

Study to Increase the Understanding of the Economic Effects of the VAT Exemption for Financial and Insurance Services

Final Report to the European Commission

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TABLE OF CONTENTS

PREFACE		6
EXECUTIVE	E SUMMARY	7
1	Introduction	8
2	RESEARCH PHASE I: PROBLEM DEFINITION.	9
3	RESEARCH PHASE II: EMPIRICAL EVIDENCE	
3.1	CASE STUDY RESEARCH FINDINGS	
3.2	REVIEW OF SECONDARY MATERIALS	
4	COMMENTARY ON RESEARCH PHASE II FINDINGS	
4 1	ARE THERE VAT-RELATED DISTORTIONS IN THE EU25 FINANCIAL SERVICES MAR	
4.2	HOW IMPORTANT ARE THE IDENTIFIED DISTORTIONS?	
4.3	WHAT FEATURES OF THE VAT SYSTEM UNDERPIN DISTORTIONS?	
5	RESEARCH PHASE III: VAT SOLUTIONS	
5.1	EVALUATION FRAMEWORK FOR SOLUTIONS	
5.2	DESCRIPTION OF PROPOSED SOLUTIONS	
5.2.1	VAT Solutions Based on Fundamental VAT Principles	
5.2.2	Pan-European Financial Services Solutions	
5.2.3	Industry Specific Solutions	
5.2.4	Pan-European Guidance	
5.3	EVALUATION OF SOLUTIONS	
6	OVERALL CONCLUSIONS	
7	PRIORITY SOLUTIONS	
,		
GLOSSARY		47
REPORT		53
CHAPTER	1 METHODOLOGY	54
1.1	Introduction	54
1.2	APPROACH	54
1.2.1		55
1.2.2	Research Phase II: Empirical Evidence	56
	2.1 Introduction	
	2.2 EU25 Case Study Research	56
	2.3 EU25 VAT Distortion vis-à-vis Rest of the World	
	Research Phase III: VAT Solutions	
	3.1 Definition of Evaluation Criteria	
1.2.	3.2 Identification of Alternatives	
	Involvement of the Expert Panel	
	The PwC Project Team	
1.2.5	The PwC Deliverables and Timing	
	<u> </u>	
RESEARCH	PHASE I: PROBLEM DEFINITION	
CHAPTER	2 VAT AND FINANCIAL SERVICES	69
2.1	Introduction	
2.2	VALUE ADDED TAX AND THE SIXTH EU VAT DIRECTIVE	69
2.2.1	Value Added Tax Defined	69
2.2.2	The Sixth EU VAT Directive and Financial Services	
2.2.3	VAT Exemption and B2B Transactions	
2.2.4	VAT Treatment of Financial Services and Tax Principles	
2.3	DIFFERENCES BETWEEN EU25 MEMBER STATES.	
2.4	VAT TREATMENT OF FINANCIAL SERVICES IN NEW MEMBER STATES	
2.5	VAT TREATMENT OF FINANCIAL SERVICES IN SELECTED NON-EU COUNTRIES	
2.6	PROFILE OF DISTORTIONS FOR EMPIRICAL EXAMINATION	

RESEARCE	I PHASE II: EMPIRICAL EVIDENCE	87
PREFACE.		88
CHAPTER		
3.1	INTRODUCTION	
3.2	RESEARCH APPROACH	
3.3	PROFILE OF RESPONDENT COMPANIES	
3.4	EMBEDDED VAT COSTS	
3.5		
3.6	VAT AND UNFAIR NON-EU25 COMPETITION	
3.7 3.8		
	VAT, OUTSOURCING & SHARED SERVICESVAT AND EXPLOITATION OF SINGLE MARKET OPPORTUNITIES	
3.9 3.10	KEY CHAPTER FINDINGS	
CHAPTER		
4.1	Introduction	120
4.2	RESEARCH APPROACH AND CHALLENGES.	121
4.3	SCALE AND EXPLOITATION OF SINGLE MARKET OPPORTUNITIES	
4.4	PRICING PRACTICES OF EU25 FINANCIAL SERVICES FIRMS & PROFITABILITY	131
4.5	OFFSHORING & OUTSOURCING AMONG EU25 FINANCIAL SERVICES ORGANISATION	s 139
4.6	KEY CHAPTER FINDINGS.	147
CHAPTER	5 COMMENTARY ON RESEARCH PHASE II FINDINGS	149
£ 1		
5.1	INTRODUCTION	149
5.2		150
5 2 1	MARKET?	
5.2.1	Introduction	
5.2.2 5.2.3	Pricing Practices & Profitability of EU25 Financial Services Providers	
	VAT as a Basis of Unfair Competition	
5.2.4 5.2.5	Country Location of Operations	
	Outsourcing & Shared Service Centres	
5.2.6	Exploitation of Single Market Opportunities	
5.2.7 5.3	Corporate Structures	
	WHAT FEATURES OF THE VAT SYSTEM UNDERPIN DISTORTIONS?	156
5.4		
5.5	VAT AND A SINGLE MARKET FOR FINANCIAL SERVICES	
RESEARCH	I PHASE III: VAT SOLUTIONS	158
CHAPTER	6 EVALUATION FRAMEWORK FOR SOLUTIONS	159
6.1	Introduction	159
6.2	OVERVIEW OF EVALUATION CRITERIA	
6.2.1	Combating Distortions	160
6.2.2	Ease of Implementation	
6.2.3	Future Proof	
6.3	BUDGETARY IMPACT OF VAT SOLUTIONS FOR MEMBER STATES	162
6.3.1	Budgetary Impact in Case of Adoption of VAT Solutions	162
6.3.2	Budgetary Impact in Case of Status Quo or no Adoption of VAT Solutions	
6.4	DEFINITION OF INDIVIDUAL EVALUATION CRITERIA	165
6.4.1	Combating Distortions	165
6.4.	1.1 Positive Impact on Cost Efficiency of EU25 Financial Services Providers	165
	1.2 Effectiveness in Combating Identified Distortions	
6.4.2	Ease of Implementation	
6.4.		
6.4.		
6.4. 6.4	2.3 Ease of Administration and Control for Revenue Authorities	
6.4.		
U. T.		107

6.4.3	Future Proof	
6.4	3.1 Exploitation and Contribution towards Single Market Opportunities (EU Finance	cial
	Services Action Plan and Lisbon Objectives)	
	3.2 Efficiency in Combating Identified Distortions	
6.4	3.3 Legal Certainty for Economic Operators facilitating Long-Term Business Plans Investments	
6.4	3.4 No scope for Abuse of Provisions	
	3.5 Consistency with VAT Principles	
	3.6 Durability of Impacts	
6.5	The Evaluation Framework	
CHAPTER	7 DESCRIPTION OF PROPOSED SOLUTIONS	176
7.1	Introduction	176
7.2	SOLUTIONS BASED ON FUNDAMENTAL VAT PRINCIPLES	
7.2.1	Extension of the Scope of Exemption for B2B Supplies	
7.2.2	Reduction of the Scope of Exemption for B2B Supplies	
7.2.3	Option to Tax for B2B Supplies	
7.2.4	Zero Rating of Specific Financial Transactions	
7.2.5	Mandatory Domestic VAT Grouping	
7.2.6	Cross-Border VAT Grouping	
7.2.0	PAN-EUROPEAN FINANCIAL SERVICES SOLUTIONS	
7.3 7.3.1	Cost Sharing	
7.3.1	More Refined Input VAT Recovery Calculations	
7.3.2	Uniform Limited Input Tax Credit	
7.3.3 7.4	Industry Specific Solutions	
7.4 7.4.1	Industry specific solutions Insurance - Article 13(B)(a)	
	1.1 Extending the Scope of the Insurance Exemption	
	1.2 Taxing Insurance Premium Income	
7.4.2	Banks - Articles 13(B)(d)(1) to (5)	
7.4.3	Funds - Article 13(B)(d)(6)	
7.4.3	PAN-EUROPEAN GUIDANCE	
7.3		
CHAPTER	8 EVALUATION OF SOLUTIONS	222
8.1	Introduction	222
8.2	METHODOLOGY	224
8.2.1	General	224
8.2.2	Budgetary Impact	228
8.3	SELECTED SOLUTIONS.	229
8.3.1	Liability Based Solutions	229
8.3	1.1 Industry Specific Solutions	
8.3	1.2 Option to Tax for B2B Supplies	
8.3		
8.3.2	Input Tax Based Solutions	
8.3		
	2.2 Uniform Limited Input Tax Credit	
8.3	· · · · · · · · · · · · · · · · · · ·	
0 2 2	Credit	
8.3.3 8 .3		
o.s 8.3		
8.3		
8.3	<u> </u>	
	Pan-European Guidance	249

ANNEXES		251
ANNEX I:	LIST OF RELEVANT EUROPEAN COURT OF JUSTICE CASES REGAR	DING
	ARTICLE 13 OF THE SIXTH EU VAT DIRECTIVE	252
ANNEX II:	TEMPLATE QUESTIONNAIRES	25 <i>6</i>
ANNEX II.1:	TEMPLATE QUESTIONNAIRE BANKING	257
ANNEX II.2:	TEMPLATE QUESTIONNAIRE INVESTMENT MANAGEMENT	287
ANNEX II.3:	TEMPLATE QUESTIONNAIRE INSURANCE	317
ANNEX III:	DETAILED STATISTICAL ANALYSIS OF CASE STUDY FINDINGS	347
ANNEX IV:	CV'S CORE TEAM	352

PREFACE

It is important to understand the context of this Study. The ultimate aim of the Study was to increase the understanding of the economic effects of the VAT exemption for financial and insurance services. Subsequently, three solutions had to be suggested to what was implicitly considered to be a single problem – VAT in financial services. Indeed described as such, it is a single problem. However, our research and the empirical evidence obtained, suggest a myriad of problems for which there are a number of solutions. In addition to the high level and wide reaching solutions, this Study also contains some small but effective solutions (for example around dealing in commodities, B2B insurance supplies, etc.) for discrete problems.

