REPORT

CHAPTER 1 METHODOLOGY

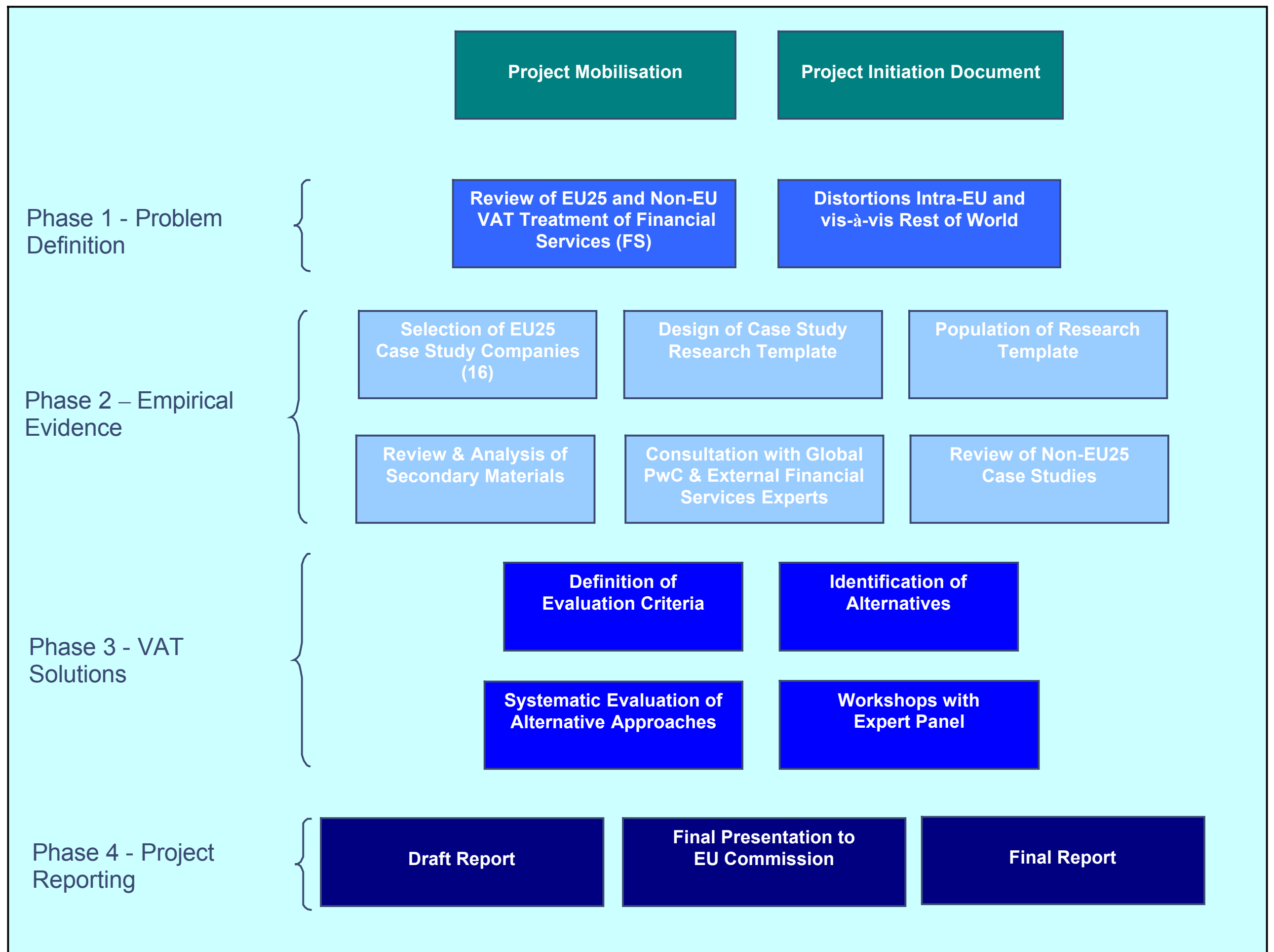
1.1 Introduction

1.1 The purpose of this Chapter is to outline our methodology for the completion of the Study to increase the understanding of the economic effects of the VAT exemption for financial and insurance services. The Chapter describes our approach taking into account the overall project objectives. Therefore, below we indicate all individual research tasks and deliverables.

1.2 Approach

Figure 1.1 presents an overview of the PwC research approach.

Figure 1.1: Overview of PwC Research Approach



1.2 The research approach started with a project mobilisation meeting between the PwC project team and the European Commission to ensure that there was a commonality of understanding regarding project objectives, research inputs and deliverables.

1.2.1 Research Phase I: Problem Definition

1.3 The first Research Phase was essentially exploratory in nature, aimed at scoping the scale of the potential problem caused by existing VAT arrangements – having explicit regard to existing VAT/GST arrangements within the EU25 (and having regard to jurisdictional differences), as well as in a selection of non-EU countries, e.g. Australia and New Zealand. The VAT treatment of financial services in new Member States prior to accession was also considered as part of this Research Phase.

1.4 In order to achieve a detailed analysis and overview of existing VAT/GST arrangements within the EU25 and a selection of non-EU countries, an extensive survey was launched in February 2006 (updated in October 2006) within the PwC Financial and Insurance Services VAT/GST Network and completed by our local financial services VAT/GST country experts. Based on these results and the experiences of our country experts, potential distortions were identified.

1.5 The deliverable from this Research Phase was a preliminary assessment of the extent to which a problem or distortion exists in theory, particularly vis-à-vis the rest of the world. Differences in the VAT treatment of financial services, distinguishing between individual sub-sectors, among EU25 countries, have been examined here.

1.2.2 Research Phase II: Empirical Evidence

1.2.2.1 Introduction

1.6 The second Research Phase is closely aligned to the first objective of the Commission's Terms of Reference, namely the determination of the existence, intensity and nature of any distortion caused by the existing VAT treatment of financial services in the EU25. This Research Phase was crucial in the understanding of the extent and nature of the distortions, which is clearly a prerequisite to the formulation of any meaningful solution in the third Research Phase.

1.7 This Research Phase comprised two distinct sub-phases, namely:

- the determination of the extent to which there is a VAT-related distortion within the EU25;
- the estimation of the scale of the disadvantage imposed vis-à-vis financial services sectors outside the EU25.

These are described, in turn, in the remainder of this Section.

1.2.2.2 EU25 Case Study Research

1.8 The EU25 case study research comprised three distinct research tasks, namely:

- the selection of EU25 Case Study Companies;
- the design of a standard template for completion in respect of each of the Case Study Companies;
- the population of the Case Study Templates, i.e. carrying out the company case studies.

1.9 In choosing Case Study Companies for inclusion in the case study research, the PwC project team paid regard to the need for the sample to include:

- both small, medium-sized and large companies, having regard to the European Commission's belief that smaller firms may be particularly disadvantaged;
- companies in the banking, investment funds and insurance sub-sectors;
- companies in some of the new Member States, who until recently had distinct VAT arrangements in respect of financial services.

1.10 The second research step entailed the design of a template for the collection of a standard set of information from the Case Study Companies. This template was subject to review by the technical Expert Panel and subject to a detailed proof or test in conjunction with a number of client financial services firms of the PwC Financial and Insurance VAT/GST Network. The template is sufficiently comprehensive to allow for meaningful commentary on:

- the size of the direct or actual distortion, i.e. the cost or service implications to taxable users of financial services in the EU25;
- the precise nature of the direct or actual distortion;
- the size and nature of notional distortions, e.g. limited use of outsourcing arrangements and less than optimal business structures;
- the inefficiencies caused by the provisions of the Sixth EU VAT Directive, by preventing the implementation of efficient business initiatives/improvements;
- the constraints imposed by existing VAT arrangements on the scope offered to the Case Study Company to derive maximum benefit from the Single Market.

1.11 The final research step entailed carrying out the case studies. In this respect, members of the PwC project team held meetings with representatives (Chief Executive Officers, Chief Financial Officers, VAT specialists or management) of each of the Case Study Companies with a view to fully completing the standard information template. To ensure consistency in the preparation of the case studies, one member of the PwC project team attended all of the case study visits – together with local market PwC experts (whenever advisable).

1.12 The deliverable from this research step is 22 detailed company case study reports, which include details of the intensity and nature of VAT distortions identified in the EU25 financial services sector. As indicated previously, regard has been paid to both actual and notional distortions in the preparation of these case study reports. The case study reports have been fed into Chapter 3 of the final report, describing the existence, intensity and nature of VAT-related distortions in the EU25 financial services sector, distinguishing between sub-sectors, EU25 Member States and company size category.

1.2.2.3 EU25 VAT Distortion vis-à-vis Rest of the World

1.13 The second sub-phase of Research Phase II – Empirical Evidence comprised three distinct tasks, namely:

- the review and analysis of relevant secondary materials;
- the consultations with global PwC and external financial services experts;
- the preparation of three non-EU or pre-EU25 case studies.

1.14 The first of these research tasks essentially entailed the PwC project team collating and reviewing secondary materials on the financial services sector in the EU25 vis-à-vis the rest of the world, having particular regard to reported efficiency differentials. Publications such as the Economist Intelligence Unit's review[44] on the incidence of outsourcing by financial services operators in the developed world were reviewed as part of this research step, as well as various global surveys of the sector.

1.15 While important information was gleaned from this research step, the very specific nature of the research topic is such that primary or empirical research was also required to make a meaningful commentary on the extent to which VAT arrangements in the EU25 have impaired sectoral efficiency vis-à-vis the rest of the world.

1.16 Given this, the PwC project team also consulted with a number of global experts on the financial services sector, with a view to obtaining opinions on the relative efficiency of the financial services sector in the EU25 and underlying causes of differentials, to the extent that such are reported to exist. These experts included PwC pan-territorial financial services leaders as well as non-PwC experts not included in the technical Expert Panel.

1.17 The output from this research sub-phase is the basis of a fourth Chapter of the final report, which describes the extent to which there is evidence of an efficiency differential between the financial services sector in the EU25 and that in other developed economies (e.g. New Zealand) and, to the extent that this is found to be the case, examines the extent to which such differentials are attributable to distinct VAT treatments.

1.18 The outcome of this Research Phase is an essential input to the Research Phase III – VAT Solutions, details of which are provided in the next Section.

[44] The Economist Intelligence Unit is an Economist Group business established in 1946 and the world's leading provider of country analysis. The review examined experiences and best practice in offshoring by financial institutions, aiming to identify the risks and rewards of offshoring functions, gauging the secrets of successful offshoring in the financial services industry, and identifying the emergent models for future offshoring activity, from outsourcing to captives.

1.2.3 Research Phase III: VAT Solutions

1.19 The aim of Research Phase III - VAT Solutions is to identify a number of alternative solutions with a view to mitigating the distortions coming out of Research Phase II – Empirical Evidence (see Chapter 3). Each of these solutions is evaluated in the PwC Evaluation Framework using a set of pre-defined evaluation criteria.

1.2.3.1 Definition of Evaluation Criteria

1.20 Key evaluation criteria have been outlined in Chapter 6 to evaluate various alternative solutions to the distortions identified during Research Phase II – Empirical Evidence. When evaluating the VAT solutions, the PwC project team has been particularly mindful of the following three main elements:

- **Combating distortions**: the extent to which the solutions address the inefficiencies caused by the distortions identified in Research Phase II (based on the empirical evidence found in Research Phase II);
- **Ease of implementation**: the ease of implementation for economic operators and revenue authorities of each of the solutions identified;
- **Future proof**: the extent to which the solutions keep pace with, and facilitate changes in, the financial services industry (i.e. the long-term effects of the solutions have been taken into account as the solutions should not only be compatible with the overall development of the Single Market, the framework of the Financial Services Action Plan[45] and the Lisbon Objectives[46] but should actually be designed to last for another 30 years).

[45] "White Paper on Financial Services Policy (2005-2010)" at http://europa.eu.int/comm/internal_market/finances/ policy/index_en.htm.
[46] 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.

