VAT incurred on inputs, notably – but not exclusively – on investment goods, that are used to produce exempt outputs. This deprives the tax of its neutrality: unlike for other businesses, who can deduct it, VAT becomes a cost for providers of financial and insurance services, and, eventually, for their customers (as the so-called 'hidden VAT').

To address the problem of hidden VAT, the VAT Directive provides for a number of structural provisions:

- **The option to tax** allows providers of financial services to charge VAT on certain otherwise exempt services, and thus to increase the proportion of taxed turnover and the corresponding input deduction. It is, however, up to Member States to introduce such an option and it is not available to insurance service providers.
- More commonly, financial and insurance service providers make use of two other existing instruments to minimise irrecoverable (hidden) VAT: **VAT groups** and – until recently – **cost-sharing arrangements**.

Since financial and insurance service providers are usually part of large company groups or other networks, these two instruments, albeit being different from a legal perspective, allow them to centralise at group level common business functions (e.g. IT services, accountancy, regulatory compliance, back office support, tax advisory) without generating irrecoverable input VAT on intra-group charges. However, on the one hand, the Court of Justice of the European Union (CJEU) in 2017 found cost-sharing arrangements used by financial and insurance operators inadmissible (see judgements 1, 2 and 3). On the other hand, the VAT grouping scheme is limited exclusively to operators established in the same Member State and is implemented (if at all) in various ways across the EU. This raises the question of how to address the problem of hidden VAT in this important economic sector.

Apart from the implications of this recent case law, the VAT treatment of financial and insurance services raises other problems. The current rules are believed to be **complex** and **difficult to apply in practice**, and possibly **have not kept pace with the developments of new services** in the financial industry (for example services linked to crypto-assets and e-money). This seems to have 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, which contributes to **distortions** within the EU and in exchanges with third countries.

The Commission proposed to review the rules on the VAT treatment of financial and insurance services already in 2007 through a legislative package that comprised a proposal for a Council Directive and a proposal for a Council Implementing Regulation. However, the discussions in the Council came to a standstill and the proposals were withdrawn in 2016.

Against this background, as announced in the Communication on an Action Plan for fair and simple taxation supporting the recovery strategy, the Commission is currently preparing a proposal to review the VAT rules for financial and insurance services. This initiative is part of the objective to simplify the life of taxpayers operating in the Single Market, one of the priorities laid down in the Political Guidelines for the present Commission.

Glossary:

Terms used in this context:

- **Taxable amount:** the amount in respect of a taxable transaction upon which VAT is chargeable.
- **Output VAT:** the VAT due on taxable persons' supplies' or outputs.
- **Input VAT:** the VAT paid by taxable persons for supplies made to them with regard to their business activity.
- **Hidden VAT:** a consequence of the exemption; input VAT becomes irrecoverable and increases costs for service providers while being invisible to customers as not invoiced as such to them.
- **VAT neutrality:** one of the most important principles of the VAT system, ensuring that the VAT due by the final consumer is the same, regardless of the nature or length of the supply chain for producing it; VAT is collected fractionally via a system of partial payments whereby at each stage of the supply chain, the taxable person deducts input VAT paid from the output VAT collected.
- **Option to tax** under Article 137(1)(a) of the VAT Directive: an optional regime allowing financial service providers to consider otherwise exempt supplies as taxed.

- **VAT grouping** under Article 11 of the VAT Directive: a simplification measure that allows, if introduced by the Member State, groups of 'legally independent' persons 'closely bound to one another by financial, economic, and organisational links' to be treated as a single taxable person. Consequently, intra-group transactions become, from a VAT perspective, "intra-company" supplies and thus fall outside the scope of the tax and do not result in irrecoverable input VAT.
- **Cost-sharing arrangements** under Article 132(1)(f) of the VAT Directive: an exemption allowing amongst others providers of certain exempt services to form 'independent groups', to pool the acquisition of input supplies and re-distribute the costs, from the group to its members.
- **Proportional (pro rata) deduction** based on Article 173 et sec. of the VAT Directive: Member States may apply different methods to determine the input VAT that can be deducted in the case of a taxable person supplying taxed, exempt and out-of-scope services.
- **Fee-based taxation:** a method of calculation of the taxable amount based on the remuneration linked to financial and insurance services.

<u>**Your experience with the current rules:**</u>

Q20 The exemption of financial and insurance services from VAT was introduced in 1977 as an exception to the general rule that VAT is to be levied on all services supplied for consideration by a taxable person. To what extent do you agree that the exemption is still needed?