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Ine Lejeune Leader Global VAT/GST Network PricewaterhouseCoopers

2 November 2006

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EXECUTIVE SUMMARY

1 Introduction

- 1. This document contains a summary of findings of the Study undertaken by PricewaterhouseCoopers (PwC) on behalf of the European Commission into the economic effects of the VAT exemption of financial and insurance services in the EU25. More specifically, the Terms of Reference for this Study required that the PwC project team provides evidence of the distortions caused by current VAT arrangements and identifies options to remove any identified distortions.
- 2. Particular emphasis was to be given to the following:
- distortions which are particular to smaller financial services firms, with these thought to face greater pressure for outsourcing as a result of scale issues;
- barriers to entry which result from, among others, VAT costs associated with the outsourcing of back-office functions in the early stages of market development;
- distortions in the European financial services sector vis-à-vis the rest of the world, where many firms face a more benign tax environment.
- 3. With regard to solutions, the PwC project team was required to advance a minimum of three solutions to combat identified distortions which were broadly compatible with the existing exemption model. These three solutions were to include an option to tax for economic operators in conjunction with a simplified pro rata deductibility system. The costs and benefits of all identified options were required to be explicitly evaluated.
- 4. PwC findings and recommendations are presented in the remainder of this document.

2 Research Phase I: Problem Definition

- 5. This Section provides a basic introduction to VAT and the scope for economic distortions to arise in a VAT exempt system as it applies to financial services.
- 6. VAT is defined in article 2 of the First Council VAT Directive (67/227/EEC) as:

"The principle of the common system of value added tax involves the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, whatever the number of transactions which take place in the production and distribution process before the stage at which tax is charged.

On each transaction, value added tax, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of value added tax borne directly by the various cost components. The common system of value added tax shall be applied up to and including the retail trade stage".

7. An illustrative example of how VAT is intended to operate is shown in Table 1.

Sales (VAT Exclusive) Purchases Tax @ 21% **Tax Reporting** €1.000 Supplier A (to Supplier B) €210 €210 €210 0 Supplier B (to Supplier C) €2,000 (€1,000) €420 €420 €210 €210 Supplier C (to Consumer D) €3,000 €630 (€2,000) €630 €420 €210 Consumer D (€3,630) Total Tax €630

Table 1: VAT in the Product / Service Production Cycle

8. Table 1 shows clearly that the total value of VAT which accrues to the Exchequer in respect of the consumption of a given product or service is intended to be equivalent to the relevant rate of VAT (i.e. 21%) multiplied by the value of the retail or consumer price (i.e. €3,000) – or €630. Similarly, the intended cost-neutral nature of VAT for taxable enterprises is clearly illustrated, i.e. supplier A charges €210 in VAT and reports the same amount to the fiscal authority. Supplier B charges €420 and when reporting this to the fiscal authority is allowed to deduct the €210 it incurred on the purchase from supplier A; net payment €210. In principle the deduction or credit entitlement for VAT on costs arises if those costs have been incurred for the purposes of making taxable supplies. If the supplies made are exempt from VAT, no deduction entitlement arises for VAT incurred on related costs (although there are exceptions).

- 9. The Sixth EU VAT Directive (77/388/EC) provides a binding framework for the formulation of VAT law at national level throughout the European Union. The Directive provides that specified financial services are exempt from VAT. This essentially means that no VAT shall be charged on these financial services and that no credits are allowed on the inputs used to produce these VAT exempt services².
- 10. No definition of financial services is, however, provided, nor is any explicit reference made to definitions used by regulatory bodies. This lack of precision has resulted in considerable confusion for fiscal authorities and for taxpayers. Reflecting this, as well as the use of options and derogations amongst others, there are considerable differences between Member States with regard to the VAT treatment of financial services.
- 11. Table 2 illustrates the impact of the VAT exemption when financial services are sold to taxable entities within the EU25, i.e. inter-EU25 business to business. This is the prime focus of the Study as it is in such situations that one of the most serious problems arises i.e. the issue of embedded VAT in the context of supplies made by financial services providers to taxable suppliers of goods/services. Such embedded VAT is passed on in the prices charged by those other suppliers when their goods/services are purchased by final consumers. This problem does not arise for financial services providers when selling their services directly to final consumers i.e. in a B2C context.

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² This contrasts with a zero rated status, whereby no VAT is payable on the final good/ service, but the supplier qualifies for credits in respect of VAT paid for the production of the zero rated good/ service.

Table 2: The Impact of the VAT Exemption (Business to Business)

	VA	T Exempt	Nor	ı-Exempt
Input Costs	Supplier A	Supplier B	Supplier C	Supplier D
VAT Exempt	Yes	Yes	No	No
Total Cost of Inputs (VAT Exclusive)	€10,000	€10,000	€10,000	€10,000
Total Cost of Direct Employment	€1,000	€9,500	€1,000	€9,500
Total Cost of Vatable Inputs (VAT Exclusive)	€9,000	€500	€9,000	€500
Rate of VAT	21%	21%	21%	21%
VAT Component of Input Costs	€1,890	€105	€1,890	€50
Net Input Costs	€11,890	€10,105	€10,000	€10,000
Scenario 1 (Embedded VAT Absorbed in Service Price)	Supplier A	Supplier B	Supplier C	Supplier D
Total Revenues (VAT Exclusive)	€13,890	€12,105	€12,000	€12,000
Total Revenues (VAT Inclusive)	€13,890	€12,105	€14,520	€14,520
VAT Component of Revenues	€0	€0	€2,520	€2,520
Net Profit before Tax	€2,000	€2,000	€2,000	€2,000
Scenario 2 (Embedded VAT Absorbed in Profit Margin)	Supplier A	Supplier B	Supplier C	Supplier D
Total Revenues (VAT Exclusive)	€12,000	€12,000	€12,000	€12,000
Total Revenues (VAT Inclusive)	€12,000	€12,000	€14,520	€14,520
VAT Component of Revenues	€0	€0	€2,520	€2,520
Net Profit before Tax	€110	€1,895	€2,000	€2,000

12. Key points to note from Table 2 are the following:

- in the case of VAT exempt enterprises, there would appear to be a financial incentive for the non-outsourcing of services, which are liable to VAT;
- this is shown in the fact that the net input costs of VAT exempt supplier A, which is heavily dependent on vatable supplies, are €11,890 as opposed to €10,105 in the case of VAT exempt supplier B which is very self-reliant;
- reflecting the absence of embedded VAT in the case of non-exempt suppliers, net input costs are lower in the case of both suppliers C and D (€10,000) than for exempt suppliers A (€11,890) and B (€10,105);
- the embedded VAT cost may be passed onto service users via a higher VAT exclusive price, with obvious implications for the price competitiveness of suppliers A and B (Scenario 1);
- or the embedded VAT cost may be absorbed into the total operating cost base of the exempt suppliers with profit implications (Scenario 2).

- 13. Finally, a potentially obvious but important point in this regard is the fact that exempt suppliers of financial services resident in countries with relatively low standard rates of VAT enjoy a cost advantage vis-à-vis those resident in higher-VAT jurisdictions.
- 14. Related to the foregoing, many OECD (non-EU) countries have VAT regimes which are more benign than that in the EU25. In the case of the United States, for example, there is no federal tax on consumption. State-level retail sales taxes do not apply to financial services.
- 15. Table 3 presents a high-level description of the major potential distortions which may result from the VAT treatment of financial services in the EU25.

Table 3: Description of Major Potential VAT-related Distortions for Empirical Examination

Higher Cost Base of Financial Services Fi	rms within the EU25
Higher Prices	This distortion refers to the fact that financial services firms in the EU25 have an embedded VAT cost which could lead to higher service costs, <i>ceteris paribus</i> , for firms which have no embedded VAT costs. This could be reflected, <i>inter alia</i> , in higher interest rate charges. This distortion relates closely to unfair competition, but potentially has ramifications for the competitiveness of the wider EU25 enterprise sector.
Lower Profit Margins	Assuming that EU25 financial services firms absorb some share of embedded VAT costs into their overall costs, this has negative implications for profitability. This may, in turn, translate into other issues such as a risk-adverse approach to lending, limited product innovation and reduced appetite or scope for market expansion activities.
Sub-Optimal Business Models	
Country Location	In a bid to reduce the cost of embedded VAT, EU25 firms may engage in some level of VAT-shopping when choosing where to locate operations within the EU25. A low standard rate of VAT, a particularly favourable VAT treatment of some type of financial service or the allowance of cross-border VAT Groups may be the basis for this decision. If the country which is selected using VAT-related criteria is not optimal in other aspects, e.g. language skills, then this has the scope to impair the competitiveness of the firm.
Vertical Integration	As indicated clearly in Table 2, the VAT exemption of financial services could constitute a disincentive to the vertical disintegration of firms, or outsourcing of services. Outsourcing is reported to be resulting in substantial savings for large firms in many sectors, and continued high levels of vertical integration may constitute a considerable lost opportunity - with potentially important implications for the competitiveness of the financial services sector within the EU25. This, in turn, could have implications for the competitiveness of the wider EU25 enterprise sector, which lies at the heart of economic competitiveness in a global context.
Reduced Potential for Market Expansion	
Market Expansion	Closely related to the issue of exploiting Single Market opportunities, the VAT exemption could constitute a constraint to the market expansion ambitions of EU25 financial services firms. For example, an EU25 firm resident in an economy with a high VAT rate such as Ireland might find it necessary to establish operations in a target country in order to be able to compete effectively. This, however, constitutes a considerable investment which the company may not be in a position to fund. Closely related to the foregoing, a reliance on third-party providers of services in a new market will result in an embedded VAT cost proportionate to the total value of services provided – which could be significantly higher than if the company in question decided to establish a branch or subsidiary operation. Equally, the complexity of VAT arrangements in respect of financial services might constitute a knowledge-based barrier to market expansion, while relatively low profitability might have implications for expansion appetite and capability. Finally, restricted regulations regarding the allowance of cross-border VAT Groupings could also have implications in this regard. In this context, it is worthy of note that the development of the internal market for financial services is a key policy objective of the Internal Market and Services DG of the Commission. Moreover, the further development of the Internal Market was cited as a core objective of the Austrian and Finnish Presidencies of the Council of the EU in 2006 ³ .
Unfair Competition	
Unfair Competition within the EU25	For VAT exempt enterprises selling to taxable entities, the lower the standard rate of VAT and the more favourable the terms surrounding the VAT treatment of financial services (including options to tax) the lower the embedded cost associated with VAT. In cross-border transactions, this may afford an important competitive advantage to a firm based in one EU25 Member State over another.
Unfair Competition with non-EU25	Closely related to the foregoing, the non-existence of VAT or a more favourable VAT treatment of financial services firms may confer price advantages on financial services firms based outside of the EU25 over those seeking to sell from operations within the EU25.