1.2.3.2 Identification of Alternatives

1.21 In Chapter 7, we have presented potential solutions taking into account the conclusions from our previous Research Phases.

1.22 As a first step, a review of existing international models of financial services taxation has been performed and, more specifically, experiences in non-EU countries that have VAT type tax systems (e.g. Australia, Singapore and New Zealand), indicating:

- how their existing systems work;
- findings of national expert groups that have evaluated the implementation of VAT type taxes in these jurisdictions;
- the experiences (advantages/disadvantages) of the existing models to date.

1.23 This information has been gathered from:

- our PwC financial services specialists having experience with VAT type tax systems in non-EU countries and who have been involved in the studies that were preliminary to the introduction of those models;
- publications of studies provided by financial sector study groups;
- publications from the authorities in the respective non-EU countries on how the existing models work.

1.24 Secondly, careful consideration has been given to the Sixth EU VAT Directive, considering to what extent, for example:

- definitions of exempt services contained in article 13 of the Sixth EU VAT Directive should be adapted to take into account developments in the financial services industry;
- changes could be made to EU legislation clarifying or simplifying the analysis of composite (complex) services – in so far as they can be fragmented – and allowing the identification and discrete treatment of exempt components;
- VAT Grouping should be introduced by all Member States (harmonisation of the European market);
- VAT Grouping, recovery methods and tax authority co-operation should be cross-border;
- alternative recovery methods can be implemented, and if needed per sector in order to abolish the existing (often unduly complex) methodologies used to recover VAT;
- it is possible to clarify the key criteria for applying existing exemptions to outsourced services.

1.25 This information has been gathered from:

- a comprehensive analysis of both EU and non-EU legislation (where relevant) as well as decisions of the European Court of Justice (ECJ) and feedback from the PwC Financial and Insurance Services VAT/GST Network;
- publications of studies provided by financial sector study groups;
- publications by universities;
- OECD reports.

The output of this exercise is a number of possible alternatives as outlined in Chapter 7.

1.26 The European Commission's Terms of Reference also explicitly required that one of the measures to be looked at be the option to tax accompanied by simplified pro rata deductibility. Experiences, with pros and cons, with respect to existing option systems in other Member States have been taken into account as a basis/starting point.

1.2.3.3 Systematic Evaluation of Alternative Approaches

1.27 In accordance with the evaluation criteria as set out in Chapter 6, the proposed alternatives have been evaluated in Chapter 8.

1.28 The proposed alternatives have been evaluated by applying them to the case studies from Research Phase II – Empirical Evidence. These solutions have been described more in-depth in Chapter 8 by investigating:

- to what extent the proposed alternatives at a macro level are feasible solutions valid for the financial sector as a whole;
- whether the solutions are valid for a specific financial service or sector, taking account of the needs for each sub-sector, and;
- whether the proposed alternatives are valid for transactions cross-border, i.e. between all EU25, mindful of the neutrality of the VAT system.

1.29 The output of this exercise is a description of the alternatives that have been evaluated on their merits, concluding, in Chapter 8, with an analysis of those solutions that have ultimately been selected.

1.30 For the alternatives selected, it has been demonstrated why and to what extent they are valid for transactions cross-border, i.e. between all EU25, mindful of the neutrality of the VAT system.

1.31 As is the case for the evaluation of the option to tax alternative, the recommendations contain our assessment on the appropriateness to implement such system, indicating and taking into account the potential gains from increased efficiency and competitiveness in the sector.

1.32 Finally, the various alternatives have been applied to the case studies from Research Phase II – Empirical Evidence. The recommendations have been tested with the Expert Panel and, if appropriate, the solutions have been amended or modified to reflect expert feedback.

1.2.4 Involvement of the Expert Panel

1.33 The role of the Expert Panel has been to act as a sounding board, to advise and challenge on our findings. The Expert Panel played a significant role in our Study by offering a forum for discussion. This forum did not simply consist of VAT/GST specialists but also of specialists in other identified areas of expertise that are relevant to the financial services sector.

1.34 In this respect, the Expert Panel has been composed of:

- 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.

1.35 A workshop with the Expert Panel was held on 2 June 2006. During that day, PwC presented their findings in respect of identified inefficiencies associated with the existing VAT regime (Research Phase II – Empirical Evidence). At this stage, the Expert Panel was encouraged to critically analyse and discuss these findings to increase the robustness of our findings.

1.36 Through this review process, we have been enhancing the cross-fertilisation process amongst industry experts, relevant academics and members of the PwC project team.

1.37 In addition, the various evaluation criteria and each of the proposed solutions were discussed at a full-day meeting on 5 September 2006. The purpose of the meeting was to invite the Expert Panel to systematically evaluate our proposed solutions with a view to ensuring that we considered all potential implications of the proposed solutions. In this respect, the Expert Panel brought a fresh and critical perspective to the Study and added significant value by bringing their particular and special expertise to bear.

1.2.5 The PwC Project Team

Table 1.2 presents an overview of the core PwC project team.

Table 1.2: Overview of Core PwC Project Team

Name	PwC Office	Line of Service	Grade	Project Role
Ine Lejeune	Brussels	VAT	Partner	Project Director
Frans Oomen	Amsterdam	VAT	Partner	Manager
John Fay	Dublin	VAT	Partner	Manager
Stephen Coleclough	London	VAT	Partner	Manager
Cathy Hargreaves	London	VAT	Partner	Manager
Antony Brooker	London	VAT	Manager	Research
Elisabeth Bott	London	VAT	Manager	Research
Colm Blaney	Dublin	VAT	Director	Research
Rachael Morgan	Dublin	Corporate Finance - Advisory	Director	Research
Inge Stuyver	Brussels	VAT	Senior Manager	Project Manager
Bart Caluwé	Brussels	VAT	Senior Consultant	Research

1.38 Ine Lejeune, Leader of the Global VAT/GST Network of PwC and VAT Partner with PwC Belgium, assumed overall responsibility for the assignment and for the quality of the final deliverable. John Fay, VAT Partner with PwC Ireland, Frans Oomen, Financial Services VAT Leader & VAT Partner with PwC Netherlands, and Stephen Coleclough, VAT Partner with PwC UK, had day-to-day responsibility for the management of individual research tasks, with assistance provided by a selection of Irish, UK, Dutch and Belgium-based (senior) managers and consultants (see Annex IV for CV's).

1.39 The PwC project team would also like to thank the members of the PwC Financial and Insurance Services VAT/GST Network for their contributions with respect to both the survey and the reading of the final report.

Table 1.3 presents an overview of our PwC VAT/GST experts in the various countries that have contributed in addition to the core team.

Table 1.3: PwC Financial and Insurance Services VAT/GST Country Experts[47]

Europe	
Country	**Country Experts**
Austria	Christine Sonnleitner
Belgium	Manuel Van Der Veken
Bulgaria	Malina Marinova Milen Raikov Teodosiya Kirilova
Cyprus	Chrysilios Pelekanos
Czech Republic	Vaclav Patek
Denmark	Jan Huusmann Christensen
Estonia	Ain Veide
Finland	Juha Laitinen
France	Stéphane Henrion Nathalie Martin-Queulin
Germany	Sylvia Neubert
Greece	Mary Psylla
Hungary	Tamas Locsei
Italy	Nicola Broggi
Latvia	Zlata Elksnina-Zascirinska
Lithuania	Kristina Bartuseviciene
Luxembourg	Michel Lambion
Malta	David A. Ferry
Norway	Yngvar Engelstad Solheim
The Netherlands	Michel Schrauwen Edwin van Kasteren
Poland	Marcin Chomiuk
Portugal	Mario Braz
Romania	Diana Coroaba
Slovakia	Eva Fricova
Slovenia	Crtomir Borec
Spain	Miguel Blasco
Sweden	Lars Henckel
Switzerland	Tobias Meier Kern

Rest of World	
Country	**Country Experts**
Australia	Ken Fehily
New Zealand	Paul Mersi
Singapore	Soo How Koh Colin Eades
South Africa	Charles De Wet Leon Oosthuizen

[47] Countries in italics are non-EU countries. The countries where no VAT/GST expert contributed other than the core team are not mentioned.

1.2.6 The PwC Deliverables and Timing

1.40 Report drafting started as from mid-February 2006, with each of the deliverables presented in Table 1.4 constituting some component of the proposed full draft report.

Table 1.4 presents an overview of PwC's project deliverables and their timing.

Table 1.4: PwC Deliverables and Timing

Deliverable	Completion Deadline
Kick-off Meeting with European Commission	31 January 2006
Research Phase I – Problem Definition	
Description of VAT Treatment of Financial Services inside and outside EU25	Mid-February
Research Phase II – Empirical Evidence	
Deciding on Case Study Companies	Mid-February
Drafting of Case Study Template	End of February
EU25 Case Study Reports (including Interviews)	Mid-March
Extra EU25 Case Study Reports (including Interviews)	Mid-March
Meeting with European Commission to discuss Approach	20 March 2006
Write-up of Research Phase II (VAT Distortion within EU25)	End of March
Meeting with EU Commission	3 May 2006
Revised Draft Report (Input from European Commission)	Mid-May
Workshop with Expert Panel	2 June 2006
Revised Report (Input from Expert Panel)	Mid-June
Research Phase III – VAT solutions	
Formulation of Evaluation Criteria for VAT Solutions	Mid-April
Description of VAT Solutions	End of April
Evaluation of VAT Solutions	Mid-May
Workshop with Expert Panel	2 June 2006
Revised draft Report (Input from Expert Panel)	Beginning of July
Meeting with European Commission	18 July 2006
Revised Draft Report (Input from European Commission)	Mid-August
Meeting with Expert Panel	5 September 2006
Revised Draft Report (Input from Expert Panel)	Mid-September
Full Report	
Final Meeting with European Commission	26 September 2006
Final Report	2 November 2006

1.41 The ultimate deliverable is a full final report written in a language that will render the results and recommendations accessible to both the lay reader and the expert reader, in a publication-friendly format.

RESEARCH PHASE I: PROBLEM DEFINITION

CHAPTER 2 VAT AND FINANCIAL SERVICES

2.1 Introduction

2.1 The primary purpose of this Chapter is two-fold, namely:

- to provide a basic introduction to the VAT-related issue which forms the basis of this Study, i.e. problem definition;
- to describe details of the VAT treatment of financial services within the EU25 and to place this in an international context.

2.2 The remainder of this Chapter comprises four Sections, the next of which provides a basic introduction to VAT within the EU25. Section 2.3 describes the scope for Member State discretion in the VAT treatment of financial services, having regard to findings of an EU25 VAT survey undertaken by PwC as part of this assignment. The pre-accession VAT treatment of financial services in new EU25 Member States is the subject of Section 2.4, while Section 2.5 places EU25 arrangements in an international context.

2.3 A high-level profile of the distortions that could arise from existing VAT arrangements, the review of which lies at the heart of this assignment, is the subject of Section 2.6.

2.2 Value Added Tax and the Sixth EU VAT Directive

2.2.1 Value Added Tax Defined

2.4 Value Added Tax (VAT) is defined in article 2 of the First Council VAT Directive (67/227/EEC) as follows:

"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".

2.5 Table 2.1 shows a simple example of how VAT is intended to operate in practice.

Table 2.1: VAT in the Product / Service Production Cycle

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

Table 2.1 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 typically 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 in the example provided in Table 2.1.

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.

2.2.2 The Sixth EU VAT Directive and Financial Services

2.6 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, in principle, no credits are allowed on the inputs which are used to produce these VAT exempt services[48]. Research commissioned by the OECD[49] indicates that the European Union is not exceptional in its VAT treatment of financial services. International commonality in this regard is attributed to the reported practical difficulties entailed in the application of mainstream VAT to financial services:

"There is no readily apparent means under the normal VAT system to allocate the margin (measured for corporate tax and financial reporting purposes on an aggregate basis as the difference between interest received and interest paid by the financial institution) to individual transactions which is a necessary requirement if commercial entities are to be able to claim refunds of VAT paid on financial services"[50].

