

Review of VAT rules for financial and insurance services

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Questions to stakeholder associations- follow up to the meeting of 10/12/2020

Q1: Some of you referred to the fact that some of the firms are domestically focused whereas other have extensive cross-border activities (intra-EU and with third countries). Could you please comment on the latter?

Multinational firms are centralizing both core function (e.g. product development, claims handling) and non-core functions (e.g. accounting) in central locations in order to generate cost savings (i.e. through economies of scale). Under the current VAT regime services supplied by central service providing entities are subject to VAT once these are supplied cross border which reduces cost savings or even exceeds cost savings. Domestically focused firms are generally able to centralize functions without VAT disadvantages by using purely domestic VAT Groups.

Q2: The risk of delocalisation of activities in case of taxation of financial services was mentioned at the meeting. Could you please elaborate?

As there are different tax regimes available, a multinational company might centralize its services in the most favourable country.

Q3: It was pointed out that the specific VAT regime for asset management should not increase the amount of irrecoverable VAT for insurance companies. Could you please elaborate?

The issue is related to the introduction of VAT on some financial services in a legal environment where exempt undertakings have no deduction rights.

Therefore, the introduction of a VAT liability on asset management as well as other financial services such as deposits or securities transactions should be addressed.

The conduct of insurance and reinsurance business entails holding appropriate amounts of capital in compliance with local, European or even international rules. Insurers are therefore massive investors on financial markets and large consumers of financial services provided for by external contractors. To have an idea of the figures at hand, the global amount of assets held by insurers throughout the European market is €8,825 billion according to the European Central Bank data.

Consequently, should VAT be applied on asset management services or any other financial service, it would turn out to be an additional irrecoverable VAT thus increasing service costs for insurance companies and therefore for policyholders. This is mainly true for life insurers, broadly relying on asset management and financial services in general to carry out their business.

Q4: As regards asset management, is there any potential for localisation effects due to differences in taxation?

Different tax regimes always provide options for cost savings and therefore (de)centralization.

Q5: As regards insurance services, can you elaborate on the problems linked to claims handling and outsourcing? Are there grounds for a special treatment of reinsurance?

The insurance industry takes into consideration the outsourcing of services in order to focus on its key business: to provide for insurance cover. However any plan to outsource one stage or more of insurance operations raises irrecoverable VAT issues, which set genuine constraints on operational organisations. For this reason a wide range of services that are necessary to the execution of the insurance activity are in some countries provided for within a sole insurance company or a Vat group (or as long it was possible by CSG schemes). Outsourcing only makes sense in case the business efficiency gain exceeds the cost (the hidden VAT).

Unlike what is provided for other financial services, the scope of the VAT exemption on insurance is strictly defined, and under point (a) of Article 135 (1) of Council Directive 2006/112/EC reserved to "*insurance and reinsurance transactions, including related services performed by insurance brokers and insurance agents*".

While taking into account the specific case of insurance brokers and agents, any plan to outsource one stage or more of insurance operations raises irrecoverable VAT issues, which set genuine constraints on operational organisations. Claims handling services may be subjected to VAT in different countries, but while insurance companies are not eligible to deduct VAT, costs increase.

Contrary to what happens for non-exempted operators, VAT is therefore not neutral when it comes to adopting an operational organisation. That's why it is important that the intended amendment of the VAT directive on financial services should enable to solve such cases and bring back some neutrality. In this respect, outsourced activities such as underwriting of risk, risk management, insurance company administration, policy administration, product development, marketing, identification of new products and opportunities, investment management and claims handling, are to be considered specific and essential to the purpose of carrying out insurance business and therefore should benefit from a VAT exemption in all Member States.

Revising the VAT Directive in this perspective would also mean harmonising VAT rules according to the significant number of ECJ rulings on this subject: a particularly remarkable example of how and to what extent the Court's attitude can affect the insurance industry is the ECJ ruling in the case C 40/15 Minister Finansów v Aspiro, which gave a strict interpretation (rather, tightly bound to the wording of Art. 135.1(a) of the VAT Directive) by stating (among others) that outsourced claims handling services provided by a subject other than an insurance company cannot benefit from the exemption, unless they are performed by an insurance broker or agent.

From a level playing field perspective, the VAT exemption of outsourced services as a whole should rather follow the nature of the service in terms of specificity and essentiality to the insurance transaction, in accordance with the principles laid down by the Court in the SDC case C 2/95.

A solution could be represented by the rephrasing the text of Article 135.1 (a) of the VAT Directive with the aim of envisaging the exemption of all services related to the insurance business cycle, regardless of the provider, allowing a uniform interpretation of Article 135.1 (a), (d), (e) and (f) alongside the ECJ orientation.

As regards the reinsurance business, in so far as it is a specific form of insurance, a treatment different from that of direct insurance does not seem justified.

For example, in Italy the Italian Revenue Agency is currently conducting several tax audits on the branch assistance insurance, which in Italy – pursuing to a specific regulation issued by the Supervisory Authority - is basically run through a reinsurance treaty between the insurer and the reinsurer (who provides the necessary services in order for the contract to be executed: call center, claims handling, etc.).

In a recent ruling, the tax authorities questioned that all the costs charged by the reinsurer are VATable, irrespective of the fact that this specific business is run by means of reinsurance (according to Aspiro case). The incoming revision of the VAT directive would represent the chance to assess the exemption of reinsurance service as a whole.

Q6: To which extent does automation and digitalisation change the nature of the financial and insurance services? Should this be reflected in the VAT rules? If so, how?

Automation and digitalisation represent an evolution in operational organisations for efficiency and cost rationalisation purposes. Such evolution may lead to increased breakdowns of the various steps of carrying out insurance operations. This phenomenon is hastened by the automation and digitization of the economy. In a digital context, resorting to third parties, however specialized, increases the issues mentioned above in the answer to question 5. Services could be set up in the most favourable country and increase costs in some countries due to the fact, they might be VAT-able in one country and tax free in another.