16. PwC primary and secondary research was used to examine the existence and intensity of these distortions. Findings are now presented.

³ Council of the European Union, Operational Programme of the Council for 2006 submitted by the Incoming Austrian and Finnish Presidencies (16065/05).

3 Research Phase II: Empirical Evidence

- 17. To test the existence and intensity of VAT-related distortions in the EU25 financial services sector, the PwC project team undertook a combination of primary and secondary research. Primary research took the form of detailed case studies while secondary research entailed a review of relevant secondary materials.
- 18. Details of our research approach and findings are presented in the following sections.

3.1 Case Study Research Findings

- 19. A combination of factors lead the PwC project team to choose a case study approach over a more broad-based survey of financial services firms. The key factor influencing this decision was the relatively complex nature of the issue under consideration, coupled with a view that many financial services firms would need to invest considerable resources to obtain financial information of the nature required.
- 20. Key elements of the case study research approach were the following:
- the selection of financial services Case Study Companies, with regard paid to the need for sectoral, country and size representation;
- the design and piloting of a Case Study Template;
- the receipt and analysis of findings from the Case Study Template;
- follow-up discussions with individual Case Study Companies, as deemed appropriate by the PwC project team.
- 21. A copy of the Case Study Template is attached as Annex II.
- 22. Confidentiality issues preclude the inclusion of a full list of Case Study Companies. A profile of the respondent firms is presented in Figures 1 to 4.

Figure 1: Sectoral Profile of Case Study Companies

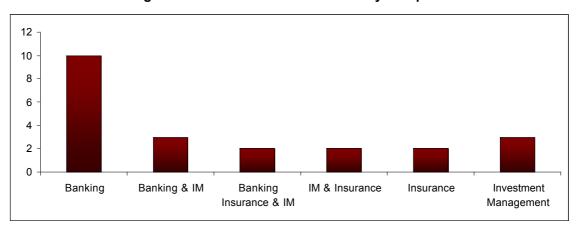


Figure 2: Country Location of Case Study Companies' Headquarters

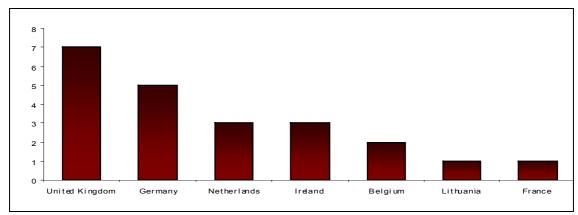
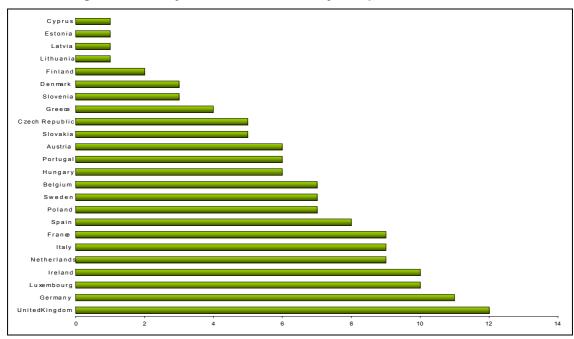


Figure 3: Country Location of Case Study Companies' Subsidiaries



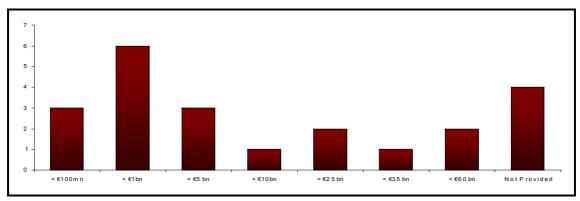


Figure 4: Revenue Profile of Case Study Companies

- 23. In total, 16 financial services firms submitted 22 completed templates⁴. Case Study Companies were drawn from banking, insurance and investment management sectors, were headquartered in one of seven EU25 Member States, had operations in a very wide range of territories and had a wide range of revenues ranging from major global players to companies which are small in a global and EU25 context.
- 24. The Case Study Template sought information of a quantitative nature (financial detail and opinion questions) as well as of a qualitative nature, which was supplemented with face-to-face interviews with the PwC project team.

Key findings were as follows:

25. Embedded VAT Costs

- there was a wide range of VAT recovery rates among Case Study Companies, reflecting a combination of factors including the nature of services provided and the location of key client accounts (see Table 4);
- a preliminary analysis of data provided regarding the value of irrecoverable VAT found that the net profit margins of the Case Study Companies was reduced by between 1 to 3 percentiles or 5 to 10% as a direct result – assuming that all irrecoverable VAT costs were absorbed into operating costs (see Table 4);

⁴ A template was submitted in respect of distinct corporate entities – typically operating in distinct markets, i.e. banking vs. insurance.

Table 4: Irrecoverable VAT and Implications for Net Profit Margin (%) of Case Study Companies

Case Study Template No.	% of VAT Recovered	Implication for Net Profit Margin
1	10%	n.a.
2	19%	-1.7%
3	n.a.	n.a.
4	n.a.	n.a.
5	n.a.	n.a.
6	n.a.	n.a.
7	52%	-0.5%
8	10%	-0.2%
9	2%	-3.2%
10	16%	-0.7%
11	10%	-1.2%
12	74%	-1.6%
13	7%	-0.1%
14	n.a.	n.a.
15	n.a.	-0.6%
16	22%	n.a.
17	32%	-1.5%
18	0%	-0.1%
19	8%	-1.1%
20	5%	-0.8%
21	28%	n.a.
22	16%	-0.6%

- this analysis has, however, no regard to the fact that VAT exempt status can have favourable implications when supplies are made to non-taxable entities (B2C) – reflecting the fact that companies were not in a position to provide this breakdown;
- in practice, Case Study Companies struggled to provide details of how irrecoverable VAT was distributed between service pricing and overhead allocation.

26. VAT and Unfair Competition within the EU25

- Case Study Companies do not generally feel that differences in the standard rates of VAT between EU25 Member States are a source of unfair advantage for financial services firms in certain EU25 jurisdictions;
- differences in the VAT treatment of financial services were found to constitute a
 theoretical source of competitive advantage, with the United Kingdom, Luxembourg,
 Ireland and Belgium considered to have the most favourable VAT regimes for financial
 services firms (see Figure 5 and Table 5);

A ustria
Spain
Greece
Netherlands
France
Germany
Belgium
Ireland
Luxem bourg
United Kingdom
0 2 4 6 8 10 12 14 16

Figure 5: Number of Country Citations in Top Most Favourable EU25 VAT Locations

Table 5: Factors Underpinning Favourable VAT Jurisdictions

	BE	FR	DE	EL	IE	LU	NL	AT	ES	UK
Definition of Financial Services	1	0	0	0	6	7	1	0	0	5
Pro Rata Calculation	0	0	0	1	0	0	1	0	0	3
Use of Derogations	2	3	0	0	0	2	0	0	0	1
Use of Options	1	0	3	0	1	0	0	0	0	0
VAT Group Rules	1 ⁵	0	1	0	2	0	1	1	1	4
Other	0	0	0	0	0	0	0	0	0	1

- in reality, however, and reflecting the fact that most providers of financial services firms feel that a local market presence is a prerequisite to market operations, the scope for capitalising on such differences is considered small to minimal;
- certain fund management services were identified as a possible exception in this regard, but again no case study respondent indicated that they were suffering strong adverse effects from an unfair VAT-based competition.

27. VAT and Unfair Competition with non-EU25 Companies

with the exception of a very small number of niche investment management services,
 Case Study Companies did not face significant competition from non-EU25 companies
 which did not have substantial operations within the EU25.

⁵ In completing the questionnaire, this respondent indicated that the VAT advantage pertained to VAT Grouping. Upon discussion, however, it emerged that this was due to the availability of the exemption under article13(A)(1)(f) of the Sixth EU VAT Directive as VAT Grouping is not provided for in Belgium at the time of completing this Study.

28. Country Location of Operations

- choosing EU25 country locations based on VAT considerations is the preserve of the major global financial services firms – with smaller firms being motivated to a much greater extent by market development objectives as opposed to the pursuit of group-wide cost efficiencies in the establishment of new country operations;
- even among those companies which chose country locations based on VAT considerations, the extent of this activity is limited with examples, by-and-large, constrained to jurisdictions with favourable VAT Grouping rules;
- in choosing a country in which to locate a non market-development operation, however, all case study respondents stressed that VAT was a relatively small consideration in a much larger cost environment;
- with regard to the competitiveness of the EU25 for the attraction of financial services investment, one company indicated that a relatively restrictive VAT treatment of financial services in certain Eastern European Member States had contributed to decisions to locate shared service activities outside of the EU25.

29. Corporate Structure

 with regard to corporate structures, relatively strong views were expressed by a number of Case Study Companies regarding the less than optimal situation at present where corporate structures dictated VAT liabilities.

30. Outsourcing & Shared Services

- there is a strong sense among Case Study Companies that outsourcing will be crucial to their future competitiveness, although third-party outsourcing was found to be the preserve of only the largest Case Study Companies;
- reflecting this, close to two thirds of respondents are planning on outsourcing certain services in the coming years although on discussion, it emerged that much of this activity will actually be *inside outsourcing*, i.e. the concentration of group-wide activities within one corporate entity or shared service centres;
- nearly a quarter of respondents indicated that VAT had made the difference between a successful and unsuccessful business case for outsourcing, while a third agreed that their outsourcing ambitions had been frustrated by VAT;

- of the companies which agreed that VAT had frustrated their outsourcing ambitions, underpinning VAT constraints were identified as: a) the non-availability of the exemption in article 13(A)(1)(f) of the Sixth EU VAT Directive; b) the uncertain or non-application of the ruling in SDC⁶; c) the perceived stringent application of the rules attaching to the exemption for insurance services; and d) uncertainty regarding the likely VAT treatment of outsourcing arrangements;
- in addition, a further two companies indicated that while VAT had not constrained their outsourcing ambitions to date – this would change if the *Andersen*⁷ decision on insurance services was implemented;
- similarly, a majority of respondents indicated that VAT had inhibited the development of shared service centres and had an influence on the range and/or volume of services provided from such centres;
- case study research also showed that companies based in jurisdictions which permit VAT
 Grouping were most likely to be the beneficiaries of shared services, with the United
 Kingdom, Ireland, Germany, the Netherlands, Hungary and Sweden featuring in this
 regard;
- Case Study Companies have been heavily reliant on VAT Group registration and the
 decisions of the European Court of Justice (ECJ) in rendering their outsourced or shared
 services efficient from a VAT perspective, with SDC⁸ being the most commonly used ECJ
 ruling;
- indeed, the majority of outsourced services were reported to be not liable to VAT. In certain cases, the use of place of supply rules, overseas VAT Group members or head office to branch charging mitigated/eliminated potential VAT costs;
- there would appear to be very limited use of the exemption in article 13(A)(1)(f) of the Sixth EU VAT Directive, owing to its non-availability in certain territories and confusion about its application generally.

