

The VAT impact of EU enlargement on insurance businesses

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VAT is likely to be as complex and costly in the new accession countries as it is in the current Member States and there is little time to identify and deal with the risks and opportunities.

THE VAT IMPACT OF EU ENLARGEMENT ON INSURANCE BUSINESSES

The process of joining the EU is designed to happen as a 'Big Bang' – businesses close on 30 April 2004 and open again on 1 May 2004 as part of the enlarged EU, with all the VAT burdens and benefits of the EU VAT system. This will have a major impact on businesses with operations within the accession countries and on those businesses that supply services into the accession countries. The enlargement of the Single Market by ten countries (see Figure 1) will facilitate cross border trade with the accession countries, thereby opening up new opportunities. However, there will also be issues and problems associated with the enlargement.

VAT has always been a complex and costly tax for the insurance sector and there is nothing to suggest that it will be any less costly or complex in each of the new Member States. There will be the usual compliance burden of making returns but also the need to adopt or adapt VAT recovery methodologies and manage the VAT cost.

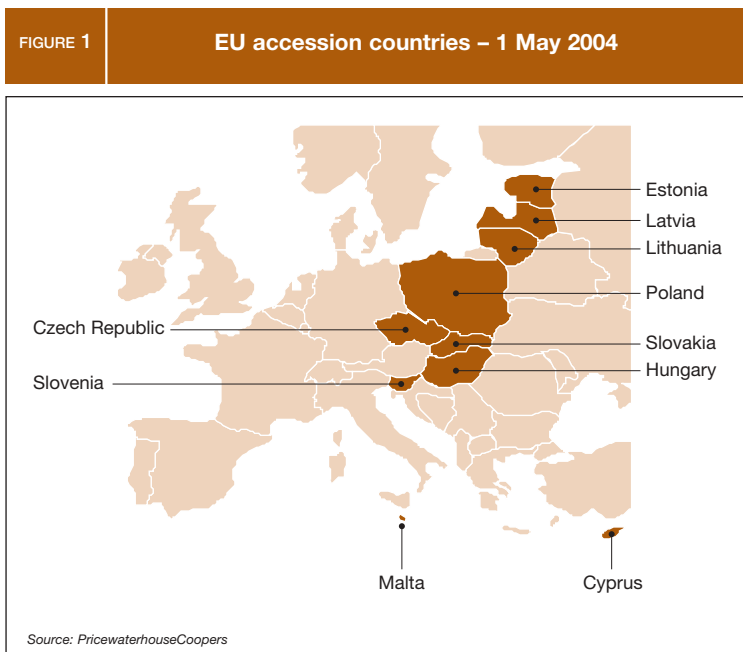
As insurance is closely regulated it seems unlikely that an EU insurer is currently selling business within any of the accession countries without having established a presence of some sort in the relevant country. Consequently, there is likely to be little impact on

VAT recovery for the EU insurer as a result of premiums from the accession countries which once gave recovery no longer doing so (non-EU premiums carry a right of recovery of VAT on related expenditure whilst EU premiums do not). Notwithstanding this, any EU insurers or intermediaries that do have business with the accession countries will no longer be able to recover VAT which is directly attributable to supplies of insurance services to the clients within any of the accession countries. In addition, it will also affect the residual recovery rate and, taken together with the directly attributable VAT, the business will suffer a real VAT cost. Dependent upon the size of this cost, it may be prudent to review and revise the partial exemption method for the business. As many FS businesses will be aware, agreeing revisions to a VAT recovery method can be a time consuming process and there is little time left before accession. Similar issues arise for brokers and insurance agents, as VAT exemption should also apply to their services.

Insurers or brokers with operations in an accession country will be subject to the current national VAT legislation of that country. However, the accession countries are in the process of implementing the EC 6th Directive into the national legislation. Significant changes



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are likely to be needed both to the national VAT legislation and to administrative practice if the 10 accession countries are to come into line with the EU system for VAT treatment of insurance services. This process is due to be completed in time for 1 May 2004, but at the time of writing, the specific details of all the new legislation have not been finalised. EU insurers and brokers will be aware of the framework (the EC 6th VAT Directive) on which the national legislation will be based and will also be aware of how differently the EU 6th Directive is implemented in each of the current Member States giving rise to issues and opportunities but also to considerable uncertainties.