[48] This contrasts with a zero rated status, whereby no VAT is payable on the final good or service, but the supplier qualifies for credits in respect of VAT paid for the production of the zero rated good/service.
[49] Indirect tax treatment of Financial Services and Instruments, OECD ,1988: http://www.oecd.org/dataoecd/9/26/1915300.pdf.
[50] HA Kogels - General Report, "Consumption taxation and financial services", Volume LXXXVIIIb, International Fiscal Association, 2003 Sydney Congress.

2.7 The Sixth EU VAT Directive provides that financial services as defined under articles 13(B)(a) and (d) are VAT exempt. This exemption, being an exception to the general application of VAT, needs to be interpreted restrictively. 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 in defining the scope and application of the exemption. Confusion is evidenced in a number of national court cases, as well as a growing number of referrals to the European Court of Justice (ECJ). An indicative listing of ECJ cases is provided in Annex I to this report.

2.8 Three factors which may underpin a growing number of ECJ referrals are:

Divergence between Definitions used for Regulatory and Tax Purposes;
While, in the year of adoption of the Sixth EU VAT Directive, there may have been a high-level of overlap between the national definitions of financial services used for the purposes of VAT and those used for regulatory purposes in the European Union, the gradual broadening of the range of financial services falling into the regulatory ambit means that this may no longer be the situation. For this reason, regulatory definitions may no longer provide guidance.

Relative Complexity of Financial Services and Products;
Closely related to the foregoing, the more complex nature of financial services and products in 2006 vis-à-vis 1977[51] would appear to have compounded definitional issues.

Practice of Outsourcing;
The practice of outsourcing has raised issues regarding what precisely constitutes a financial service in its own right as opposed to something that is merely an input to a financial service.

[51] The range of financial services has increased significantly, examples of financial services which were not mainstream in 1977 or did not exist include *inter alia*: derivative products, securitisation products, structured financing and hedge funds.

2.2.3 VAT Exemption and B2B Transactions

2.9 As indicated in Chapter 1, the primary emphasis of this Study is VAT on financial services supplied to businesses or taxable entities.

Table 2.2 *illustrates* the impact of the VAT exemption on such transactions. In this example, it is assumed that none of the input tax paid by the suppliers is deductible.

Table 2.2: The Impact of the VAT Exemption (Business to Business)

	VAT Exempt		Non-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

2.10 Key points to note from Table 2.2 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, i.e. for the formation of strongly vertically integrated enterprises;
- 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;
- this is not the case for suppliers C and D, who are not VAT exempt – net input costs in the case of both standing at €10,000;
- 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 alternatively, the embedded VAT cost may be absorbed into the total operating cost base of the exempt suppliers – with implications for profit margins (Scenario 2);
- the third alternative is obviously a combination of Scenario 1 and Scenario 2, which is not illustrated in Table 2.2.

2.11 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. This is illustrated in Table 2.3, which shows the net input costs of supplier A in Table 2.2 when different EU25 locations are assumed, i.e. Hungary (25%), Ireland (21%) and Luxembourg (15%).

Table 2.3: Illustrative Example of Country-Specific VAT-related Cost Advantage

	Supplier A	Supplier A	Supplier A
VAT Exempt	Yes	Yes	Yes
Assumed Country Location	HU	IE	LU
Total Cost of Inputs (VAT Exclusive)	€10,000	€10,000	€10,000
Total Cost of Direct Employment	€1,000	€1,000	€1,000
VAT Exclusive Cost of Vatable Inputs	€9,000	€9,000	€9,000
Rate of VAT	25%	21%	15%
VAT Component of Input Costs	€2,250	€1,890	€1,350
Net Input Costs	€12,250	€11,890	€11,350
Scenario 1 (Embedded VAT Absorbed in Service Price)			
Total Revenues (VAT Exclusive)	€14,250	€13,890	€13,350
Net Profit before Tax	€2,000	€2,000	€2,000
Scenario 2 (Embedded VAT Absorbed in Profit Margin)			
Total Revenues (VAT Exclusive)	€12,000	€12,000	€12,000
Net Profit before Tax	(€250)	€110	€650

Table 2.3 shows that the net input costs of supplier A, i.e. a VAT exempt provider of financial services to business, are lowest in case of the country with the lowest standard rate of VAT and highest in the case of the country with the highest standard rate of VAT.

The data contained in Table 2.3 are, however, intended for illustrative purposes only, having no regard to the fact that the effective rate of VAT may be below the standard rate[52] nor to differences between EU25 jurisdictions in the cost of inputs, e.g. labour or purchased goods.

[52] Reflecting the fact that certain products and services qualify for lower rates of VAT in each of the "hypothetical" locations.

2.2.4 VAT Treatment of Financial Services and Tax Principles

2.12 Basic principles of sound general systems of taxation include the following:

- **simplicity** – tax systems should be capable of being relatively easily understood;
- **efficiency** – compliance costs for authorities and taxpayers should be minimised;
- **certainty** – tax costs should be capable of easy and certain computation.

2.13 In addition to these broad principles of taxation, the preamble to the various Council Directives on VAT and the text of selected ECJ rulings set out a number of additional principles which relate specifically to VAT, including:

- **broad-based** – or the need to *limit special systems and exceptional measures*[53];
- **proportionality** – or the requirement that *the taxable amount … cannot exceed the consideration actually paid by the final consumer*[54];
- **non-distortionary** – or the need to ensure *neutrality in competition between Member States*[55] and to ensure that *within each country, similar goods should bear the same tax burden whatever the length of the production or distribution chain*[56];

2.14 With regard to proportionality, Table 2.4 shows that the principle of proportionality is capable of being breached when a VAT exemption applies.

Table 2.4: VAT Exemption and the Principle of Proportionality

	Sales (VAT Exclusive)	Purchases	Tax @ 21%	Tax Reporting
Supplier A (to Supplier B)	€1,000		€210[57]	€210
Supplier B (to Supplier C) (B = VAT Exempt)	€2,000	(€1,210)	€0	€0
Supplier C (to Consumer D)	€3,000	(€2,000)	€630	€630
Consumer D		(€3,630)		-
Total				€840

Table 2.4 shows that, assuming an applicable VAT rate of 21%, the aggregate VAT inflow to the fiscal authority under the scenario presented in Table 2.4 is €840 as opposed to €630 which is the VAT charge to the final consumer (i.e. €3,630 - €3,000).

This higher charge is the result of irrecoverable VAT embedded in the price of services early in the production cycle, i.e. when exempt supplier B sells to supplier C.

[53] Preamble to Second Council Directive, 67/228/EEC.
[54] ECJ judgement of 24 October 1996 in *Elida Gibbs Ltd v. Commissioners of Customs and Excise*, Case C-317/94, Para. 19.
[55] Preamble to Second Council Directive, 67/228/EEC.
[56] ECJ judgement of 24 October 1996 in *Elida Gibbs Ltd v. Commissioners of Customs and Excise*, Case C-317/94, Para. 20.
[57] This is the embedded VAT cost to exempt supplier B.

2.15 Finally, Table 2.3 provided an illustrative example of how the *non-distortionary* principle of VAT may be contravened in the case of VAT exempt suppliers. This potential for competitive distortion has also been noted in various academic publications on EU25 VAT:

"When a different tax burden, caused by the various degrees of integration of businesses, is borne by identical products, the business that has to pay the highest tax cannot fully shift the tax burden forward if it wants to remain competitive.

The business will have to bear part of the tax burden itself and this is contrary to the legal intentions of the legislator. In other words in these situations the tax is not competition neutral"[58].

2.16 The fundamental principles of taxation and VAT, as expressed in the Council Directives and in the text of relevant ECJ rulings, will be given explicit consideration in the formulation of evaluation criteria for proposed solutions in Chapter 6 of the report.

2.3 Differences between EU25 Member States

2.17 The Sixth EU VAT Directive provides a binding framework for the VAT treatment of financial services within EU25 Member States. Notwithstanding this fact, there are important differences between Member States in implementation or practice. These differences stem from some combination of the following:

- the interpretation of financial services which is applied, there being no exhaustive definition contained in the text of the Sixth EU VAT Directive;
- the extent to which the options contained in, and derogations from, the Sixth EU VAT Directive are exercised by Member States;
- differences between the official language versions of the Sixth EU VAT Directive, with these being on occasion the subject of ECJ cases;
- the application of national tax rules to the VAT environment, e.g. practices with regard to the allocation of input costs to distinct taxable inputs;
- the manner in which Sixth EU VAT Directive provisions in areas such as the computation of deductible VAT are transposed into national legislation and, indeed, differences of legal approach and interpretation;
- differences of interpretation of ECJ cases in various Member States.

[58] Terra, B. and C. Kajus, "A Guide to the European VAT Directives", http://online2.ibfd.org/evd, *International Bureau for Fiscal Documentation*, Volume 1, 2005, page 396.

2.18 Research undertaken by PwC regarding the VAT treatment of financial services within the EU25 points to significant differences between Member States.

Selected findings are presented in Tables 2.5 to 2.7 inclusive.

2.19 In reviewing these tables, however, it should be borne in mind that Member States apply different definitions to financial services (e.g. the management of special investment funds or insurance related services) details of which are not and cannot be reflected in the tables which follow. It should also be noted that in many cases, there is no or only limited public guidance available, meaning that the precise VAT treatment is uncertain. This was often the case in the Member States that joined the EU on 1 May 2004[59]. When there was no or only limited guidance on the VAT treatment, we refer in the tables to no/limited Member States guidance.

[59] The 10 new Member States were Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia – results for the 10 new Member States have been specified between brackets in the various Tables.

Table 2.5: VAT Treatment of Insurance, Banking and Investment Services (25 Member States)

Insurance Sector	Exempt	Taxable/Tax Option	Outside Scope	No/limited Guidance	Total
Insurance & Reinsurance Transactions	25 (10)	0	0	0	25
Insurance-related Services	25 (10)	0	0	0	25
Banking Sector	**Exempt**	**Taxable/Tax Option**	**Outside Scope**	**No/limited Guidance**	**Total**
Granting of Credit	22 (8)	3 (2)	0	0	25
Management of Credit	20 (7)	3 (2)	0	2 (1)	25
Intermediary Credit Negotiation	20 (6)	3 (2)	0	2 (2)	25
Deposit	21 (8)	4 (2)	0	0	25
Intermediary Deposit	19 (8)	4 (1)	0	2 (1)	25
Payment Transactions	20 (8)	5 (2)	0	0	25
Transfers in Receivables/Debts	21 (8)	4 (2)	0	0	25
Registration of Securities	16 (5)	4 (1)	1 (1)	4 (3)	25
Depositary Services	6 (2)	12 (5)	0	7 (3)	25
Investment Management Sector	**Exempt**	**Taxable/Tax Option**	**Outside Scope**	**No/limited Guidance**	**Total**
Management of Securities	6 (1)	15 (5)	0	4 (4)	25
Management of Special Investment Funds	20 (7)	3 (1)	0	2 (2)	25
Global Custody	11 (5)	5 (1)	0	9 (4)	25
Fund Administration	15 (5)	7 (3)	0	3 (2)	25
Investment Advice	9 (3)	13 (7)	0	3	25
Rebalancing Fees	13 (5)	0	1 (1)	11 (4)	25
Bookkeeping	9 (3)	15 (6)	0	1 (1)	25
Net Asset Value Computation	11 (4)	11 (5)	0	3 (1)	25
Accountancy Fees	9 (3)	15 (6)	0	1 (1)	25

Source: PwC Survey October 2006

Table 2.6: Overview of Treatment of VAT Groups and Cost Sharing (25 Member States)