31. Exploitation of Single Market Opportunities

- VAT was not identified as an important constraint to the exploitation of Single Market demand opportunities, although a small number of very large players indicated that certain low-cost EU25 jurisdictions had not been considered for the location of shared service centres as a result of VAT restrictions;
- such investment had typically been lost to non-EU25 jurisdictions, e.g. India;
- finally, and with respect to the use that has been made of the Single European Company, nearly all respondents felt that they were not sufficiently familiar with the concept nor its application to implement structures using it.

ECJ judgement of 5 March 2005 in Secretary of State for Finance v. Arthur Aridersen & Co. Acct ECJ judgement of 5 June 1997 in Sparekassernes Datacenter v. Skatteministeriet, Case C-2/95.

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⁶ ECJ judgement of 5 June 1997 in Sparekassernes Datacenter v. Skatteministeriet, Case C-2/95.

⁷ ECJ judgement of 3 March 2005 in Secretary of State for Finance v. Arthur Andersen & Co. Accuntants, Case C-472/03.

3.2 **Review of Secondary Materials**

- 32. The purpose of the secondary Research Phase was essentially to determine the extent, using secondary materials to which there was evidence of VAT-related distortions in the EU25 financial services sector vis-à-vis the rest of the world.
- 33. The following were the main sources of secondary information reviewed:
- OECD Banking Statistics (2005)9;
- OECD Insurance Statistics (2005)¹⁰;
- World Retail Banking Report (2006)¹¹;
- PwC, Offshoring in the Financial Services Industry (2005)¹²;
- Datamonitor & Mintel Reports (Various Years)¹³;
- European Central Bank, US Federal Reserve & Reserve Bank of Australia¹⁴;
- Dow Jones & Reuters Company & Industry Databases¹⁵.

Key findings were as follows:

Scale of EU25 Financial Services Firms

34. The question of firm scale relates closely to the question of the extent to which financial services firms are frustrated in exploiting the demand opportunities associated with the Single Market as well as competitiveness vis-à-vis firms located outside of the EU25. An analysis of the number of EU25 headquartered banking and insurance companies in the Top 100 global banking and insurance Plcs indicated that the sector is presently not suffering disadvantages of scale (see Table 6).

15 Otherwise known as "Factivia".

⁹ OECD 2004 - "Bank Profitability, Financial Statements of Banks, 1994-2003".

OECD 2005 - "Insurance Statistics Yearbook, 1994-2003".

¹¹ EFMA, CapGemini, ING, 2005 – "World Retail Banking Report 2005".

12 PricewaterhouseCoopers/ Economist Intelligence Unit 2005, "Offshoring in the Financial Services Industry: Risks and Rewards" - http://www.pwcglobal.com/extweb/ncsurvres.nsf/docid/58BED7FBF2646C6BCA25707D002F698F.

13 Including Mintel, 2005 – "European Banking Market, Special Report, November 2005".

¹⁴ http://www.ecb.int - http://www.rba.gov.au/ - http://www.federalreserve.gov.

Table 6: Location of Banking & Insurance Top 100 Plcs in Wider Industry Perspective¹⁶

% of Top 100 Pics	Banking	Insurance	Airlines	Telecoms	Automobiles	Media
EU25	42%	34%	16%	28%	22%	34%
United States	27%	32%	35%	18%	32%	41%
Other	14%	13%	37%	38%	13%	3%
Canada	6%	6%	4%	5%	2%	9%
Australia	3%	3%	3%	2%	0%	3%
Japan	6%	6%	2%	5%	31%	9%
Non-EU25	2%	6%	3%	4%	0%	1%
Total	100%	100%	100%	100%	100%	100%
% of Top 100 Pic Sales	Banking	Insurance	Airlines	Telecoms	Automobiles	Media
EU25	40%	52%	27%	36%	34%	23%
United States	38%	26%	33%	24%	31%	59%
Other	7%	5%	21%	21%	6%	2%
Canada	4%	5%	5%	3%	1%	7%
Australia	2%	1%	4%	1%	0%	1%
Japan	4%	5%	8%	12%	27%	8%
Non-EU25	5%	6%	1%	2%	0%	0%
Total	100%	100%	100%	100%	100%	100%

Net Interest Margins

35. The interest margins of EU25 and non-EU25 banking companies were examined with a view to determining if EU25 banks were seeking to pass off embedded VAT costs by charging higher interest rates to end-users. An analysis of the interest margins of a selection of banking Plcs (see Table 7) as well as a review of OECD banking profitability statistics presented no evidence in this regard.

¹⁶ Dow Jones Reuters Business Interactive LLC (April 2006), PwC Derived.

Table 7: Net Interest Margin¹⁷ of Selected Banking Plcs, 2005

Top 100 Plc Ranking	Name	Location	Net Interest Margin
2	Citigroup	United States	52%
3	HSBC	United Kingdom	52%
4	Bank of America	United States	52%
7	Credit Agricole	France	22%
8	Deutsche Bank	Germany	14%
11	UBS	Switzerland	16%
12	JP Morgan	United States	44%
14	HBOS	United Kingdom	28%
15	Banco Santander	Spain	32%
16	BNP Paribas	France	24%
85	Natexis	France	26%
87	Bank Austria	Austria	48%
90	Deutsche Post Bank	Germany	30%
92	Standard Bank Group	South Africa	34%
93	Golden West Financial	United States	47%
95	Capitalia	Italy	45%
96	AIB	Ireland	49%
97	Svenska	Sweden	32%
99	Sper Bank	Russia	49%
100	Capital One	United States	64%

Profit Margins

36. The profit margins of EU25 and non-EU25 banking companies were examined with a view to determining if EU25 financial service firms were less profitable than their non-EU25 counterparts - with the absorption of embedded VAT costs into overall operating costs providing a potential explanation in this regard.

Selected findings are shown in Table 8 and Table 9.

Table 8: Net Profit Margin of Banking Sector, Top 90 Global Plcs, 2005¹⁸

	EU25	United States	Australia and New Zealand	Asia	Canada	RoW ¹⁹	Total
Sales	\$696,850	\$607,878	\$51,068	\$358,867	\$56,496	\$160,045	\$1,931,204
Companies	36	22	4	14	5	9	90
Net Profit	\$86,530	\$88,532	\$8,007	\$49,255	\$6,850	\$17,205	\$256,377
Net Profit (%)	12.4%	14.6%	15.7%	13.7%	12.1%	10.7%	13.3%

Net interest margin was computed as (Total Interest Income – Interest Income)/ Total Interest Income.
 Profit margins were available in respect of 90 of the top 100 global Plcs falling under into the "banking/credit" sectoral classification - Dow Jones Reuters Business Interactive LLC (April 2006), PwC Derived.
 Rest of World – any country other than those listed.

Table 9: Net Profit Margin of Insurance Sector, Top 96 Global Plcs²⁰, 2005

	EU25	United States	Australia and New Zealand	Asia	Canada	RoW ²¹	Total
Sales	\$1,083,973	\$537,845	\$22,307	\$130,611	\$76,198	\$188,355	\$2,039,289
Companies	33	31	3	11	5	13	96
Net Profit	\$46,398	\$43,860	\$2,040	\$4,145	\$6,269	\$7,508	\$110,221
Net Profit (%)	4.3%	8.2%	9.1%	3.2%	8.2%	4.0%	5.4%

- 37. Table 8 shows that average net profit of Europe's largest banking Plcs is, at 12.4%, less than that for the top 90 banking Plcs globally (13.3%). Perhaps, more significantly, profit margins are considerably below those realised by US and Asian banking Plcs - which, after Europe, dominate the list of large global players.
- 38. A similar conclusion is in evidence in Table 9, which shows average net profits among EU25-owned insurance Plcs of just 4.3% compared with 8.2% in the United States. In contrast to the situation for banking, however, the net profit margins of Asian and rest-of-world companies lags that of Europe – bringing down the overall average.
- 39. An analysis of individual EU25 country performance indicates that while certain countries have had an undue (negative) influence on overall EU25 profitability outcomes presented in Tables 8 and 9, profit margins in all countries tended to be lower than those for the United States and other developed economies.
- 40. Factors underpinning profitability differentials cannot, however, be determined - a more intense competition in supply being one of many potential explanations.

Outsourcing

41. With regard to the outsourcing behaviours of financial services firms vis-à-vis the rest of the world, a review of secondary materials indicated no significant differences.

²⁰ Profit margins were only available in respect of 96 of the top 100 global Plcs falling under into the "banking/ credit" classification. Source: Dow Jones Reuters Business Interactive LLC (April 2006), PwC Derived. ²¹ Rest of World – any country other than those listed.

- 42. A 2005 PwC/EIU analysis of financial services offshoring²² found that European financial services firms were more inclined to offshore key activities than their American or Asian equivalents and have been offshoring for more extended periods. European financial services firms were, however, found to be somewhat more conservative than their American or Asian equivalents in their choice of offshoring model, with outsourcing being less popular than in-house offshoring.
- 43. Subsequent research undertaken by the Economist Intelligence Unit into business process re-engineering in financial services firms²³ found that European financial services firms were actually more favourably disposed towards outsourcing than their US equivalents, although a significant share of contracts were not offshored, i.e. local outsourcing predominated. The relevant report excerpt reads as follows:
- 44. "Some regional patterns emerged from the survey results, with US companies generally more reluctant to outsource (business processes) than their European counterparts. One possible reason for this is that US banks are more focused on cross-selling and, therefore, their operations are more complicated²⁴".
- Similarly, a review of Datamonitor²⁵ press releases for the 12 months to March 2006 45. indicated very significant levels of outsourcing behaviour among EU25 financial services firms, including ABN Amro, Nordea, Norwich Union, La Caixa, Deutsche Bank, Aviva Plc, AXA and ING Groep NV among others.
- 46. Secondary research materials are, however, heavily biased towards larger firms. Moreover, it is likely to be the case that EU25 financial services firms will start to lag their non-EU25 counterparts in outsourcing as the trend moves in favour of back-office functions, with the particular VAT treatment of front-office functions in the EU25 meaning that such services can frequently be outsourced in a VAT exempt fashion.