As said, the industry believes that an evolution of the VAT rules into a more uniform VAT treatment restricting the amounts of irrecoverable VAT is much needed. In order to keep up with the changes brought by the latest technologies, the revised draft VAT rules on financial and insurance services should be written in a rather flexible way, to be complemented by guidelines issued by the VAT Committee, which would be easier to amend.

Q7: Fintech results in an emergence of new services and disruption of traditional business models. Could you please comment on these? Which are, in this context, the main problems related to VAT?

The main aim should be to create a level playing field. If Fintech companies are not liable to IPT and are eligible for VAT deduction, products could be offered to a lower price. Conversely, in cases in which Fintechs are supplying services to insurances, differences in VAT rules among countries can lead to distortions if the services of the Fintechs are not treated identically for VAT purposes and only insurance companies in some countries benefit from VAT exemptions on these received services.

Q8: How should high-frequency trading be taxed? Is there any scope for localisation effects?

If treatments are not uniform, some countries could face disadvantages due to higher costs.

Q9: Is there any scope for transformation of products traditionally priced using fees or commissions into products with interest-based pricing? If so, what kind of financial products could be affected?

N/A

Q10: Do you believe that recent rules to increase price transparency in the financial sector would make it easier to determine the tax base for financial and insurance transactions (or at least for some of them)? Please explain.

No, as the company providing the product usually would know the details anyways.

Q11: Could you provide examples of changes in business structures due to the exemption and lack of deduction?

In some Member-States and under certain terms, VAT-exempt cost-sharing agreements were for a long time a way for insurers to centralize some functions of the business and operate efficiently while complying with the regulatory segmentation between general insurance and life insurance, in the absence of any guidelines from the side of tax administrations or, as it is the case in Italy or France, on a thorough and full acceptance of a widespread application of the CSG mechanism in the domestic VAT legislation.

The shift in the European Union Court of Justice case law that occurred in 2017 questions such operational organisations and urges to resort to new operational schemes. Often the VAT grouping appears as an alternate option, but its conditions does not allow the same scope of operations as within a cost-sharing agreement. According to the ECJ reasoning, the exemption from VAT is limited to CSGs whose members conduct activities in the public interest (e.g. education, healthcare). Previously, it had been understood that CSG schemes could cover services provided by CSGs to their members that are directly necessary to run their VAT exempt (or non-taxable) activities. These rulings are clearly liable to entail an additional VAT burden for insurers who have relied so far on CSG schemes to mitigate the effects of the "blocked input VAT".

Therefore, the VAT exemption should be extended to cost-sharing agreements implemented for efficiency purposes in the financial and insurance services industry.

That being said, ECJ rulings have proved to be an inefficient means of providing certainty to the European VAT system. As a matter of fact, the rulings of the Court in the field of cost-sharing groups (CSGs) - namely Case C 605/15 Minister Finansów vs Aviva and Case C 326/15 DNB Banka vs Valsts ienemumu dienests - have shown that the issue of adaptation of VAT Directive to the modern business environment of exempt services providers may not be postponed further. Due to the lack of adaptation to this business model, Member States are inevitably driven to support their own interpretation of the law.

This results in an uneven playing field within the EU, causing VAT to become a key factor affecting the competitiveness of the EU and a driver in business decisions for financial services providers. Eventually, this situation raises the underlying issue of the inappropriate taxation of financial services.

This can be demonstrated on the application of the ECJ case Skandia. Prior to this judgment, it has been beneficial from both an organizational and economic perspective to centralize function at the head office of a company. Foreign branch offices of this company would be equipped with locally necessary resources only. Under the application of the Skandia case law, head office charges to the branch offices for the provision of central functions are subject to VAT in some Member States. This leads to (a) an uneven playing field and (b) to a change in business structures as companies are de-centrally building up former central functions in branch offices while reducing staff at the head quarter in order to reduce VATable head office to branch charges. This de-centralization reduces benefits which were achieved by former centralization of head office functions.

Q12: Do you think that the global competitiveness of the EU financial and insurance sectors is penalised by the current VAT rules on financial and insurance services? How?

Under current VAT rules, insurance and reinsurance benefit from a VAT exemption provided for by point (a) of Article 135 (1) of Council Directive 2006/112/EC. For instance, in terms of outsourcing the insurance sector is penalised, as the costs for the same services are lower for other industries, as VAT charged turns into expenses for the financial and insurance sector, as it is impossible for undertakings to recover input VAT, whereas in some Member States they are liable under a substitute tax (e.g. the French payroll tax).

The overall competitiveness of the insurance sector would of course benefit from ways to reverse such outcome and allow for more VAT reclaim. Similarly, introducing common rules to regulate possible substitute taxes would be helpful for the competitiveness of the various parties involved. In addition to that, ECJ decisions need to be consistently interpreted and applied across EU countries: Skandia case, for instance, has not been implemented by all Member States in their relevant domestic tax legislation and discrepancies arise between the models adopted by several Member States.

Q13: You pointed out that Brexit will put at risk competitiveness in the EU market. Could you please explain the main issues?

Should the UK exempt some key services for insurance business, such as underwriting, claims handling etc., competition would be hindered consequentially.

Q14: How, in your view, could the EU VAT rules ensure a level playing field while keeping the revenue sustainable for Member States?

N/A

Q15: Could you provide examples of not involving in cross-border trade due to the current VAT rules and their non-harmonised application?

N/A

Insurance Europe is the European insurance and reinsurance federation. Through its 37 member bodies — the national insurance associations — it represents all types and sizes of insurance and reinsurance undertakings.

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