	Yes	No	No/limited Guidance	Total
Is a VAT/GST Group allowed in your Country?	12 (3)	13 (7)	0	25
Is a Cross-Border VAT/GST Group allowed in your Country?	2	23 (10)	0	25
Is a VAT/GST Exempt Cost Sharing Provision available by Law?	16 (5)	9 (5)	0	25
Is a VAT/GST Exempt Cost Sharing Provision available in Practice?	11 (2)	11 (5)	3 (3)	25
Is VAT/GST Exempt Cross-Border Cost Sharing allowed?	3	12 (5)	10 (5)	25

Source: PwC Survey October 2006

Table 2.7: Computation of Deductible VAT (25 Member States)

	Yes	No	No/limited Guidance	Total
Is a general Pro Rata Calculation applicable?	23 (10)	2	0	25
Is a System of Attribution of Goods & Services to Taxable/Non-taxable Sectors applicable?	24 (10)	1	0	25
Can a Taxable Person be compelled to make a Deduction on a Use Basis?	18 (6)	6 (4)	1	25
Can a Taxable Person be compelled to determine a Proportion for each Sector?	15 (2)	10 (8)	0	25
Can a Taxable Person be authorised to determine a Proportion for each Sector?	18 (5)	7 (5)	0	25

Source: PwC Survey October 2006

2.20 Key findings from Table 2.5 are the following:

- there would appear to be a relatively high-level of uniformity in the VAT treatment of non-intermediary insurance services across the EU25, although the treatment of insurance services provided by intermediaries is less uniform;
- by contrast, there is some level of divergence between Member States in the VAT treatment of distinct banking services – with certain services subject to some legal uncertainty (e.g. security registration or intermediary credit negotiation);
- in the investment management sector, there appears to be a wide divergence in the VAT treatment of services across the EU25;
- in the case of investment advisory services, for example, these are exempt in nine Member States, taxable (or option to tax) in thirteen and the subject of legal uncertainty in three;
- similarly, in the case of global custody services – these are exempt in eleven Member States, taxable (or option to tax) in five and the subject of legal uncertainty in nine.

2.21 Key findings from Table 2.6 are the following:

- VAT Groups[60], following article 4(4) of the Sixth EU VAT Directive, are permitted in twelve Member States and not permitted in thirteen;
- cross-border VAT Groups in practice are permitted in two Member States only, i.e. the United Kingdom[61] and the Netherlands[62];
- the number of Member States which allow, in practice, for VAT exempt cost sharing between corporate entities is eleven – fewer than the number for VAT Groups;
- again, however, the number of Member States which allow for such VAT exempt cost sharing on a cross-border basis is small – at just three.

2.22 Table 2.7 shows that there is a broad comparability among EU25 Member States regarding accepted means of computing deductible VAT, although there is some obvious divergence in terms of revenue authorities' powers to compel businesses to comply with a particular methodology, e.g. separate sector computations and/or VAT deduction on a usage basis.

2.23 A particularly noteworthy finding from the PwC analysis of the VAT treatment of financial services within the EU25 was the limited use of the option to tax specified financial services contained in article 13(C) of the Sixth EU VAT Directive.

While the use of this option might potentially by-pass many of the problems associated with an embedded VAT cost, practical difficulties in its application (i.e. the determination of the value of the supply) mean that it has been exercised by few Member States.

[60] Which essentially refers to the practice of revenue authorities allowing separate corporate entities to form a group for VAT purposes and, thereby, incurring no VAT charge on intra-group transactions.
[61] Overseas branches of UK companies are permitted as members of UK VAT Groups – Section 43 of VAT Act 1994.
[62] Supreme Court of the Netherlands, No. 35.976, 14 June 2002.

2.4 VAT Treatment of Financial Services in New Member States

2.24 Upon accession to the EU25, the VAT treatment of financial services sectors in the new Member States was required to conform with the provisions of the Sixth EU VAT Directive. As a context to the case studies involving firms with significant (pre-accession) business interests in the new Member States, it was considered appropriate to present a high-level overview of the changes that were effected to the VAT treatment of the financial services sector upon accession.

2.25 According to PwC research, accession to the EU25 resulted in positive changes in the VAT environment of financial institutions in the new Member States. More specifically, the alignment of national law with the provisions of the Sixth EU VAT Directive and in line with ECJ case law has resulted in a more level playing field between the accession countries and the original 15 Member States. The recoverability of input tax attributable to services provided to non-EU25 clients was cited as an example in this regard. This was not commonplace prior to accession.

2.5 VAT Treatment of Financial Services in Selected Non-EU Countries

2.26 While at one level, the non-EU countries surveyed by PwC have adopted a similar approach as embodied in the Sixth EU VAT Directive, there are some important differences which contribute to what has been argued is a more efficient and fair model and which seem to avoid some of the potential distortive impacts that have set the frame of reference for this Study.

2.27 For example, in New Zealand - while exemption is afforded to many supplies of financial services - these supplies can be zero rated (at the option of the supplier) when made to principally taxable persons[63]. This ensures that financial service providers can recover a substantial or significant element of the GST incurred on inputs purchased from third-party suppliers. It is also interesting to note that in New Zealand, the GST exemption is limited to certain supplies of insurance such as supplies of life insurance (and life reinsurance) and insurance of risks under certain financial instruments, i.e. the general insurance market is taxable.

[63] GST Guidelines for Working with New Zero Rating Rules for Financial Services, Published by Policy Advice Division of the Inland Revenue Department (New Zealand), October 2004.

2.28 The New Zealand system of taxation of non-life insurance would seem to have been followed in a number of other countries (including Australia and South Africa[64]) and very broadly taxes gross premiums but gives insurers the ability to reclaim deemed input tax on indemnification payments, whether or not made to GST-registered insured parties. The model used taxes an insurer's cash flows as a surrogate for value added.

2.29 With regard to Australia, the exemption approach to financial services applies in principle so that a denial of input credit entitlement arises for GST incurred on related costs. However the distortive impact of the input credit provision is mitigated by what is termed the *Reduced Input Tax Credit* (RITC) scheme. This is a unique feature of the Australian GST code and allows suppliers of financial services to recover 75% of tax paid on specified inputs. The object of the RITC scheme is to eliminate the bias to vertical integration (self-supplying inputs) and to facilitate outsourcing presumably from a cost efficiency perspective. The inputs that give rise to an RITC are itemised in regulations, but include the following:

- transaction banking and cash management services;
- payment and fund transfer services;
- securities transactions services;
- loan services;
- debt collection services;
- funds management services;
- insurance brokerage and claims handling services;
- trustee and custodial services;
- supplies for which financial supply facilitators are paid a commission[65].

2.30 While some elements of these services may qualify for exemption in their own right under the Sixth EU VAT Directive, the RITC scheme is an interesting concept and may contribute to the elimination of the bias against outsourcing inherent in other systems.

2.31 Looking further afield, the most noteworthy example of a country which does not operate a VAT system is the United States (US). The United States does not impose any federal tax on consumption, with most individual States imposing single-stage retail sales taxes that do not apply to financial services. This could place US-based providers of financial services at a cost advantage to their equivalents in EU25 jurisdictions, which some commentators[66] have observed results in potential for unfair competition on the EU25 market.

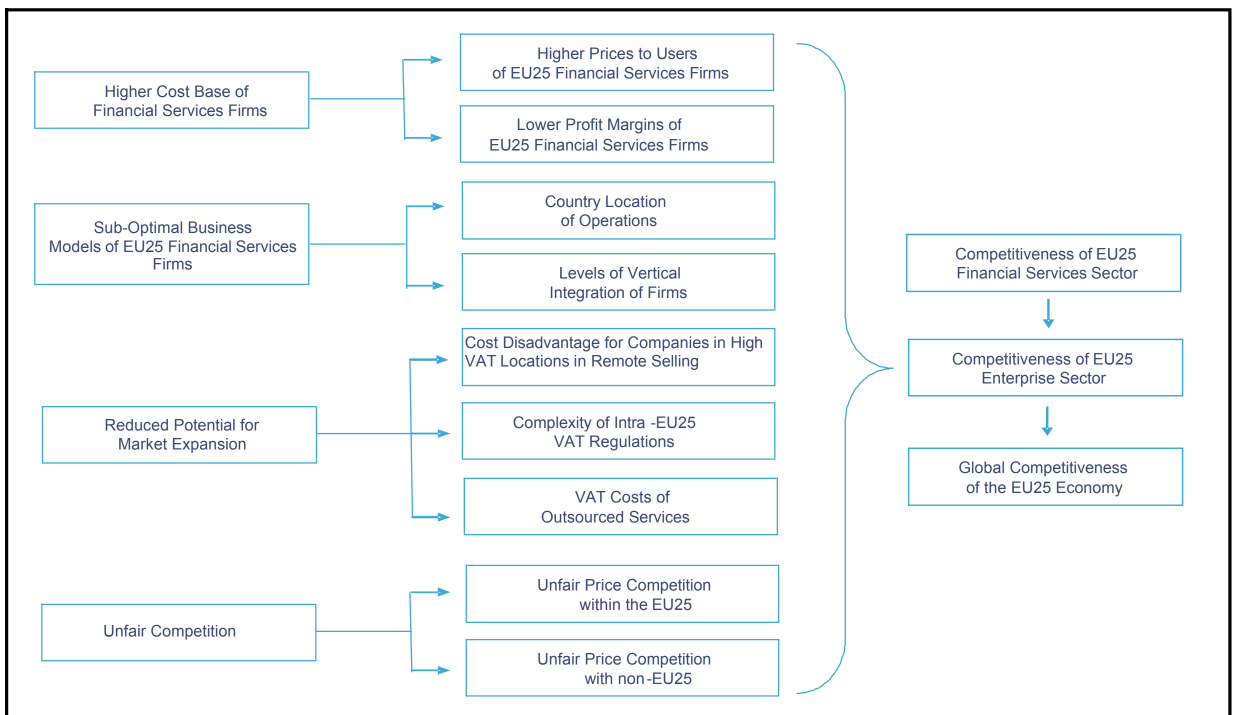
[64] The Value Added Tax Act, no 89 of 1991 provides that various financial services are exempt from VAT for example long term insurance (sec 2(1)(i) and sec 12(a)). However short term insurance and commissions received from selling long term and short term insurance are taxable supplies and subject to VAT at 14%.
[65] Australia branch report by Peter McMahon, "Consumption taxation and financial services" Volume LXXXVIIIb, International Fiscal Association, 2003 Sydney Congress.
[66] Including Alan Schenk - United States branch report, "Consumption taxation of financial services" Volume LXXXVIIIb, International Fiscal Association, 2003 Sydney Congress.

2.6 Profile of Distortions for Empirical Examination

2.32 The foregoing Sections provided an overview of the VAT treatment of financial services within the EU25 and placed this within a wider international context. The purpose of this Section is to present a concise overview of the most significant distortions that could arise from the existing VAT treatment of financial services within the EU25 and which will be subject to empirical examination as part of the case study research.

In this Section, and consistent with the Terms of Reference for this Study, the emphasis is on business to business transactions. This approach reflects the reality of the situation that the intra-EU25 and inter-EU25 market for financial services, where VAT-related distortions are most likely to arise, is dominated by business to business transactions. In other words, non-business buyers of financial services are less likely to look beyond their domestic market.

Figure 2.1: PwC Schematic of Potential VAT-related Distortions for Empirical Examination



2.33 A high-level schematic of the nature of such distortions is presented in Figure 2.1.

The schematic presented at Figure 2.1 is one-dimensional by necessity, there clearly being a whole host of inter-dependencies between the potential distortions identified.

For example, sub-optimal business models have implications for the cost base of financial services firms which, in turn, impacts profitability and/or the prices charged to end users.

2.34 Similarly, VAT-related constraints to market expansion have important implications for the scale of operations which, in turn, impacts the scope for realising fixed cost efficiencies.

A high-level description of the major potential distortions shown is presented in Table 2.8.