²² PricewaterhouseCoopers/ Economist Intelligence Unit 2005, "Offshoring in the Financial Services Industry: Risks and Rewards" - http://www.pwcglobal.com/extweb/ncsurvres.nsf/docid/58BED7FBF2646C6BCA25707D002F698F.
²³ http://www.eds.com/services/innovation/downloads/bpt_financial.pdf.
²⁴ http://www.eds.com/services/innovation/downloads/bpt_financial.pdf (page 14).

Datamonitor plc is a premium business information company specialising in industry analysis. Financial services is one of seven sectors within which the company specialises

4 Commentary on Research Phase II Findings

4.1 Are there VAT-related Distortions in the EU25 Financial Services Market?

- 47. With regard to financial services firm profitability/pricing practices, it is clear that the greatest number of EU25 financial firms suffer a significant embedded VAT cost with the importance of this cost varying, depending on the client profile of the firm in question. It is also clear that, in aggregate, financial services firms in the EU25 are somewhat less profitable than their equivalents in certain other highly developed economic regions, including the United States. It cannot be stated definitively that embedded VAT costs are the cause of profitability differentials, although it is clear that the VAT exemption of financial services (and the inability to reclaim VAT on costs as a consequence) is making at least some contribution.
- 48. With regard to VAT-based unfair competition, Case Study Companies did not report any significant experience of VAT-based unfair competition from within or beyond the EU25. This fact was found to be attributable to the fact that a series of factors unrelated to VAT require that financial services providers in EU25 markets have a physical presence in the market in which they wish to operate. This requirement effectively equalises the VAT treatment of all service providers within any given EU25 jurisdiction.
- 49. Certain investment management services, which are provided relatively easily on a cross-border basis as a result of their nature and/or regulatory factors, were found to be the exception.
- 50. Notwithstanding the foregoing, the strong emphasis placed on the development of a more liberalised or borderless market for financial services in the EU25 in the Financial Services Action Plan (FSAP) of the European Commission²⁶, coupled with the series of regulatory initiatives in this regard, means that complacency regarding the potential for VAT to promote unfair competition is inadvisable.
- 51. Closely related to the foregoing is the question of the influence which the VAT treatment of financial services brings to bear on the EU25 country in which financial services companies choose to locate *mobile* operations, i.e. those operations which are truly flexible in terms of the country in which they are located.

 $^{^{26}}$ "White Paper on Financial Services Policy (2005-2010)" at http://europa.eu.int/comm/internal_market/finances/ policy/index_en.htm. 26/369

- 52. While it is clear that the ongoing requirement for financial services companies to establish a physical presence in the country in which they wish to provide services means that the number of financial services operations which are truly mobile in terms of country location is limited, there was some evidence that VAT had influenced the location of operations of special investment fund companies as well as the country structure of the shared service arrangements of very large financial services firms.
- 53. Research findings with regard to the incidence of outsourcing and shared service centres among financial services firms within the EU25 were mixed. While an analysis of secondary materials pointed to a financial services sector in the EU25 which was at least equivalent to that of the United States in terms of its appetite and use of outsourcing and shared service centres, a review of the actual behaviours of Case Study Companies pointed to firms which were at least partially constrained by VAT²⁷.
- 54. The apparent dichotomy between case study and secondary research findings is explained by the fact that while large EU25 financial services firms are engaging in outsourcing and the establishment of shared services the range and volume of outsourced or shared services is being constrained by VAT. More specifically:
- shared service centres are engaged primarily in the provision of services which are: a) considered exempt from VAT in the country from which they are being supplied or where they are being received; b) not liable to VAT as a result of being provided between branches or within a national or cross-border VAT Group;
- outsourced services are: a) those which are considered VAT exempt under various ECJ rulings or by tax authorities; or b) not taxed on a reverse charge basis.
- 55. The implications of the foregoing are three-fold:

Firstly, and reflecting reported divergences between Member States in what constitutes exempt or non-exempt financial services, financial services firms face considerable legal uncertainty when deciding to outsource or to establish a shared services centre.

The second implication is that EU25 financial services firms are constrained in terms of the range of functions which may be, cost-efficiently, outsourced.

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²⁷ In advance of expanding on this issue, however, it is worthwhile noting that questions of outsourcing and shared services are byand-large the preserve of only the largest financial services firms in the EU25. Smaller market players would appear to be driven in company structure considerations by market development objectives primarily, with relatively limited consideration given to the need to realise efficiencies in back-office functions.

The third implication pertains to the scale of shared service centres which may be established, with the provision of services to a multiplicity of corporate entities which do not necessarily form part of a VAT Group likely to result in considerable additional VAT charges, assuming of course that the services in question are not VAT exempt.

- 56. PwC primary and secondary research provided no evidence that the VAT exemption for financial services in the EU25 was frustrating companies in developing EU25 markets or from taking full advantage of the demand opportunities presented by the Single Market. This was equally true of small and large financial services firms.
- 57. Secondary research findings supported this conclusion.
- 58. Finally, there was evidence from PwC primary research that certain financial services companies were suffering relatively high rates of irrecoverable VAT as a result of corporate structures based around subsidiaries, while others were required to put in place structures which were considered less than optimal from a regulatory or corporate tax perspective to minimise intra-group VAT charges.

4.2 How Important are the Identified Distortions?

59. Key findings in this regard are:

- the existence of non-VAT-related constraints to the remote or cross-border provision of financial services has spared the EU25 financial services market the worst effects of what is clearly a less than level playing field in terms of the VAT treatment of financial services firms between EU25 Member States;
- a series of implemented and planned regulatory changes, however, means that the remote provision of financial services into EU25 Member States should become increasingly more feasible in the period to the end of 2010;
- a more liberalised market will increase the potential for differences in the VAT treatment of financial services between EU25 Member States to be used as a source of potential cost advantage, resulting in unfair competition and opportunities for arbitrage;
- a series of factors, including differences in the definitions of exempt financial services between jurisdictions as well as the full taxation of certain outsourced or shared services, would appear to be having a heavy influence on the nature of services which are being outsourced or transferred to shared service centres;
- similarly, the scale of financial services shared service centres is being negatively impacted by regulations which allow only for the tax-free provision of such services (excluding those which are considered exempt) to corporate entities in a national or cross-border VAT Grouping or between branch and head office;
- the resource-intensive nature of the back-office functions of financial services companies means that the realisation of efficiencies in this regard will likely be crucial to the relative profitability of the EU25 financial services sector going forward;
- while shared service centres and outsourcing issues are presently by-and-large the preserve of very large EU25 financial services firms only, the emergence of a more intense competitive environment going forward could mean that smaller firms will look increasingly to such structures as a means of reducing costs.

4.3 What Features of the VAT System Underpin Distortions?

- 60. Perhaps the most interesting response to this question is the fact that Case Study Companies and global experts did not identify the exemption of financial services *per se* as the source of identified VAT-related distortions in the EU25 market for financial services.
- 61. Reflecting this, Case Study Companies, when questioned as to potential remedies, emphasised the need for harmonisation of treatment between EU25 Member States, their need for legal and financial certainty and the removal of a situation where there existed real VAT-based disincentives to *inside* or external outsourcing.
- 62. More specifically, features of the existing VAT system which underpinned identified distortions in the EU25 market for financial services were identified as follows:
- differences between Member States in terms of the definition of financial services and uncertainty regarding individual tax authority treatment of particular services;
- closely related to the foregoing, uncertainty and unevenness in the interpretation of the decisions of the ECJ, e.g. SDC²⁸;
- differences in VAT Group regulations between EU25 Member States;
- differences between Member States in terms of pro rata systems for calculating the deductibility entitlement for companies with partial recovery entitlements;
- the (perceived) illogical situation where a corporate entity incurred incremental irrecoverable VAT costs as a result of a corporate structure which was based around subsidiaries – as a result of an acquisition – based growth strategy;
- the (perceived) illogical situation where outsourced or shared services are subject to VAT on the full value of the service provided, as opposed to simply on the value added component of the transaction.

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²⁸ ECJ judgement of 5 June 1997 in *Sparekassernes Datacenter v. Skatteministeriet*, Case C-2/95.

5 Research Phase III: VAT Solutions

5.1 Evaluation Framework for Solutions

- 63. The evaluation criteria and solutions must be viewed in the context of and be compatible with the long-term goals of the European Commission, as outlined in its Financial Services Action Plan²⁹, and the contribution of taxation and customs policies to the Lisbon Strategy³⁰.
- 64. The evaluation criteria have been grouped according to the main aims of the solutions to combat identified distortions, to be easy to implement, and to be durable.
- 65. The PwC project team has not quantified the budgetary impact of each proposed solution. This exercise is beyond the remit of this Study. However, as budgetary impact may affect an individual Member States' willingness to accept a certain VAT solution, we have indicated at a very high level where a solution may have an impact on EU25 budgets (although not supported by any economic analysis).
- 66. The individual evaluation criteria are:
- positive impact on cost efficiency of EU25 financial services providers;
- effectiveness in combating identified distortions;
- pan-sectoral application of the proposed solution;
- no unequal impact of the proposed solution;
- ease of administration and control for revenue authorities;
- ease of administration for economic operators;
- limited timeframe for implementation;
- exploitation and contribution towards Single Market opportunities;
- efficiency in combating identified distortions;
- legal certainty for economic operators allowing long-term business plans and investments;
- no scope for abuse of provisions;
- consistency with VAT principles; and
- durability of impacts.

²⁹ "White Paper on Financial Services Policy (2005-2010)" at http://europa.eu.int/comm/internal_market/finances/ policy/index_en.htm.
³⁰ Implementation of the Community Lisbon programme – Communication from the Commission to the Council and the European Parliament – The contribution of taxation and customs policies to the Lisbon strategy – COM(2005) 532 of 25 October 2005 - http://ec.europa.eu/taxation_customs/common/publications/com_reports/taxation/index_en.htm.

