



National Outsourcing Association makes VAT submissions to European Commission

The National Outsourcing Association has recently submitted its response to the European Commission's Consultation Paper on modernising VAT obligations for enterprises in the financial services and insurance sectors. The Consultation Paper has huge implications for outsourcing deals in the financial services and insurance sectors and the NOA's representations to the European Commission were produced following high-level meetings jointly hosted by the NOA and Dundas & Wilson at which various financial services companies and other interested parties were represented.

Summary

The decision to produce a Consultation Paper was in part motivated by an acknowledgement that the VAT system as it applies to the financial services industry has been left behind by changes in market practice (which is unsurprising given the pace of change in the sector and the fact that the basic structure of the VAT legislation has remained unchanged for about 30 years). The Consultation Paper highlights that the current VAT system has caused major areas of tension for enterprises in their current business strategies of outsourcing, off-shoring, pooling of activities and sub-contracting.

The areas of tension these strategies face include (i) the generation of non-recoverable input VAT (which has become an important factor in the decision-making process on where and how an operator supplies financial or insurance services); (ii) the definition of exempt services; and (iii) calculation of the amount of deductible input VAT. In particular, where enterprises outsource, pool or sub-contract certain services, unless the relevant services fall within the definition of exempt services, the services need to be invoiced by the supplier with VAT which is not deductible for the enterprises concerned. These additional VAT costs diminish the cost saving efforts of the enterprises concerned and are a major impediment to their cost-efficiency efforts.

Options for Reform

The European Commission has proposed five options in the Consultation Paper:-

- An increase in the scope of zero-rating;
- Extending the scope of exempt services;
- The introduction of a uniform limited input credit option;
- An option to elect for tax on business-to-business supplies; and
- The use of cross-border VAT bodies (such as the Societas Europaeas).

The consensus amongst the financial services companies who were represented at the NOA/D&W meetings was that the uniform limited input credit option was the most favourable option albeit that the same economic result could be achieved, with greater simplicity, by applying a lower VAT rate to supplies made by outsourcing service providers, to the extent that the supplies of a service provider are directly incorporated in an exempt supply made by a financial services operator. The advantages of this system would be:

- The VAT system already accommodates multiple tax rates, whereas the uniform limited input credit option would be wholly novel;
- The system of exemption would remain undisturbed and this option would therefore be simpler to operate;
- As the solution does not involve reliance on VAT exemption, the ECJ would not be bound to construe the scope of the arrangement restrictively with the result that it would be likely to eliminate legal uncertainty for operators and generate budgetary security for Member States;
- Setting the level of VAT charged by service providers would allow Member States to avoid the politically unacceptable tax losses associated with the option of zero rating.

Introduction

The objectives of the European Commission are three-fold:-

- To reduce administrative costs for taxpayers and tax administrations;
- To create budgetary and legal certainty for Member States and taxpayers; and
- Addressing inconsistencies between the VAT provisions of the Sixth Vat Directive and other regulatory and legal provisions such as those falling within the Financial Services Action Plan and the EU's White Paper on Financial Services Policy.

The Consultation Paper, whilst seeking to achieve the objectives above, also remarks that any changes to the level of deductibility will, in the absence of compensating measures, result in a reduction in VAT receipts for Member States and that a cost neutral solution would probably have to balance increased deduction by taking one or more of the services supplied by financial institutions outside the current scope of tax exempt services.

Parameters of consultation paper

The Consultation Paper highlights that neither Member States nor financial service organisations have shown an appetite to revisit the question of full taxation (i.e. to completely remove the relevant exemptions) and that, as a consequence, some of the fundamental inconsistencies inherent in the system of exempt services are likely to remain. For example, the basic principles developed by the ECJ (see final section of this bulletin) for interpreting the scope of these exemptions are to remain in place and any measures contemplated must reflect these principles.

In order to address the need of financial services organisations to engage in long-term planning and to avoid wasted or unnecessary investment, any adopted approach needs to be consistent with the European Commission's White Paper entitled "The Strategic Plans and Policy Objectives for the Integration of Financial Markets".

Zero-Rating

The option of zero-rating the supply of insurance and financial services would give financial services organisations the right to fully deduct input VAT, would not generate output VAT and should allow financial services organisations to exploit their key strategies (i.e. outsourcing, offshoring, pooling activities and sub-contracting). However, the Commission realises that this option is not compatible with the overall integrity of the tax system as it leads to fundamental distortions and economic inefficiencies – for example, it would lead to unequal treatment between suppliers of financial services/insurance and other business operators who could not benefit from zero-rating.

Extending the scope of exemptions

Advantages of Extending the Scope of Exemptions

Extending the scope of the exemptions would immediately solve some of the problems associated with non-deductible VAT and, for certain organisations, as it would carry the assurance that their services, when supplied to financial services and insurance operators, are covered by the exemption from VAT, it would reduce the problem of hidden VAT in the exempt supplies of insurance and financial services. The Commission also highlights that this solution could form part of a modernisation of the definition of exempt services to better reflect the financial services industry (rather than the views inherent in the 1977 tax legislation).

Disadvantages of extending the scope of exemptions

The Commission highlights that it would be difficult (if not impossible) to address the problems faced by outsourcing or pooling arrangements by extending the application of exemptions to services

supplied by other taxable persons to insurance and financial services suppliers, as these activities cover nearly all services which insurance or financial services providers buy in, with the result that defining the limits and borders of the exemptions would be almost impossible. This solution would also fall foul of the following, well-established general principles (i) that the nature of the service determines whether the exemption applies; (ii) that it does not matter who supplies the service or how it is supplied; and (iii) that the taxation treatment of a particular service should not be affected by which other services the service in question contributes to, or of which it is a necessary component part.