Table 2.8: Description of Major Potential VAT-related Distortions for Empirical Examination

Higher Cost Base of Financial Services Firms 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, *ceteris paribus*, for firms which have no embedded VAT costs. This could be reflected, *inter alia*, 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 (shared service centres). 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, costs of labour, then this has the scope to impair the competitiveness of the firm.
Vertical Integration	As indicated clearly in Table 2.2, the VAT exemption of financial services could constitute an incentive to the vertical integration of firms, and a disincentive to 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 general 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 disproportionate 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 European Commission. Moreover, the further development of the Internal Market is cited as a core objective of the Austrian and Finnish Presidencies of the Council of the European Union in 2006.
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.

2.35 The case study research, which will be prepared as part of Research Phase II – Empirical Evidence of this study, will be used to test the validity and comprehensiveness of the outline schematic of VAT-related distortions, as well as to measure the intensity of any identified distortions.

RESEARCH PHASE II: EMPIRICAL EVIDENCE

PREFACE

This Research Phase presents findings from the primary and secondary research tasks of the assignment, which essentially were designed to determine the extent to which there is empirical evidence of distortions in the EU25 market for financial services as a result of their current VAT treatment.

It comprises two Chapters, the first of which presents findings from PwC case study research (Chapter 3).

Chapter 4 presents findings from the PwC review of relevant secondary materials – which had a strong emphasis on determining the extent to which there was statistical evidence of distortions in the EU25 market for financial services vis-à-vis that in other developed economies/regions.

CHAPTER 3 CASE STUDY RESEARCH FINDINGS

3.1 Introduction

3.1 This Chapter presents findings from PwC case study research. The PwC project team interviewed representatives from a broad range of financial services firms in the EU25, who were required to complete a detailed template prior to talking with the PwC project team.

3.2 The primary purpose of this Chapter is two-fold, namely:

- to present quantitative findings from the case study research, with these including financial details such as the value of embedded VAT costs in 2005 as well as respondents' views on issues such as VAT-related constraints to the exploitation of Single Market opportunities;
- to present empirical evidence, to the extent that such exists, as to how the VAT treatment of financial services in the EU25 is distorting the European financial services sector.

3.3 The remainder of this Chapter comprises nine additional Sections, the next of which describes the case study research approach in more detail. Section 3.3 presents a profile of respondent companies, which, for the purposes of confidentiality, cannot be named. In Section 3.4, findings with respect to the absolute and relative value of irrecoverable VAT embedded in the cost structure of Case Study Companies are presented.

3.4 Respondents' views on the extent to which the financial services VAT exemption creates a less than level playing field between EU25 and non-EU25 competitors are the subject of Sections 3.5 and 3.6 respectively. The influence exerted by VAT regulations on the choice of EU25 location of financial services operations is the subject of Section 3.7. Case study findings regarding the role played by VAT in the decision to outsource or establish shared service centres are presented in Section 3.8. Section 3.9 considers the extent to which VAT has frustrated Case Study Companies in terms of fully exploiting Single Market opportunities.

3.5 Key chapter findings are presented in Section 3.10.

3.2 Research Approach

3.6 The research approach adopted incorporated a series of distinct tasks, including:

- 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.

3.7 The use of a Case Study Template, in conjunction with follow-up discussions with Case Study Companies was designed to ensure that a standard set of information (partially quantitative) was received from all Case Study Companies as well as to maximise the information return on face-to-face consultation time, as deemed necessary. A copy of the template is attached as Annex II to this report.

3.8 The potential weakness of a case study, as opposed to a purely survey-based approach, is that it is more constrained in terms of enterprise or company reach. The relatively complex nature of the subject matter, coupled with the very considerable resources required for companies to collate information of the nature required, however, effectively precluded the use of a survey-based approach.

3.9 While confidentiality issues mean that Case Study Companies may not be named in this Study, PwC would like to extend its sincere gratitude to the sixteen companies and their representatives who gave very generously of their time in completing Case Study Templates and talking with the PwC project team. A full statistical analysis of findings is presented as Annex III.

3.3 Profile of Respondent Companies

3.10 While confidentiality issues preclude the inclusion of a full list of Case Study Companies, it is instructive to present a profile of the companies with whom the PwC project team have consulted as part of this exercise.

An overview of all companies who have submitted Case Study Templates is presented in Figures 3.1, 3.2, 3.3 and 3.4. The case study research was carried out in the period March-April 2006.

Figure 3.1: Sectoral Profile of Case Study Companies

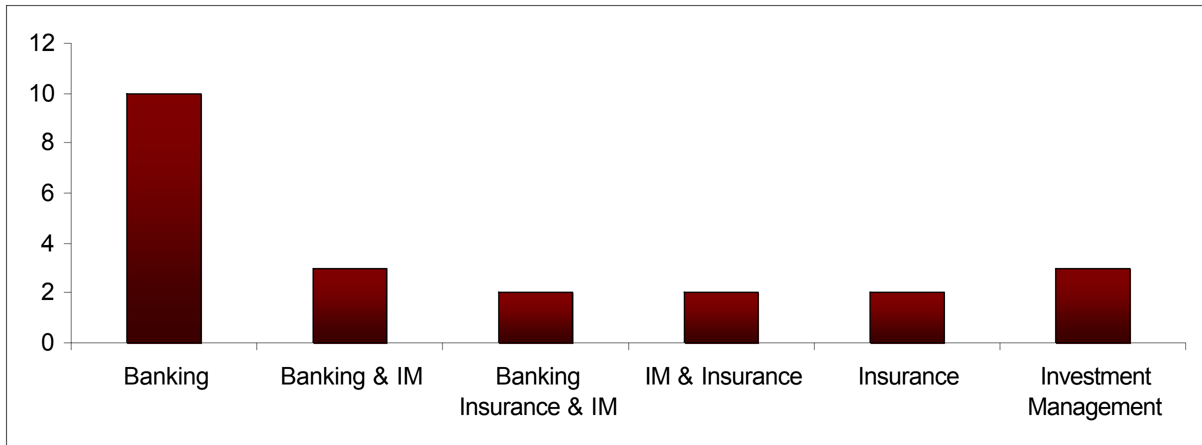


Figure 3.2: Country Location of Case Study Companies' Headquarters

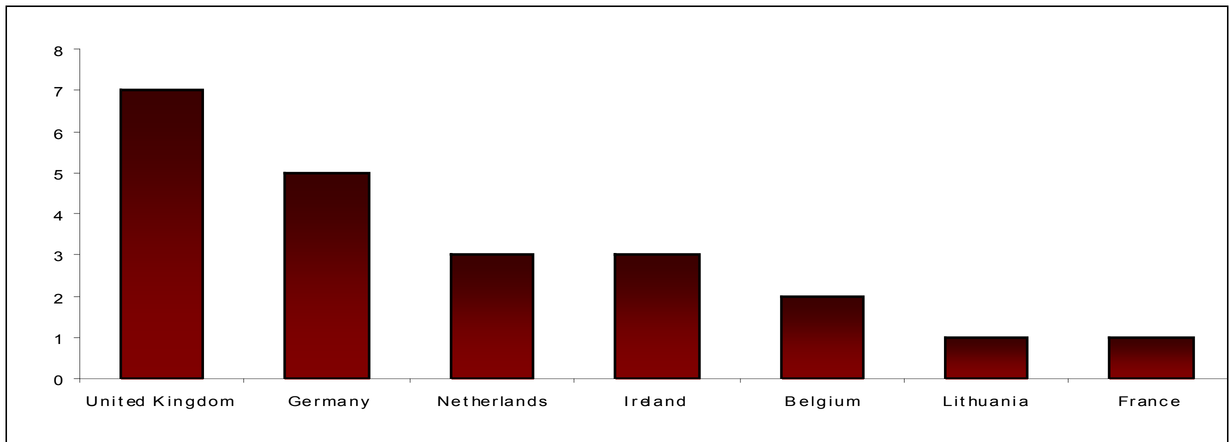


Figure 3.3: Country Location of Case Study Companies' Subsidiaries & Branches

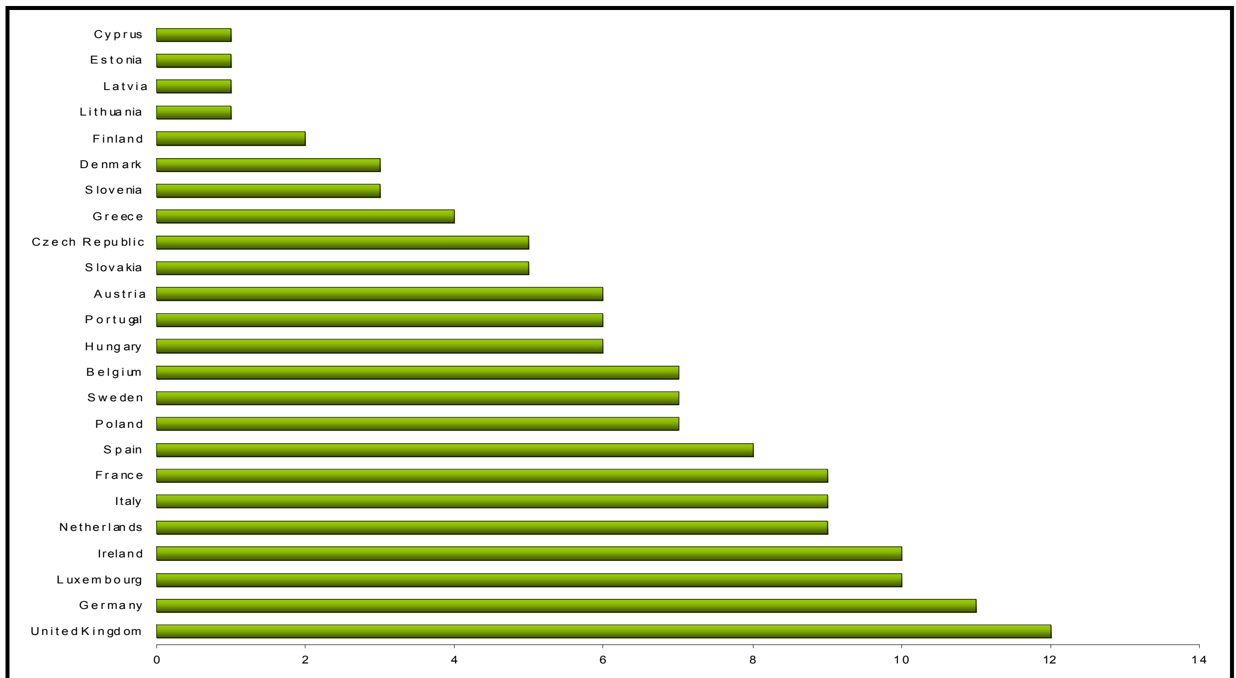
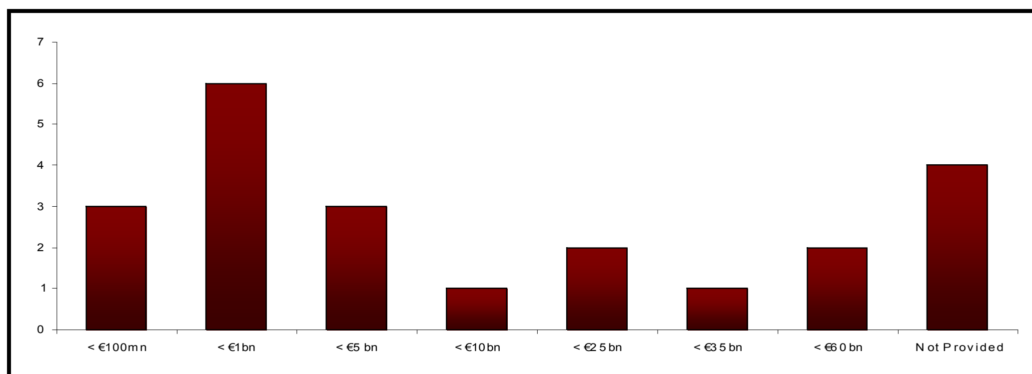


Figure 3.4: Revenue Profile of Case Study Companies[67]



3.11 As is clear from the foregoing, 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 have a broad revenue profile – incorporating players which are very small in a global context as well as a number of major global players.