	Strongly agree
x	Agree
	Neutral
	Disagree
	Strongly disagree
	Not sure

Q21 In general, how would you assess the functioning of the exemption of financial and insurance services? The exemption...

	…works very well
x	…works well, but could be improved
	…works poorly and should be improved
	…should be removed
	No opinion

Q22 Please indicate the reason(s) why. (multiple answers possible) The exemption...

	…is too costly to apply
	…is too complex in terms of notions (structural provisions and the definition of exempted services)
x	…is not clear in terms of notions (structural provisions and the definition of exempted services)
x	…may have a distortive effect on competition with businesses in other Member States
x	Other
	No opinion

Q23 Please indicate which other reason(s)

The definitions and their interpretations need an adaptation, development and harmonization, which in our view is necessary to avoid discrepancies in the application of the exemptions and to contribute to legal security. More specifically, the VAT exemptions are too tight, and the definitions of exempted services are not up to date. They are not taking care of digitalized business approaches and banking services. Moreover, the division of work processes is not reflected properly, e.g. payment services: preparatory services are taxable. A modern definition of effort pooling would be needed and, again, the overall legal certainty could be increased. (The lack of input tax deduction or the input tax allocation are a problem in some Member States (definitive cost burden). Outsourcing regularly is taxed. They can not use Cost Sharing Arrangements.)

Q24 How do you estimate the impact of the lack of input tax deduction and hidden VAT? (multiple answers possible)

x	They create a price barrier to outsourcing
x	They undermine the level playing field between providers of outsourced services and in-house providers
x	They increase compliance costs
x	They affect the business structures of those operating in the financial and insurance sector
	They undermine the competitiveness of the sector / Other / Do not know
x	They increase the costs for business customers

Q25 Please indicate which other reason(s)

The VAT system guideline contains very few provisions regarding the distribution of input taxes (input tax key). This means that on the one hand the savings banks have a large scope to design their investigation methods, but on the other hand there is also great legal uncertainty whether these methods are compatible with the provisions of the directive. Due to the lack of neutrality of VAT, it is a fake tax exemption, which leads to a definitive cost burden for the savings banks.

Q26 The compliance with VAT rules can be more difficult when supplying financial and/or insurance services cross-border. How do the factors listed below contribute to that effect?

	Not at all	Somewhat	To a large extent	No opinion
Difficulty of finding information on VAT obligations in other Member States		x		
Different interpretations on definitions of exempted services			x	
Different rules for opting to tax			x	
Availability of VAT grouping		x		
Availability of cost-sharing arrangements		x		
Different deduction methods			x	
Different VAT obligations in other Member States		x		
Other		x		

Q27 Please indicate which other factor(s).

A lack of harmonization of VAT leads to a different application in the member states.

Q28 Do you think that the current rules hinder the development of cross-border supplies of financial and insurance services?

x	Yes
	No
	Do not know

Q29 Please indicate the reason(s) why.

	Regulatory ecosystem too complex
x	VAT rules for financial and insurance services too complex
x	Discrepancies across VAT treatment by Member States
	Other

Q30 Please indicate which other reason(s).

Q31 To what extent are the foreign VAT rules for financial and insurance services important when deciding whether to establish your business in a specific Member State?

	Very important
x	Important
	Not very important
	Not important at all
	No opinion

Q32 Which of the structural provisions listed below do you apply?

x	Option to tax
x	VAT grouping
x	Cost-sharing arrangements
x	Proportional deduction
	Other

Q33 Please indicate which other provision(s).

Outsourcing regularly is taxed in some jurisdictions. We urgently need improvements here. It would therefore be necessary to include a definition of outsourcing based on the case law of the ECJ in the directive.

Q34 The exemption was put in place i.a. due to the technical difficulty to calculate the taxable amount. To what extent do you agree that progress in technology, enhanced transparency rules and experiences gained from other countries and from other indirect taxes could help overcome this issue?

	Strongly agree
	Agree
	Neutral
x	Disagree
	Strongly disagree
	Do not know

Q35 Do the current VAT rules for financial and insurance services result in prices lower than those that would apply if these services were taxed?

x	Yes, but just for final non-taxable customers
	Yes, for all customers
	In part, due to other similar taxes
	No
	Do not know

Q36 To what extent are the current structural provisions effective in increasing the deduction of input tax and reducing the impact of hidden VAT?