Extending the scope of the exemptions would also create the following problems:-

- The system would give rise to various practical issues for fiscal authorities if it resulted in the requirement to resolve many different scenarios on a case-by-case basis - unless linked to significant clarification, this approach could lead to complex resolution issues with extremely high administrative charges for Member States;
- The system could result in high administrative charges for the suppliers of insurance and financial services; and
- In attempting to bring a wider range of outsourced activities within the ambit of the exemption, the problems of irrecoverable VAT may simply be shifted elsewhere.

Uniform limited input credit option

Advantages of the Uniform Limited Input Credit Option

This option acts as a refinement to the exemption based VAT model whereby providers of financial services or insurance may not be entitled to claim full input tax credits, but could be entitled to reduced input tax credits in respect of specific acquisitions. The purpose of this option is to allow the VAT exempt business to recover part of the VAT so that it finds itself in a similar position as if it had undertaken the outsourced work in-house. The proportion of VAT recoverable would be linked to the estimated wage element in the underlying outsourced contracts (although it is not clear how this estimate would be calculated). The Consultation Paper highlights that this option could be structured so that outsourcing decisions are not distorted by the generation of extra VAT by linking the percentage of irrecoverable VAT to the average non-labour content of specified outsourced services.

Disadvantages of the Uniform Limited Input Credit Option

The disadvantages associated with the uniform limited input credit option are that:-

- It could give rise to complex apportionment and characterisation issues;
- It raises issues of consistency with fiscal neutrality (although there may be a balancing argument that it would simply restore the economic neutrality which is absent from the exemption model); and
- As recovery rates vary significantly between Member States, it could be extremely difficult to arrive at a common recovery rate.¹

¹ The reasons for variation in recovery rates are not always evident. Furthermore, the range of standard VAT rates prevailing in the Community is not going to make it any easier to reach a common level. The Commission services may need to investigate this issue further to ensure that differences in recovery rates are consistent with neutrality.

Option to tax for B2B suppliers

Advantages of the Option to Tax for B2B Supplies

Giving financial services organisations the option to render taxable their supplies of insurance and financial services to other taxable persons, subject to precise conditions requiring the matching of taxable output with deductible input VAT (e.g. product specific cost management), is viewed by the Commission as a potentially realistic means of addressing the current problems encountered in outsourcing and offshoring arrangements. The Consultation Paper views this as a fair solution as it grants insurance and financial services suppliers the same rights as other economic operators.

In addition, the Consultation Paper highlights the following advantages of this option:-

- It is fully consistent with the jurisprudence of the ECJ and the nature of the service will continue to play the dominant role in establishing whether the service is exempt.
- The solution is consistent with all objectives of the EU's White Paper on Financial Services Policy, in particular with the developments in accounting, supervision and actuarial science and with important developments in the banking area under the Basel II Accord.
- The conditions for the option will give economic operators a clear perspective and an incentive encouraging them to develop and introduce product specific cost management tools which allow the economic operators to establish a specific and reliable link between taxable input and output and thus an efficient way of establishing deductible input VAT with a minimum of resources and thus reduce administrative charges and increase Member States' budgetary security.
- In the regulatory framework described in the EU's White Paper on Financial Services Policy, economic operators will inevitably have to move towards product specific cost management tools to measure their competitiveness in business and to verify whether they comply with the rules (e.g. under Basel II). Economic operators would also have the additional incentive of being able to deduct input VAT on the basis of these management tools (and potentially even the VAT on the costs for developing these tools), and would also contribute to the competitiveness of the operators concerned.
- The option also has the advantage of creating legal certainty for the economic enterprises concerned.

Disadvantages of the Option to Tax for B2B Supplies

The disadvantages of the option to tax for B2B supplies include:-

- Using the option will require some time and considerable investments by economic operators, particularly in those Member States where the option is not currently available under their domestic law.
- Where the reverse charge mechanism (i.e. the recipient of the service as opposed to the supplier is the person liable to VAT) is used for cross-border supplies, there is a need to communicate that the supplier has opted for taxation to make sure that the fiscal authorities in the Member State of establishment of the recipient can exercise fiscal control. This communication will generate administrative charges for economic operators and fiscal authorities. However, in one sense, since the option to tax is already available and exercised in some Member States this is not viewed by the Commission as a new or fundamental problem with the solution.
- In order to ensure fiscal neutrality, it will be necessary to agree on a mechanism for charging VAT (this however is not viewed by the Commission as an insurmountable difficulty (particularly as the solution is limited to B2B supplies)).
- The solution requires that a distinction is drawn between B2B and B2C customers.
- Particular issues arise with the insurance sector where insurance premium taxes and other similar fiscal charges apply.
- Since much of the output VAT charged by the economic operators to B2B customers will be recovered by them, the budgetary consequences for Member States remain uncertain.

Cross-border VAT Bodies

The Commission notes that the VAT implications of the Societas Europaea (SE) are only now being fully appreciated but that, in certain circumstances, the adoption of an SE structure may allow an economic operator to restructure pan-European operations in a manner which does not generate irrecoverable VAT. However, the Commission notes that this option is likely to be of more limited application than the other solutions covered by the Consultation Paper.

European Court of Justice

One issue considered by the European Commission was that any proposed measures would need to meet the needs of enterprises and Member States fiscal authorities whilst complying with the following key jurisprudential principles established by the ECJ:-

- The terms used to specify the exemptions within Article 13 of the Sixth VAT Directive are to be interpreted strictly, as they constitute exceptions to the general principle that every service provided by a taxable person is subject to VAT.
- The nature of the service is paramount to its VAT treatment (and it does not matter who supplies the service, how it is supplied or whether the service in question forms a necessary component part of another service).
- The requirements of fiscal neutrality on which the VAT system is based.