3.12 Particularly noteworthy from the information presented in the foregoing page is the fact that many Case Study Companies have an operational presence in more than one Member State. This *helicopter* view of tax arrangements across the EU25 came across strongly in certain responses to the Case Study Template.

3.13 Finally, a number of respondent companies submitted more than one template, i.e. a template was submitted in respect of distinct corporate entities within a group. Reflecting this, the number of completed template responses is twenty two compared with a total number of respondents of sixteen.

[67] When relevant information was not provided by the Case Study Company, it was obtained from public sources.

3.4 Embedded VAT Costs

3.14 As part of the Case Study Template, Case Study Companies were asked to provide details on the value of irrecoverable VAT in 2005 and to place this in a wider company perspective. High-level findings are presented in Tables 3.1, 3.2 and 3.3.

3.15 Table 3.1 shows that VAT recovery rates among Case Study Companies which had provided the relevant information at the time of writing ranged from a very low 2% in the case of a bank located in an Eastern European Member State to more than 70% in the case of a London-based fund management company.

3.16 Factors which underpinned differentials in rates of VAT recovery included:

- the nature of the financial service being provided;
- the location of the customer base, with three of the Case Study Companies selling predominantly to a non-EU25 customer base;
- the methodologies agreed with local tax authorities for the allocation of costs to distinct financial services or clients;
- more generally, practical differences in the means by which the provisions of the Sixth EU VAT Directive have been given expression in individual Member States.

3.17 No explanation regarding differing rates of recovery between capital and non-capital spend was provided by respondents.

Table 3.1: VAT (€ mn) Paid by Case Study Companies, 2005[68]

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22
Total Spend on Non Capital Goods & Services	3,822.0	9.0	n.a.	n.a.	n.a.	n.a.	2.3	10.0	26.6	61.0	3,382.0	437.0	83.0	n.a.	n.a.	88.4	381.0	1.0	4,126.0	369.0	267.2	2,367.0
VAT Paid on Non Capital Goods & Services	650.0	1.0	n.a.	n.a.	n.a.	n.a.	0.2	0.4	4.8	11.5	564.0	72.0	12.0	n.a.	n.a.	12.2	74.7	0.2	722.0	62.0	56.5	88.0
VAT Recovered on Spend	65.0	0.2	n.a.	n.a.	n.a.	n.a.	0.1	0.0	0.1	0.6	56.0	53.0	0.8	n.a.	n.a.	2.7	24.9	0.0	55.0	3.0	17.1	15.0
% of VAT Recovered	10%	20%	n.a.	n.a.	n.a.	n.a.	52%	0%	2%	5%	10%	74%	7%	n.a.	n.a.	22%	33%	0%	8%	5%	30%	17%
Total Capital Expenditures	670.0	16.0	n.a.	n.a.	n.a.	n.a.	0.0190	1.0	6.1	39.1	1,205.0	37.0	0.0	n.a.	n.a.	n.a	376.0	0.0	n.a.	136.0	0.0	3,693.0
VAT Paid on Capital Expenditures	112.0	0.6	n.a.	n.a.	n.a.	n.a.	0.00300	0.1	1.1	7.9	201.0	1.0	0.0	n.a.	n.a.	n.a	8.3	0.0	n.a.	20.0	12.5	9.0
VAT Recovered on Capital Expenditures	11.0	0.1	n.a.	n.a.	n.a.	n.a.	0.00100	0.1	0.0	2.5	20.0	0.9	0.0	n.a.	n.a.	n.a	2.1	0.0	n.a.	1.4	2.0	1.0
% of VAT Recovered	10%	17%	n.a.	n.a.	n.a.	n.a.	33%	50%	0%	32%	10%	90%	n.a.	n.a.	n.a.	n.a	25%	n.a.	n.a.	7%	16%	11%
Total Expenditures	4,492.0	25.0	n.a.	n.a.	n.a.	n.a.	2.3	11.0	32.7	100.1	4,587.0	474.0	83.0	n.a.	n.a.	88.4	757.0	1.0	4,126.0	505.0	267.2	6,060.0
VAT Paid on Total Expenditures	762.0	1.6	n.a.	n.a.	n.a.	n.a.	0.2	0.5	5.9	19.4	765.0	73.0	12.0	n.a.	n.a.	12.2	83.0	0.2	722.0	82.0	69.0	97.0
VAT Recovered on Total Expenditures	76.0	0.3	n.a.	n.a.	n.a.	n.a.	0.1	0.1	0.1	3.1	76.0	53.9	0.8	n.a.	n.a.	2.7	26.9	0.0	55.0	4.4	19.1	16.0
% of VAT Recovered	10%	19%	n.a.	n.a.	n.a.	n.a.	52%	10%	2%	16%	10%	74%	7%	n.a.	n.a.	22%	32%	0%	8%	5%	28%	16%

[68] The term "n.a." refers to not available. Data are considered not available when it has not been provided by the Case Study Company or when it is considered inaccurate. Similarly, a "n.a." may appear even when the information is available but the balance of information required to complete the Table is not. All data were provided by the Case Study Companies and have not been independently verified by PwC. Where data inconsistencies existed within an individual template, the most consistently used data were used.

Table 3.2 shows the total value of irrecoverable VAT paid by the Case Study Companies in 2005 as a % of revenue, total costs and profit.

Table 3.2: Irrecoverable VAT in Wider Case Study Company Perspective, 2005

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22
Irrecoverable VAT € mn	n.a.	1.3	n.a.	n.a.	n.a.	n.a.	0.1	0.5	5.8	16.3	689.0	19.1	11.2	n.a.	99	9.5	56.1	0.2	667.0	77.6	n.a.	81.0
Total Revenues € mn	n.a.	76.0	n.a.	n.a.	n.a.	n.a.	30.4	230.0	184.0	2,333.8	57,427.0	1,223.0	9,835.0	n.a.	15,667	n.a.	3,652.0	289.0	59,141.0	10,263.0	n.a.	14,262.0
Total EU25 Revenues € mn	n.a.	73.0	n.a.	n.a.	n.a.	n.a.	18.1	46.0	182.1	2,141.8	16,017.0	831.4	1,967.0	n.a.	5,106	n.a.	3,287.0	289.0	47,507.0	9,847.0	n.a.	12,265.0
Total Costs € mn	n.a.	25.0	n.a.	n.a.	n.a.	n.a.	2.3	11.0	32.7	100.1	4,587.0	474.0	83.0	n.a.	n.a.	n.a.	757.0	1.0	4,126.0	505.0	n.a.	6,060.0
Net Profit Margin %	n.a.	30%	n.a.	n.a.	n.a.	n.a.	15%	19%	27%	23%	6%	-2%	21%	n.a.	15.8%	n.a.	24%	99%	17%	13%	n.a.	2%
Irrecoverable VAT as a % of Total Revenues	n.a.	2%	n.a.	n.a.	n.a.	n.a.	0%	0%	3%	1%	1%	2%	0%	n.a.	1%	n.a.	2%	0%	1%	1%	n.a.	1%
Irrecoverable VAT as % of EU25 Revenues	n.a.	2%	n.a.	n.a.	n.a.	n.a.	1%	1%	3%	1%	4%	2%	1%	n.a.	2%	n.a.	2%	0%	1%	1%	n.a.	1%
Irrecoverable VAT as a % of Total Costs	n.a.	5%	n.a.	n.a.	n.a.	n.a.	4%	4%	18%	16%	15%	4%	13%	n.a.	n.a.	n.a.	7%	23%	16%	15%	n.a.	1%
Net Profit Margin in Absence of Embedded VAT %	n.a.	32%	n.a.	n.a.	n.a.	n.a.	15%	19%	30%	24%	7%	0%	21%	n.a.	16.3%	n.a.	26%	99%	18%	14%	n.a.	2%

3.18 The key finding from Table 3.2 is that the costs associated with irrecoverable VAT have a clear bearing on the profitability of EU25 financial services firms, with net profit margins rising between 1 and 3 percentiles or 5 and 10% in the case of nearly all of the Case Study Companies for which information is available – assuming obviously that there is a direct correlation between the cost of irrecoverable VAT and profitability.

3.19 The share of total costs accounted for by VAT ranges from 4% in the case of a small Eastern European bank to close to 0% in the case of a small bank with a high dependence on non-EU25 sales and, therefore, a small dependence on EU25 sales. It is, therefore, clear that irrecoverable VAT is a significant cost for many financial services firms selling predominantly to an EU25 client base.

3.20 In reviewing the foregoing Table, however, it should be borne in mind that a majority of the Case Study Companies provide services to VAT-registered and non VAT-registered clients[69]. As was evidenced in Research Phase I, suppliers of exempt services selling to non VAT-registered buyers enjoy an advantage vis-à-vis those which are subject to VAT. Case study respondents were asked to provide cost and revenue detail distinguishing between VAT-registered and non VAT-registered buyers. They were not, however, in a position to provide this level of detail.

3.21 Purely for indicative purposes, Table 3.3 shows the implications of a pro rata assigned irrecoverable VAT for the pricing of financial services to EU25 business customers in 2005.

Table 3.3: Implications of Irrecoverable VAT for the Cost of Services to Business

		1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22
A	Value of Irrecoverable VAT (€ mn)	n.a.	1.3	n.a.	n.a.	n.a.	n.a.	0.1	0.5	5.8	16.3	689.0	19.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	667.0	n.a.	n.a.	n.a.
B	EU25 Business Revenues (€ mn)	n.a.	1.0	n.a.	n.a.	n.a.	n.a.	18.1	46.0	161.8	2,139.7	16,017.0	831.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	25,944.0	n.a.	n.a.	n.a.
C	EU25 Non-Business Revenues (€ mn)	n.a.	72.0	n.a.	n.a.	n.a.	n.a.	0.0	0.0	20.3	2.1	0.0	0.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	21,563.0	n.a.	n.a.	n.a.
D = B + C	Total (€ mn)	n.a.	73.0	n.a.	n.a.	n.a.	n.a.	18.1	46.0	182.1	2,141.8	16,017.0	831.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	47,507.0	n.a.	n.a.	n.a.
E = B / D	EU25 Business Revenues (% of EU25)	n.a.	1%	n.a.	n.a.	n.a.	n.a.	100%	100%	89%	100%	100%	100%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	55%	n.a.	n.a.	n.a.
F = C / D	EU25 B2C Revenues (% of EU25)	n.a.	99%	n.a.	n.a.	n.a.	n.a.	0%	0%	11%	0%	0%	0%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	45%	n.a.	n.a.	n.a.
G = E + F	Total	n.a.	100%	n.a.	n.a.	n.a.	n.a.	100%	100%	100%	100%	100%	100%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	100%	n.a.	n.a.	n.a.
H = E * A	Assumed VAT Charge to Business	n.a.	0.0	n.a.	n.a.	n.a.	n.a.	0.1	0.5	5.2	16.3	689.0	19.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	364.3	n.a.	n.a.	n.a.
I = H + B	EU25 Business Revenues + IR[70] VAT	n.a.	1.0	n.a.	n.a.	n.a.	n.a.	18.2	46.5	167.0	2,156.0	16,706.0	850.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	26,308.3	n.a.	n.a.	n.a.
J = ((I / B)-1)	Uplift in Cost of Business Services	n.a.	2%	n.a.	n.a.	n.a.	n.a.	1%	1%	3%	1%	4%	2%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1%	n.a.	n.a.	n.a.

[69] The exceptions in this regard are case studies 7,8,11 and 12.
[70] Irrecoverable VAT.