This uncertainty can therefore only be increased with the accession of the ten countries. Issues to consider will of course be dependent on both the country and the nature of the business undertaken in that country, but as legislation has not been finalised, it is difficult to speculate on all the issues that will be faced by insurers in these countries. However, some of the key issues are outlined below:

- There will be a need to ensure that any registration procedures are fulfilled and also that the necessary processes for compliance with reporting procedures and processes are implemented;
- The ten accession countries currently recognise the standard practice in providing exemption for insurance services, but they do so in means that differ greatly from

the mandatory treatment prescribed in EU jurisprudence. Most insurers and insurance intermediaries will be very aware of the difficulties of definition experienced in the current EU countries. This difficulty is set to be repeated in the accession countries so exemption for all activities should not be taken as read;

- EU accession will also see increases in VAT rates. This will inevitably see a significant rise in irrecoverable VAT for insurance businesses. In the Czech Republic, for example, VAT on most services has increased from 5% to 22% on 1 January 2004;
- Certain EU accession countries (e.g. the Czech Republic and Slovakia) do not impose VAT on certain intangible and intellectual services received from overseas (the reverse charge). This reverse charge is imposed in all current EU countries on a number of services received from overseas so that overseas suppliers do not have a competitive advantage over local suppliers. In effect, local VAT is added to the price on the invoice and paid to the tax authorities. This imputed VAT is also available for deduction, but this deduction will be restricted to the extent that it relates to exempt income. As a result the import of services will be subject to a VAT cost for insurers, brokers and insurance agents. This reverse charge has not been imposed up until now in some EU accession countries

and as such it has been possible for local businesses to receive services from overseas VAT free. This will end upon accession and from 1 May 2004 the first question businesses in the accession countries will have to consider is whether the incoming service should trigger any reverse charge VAT and consequently additional (VAT) costs. Conversely there is an opportunity to import services prior to accession VAT free. In addition to this there will be a need to adjust administrative and IT systems to deal with this mechanism and also to train the relevant staff;

- In most countries there will be a change to the methods for recovering VAT on expenditure, which relates to taxable income. It is expected that, in general, this will result in greater scope to recover previously irrecoverable VAT because of the introduction of direct attribution of costs to particular income and also for a broader approach to the recovery of VAT on overhead costs. However, it is not certain that each new Member State will introduce legislation allowing recovery of VAT by insurers in relation to non-EU transactions. If this is the case, it may be necessary to lobby the relevant Governments and/or formally complain to the European Commission;
- Whether VAT grouping will be available in each of the accession countries is not clear as yet but it is being lobbied for. A number of the

accession countries have presented VAT grouping in the proposed new legislation but often in very different terms from those we are accustomed to in the current EU countries; and

- Ways in which the VAT cost can be mitigated will vary from accession country to accession country, but there are areas e.g. the reverse charge, where VAT mitigation may be possible.

What actions should the business take?

Businesses will need to focus on three main areas:

- Identifying the areas of risk and the issues for the business;
- Implementing the necessary system and administrative changes; and
- Identifying planning opportunities.

Experience has shown that it is important to break down the necessary actions into different phases. The first phase will be to identify the key risks and opportunities. This is best started by identifying those countries with which the business has involvement, whether that is through an establishment or simply through trade. This phase is likely to vary in complexity and it should be followed by reviewing the detailed transaction flows with or within the accession countries with a view to understanding the implications for invoicing, systems, contracts, flows of goods or services, legal issues, recovery methods and



the extent to which VAT may become a cost. For insurance businesses, the latter two aspects will be complicated and will probably require local knowledge of the operation of the new legislation in the relevant accession country. Such knowledge would also help in understanding what mitigation may be available, either through taking action before relevant dates or by establishing lasting mitigation structures.

The next phase would be to implement changes as appropriate in each of the accession states and in domestic systems, followed by systems checks from an operational and compliance perspective and possibly followed by a post accession review.

It is clear that doing nothing is not an option. Businesses have very little control over the changes and whilst we can aim to influence legislation, there is little time to do this before 1 May 2004. Notwithstanding this however, in VAT law alone there are 80+ occasions where a Member State may adopt its own processes in the application of the law and some 50+ occasions where a Member State has no choice. Even though there is little time before accession there may still be time to influence new

legislation or to lobby for amendments to the legislation so that business friendly tax practices are introduced that are beneficial to both state and business. Remember, compliance failures can be expensive to sort out and lack of preparedness can result in loss of margins, unexpected costs and inappropriate contract terms.

Conclusion

The accession of the ten countries on 1 May 2004 could have a major impact on insurance businesses. Changes will be forced upon these businesses, which will require co-ordination between tax, logistics, accounts and IT. Not taking action now to ensure that insurance businesses are compliant, ready in both administrative and IT terms and that opportunities for mitigation have been identified could prove costly in either lost opportunities or in interest and penalties. Remember there is little time left to identify these risks or opportunities. Consider the options before it is too late!

Our experience to date has shown that EU accession will create opportunities for VAT planning to realise both real cash, as well as cash flow savings for your company. □



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