	Not effective at all	Somewhat ineffective	Neither effective nor ineffective	Somewhat effective	Very effective	No opinion
Option to tax					x	
VAT grouping				X		
Cost-sharing arrangements					x	
Proportional deduction			x			

Q37 VAT provisions related to financial and insurance services can be perceived as complex. For which of the current structural provisions is that correct?

	Option to tax
x	VAT grouping
x	Cost-sharing arrangements
x	Proportional deduction
	None

Q38 To what extent do you agree or disagree with the following statement: The lack of input tax deduction is detrimental to the financial and insurance sector. It compels the sector to outsource services which are typically provided in-house, thus raising the costs.

	Strongly agree
	Agree
x	Neutral
	Disagree

	Strongly disagree
	Do not know

Q39 Unless you make use of the option to tax, does your business incur any costs related to irrecoverable (hidden) VAT?

x	Yes
	No
	Do not know
	My business is applying the option to tax

Q40 To what extent do you agree that the current VAT rules are fit to cover emerging trends in the industry (such as digitalisation)?

	Strongly agree
	Agree
	Neutral
x	Disagree
	Strongly disagree
	Do not know

Q41 The VAT treatment of emerging trends under the current VAT rules for financial and insurance services can be problematic due to unclear definitions for VAT purposes. In connection with which of the emerging trends listed, do you consider this correct? (Multiple answers possible)

x	Services provided by means of fintech
x	E-money
x	Services linked to crypto-assets (such as mining)
x	Payment services
x	Other
	Do not consider it problematic
	Do not know

Q42 Please indicate which other trend(s).

Any review of the regulatory framework should in any case ensure a uniform application of the exemptions, regardless of the means used to offers the services.

Q43 The regulatory framework in the financial and insurance sector (e.g. the Markets in Financial Instruments Directive (MIFID) and the Insurance Distribution Directive (IDD)) has strengthen the role of intermediaries. Do you consider the VAT exemption to be coherent with this development?

	Yes
x	No
	Do not know

<u>Possible changes to the current rules:</u>

The Commission is intending to prepare a proposal that will seek to modernise the current VAT rules for financial and insurance services. Your answers will feed into the review of these rules.

Q44 In your view, which would be the best way to reform the rules on exemption? (Multiple answers possible)

x	Update definitions of exempt services drawing on the extensive CJEU case law in the field of VAT
x	As regards the definitions, refer to other EU regulations governing the financial and insurance sector
	Removing the exemption, so that definitions will be no longer needed
x	Other
	Do not know

Q45 Please indicate which other way(s).

One of the key measures would be the introduction, for Member States, of the mandatory renunciation to the exemption, transaction by transaction, by the taxable person. As much as possible, VAT rules should establish the reversal of the taxable person in those cases in which the recipient of the service is a corporate or professional user.

With the objective of reducing the costs, we would find it convenient if VAT rules facilitate the outsourcing of services, through the development of a specific cost-sharing regime.

Finally, we consider it necessary that Group VAT (with a unique taxable entity) rules are harmonized at EU level, due to their possible cross-border effects, and at least, in relation to the permanent branches in other jurisdictions than that of the Home Country.

More in general, definitions are not up to date and should be reworked. The CJEU case law is very narrowly interpreted and therefore hardly applicable, especially for payment services.

Q46 The removal of the exemption for financial and insurance services could benefit the neutrality of the VAT system. What could be other effects of such a removal? (Multiple answers possible)

	Simplification in the application of the VAT rules for financial and insurance services
	Lower VAT compliance costs
	Less distortive effect of the exemption on competition linked to suppliers from non-EU countries operating in the EU
x	Higher VAT compliance costs
x	Higher complexity of VAT rules
	None
x	Other

Q47 Please indicate which other effect(s).

- Higher costs for private consumers on all bank products;
- Massive investments in compliance system needed.
- In some Member Sattes, there is an obligation to issue invoices for services subject to VAT
- Problems in determining the assessment basis for the VAT

Q48 If only fee-based financial services were to be taxed, in relation to which of them would it be difficult to determine the taxable amount? Please explain.

The distinction between fee-based on the one hand and interest and trading income on the other hand will bring enormous complexity and uncertainty and is not of any help. At the same time, the complexity of the calculation of the proportional (pro rata) deduction remains.