3.22 Assuming that irrecoverable VAT costs are assigned on a pro rata revenue basis to financial service prices, Table 3.3 shows an uplift of between 1% and 4% in the price of financial services to EU25 business customers as a result of irrecoverable VAT. Again, it should be emphasised that this assumes that irrecoverable VAT costs are built entirely into prices and allocated purely on the basis of revenues.

3.23 The actual cost of irrecoverable VAT is, however, not the only VAT-related cost incurred by financial services firms operating within the EU25. Rather, it is clearly the case that a VAT exemption imposes administrative costs on firms over-and-above those that might be realised by taxable enterprises. The divergent treatment of financial services for VAT purposes (see Research Phase I) between EU25 countries may serve to increase these costs further. Reliable estimates of the € value of such costs, particularly vis-à-vis non-exempt business, are not available.

3.5 VAT and Unfair Competition within the EU25

3.24 Section 4 of the PwC Case Study Template (see Annex II) was designed to elicit respondents' views on the extent to which inconsistencies in the VAT treatment of financial services between EU25 jurisdictions are promoting an unlevel playing field between competitor providers of financial services. An overview of findings from the closed or quantitative questions is provided in Table 3.4, while a selection of the qualitative feedback is provided in a selection of *story boards*.

Table 3.4: % of Case Study Companies Agreeing with Statements

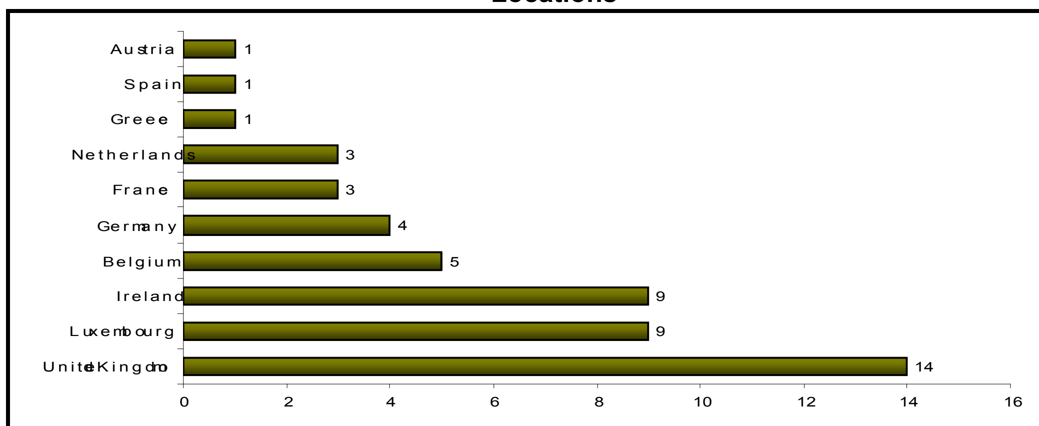
	Any Banking	Any Investment Management	Any Insurance	Total
Our Company faces Intense Competition from Firms with Significant Operations within the EU25:	87%	86%	83%	91%
Certain of these EU25 Competitors enjoy a Considerable VAT-related Cost Advantage as a Result of Standard Lower Rate of VAT:	20%	0%	17%	18%
Certain of these EU25 Competitors enjoy a Considerable VAT-related Cost Advantage as a Result of a More Favourable VAT Treatment of Financial Services:	53%	57%	67%	55%
VAT-related Costs are Not Sufficiently Large to Confer Any Significant Cost Advantage on EU25 Competitors:	53%	29%	17%	41%
Our Company is Structured in Such a Way as to Minimise the Scope for EU25 Competitors to Enjoy a VAT-related Cost Advantage:	27%	29%	17%	23%

3.25 Key findings from Table 3.4 are the following:

- competition in the services provided for the Case Study Companies would appear to emanate predominantly from within the EU25;
- differences in the standard rates of VAT between jurisdictions were not considered by 82% of respondents to confer any significant VAT-related cost advantage on financial services firms within the EU25;
- however, a small majority of respondents agreed with the statement that differences in the particular VAT treatment of financial services within the EU25 had the potential to confer cost advantage on competitors;
- more than half of respondents agreed that the costs of irrecoverable VAT were sufficiently large to constitute a meaningful cost advantage;
- notwithstanding this, it was clear that – with the exception of a number of global players – respondent firms had not sought to significantly manage irrecoverable VAT costs through changes in organisational structures.

3.26 Questioned as to the EU25 countries where the VAT treatment of financial services was considered most favourable, the United Kingdom emerged as a clear leader followed by Luxembourg, Ireland and Belgium (see Figure 3.5).

Figure 3.5: Number of Country Citations in Top Most Favourable EU25 VAT Locations



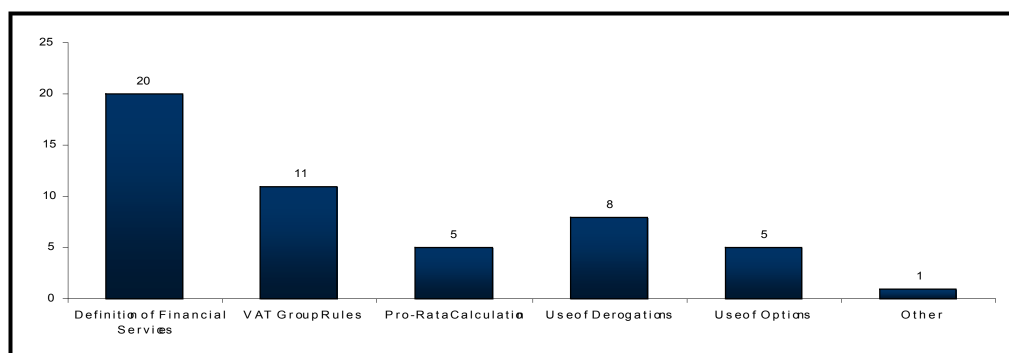
3.27 A number of factors were identified as contributing to the favourable VAT regime in the United Kingdom. Most notably the definitions which are applied to certain financial services, methodologies permitted for the pro rata allocation of vatable expenses as well as the rules regarding VAT Grouping (see Table 3.5).

Table 3.5: 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[71]	0	1	0	2	0	1	1	1	4
Other	0	0	0	0	0	0	0	0	0	1

3.28 An overview of the factors identified which render one EU25 jurisdiction more attractive from a VAT perspective than another is presented in Figure 3.6.

Figure 3.6: Factors which Contribute to Favourable VAT Jurisdictions in the EU25



3.29 The most frequent definitional issue cited by Case Study Companies was the broad exemption applying to the management of special investment funds in some territories. In addition, a number of respondents cited the guidance in the *Blue Book* in the United Kingdom agreed between the British Bankers Association (BBA) and Her Majesty's Revenue & Customs (HMRC). The *Blue Book* was reported to give financial service providers in the United Kingdom more certainty and clarity with regard to the VAT treatment of a wide range of services and transactions.

3.30 While the quantitative analysis suggests quite strongly that VAT creates a less than level playing field for financial service providers in the EU25, this sense came across much less strongly in the anecdotal evidence provided and in the individual consultations. An overview of the qualitative feedback from a selection of Case Study Companies is presented in Boxes 3.1 to 3.5.

[71] 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.

Box 3.1 VAT & Unfair Competition from EU25 Suppliers[72]

Respondent Profile: Large Bank

Respondent was of the firm view that certain suppliers of financial services could enjoy considerable cost advantages vis-à-vis competitors as a result of operating in jurisdictions with lower standard rates of VAT or in jurisdictions which had a particularly favourable VAT treatment of all or certain financial services.

Countries which were identified as having particularly favourable VAT treatment of banking services were identified as: Germany, Luxembourg, Belgium, Spain and the United Kingdom. Regulations with respect to VAT Grouping were the most commonly cited source of advantage, followed by the definitions of financial services applied and the use of options.

In the case of the United Kingdom, the ability to calculate pro rata recovery rates on a sectoral basis was identified as offering a considerable cost advantage over the more restrictive computation methods allowed in certain new EU25 Member States.

Questioned as to the extent to which the bank in question faced unfair competition from EU25 suppliers as a result of VAT regulations, the respondent indicated that this situation did not arise as the bank in question has operations in all EU25 Member States in which it provides services – limiting the scope for competitors to enjoy unfair advantages.

Box 3.2 VAT & Unfair Competition from EU25 Suppliers

Respondent Profile: Small Business Bank

The respondent was of the view that no advantage was conferred on competitors as a result of a lower standard rate of VAT or a more favourable treatment of financial services in the jurisdiction from which they operated primarily. In common with respondents from the larger banks, the rationale underpinning this response was that the small bank in question has an operational presence in those EU25 markets in which it provides services. The bank indicated that a series of supervisory, legal and cultural factors meant that the ability to provide services on a cross-border basis, i.e. without an operational presence in the country of supply, meant that issues of VAT-related unfair competition simply did not arise. Of those EU25 markets in which the bank has a presence, the financial treatment of financial services in the United Kingdom was considered most favourable. This was attributed to a favourable tax authority decision regarding the pro rata apportionment of costs by the bank.

[72] In reviewing the story boards, it should be noted that PwC is quoting directly from case study respondents and has not validated all of the technical details referred to at this stage.

Box 3.3 VAT & Unfair Competition from EU25 Suppliers

Respondent Profile: Small Investment Management (IM)

In common with many other respondents, this company did not feel that a lower standard rate of VAT conferred competitive advantage on certain EU25 competitors, but did feel that the particular VAT treatment of certain investment management services in some EU25 Member States was a potential source of competitive advantage. Countries with the most favourable VAT treatment of investment management service were identified as the United Kingdom, Ireland and Luxembourg – with the definition of exempt financial services applied as well as VAT Group rules being one of the sources of advantage identified. Issues with respect to the double taxation of portfolio management services in one EU25 Member State were cited as a particular source of difficulty. The respondent agreed with the sentiment that the scale of VAT savings available in certain jurisdictions was, in fact, a source of competitive advantage in a business where services are provided on a cross-border basis, i.e. without the need to run a *physical* operation in a Member State for doing business.

Box 3.4 VAT & Unfair Competition from EU25 Suppliers

Respondent Profile: Large Insurer/Investment Management

Again, this company did not feel that lower standard rates of VAT conferred any advantage on EU25 competitors – in spite of the fact that cross-border competition exists, i.e. services are not always provided from a locally based branch or subsidiary. However, the VAT treatment of particular financial services was identified as a potential, if not a significant, price advantage.

Countries which were identified as having the most favourable VAT treatment of financial services were identified as: Luxembourg, Ireland, Belgium and the Netherlands. The availability of the exemption in article 13(A)(1)(f) of the Sixth EU VAT Directive which allows for cost sharing was identified as a source of competitive advantage in the case of the Netherlands, Ireland and Belgium. In the case of Luxembourg and Ireland, the definition of funds applied was identified as the primary source of competitive advantage.

Box 3.5 VAT & Unfair Competition from EU25 Suppliers

Respondent Profile: Mid-Sized Bank

This company was aware of a number of situations which could confer something of a price advantage on financial services players, although not necessarily those who are in direct competition with their company. An example could be where a company sets up a central procurement centre in a jurisdiction with a low standard rate of VAT and passes savings realised into a wider branch network. This clearly shows how VAT influences the choice of a EU25 country for the location of shared service centres, as well as facilitating unfair competition between EU25 suppliers.

Similarly, the respondent made reference to the fact that global custody services are considered VAT exempt in certain jurisdictions but only partially exempt in others. Again, this creates an incentive to provide global custody services from certain EU25 jurisdictions.

3.31 The case study consultations revealed that, while most Case Study Companies could envisage how, in theory, VAT could lead to an unfair cost advantage for EU25 suppliers based in certain jurisdictions – in practice, this was reported not to be the case at the present time as the ability to provide financial services from one location in the EU to another is restricted due to different non VAT-related factors[73]. Indeed, an appreciation of differences in the VAT treatment of financial services between EU25 countries would appear to stem not from the experience of unfair competition *per se*, rather from the fact that a very significant number of the Case Study Companies have operations in more than one EU25 jurisdiction (see Figure 3.3).