67. These evaluation criteria have been used to have a systematic and fair evaluation of the VAT solutions. As some of the criteria cover similar areas, we thought it appropriate to group them for evaluation purposes. Accordingly, the first two are grouped under combating distortions, the next five under ease of implementation and the final six under future proof (see Chapter 8).

5.2 Description of Proposed Solutions

- 68. This Section takes into account the conclusions from our primary and secondary Research Phases to propose potential solutions.
- 69. The proposed solutions were split into four categories:
- VAT solutions based on fundamental VAT principles;
- VAT solutions for all financial services sub-sectors (banking, insurance and investment funds);
- VAT solutions applicable to specific financial services sub-sectors;
- pan-European guidance.
- 70. It is recognised that certain solutions may complement each other and may differ in how they should be applied to different parts of the financial services industry. The key to any proposed solution is its uniform application across EU Member States. It should also be noted that all solutions are only applicable to B2B supplies. Solutions for B2C do not fall within the scope of this Study.

5.2.1 VAT Solutions Based on Fundamental VAT Principles

Extension of the Scope of Exemption for B2B Supplies

- 71. This solution involves widening the scope of the current VAT exemptions for B2B supplies through mandatory provisions so that all Member States are required to apply the revised exemptions consistently to all taxpayers.
- 72. The actual extension to the exemptions could be done in two ways. Firstly, the existing exemptions could be extended to apply to transactions further down the supply chain so that currently taxable supplies become VAT exempt. Secondly, the exemptions could be clarified to ensure that they are applied consistently across Member States. This may involve an extension to the exemptions applied in some Member States.

- 73. Key considerations for this solution are:
- the current VAT system causes distortions in the context of outsourcing and shared services by effectively forcing organisations to limit outsourced activities to those that are VAT exempt;
- the current exemptions are not evenly applied across Member States. Any extension to the scope of the exemptions should be based on a clear definition as to what services are covered by the revised exemptions;
- this solution could be combined with the option to tax for B2B supplies (discussed below) to maximise flexibility for economic operators.

Reduction of the Scope of Exemption for B2B Supplies

- 74. This solution involves reducing the scope of the exemptions for financial and insurance services for B2B supplies. This would broaden the tax base and reduce irrecoverable input VAT.
- 75. It will be necessary to carefully consider which services should be excluded from the exemptions. A full analysis was not within the remit of this Study. The PwC project team therefore put forward examples highlighting some of the challenges that will need to be addressed in identifying the precise services that could be excluded from the exemptions.
- 76. Key considerations for this solution are:
- it could be possible to tax banking transactions but valuation issues will arise. This
 effectively restricts this solution to services where the consideration is fee or premium
 based;
- it would be possible to tax insurance transactions (property and casualty insurance). Taxation could also be extended to life and health insurance as these are wrapped around savings products (insurers are increasingly being required to separate out the premium for life cover from the savings element, for regulatory purposes).

Option to Tax for B2B Supplies

77. This solution would give financial services operators the option to tax their services when provided to other taxable persons. This would enable the recovery of input tax as it could be attributed to an onward taxable supply.

- 78. Key considerations for this solution are:
- the option to tax for financial services is currently allowed under article 13(C)(b) of the Sixth EU VAT Directive. Five countries have implemented this option. However, the provision is not mandatory and so the Sixth EU VAT Directive would need to be amended to ensure that all Member States allow taxpayers the right of option. This would help achieve consistency and neutrality across the EU;
- this solution would not eliminate all embedded VAT but would offer flexibility to economic operators to decide whether to charge VAT on certain financial services;
- this solution can easily be applied to fee based transactions but is less appropriate for margin based transactions;
- insurance services are currently excluded from the option to tax. In order to apply the option to tax to insurance services, the Sixth EU VAT Directive would need to be amended.

Zero Rating of Specific Financial Transactions

- 79. This solution is based on zero rating specific financial services transactions so that financial services providers would not have to charge VAT (just apply the rate of 0%) on certain supplies but could recover any associated input VAT.
- 80. Key considerations for this solution are:
- this solution could be applied broadly, as introduced in New Zealand, or narrowly, as in the case of zero rating under the UK Terminal Markets Order;
- the solution would not eliminate embedded VAT but would reduce it to the extent that the zero rating provisions are introduced;
- an identified advantage of zero rating, is its application to both fee based and margin based transactions.

Mandatory Domestic VAT Grouping

81. This solution would make it mandatory for all Member States to allow VAT Grouping where the eligibility tests are met in accordance with EU law. This would address the uneven playing field that currently exists with VAT Grouping currently only allowed in 12 out of 25 Member States.

- 82. Key considerations for this solution are:
- where Member States do not currently allow VAT Grouping, there is a VAT cost on intercompany recharges and on shared costs within the wider corporate group;
- the absence of VAT Grouping in certain Member States has an impact on the preferred location of financial and insurance services operators, and on corporate structures with a bias towards branch structures;
- the conditions for VAT Grouping should be set out on a European level rather than with local discretion, to ensure that a level playing field exists, subject to any specific discretion for Member States to introduce targeted anti-avoidance provisions;
- whilst budgetary matters are outside our remit, the cost of VAT Grouping does not seem to be as high in reality as Member States claim;
- in order to make VAT Grouping mandatory an amendment of the Sixth EU VAT Directive would be required.

Cross-Border VAT Grouping

- 83. This solution would make it mandatory for all Member States to allow cross-border VAT Grouping. This would allow financial services operators to reduce the VAT costs associated with cross-border operations and provide for an equal VAT treatment between branch and subsidiary corporate structures.
- 84. Key considerations for this solution are:
- at present, only 2 Member States (the United Kingdom and Netherlands) allow crossborder VAT Groups, and only within carefully defined circumstances and only in respect of their own VAT. This means that there is an uneven playing field in the EU25;
- anti-avoidance measures incorporated into the proposal to prevent abuse should make the acceptance by Member States easier;
- this solution could be combined with more refined input VAT recovery calculations to allow financial services operators to manage their VAT affairs in a more consistent way across the EU25.

5.2.2 Pan-European Financial Services Solutions

Cost Sharing

85. This solution is based on clear and definitive guidance in respect of the VAT treatment of cost sharing arrangements in order to address the current imposition of VAT. This solution could take the form of confirmation of the application of the exemption under article 13(A)(1)(f) of the EU Sixth VAT Directive, or it could take the form of direct application of the ECJ decision in EDM^{31} .

86. Key considerations for this solution are:

- article 13(A)(1)(f) is a mandatory provision but is still not implemented in nine Member States;
- pan-European guidance indicating that the provision is applicable in a business environment and for any costs and services in the financial services and insurance sector could create certainty and consistent application across Member States.

More Refined Input VAT Recovery Calculations

87. This solution is based on more refined input VAT recovery calculations on a pan-European level.

88. Key considerations for this solution are:

- the current diversity in the scope and complexity of methodologies ranges from inflexible single pro rata calculations to complex sectorised methods. This leads to legal uncertainty, complexity, potential distortion of competition between taxpayers established in different Member States and high compliance costs;
- allowing the taxpayers the option to apply a fixed method of input tax recovery could offer a potential simplification;
- a fixed recovery percentage inspired by the method applied in Singapore may be more beneficial to smaller firms that do not have the resources available to operate a complicated pro rata or special method;
- pan-European guidance could also be used to identify the scope and application of common special methods, as well as common calculations of turnover to be used by taxpayers in all Member States.

³¹ ECJ judgement of 29 April 2004 in *Empresa de Desenvolvimento Mineiro SGPS SA (EDM) v. Fazenda Pública*, Case C-77/01.

Uniform Limited Input Tax Credit (ULITC)

- 89. This solution would be similar to that introduced in certain non-EU tax regimes (the Reduced Input Tax Credit system in Australia), so that a fixed level of input tax recovery is applied to all purchases, or to a predefined range of costs.
- 90. Key considerations for this solution are:
- Member States would need to consider the rate of ULITC that is relevant for the precise service. Under the Australian RITC mechanism, the rate of recovery is linked to the wages and profit element of the outsourced service. An independent statistical survey could be undertaken to identify the proportion of labour costs for each ULITC service;
- this solution could be combined with a simplified pro rata method for small and mediumsized players.

5.2.3 Industry Specific Solutions

Insurance – Article 13(B)(a)

- 91. The solutions specific to the insurance industry can be considered in two ways. Firstly, to extend the scope of the exemption for insurance related services. Secondly, to tax insurance premium income in a B2B context.
- 92. Key considerations for this solution are:
- the wording of article 13(B)(a) could be amended to focus the exemption on the actual service performed rather than the person providing the service;
- the exemption for insurance agents and brokers could be extended so that the insurance intermediary is not required to have a direct contractual relationship with the insured;
- article 13(B)(a) could be broadened to make it clear that the exemption applies, not just when initiating a contract, but also to insurance services throughout the life of a policy;
- it would be possible to tax premium income to prevent irrecoverable VAT from becoming embedded in the insurance markets. It would then be inappropriate for Member States to continue to levy Insurance Premium Tax in addition to VAT, whether at a state or national level.

Banks - Article 13(B)(d)(1) to (5)

- 93. This solution proposes amendments to article 13(B)(d)(1) to (5) of the Sixth EU VAT Directive to modernise the definitions of the financial services that fall to be VAT exempt and to promote consistent application of those definitions across the EU25.
- 94. Key considerations for this solution are:
- article 13(B)(d)(1) to (5) could be updated to clearly include the more complex and sophisticated banking transactions that now exist;
- the exemptions could be broadened to not just include banking transactions as principal but to exempt the actual means of distribution;
- the actual text of items 1 to 5 could be significantly simplified, with details of the precise services to be covered by detailed definitions contained within up to date pan-European guidance (see below).

Funds - Article 13(B)(d)(6)

- 95. This solution could be based on clarification of the application of article 13(B)(d)(6) of the Sixth EU VAT Directive to ensure that the recent ECJ decisions in BBL32 and Abbey National³³ are applied consistently by Member States. It could be complemented with an amendment of the Sixth EU VAT Directive.
- 96. Key considerations for this solution are:
- the inconsistent application across Member States of the exemption for the management of special investment funds means that certain countries are seen as a more favourable location than others:
- consistency should be provided with this solution in relation to the application of terms such as taxable person, place of supply and the scope of the exemption;
- a funds-specific solution would create certainty for the industry and the tax authorities.