Q49 Financial service providers may currently opt for taxation and obtain the right of deduction, but it is up to each Member State to introduce such option. Should Member States keep that discretion?

	Yes
x	No, it should be available in all Member States
	No opinion

Q50 Not having a right of deduction when supplying exempt financial and insurance services impairs the neutrality of VAT. To what extent would you support or oppose the introduction of a fixed rate of input tax deduction to remedy that effect?

	Strongly support
	Support
	Oppose
	Strongly oppose
x	No opinion

Q51 If a fixed rate of input tax deduction was introduced, should such a rule remain optional for operators or, alternatively, should it be mandatory?

x	It should be optional
	It should be mandatory
	No opinion

Q52 Should cost-sharing agreements be made available to the financial and insurance services sector?

x	Yes
	No
	No opinion

Q53 In your view, should businesses established in other Member States be allowed to form part of the cost sharing arrangements?

x	Yes
	No
	No opinion

Q54 Please indicate the reason(s) why. (Multiple answers possible)

x	To achieve a more level playing field for businesses
x	To boost competitiveness of financial and insurance service providers
x	To reduce the tax burden and the administrative costs of businesses operating at cross-border level

	Other

Q55 Please indicate which other reason(s).

Q56 Please indicate the reason(s) why. (Multiple answers possible)

	To open up the cost sharing arrangements exemption cross border would negatively affect the revenues of Member States having introduced the exemption
	Because cost sharing arrangements mostly operate in the national market of their own Member State
x	To open up the cost sharing arrangements exemption may encourage crossborder operations and establishments in Member States whose tax administration are more flexible and, consequently, increase the competition between Member States
	To open up the cost sharing arrangements exemption would increase administrative costs for stakeholders and Member States' tax administration, derived from increased controls and audits
x	Other

Q57 Please indicate which other reason(s).

Cost sharing arrangements perfectly fit to fulfil the upcoming criteria of the digitalization of our business.

Q58 Which is the most beneficial aspect of establishing VAT groups for providers of financial and insurance services?

	Not beneficial at all	Somewhat detrimental	Neither beneficial nor detrimental	Somewhat beneficial	Very beneficial	No opinion
It is optional					x	
Intragroup supplies are out of scope and therefore not taxed					x	
VAT compliance costs are lower for the members of the group as they are pooling them					x	
It is easier to outsource the activity through a			x			

single taxable person						
VAT grouping increases the competitiveness of the sector by reducing hidden VAT					x	
Other						

Q59 Please indicate which other aspect(s).

Q60 Which is the most effective way to reform the rules for financial and insurance services in your country?

	Not effective at all	Somewhat ineffective	Neither effective nor ineffective	Somewhat effective	Very effective	No opinion
Remove the exemption and tax financial and insurance services at a standard rate	x					
Remove the exemption and tax financial and insurance services at a reduced rate		x				
Tax only fee-based services at a standard rate	x					
Tax only fee-based services at a reduced rate	x					
Grant businesses the option to apply VAT					X	

Grant businesses the right to constitute a VAT group in every Member State					x	
Make cost-sharing arrangements available to the sector in all Member States					x	
Other						

Q61 Please indicate which other reform(s).

Where financial and insurance services are taxed, deduction of input VAT is possible.

<u>Further comments:</u>

62 If you wish to add further information within the scope of this questionnaire, please feel free to do so here.

The Cost Sharing Arrangement (CSA) is of crucial importance for middle-sized and smaller independent banks to keep the competitive prices for the end consumers. Outsourcing is otherwise simply excluded for these institutions. In case of abolishing this VAT exemption in some of ESBG members' countries, those institutions would be forced to buy almost all of the services from third-party providers without ability to deduct the Input VAT.

The option to tax needs to be improved in some member states.

A solution which tries to offer advantages in part, such as VAT is only applied to fee-based banking or insurance products or the proportional input/fixed rate VAT deduction, might lead to a significant increase of complexity.

About ESBG (European Savings and Retail Banking Group)

ESBG represents the locally focused European banking sector, helping savings and retail banks in 21 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESBG unites at EU level some 900 banks, which together employ more than 650,000 people driven to innovate at roughly 50,000 outlets. ESBG members have total assets of €5.3 trillion, provide €1 trillion in corporate loans (including to SMEs), and serve 150 million Europeans seeking retail banking services. ESBG members are committed to further unleash the promise of sustainable, responsible 21st century banking. Our transparency ID is 8765978796-80.

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