VAT Bulletin

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European Commission publishes legislative proposals on reforming VAT for the financial services sector

The European Commission (the Commission) has today published its proposals to reform the application of the VAT system to the financial services (FS) and insurance sectors. The proposals will have important implications for all businesses operating in, or otherwise dealing with, the FS sector.

The Commission has actively pursued the modernisation of the FS VAT regime since early 2006, when it commenced a public consultation process and engaged PricewaterhouseCoopers (PwC) to study the economic effects of the VAT system as it applies to the FS and insurance sectors.

The Commission recognised that the VAT exemptions, largely drafted in the 1970s, are no longer fit for purpose in the current global financial marketplace. Furthermore, the PwC study concluded that EU-based FS firms are somewhat less profitable than their non-EU equivalents (such as US firms), and that significant embedded VAT costs may be contributing to this difference in profitability.

Today's announcement of the proposals for a new directive and a regulation, available on the Europa website via this link, represent the outcome of that review process.

The legislative proposals

The proposed directive would amend the Principal VAT Directive (2006/112/EC) to implement three main changes:

1. to rewrite the VAT exemptions , modernising their wording and scope and clarifying their application;

2. to introduce a mandatory cross-border option to tax (OTT) regime for suppliers of financial services and insurance; and

3. to create a new regime for exempting the supplies of cost-sharing vehicles operating in the FS sector.

The regulation is intended to ensure the uniform application of the exemptions, by specifying what shall, and (more importantly) what shall not, fall within their scope. The reforms (apart from the OTT) are proposed to take effect by 31 December 2009.

The modernised exemptions

The directive involves a comprehensive re-write of the FS exemptions. In addition to the changes in language (which are too numerous to set out here), the directive clarifies the VAT position of intermediaries. In particular, the directive levels the playing-field between insurance and financial services intermediation.

In a change that will be highly significant to the outsourcing industry, the supply of any constituent element of an exempt service will also be exempt, where it constitutes a distinct whole and has the specific and essential character of the exempt services. However, this principle would not expressly apply to the fund management exemption or the intermediation exemption.

The mandatory OTT

This reform would compel Member States to allow taxpayers to opt to tax financial and insurance transactions. EC law currently permits (but does not compel) Member States to allow this for financial services (but not insurance) – and only 5 of the 27 Member States have introduced an OTT.

However, there has been no agreement yet on the precise operation of the OTT – partly due to concerns over possible abuse. The proposed directive therefore introduces the OTT only from 1 January 2012, and leaves the detailed mechanics to be determined later (and to be fixed by the Member States separately in the absence of rules adopted at Community level).

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Exempt cost-sharing vehicles

The proposed directive introduces a revised form of the cost-sharing exemption, currently found in Article 132(1)(f) of the Principal VAT Directive, apparently for the FS sector exclusively. The proposed directive clarifies and enhances some aspects of the original version (for example, by allowing for transfer pricing adjustments) but leaves certain other issues unaddressed.

Key implications

The Commission's proposals, if adopted, will have important implications for a wide range of businesses – within and outside the traditional FS and insurance sectors.

It should be borne in mind that the reforms are currently only at the proposal stage, and have yet to be adopted by the Member States through ECOFIN. However, the draft directive and regulation are the product of lengthy and intensive collaboration by the Commission and the Member States and are likely to be close to the versions ultimately adopted and brought into effect.

Many would welcome the reforms as a useful modernisation of the FS regime. However, doubts remain as to whether the somewhat limited scope of the reforms, for example the absence of cross-border (or even mandatory domestic) VAT grouping and the delayed introduction of the mandatory OTT, represents a missed opportunity to solve the problems identified by the Commission and in the PwC study.

What should you do now?

All taxpayers potentially affected by the reforms, including FS businesses, their customers, and those who supply or work with the FS industry, should take immediate steps to assess the likely impact of the proposals on their business.

Those businesses or industries that may be adversely affected by the proposed changes, or who consider that the draft legislation should be clarified or enhanced, should consider making representations to HM Treasury as a matter of urgency.

Suppliers and customers of services whose liability may change as a result of the reforms (for example, from taxable to exempt) should consider the consequences of these changes for their contractual and pricing structures, accounting systems, and their VAT recovery position. This may be an issue particularly for investment funds and their managers, insurance intermediaries, and suppliers of outsourced services.

Suppliers of financial services may also want to consider what opportunities may available to take advantage of the proposed new OTT, and the changes to the cost-sharing regime, in order to mitigate irrecoverable VAT costs.

PwC is hosting a client conference in Brussels on 13 December at which the Commission's FS proposals will be presented and debated. Please speak to Cathy Hargreaves, Antony Brooker (020 7804 2188) or Janet Waweru (020 7212 4590) if you wish to attend.

For further information, please call your PwC contact or any of the people listed below.

Contacts

Cathy Hargreaves	cathy.e.hargreaves@uk.pwc.com	+44 (0)20 7212 5575
Jamie Randell	jamie.t.randell@uk.pwc.com	+44 (0)20 7213 8253
Stephen Coleclough	stephen.coleclough@uk.pwc.com	+44 (0)20 7212 4911
Keith Moore	keith.t.moore@uk.pwc.com	+44 (0)20 7212 5582
Neville Gatt	neville.gatt@mt.pwc.com	+356 2564 6791
David Ferry	david.ferry@mt.pwc.com	+356 2564 6712