5.2.4 Pan-European Guidance

97 All of the solutions above could be enhanced by clear pan-European guidance or European VAT commentary to eliminate national differences in implementation and modernise VAT in the financial and insurance services sector. This should reduce the need for taxpayers and tax authorities to increasingly resort to litigation.

32 ECJ judgement of 21 October 2004 in Bank Brussel Lambert NV (BBL) v. Belgian State, Case C-8/03.
 33 ECJ judgement of 4 May 2006 in Abbey National plc & Inscape Investment Fund v. Commissioners of Customs and Excise, Case

- 98. Key considerations for this solution (also referred to as the *blue book*) are:
- the creation of a VAT forum/working party to be responsible for agreeing the pan-European guidance and for documenting the proposed guidelines in a form of blue book or guidance paper;
- the preferred method of implementation would be via submissions to the VAT Committee, who would then make proposals to the Council under article 29a of the Sixth EU VAT Directive. The Council could then implement the proposals by Regulation which would have immediate direct effect in Member States. The less contentious financial services VAT issues could be quickly agreed through a two-stage approach to implementation;
- the article 29 procedure would not allow the working party to make proposals to change the law, simply to make recommendations to clarify the law as it currently stands;
- in order for the pan-European guidance to be effective, the European Commission would ultimately need to ensure that the guidance is applied and enforced.

5.3 Evaluation of Solutions

- 99. A detailed evaluation was performed on each solution in order to score how viable each solution is. In considering the scoring, it is important to bear in mind that every solution will take time to implement and that the ultimate success of any solution will depend on the actual uniformity of application across Member States, and that all solutions are solely in respect of B2B supplies.
- 100. Following this evaluation, the most successful solutions were grouped together to further analyse the strengths and weaknesses that they offer. It was decided at this stage that reducing the scope of the exemption and zero rating of specific financial transactions would not be taken forward for further evaluation.
- 101. The solutions that were taken forward were grouped to emphasise the link between them. For example, some solutions could have a more significant beneficial impact if they are combined with other solutions especially where the weaknesses of one solution can be addressed by the strengths of another so that the combined solution is more comprehensive and effective than the individual solutions standing alone.
- 102. Three groups of solutions were selected for further analysis, with Pan-European Guidance available to support all solutions:
- Liability Based Solutions;
- Input Tax Based Solutions; and
- Structure Based Solutions.

Methodology

- 103. In order to rank the various solutions in a systematic way, an Evaluation Framework was used. All solutions were scored in relation to various criteria and then the results were averaged to produce a total score for each solution.
- 104. The scorings were allocated based on the experience of the PwC project team in conjunction with the Expert Panel taking into account the Research Phases of the Study.
- 105. Each solution was given a scoring between 1 and 5 for each individual criterion, where 5 indicates a positive effect of a solution and 1 indicates a negative effect.
- 106. Whilst this approach has facilitated an objective method of evaluating the solutions, it should be noted that, in scoring the solutions in this way, there is an element of subjectivity. This is unavoidable.

Selected Solutions

107. The total scores for each solution are as follows:

Table 10: Evaluation of Single and Combined Solutions

Grouping	Single and Combined Solutions	Overall Score
Liability Based	Industry Specific Solutions	3.85
Liability Based	Option to Tax for B2B Supplies	4.23
Liability Based	Extending/Clarifying the Exemption with the Option to Tax for B2B Supplies	4.31
Input Tax Based	More Refined Input VAT Recovery Calculations	4.31
Input Tax Based	Uniform Limited Input Tax Credit (ULITC)	4.38
Input Tax Based	More Refined Input VAT Recovery Calculations and ULITC	4.54
Structure Based	Mandatory Domestic VAT Grouping	4.65
Structure Based	Cross-Border VAT Grouping	4.50
Structure Based	Cost Sharing	3.85
Structure Based	VAT Grouping (Domestic and Cross-Border) and Cost Sharing	4.54
Applicable to All	Pan-European Guidance	4.15

Budgetary Impact

108. Budgetary impact does not only refer to the amount of VAT revenue, as the solution may contribute to attracting or retaining key industry sectors for Member States, thus guaranteeing not only direct employment in the financial services industry but also indirect employment. From the Research Phase II – Empirical Evidence we derive that no change in the VAT treatment of the financial services sector within EU25 will have a negative impact on EU25 budgets.

6 Overall Conclusions

We can conclude the following:

109. VAT-related Distortions in the EU25 Financial Services Market

- the existence of non VAT-related constraints to the remote or cross-border provision of financial services has spared the EU25 financial services market the worst effects of what is clearly a less than level playing field in terms of the VAT treatment of financial services firms between EU25 Member States;
- a series of implemented and planned regulatory changes, however, means that the remote provision of financial services into EU25 Member States should become increasingly more feasible in the period to the end of 2010;
- a more liberalised market will increase the potential for differences in the VAT treatment of financial services between EU25 Member States to be used as a source of potential cost advantage, resulting in unfair competition and opportunities for arbitrage;
- a series of factors, including differences in the definitions of exempt financial services between jurisdictions as well as the full taxation of certain outsourced or shared services, would appear to be having a heavy influence on the nature of services which are being outsourced or sent to shared service centres;
- similarly, the scale of financial services shared service centres is being negatively impacted by regulations which allow only for the tax-free provision of such services (excluding those which are considered exempt) to corporate entities in a national or cross-border VAT Group or between branch and head office;
- the resource-intensive nature of the back-office functions of financial services companies means that the realisation of efficiencies in this regard is likely to be crucial to the relative international profitability of the EU25 financial services sector going forward;
- while shared service centres and outsourcing issues are presently by-and-large the preserve of very large EU25 financial services firms only, the emergence of a more intense competitive environment going forward could mean that small to medium-sized companies will look increasingly to such structures as a means of reducing costs.

110. Features of the VAT System Underpinning Distortions

- differences between Member States in terms of the definition of financial services and uncertainty regarding individual tax authority treatment of particular services;
- closely related to the foregoing, uncertainty and unevenness in the interpretation of the decisions of the Court of Justice, e.g. SDC³⁴;
- differences in VAT Group regulations between EU25 Member States;
- differences between Member States in terms of pro rata systems for calculating the deductibility entitlement for companies with partial recovery entitlements;
- the (perceived) illogical situation where a corporate entity incurred incremental irrecoverable VAT costs as a result of a corporate structure which was based around subsidiaries – as a result of an acquisition – based growth strategy;
- the (perceived) illogical situation where outsourced or shared services are subject to VAT on the full value of the service provided, as opposed to simply on the value added component of the transaction.

111. VAT and a Single Market for Financial Services

- the (perceived or actual) requirement for financial services firms to establish a physical presence in the country in which they wish to provide services has shielded the financial services sector within the EU25 from many potential VAT-related distortions – particularly in the field of unfair competition;
- VAT-related distortions will, however, be accentuated if the European Commission's objective of a more liberalised or borderless Market for Financial Services is realised in execution of its Financial Services Action Plan³⁵;
- the medium term potential for existing VAT arrangements to become a source of unfair competitive advantage or to frustrate the realisation of a Single Market for Financial Services.

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 ³⁴ ECJ judgement of 5 June 1997 in Sparekassernes Datacenter v. Skatteministeriet, Case C-2/95.
 ³⁵ "White Paper on Financial Services Policy (2005-2010)" at http://europa.eu.int/comm/internal_market/finances/ policy/index_en.htm.

112. Impact of Status Quo or No Change to the VAT Treatment of Financial Services

This would be negative as:

- embedded VAT costs continue to have a clear bearing on the cost efficiency of the EU25 financial services sector (especially if irrecoverable VAT arises as a result of intra-group transactions) compared to the efficiency of the non-EU global players;
- a more liberalised market will increase the potential for differences in the VAT treatment
 of financial services within the EU25 to be used as a source of potential cost advantage,
 resulting in unfair competition and opportunities for arbitrage;
- the EU25 (also low-cost EU25 jurisdictions) will continue to lose out on investment to non-EU25 countries (such as India);
- some companies within the EU25 financial services sector will continue to have suboptimal structures of operations often dictated by VAT (again having an impact on their competitiveness);
- legal uncertainty from a VAT point of view, especially in relation to cross-border transactions, could discourage the EU25 financial services sector from engaging in longterm business planning and investments;
- the resource-intensive nature of the back-office functions and the constraints on the range and volume of outsourced or shared services could have important implications for the level of profitability and competitiveness of the EU25 financial services sector.

7 Priority Solutions

- 113. We would recommend giving priority to the following solutions in view of the results of our Study.
- 114. Clearly the decisions regarding what to implement and how to proceed lies first with the European Commission, as it is the European Commission which proposes legislative change, and then for the Council as the body which can pass new legislation. Our conclusions are not to be regarded as pre-empting those decisions.

Pan-European Guidance

- 115. Inconsistent application of the current VAT rules is negative. Some cases are due to discretion being given in the primary law but this is not the case in many circumstances. The successful elimination of these inconsistencies and uniform application is reliant upon binding pan-European guidance.
- 116. Pan-European guidance does not require any legislative change and would be supportive for all other selected solutions. This is the case even though it ranks as the second lowest score on the ratings. What this rating demonstrates however is that on its own, uniform guidance without any substantive change will not address all the issues in this area.

Mandatory Domestic VAT Grouping

- 117. The ability to form VAT Groups or not as the case may be in a particular Member State appeared to have a more significant effect on the decision making process to locate financial services operations than any other VAT factor. Its presence also appears to have a very small impact on Member State budgets (although there are no doubts about the other economic benefits which flow from the inward investment which follows e.g. jobs, growth and payroll and profit taxes). This would accord with the aims of the Lisbon Agenda³⁶.
- 118. In addition, the experience of those Member States who already have VAT Grouping in combating VAT avoidance opportunities can be used to prevent future avoidance opportunities arising.
- 119. It is for these reasons that this solution had the highest rating in our evaluation.

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³⁶ Implementation of the Community Lisbon programme – Communication from the Commission to the Council and the European Parliament – The contribution of taxation and customs policies to the Lisbon strategy – COM(2005) 532 of 25 October 2005 - http://ec.europa.eu/taxation_customs/common/publications/com_reports/taxation/index_en.htm.

Cross-Border VAT Grouping

120. If the Single Market means a single market and not 25 separate markets, then requiring Member States to permit cross-border VAT Grouping is inevitable. However, the necessary adjustments to input tax recovery mechanisms would have to be made to track the use of purchases to eventual supplies wherever they are made. This would of course also require greater co-operation between tax authorities.

121. One can see that this solution had the second highest rating in our evaluation.

Mandatory VAT Grouping combined with Cost Sharing

122. Mandatory VAT Grouping combined with full implementation of the existing cost sharing arrangements between any type of business would offer the financial services industry the flexibility to structure their business to maximise their competitive position in the global market in compliance with regulatory requirements and in fulfilment of the Lisbon Agenda³⁷.

More Refined Input VAT Recovery Calculations

123. It appears that those Member States with more refined methods, allowing an analytical approach, produce more VAT-efficient financial services businesses than those without.

124. This solution, introduced by means of pan-European guidance, not requiring any change to the Sixth EU VAT Directive, would eliminate the VAT-based cost advantage presently enjoyed by certain financial services operators solely as a result of location.

125. It would also offer a solution for smaller businesses using a fixed recovery percentage (inspired by a model currently operated in Singapore). This could be attractive in that they would not be required to operate a complex input VAT recovery method. This would of course require a special regime which of course brings with it its own difficulties regarding boundary definition.

³⁷ Implementation of the Community Lisbon programme – Communication from the Commission to the Council and the European Parliament – The contribution of taxation and customs policies to the Lisbon strategy – COM(2005) 532 of 25 October 2005 - http://ec.europa.eu/taxation_customs/common/publications/com_reports/taxation/index_en.htm.

Uniform Limited Input Tax Credit (ULITC)

- 126. This solution scored highly in our evaluation and is inspired by a method used in Australia but would be refined with a statistical method derived from rules applied in Singapore. This solution could remove the current bias in favour of vertical integration and against the use of centres of excellence, shared services, outsourcing and co-sourcing, improving the competitiveness of the industry.
- 127. It would represent a major change in the structure of the current VAT system. It deserves further work in view of its potential to overcome the current economic effects of the VAT rules for financial and insurance services.

Combination of More Refined Input VAT Recovery Calculations with the ULITC

128. The combination of the More Refined Input VAT Recovery Calculations with the Uniform Limited Input Tax Credit received an even higher score as combining both offers a more complete solution to the identified impact of the current input VAT recovery methods on the financial services industry.

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GLOSSARY



The definitions below should be viewed in the context of VAT and for the purpose of this report only:

Name	Definition
B2B ³⁸	Business to business: for the purpose of determining the place of supply of
	services rules and to minimise burdens on business, taxable persons who
	also have non-taxable activities should be treated as taxable for all services
	rendered to them. Similarly, non-taxable legal persons who are registered for
	value added tax purposes should be deemed to be taxable persons
B2C	Business to consumer: See B2B
Case Study Company	Company providing information for the primary research of Research Phase II
	– Empirical Evidence
Co-sourcing	Business functions performed by internal staff and external resources
Cost Sharing	An arrangement whereby a group of related entities distribute cost with no
	additional mark-up
Cross-border VAT Grouping	A VAT tax unity of entities established in different Member States
Deductible VAT	The amount of VAT which is incurred and may be reclaimed from revenue
	authorities
Derogation	Waiver from established rules, in this context, from the EU Sixth VAT
	Directive
Domestic VAT Grouping	A VAT tax unity between entities established in the same Member State
ECB	European Central Bank

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³⁸Amended proposal for a Council Directive amending Directive 77/388/EEC as regards the place of supply of services – Com (2005) 334 final – 20 July 2005 - http://ec.europa.eu/taxation_customs/common/legislation/proposals/taxation/index_en.htm.

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Name	Definition
EIU	Economist Intelligence Unit
Embedded VAT	VAT which cannot be reclaimed and is ultimately passed on as a cost of
	production to the recipient of the supply
ERP	Enterprise Resource Planning: software used to manage business functions
EU25	Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland,
	France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania,
	Luxembourg, Malta, The Netherlands, Poland, Portugal, Slovakia, Slovenia,
	Spain, Sweden and United Kingdom
Eurozone	EU Member States that have adopted the Euro: Austria, Belgium, Finland,
	France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands,
	Portugal and Spain
Expert Panel	A team composed of the following:
	 PwC VAT/GST experts from New Zealand and Australia; academic experts and judges in taxation issues; PwC experts in direct taxes, economics and competition aspects of taxation; PwC financial services thought leaders from within EU25; selected VAT experts from leading financial services, insurance and investment management organisations within and outside EU25, having experience in EU and non-EU VAT/GST/tax legislation for financial services.
	to act as a sounding board and advise the PwC project team on the findings
Financial Services	Services of and relating to, amongst others, retail and investment banking, capital markets, fund management, insurance and brokerage and agency transactions

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Name	Definition
FSAP – Financial Services Action Plan ³⁹	The European Commission's plan for the development of the Single Market.
	It was designed to open up a Single Market for Financial Services in the EU.
	It comprises of 42 measures designed to harmonise the member states' rules
	on securities, banking, insurance, mortgages, pensions and all other forms of
	financial transactions
Fiscal Authority	Local tax authority of the Member States
Globalisation	Provision of services that transcend national boundaries
GST	Goods and Services Tax
HMRC	Her Majesty's Revenue & Customs: UK tax authority
IM	Investment management
Input tax	VAT incurred
Insourcing	The process whereby a business performs business functions internally
	which are ordinarily performed externally
IRAS	Inland Revenue Authority of Singapore
JV	Joint Venture
Lisbon Strategy ⁴⁰	Strategy to make Europe a more attractive place in which to invest and work;
	to promote knowledge and innovation; and to shape policies that allow
	European businesses to create more and better jobs. Taxation has a
	significant role to play in the attainment of these objectives
M&A	Mergers and Acquisitions
Member State	EU25 Member State
MNC	Multi National Companies
New Member States	Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland,
	Slovakia and Slovenia, who joined the EU on 1 May 2004

³⁹s White Paper on Financial Services Policy (2005-2010)" at http://europa.eu.int/comm/internal_market/finances/ policy/index_en.htm.
40Implementation of the Community Lisbon programme – Communication from the Commission to the Council and the European
Parliament – The contribution of taxation and customs policies to the Lisbon strategy – COM(2005) 532 of 25 October 2005 - http://ec.europa.eu/taxation_customs/common/publications/com_reports/taxation/index_en.htm.

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Name	Definition
OECD	Organisation for Economic Cooperation and Development
Outsourcing	The process of transferring certain internal functions, which were previously
	provided in-house, to a legally distinct (third-party) provider
Pro Rata	In this report pro rata refers to the proportion of deductible VAT
Revenue Authority	Local tax authority of the Member States
RITC	Reduced Input Tax Credit: system used in Australia whereby a fixed
	percentage of input tax may be reclaimed
Shared Service Centre	A single centre providing certain services (such as IT, accounting, etc.) to the
	whole organisation without involvement of a third party
SICAV	Société d'Investissement à Capital Variable: investment fund
Single Euro Payments Area (SEPA) ⁴¹	The European payment system initiative, enabling the European citizens to
	make payments in the Eurozone as securely, quickly and efficiently as
	payments within national borders. Differences between the levels of service
	for domestic and cross-border retail payments are to be eliminated by 2010
European Company ⁴²	Or Societas Europaea (SE): a new type of public company created by an EU
	Regulation and completed with an EU Directive. It is able to operate on a
	European-wide basis and is governed by EU law - the European Company
	Statute - and by the national laws applicable to public companies of the
	country in which it is registered
Single Market ⁴³	An area without internal frontiers in which the free movement of goods,
	persons, services and capital is ensured in accordance with the provisions of
	the EU Treaty

⁴¹ Regulation (EC) 2560/2001 of the European Parliament and of the Council of 19 December 2001 on cross-border payments in Euro - http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=en&numdoc=32001R2560&model

⁻ http://eur-lex.europa.eu/smartapi/cgi/sga_doc/smartapi/celexapii/prodi/CELExhumdoc&ig=en&numdoc=32001R2560&model = guichett.

42 Council Regulation (EC) No 2157/2001 of 8 October 2001 on the statute for a European Company (SE) - europa.eu.int/eur-lex/pri/en/oj/dat/2001/l_294/l_29420011110en00010021.pdf. and Council Directive 2001/86/EC of 8 October 2001 supplementing the Statute for a European company with regard to the involvement of employees - http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri= CELEX:32001L0086:EN:NOT.

43 Article 14 (2) of the EU Treaty - http://europa.eu.int/eur-lex/en/treaties/dat/C_2002325EN.003301.html.

Name	Definition
The Study	Study to increase the understanding of the economic effects of the VAT
	exemption for financial and insurance services
Tax	In this report means VAT unless otherwise stated
Taxable Person	As defined in Article 4 of the Sixth EU VAT Directive:
	Taxable Person shall mean any person who independently carries out in any place any economic activity specified in paragraph 2, whatever the
	purpose or results of that activity
	The economic activities referred to in paragraph 1 shall comprise all
	activities of producers, traders and persons supplying services including
	mining and agricultural activities and activities of the professions. The
	exploitation of tangible or intangible property for the purpose of obtaining
	income there from on a continuing basis shall also be considered an
	economic activity
Tax Revenue	The amount of tax collected by Member States
VAT Arbitrage	Taking advantage of the differences in VAT treatment existing in the EU25
	which can have different causes including countries' tax sovereignty
VAT Exempt without Credit	No VAT is due and where a supply is VAT exempt, input tax relating to that
	supply is not deductible
VAT Exempt Enterprise	A business which makes only VAT exempt supplies
VAT Group	Persons, established in the territory of the country who, while legally
	independent, are closely bound to one another by financial, economic and
	organizational links, who are treated as a single taxable person, as defined in
	article 4(4) of the Sixth EU VAT Directive
VAT Shopping	Locating business in Member States which are seen to have a more
	favourable VAT regime
Vertically Integrated Enterprise	A business performs functions internally which would ordinarily be performed
	by external businesses
Zero Rate	Taxable at 0% and where a supply is zero rated, input tax relating to that
	supply is deductible