3.32 In the case of both retail banks and insurers, a series of regulatory, market and cultural factors mean that it is perceived to be very difficult to provide services without a local market presence. Such a market presence essentially negates the scope for VAT-related price advantages associated with a particular EU25 jurisdiction. VAT may, however, become a more predominant influencer of EU25 competition as issues or other constraints to cross-border service provision become less important. Excepting the savings that may be realised as a result of the careful structuring of shared service centres or outsourced services (see Section 3.8), this view was widely held among case study banking and insurance respondents.

3.33 Investment management services, certain of which can already today be provided more readily on a cross-border basis, were, however, the possible exception in this regard – with the definition of fund management services applied in a small number of EU25 jurisdictions identified as having particularly favourable implications for reducing embedded VAT costs.

3.6 VAT and Unfair Non-EU25 Competition

3.34 Section 5 of the Case Study Template (see Annex II) questioned Case Study Companies as to the extent to which they face competition from companies with very limited operations within the EU25 and the extent to which such competitors enjoy a cost advantage as a result of more favourable VAT regimes in their home territories. Quantitative findings are presented in Table 3.6, while anecdotal evidence is provided in Boxes 3.6 to 3.8.

[73] "White Paper on Financial Services Policy (2005-2010)" at http://europa.eu.int/comm/internal_market/finances/ policy/index_en.htm.

Table 3.6: % of Case Study Companies Agreeing with Statements

	Any Banking	Any Insurance	Any Investment Management	Total
Our Company faces significant Competition from Firms with very Limited Operations within the EU25:	13%	17%	40%	23%
Competition from Firms with very Limited EU25 Operations has intensified over the Past 10 Years:	20%	33%	50%	32%
Competition from Firms with very Limited EU25 operations will intensify in the next 10 Years:	47%	50%	70%	50%
Our company is typically at a considerable Price Disadvantage to Competitor Firms with very Limited Operations in the EU25:	7%	17%	30%	14%
This Price Disadvantage is largely attributable to the VAT treatment of Financial Services in the EU25 vis-à-vis other Jurisdictions:	0%	25%	22%	9%

3.35 Table 3.6 points clearly to the fact that unfair VAT-related competition from firms providing financial services to EU25 clients from non-EU25 locations is not considered to be a major issue by the Case Study Companies.

3.36 This is clearly less so the case for a small number of investment management services, reflected in significantly higher scores for *Any Investment Management*. This can be attributed to the inherent nature of services provided and/or their regulatory treatment.

3.37 The anecdotal evidence presented in Boxes 3.6 to 3.8, which places a heavy emphasis on investment management, also points to the fact that while VAT is a potential source of cost advantage for non-EU25 providers of a limited range of investment management services, not many of the Case Study Companies felt particularly strongly on this issue at this point in time.

Box 3.6 VAT & Unfair Competition from Non-EU25 Suppliers

Respondent Profile: Large Bank/Investment Management

This company agreed with a series of statements regarding competition from non-EU25 firms – most notably the fact that for certain services (e.g. hedge funds) they faced very intense competition from companies with no significant operational activities in the EU25. Moreover, this company felt that such fund management competition from players with a very *light* operational presence had intensified in recent years and was likely to further intensify going forward. While non-EU25 players were reported to enjoy a cost advantage, this was deemed not to be primarily attributable to low input VAT costs nor any other VAT-related advantage. Rather, labour cost benefits of being located outside of the United Kingdom where fund managers cost command in the region of €120,000 in annual remuneration was found to be the primary source of any cost advantage enjoyed. These advantages persisted in spite of transfer pricing rules and the obligation to reverse charge VAT on any services received.

In summary, the VAT exemption on financial services in the EU25 was not the identified source of unfair price competition with companies with very limited operations in the EU25.

Box 3.7 VAT & Unfair Competition from Non-EU25 Suppliers

Respondent Profile: Investment Management

This company indicated that it does face competition from non-EU25 based companies in certain of its fund management activities. In fund management, it was reported that certain non-EU25 competitors – with Gibraltar being specifically mentioned – enjoy a series of price advantages over their EU25-based competitors. VAT was a relatively small component of this price advantage, however, with corporate tax rates, labour costs and more relaxed regulatory regimes (e.g. insolvency rules) reported to account for the greatest share of any cost advantages enjoyed.

Box 3.8 VAT & Unfair Competition from Non-EU25 Suppliers

Respondent Profile: Small-Sized Investment Management

Major global players were identified as the main non-EU25 competitors to this Case Study Company, which while identified as being non-EU25 in origin were conceded to have substantial EU25 operations. Investment Management companies with vehicles in the EU25, but managed from the United States, were reported to enjoy a VAT advantage vis-à-vis those with no US operations. This is, however, the situation for this Case Study Company (i.e. the company has a US-based operation) so competitors enjoy no relative cost advantage as a result.

However, within the EU25, this company feels that it has a VAT cost disadvantage as a result of German authorities' interpretation of place of supply rules – which place it at odds with companies offering services from other EU25 jurisdictions such as the United Kingdom.

This cost disadvantage is, however, reportedly negated by the labour cost savings associated with a German as opposed to a UK base.

3.7 VAT and Country Location / Structure of Operations

3.38 Section 6 of the Case Study Template (see Annex II) was designed to determine the extent to which EU25 financial services companies structure their operations (in terms of country location or corporate structure) to minimise the costs associated with irrecoverable VAT, i.e. the extent to which the country of location of company operations or corporate structure is influenced by VAT.

Quantitative findings are presented in Table 3.7, while a selection of qualitative feedback from companies (again – focusing on those companies where VAT was found to exert considerable influence on country choice and/or corporate structure) is presented in Boxes 3.9 to 3.15.

Table 3.7: % of Case Study Companies Agreeing with Statements

	Any Banking	Any Insurance	Any Investment Management	Total
Within the EU25, our Company has been directly influenced by VAT Costs in making Decisions regarding the Country Location of Operations:	27%	33%	30%	32%
Within the EU25, VAT has had no Direct Bearing on the Decisions our Company has made regarding the Country Location of Company Operations:	47%	17%	30%	41%
Within the EU25, the Country Location of our Company Operations is less than optimal owing to the Need to locate Operations in such a Way as to achieve VAT Savings:	27%	33%	30%	32%
Within the EU25, VAT Considerations have had a Direct Bearing on our Corporate Structures:	53%	50%	60%	55%
Within the EU25, our Corporate Structures are less than optimal owing to the Need to structure Operations to achieve VAT Savings:	40%	33%	50%	36%
Within a Global Context, the VAT Treatment of Financial Services in the EU25 is considerably less favourable than certain non-EU25 Jurisdictions:	60%	17%	30%	45%
The VAT Exemption of Financial Services had disadvantaged EU25 Member States in the Attraction of Investment from our Company vis-à-vis non-EU25 Jurisdictions:	27%	33%	30%	32%

3.39 Key findings from Table 3.7 are the following:

- a third of respondents agreed with the statement that VAT considerations had a direct bearing on the country location of their operations, with a third also agreeing that their country location of their operations had been compromised in some respect as a result of VAT;
- fifty five percent of respondents felt that VAT had had some influence on their EU25 corporate structure;
- a third felt that their corporate structures had been compromised as a result of the influence of VAT;
- almost half of respondents agreed with the statement that the VAT treatment of financial services in the EU25 was considerably less favourable than elsewhere;
- less than a third stated that VAT considerations had disadvantaged EU25 Member States in the attraction of investment from their company vis-à-vis non-EU25 jurisdictions.

A selection of the qualitative feedback, again focusing on those respondents with particularly provocative views, is presented in Boxes 3.9 to 3.15.

Box 3.9 VAT & Country Location / Structure of Operations

Respondent Profile: Large Insurance & Banking

This company agreed with the statement that the VAT treatment of financial services had influenced its choice of EU25 country for the location of business activities, had resulted in an EU25 distribution of company activities which was considered less than optimal from an efficiency perspective and had resulted in the company investing in non-EU25 countries.

Requested to provide tangible evidence of these opinions, respondents made reference to ongoing considerations regarding the movement of fund management activities from their current Member State where the head office is located to Luxembourg as well as intensive negotiations with its domestic revenue authorities regarding the VAT treatment of cross-border charges, which consumed a great deal of management time.

Box 3.10 VAT & Country Location / Structure of Operations

Respondent Profile: Small-Sized Business Bank

This company has operations in three EU25 countries, as well as in two non-EU25 countries. Questioned as to the influence VAT has exerted on the country location of the company's operations, the response came that VAT had exerted no influence on the location of its operations whatsoever. Rather, market development objectives were without exception the driver of country location decisions. This response reflects the fact that the bank provides financial services which are relatively niche in nature and which (owing to a series of regulatory factors) are reported too difficult to provide from outside the jurisdiction in which the would-be customer is resident.

The relatively small scale of the company is such that dedicated shared service centres simply do not exist.

Box 3.11 VAT & Country Location / Structure of Operations

Respondent Profile: Large Insurance and Investment Management

This global provider of insurance services has been influenced by VAT regulations in the country choice of its operations, but VAT considerations have never been allowed to compromise wider business issues, i.e. the company does not believe that its present EU25 country distribution is less than optimal from a purely business perspective when no regard is had to VAT. Specific examples given include the planned location of a Joint Venture in the United Kingdom, which would have allowed for the company in question to have been incorporated into a UK VAT Group. This plan, however, did not come to pass for reasons not relating to VAT. Beyond the EU25, the company noted that it had located some operations to India and was now enjoying certain VAT advantages as a result. Again, however, factors beyond VAT were the primary driver of this initiative.

With regard to corporate structures, the company does not feel that it has been influenced by VAT in terms of the corporate status of any of its EU25 operations and is happy that existing corporate arrangements are optimal.

Box 3.12 VAT & Country Location / Structure of Operations

Respondent Profile: Large Bank

This global banking interest is firmly of the view that the VAT treatment of financial services within the EU25 has had an important bearing on the location of their operations within the EU25 as well as globally. Examples provided included the location of a call centre in Spain, the location of which was influenced by the favourable VAT treatment of Economic Interest Groups and the location of centralised data centres in both the United Kingdom and Germany owing to relatively favourable VAT Group regulations.

The respondent was, however, anxious to emphasise that VAT was just one of many issues considered when choosing a country in which to locate operations. In this regard, it was mentioned that the company recently decided to re-locate certain business activities to Poland in spite of the fact that the VAT regime was less favourable than other reviewed alternatives, e.g. South Africa. However, Eastern European countries were reported to be losing out on investment to countries such as India and Singapore partially as a result of VAT.

With regard to corporate structures, respondent indicated that existing arrangements are considered less than optimal from a corporate tax perspective as a result of VAT.

Box 3.13 VAT & Country Location / Structure of Operations

Respondent Profile: Large Retail / Consumer Finance Bank

The corporate structure of the Case Study Company, which is made up almost entirely of subsidiaries reflecting an acquisition-based strategy to growth, is considered optimal from a general business perspective, e.g. corporate tax, legal, regulatory. However, a predominance of subsidiary companies means that the company incurs very significant intra-group VAT charges. These charges would not arise if the company structure was dominated by branches. Of the total irrecoverable VAT suffered by the company, 25% arises entirely as a result of intra-group transactions. This cost is reported to be inhibiting the competitiveness of the company in question.

Box 3.14 VAT & Country Location / Structure of Operations

Respondent Profile: Mid-Sized Bank

The respondent quoted a number of examples of how VAT might influence other companies in terms of country of location for shared services. In terms of its own operations, a specific example was given of how an Eastern European country had been chosen for the location of a shared services centre based on its interpretation of *SDC*[74] as well as the standard rate of VAT.

With regard to corporate structures, the respondent indicated that his/her company's corporate structure has experienced certain weaknesses as a result of VAT. Reference was made to certain regulatory difficulties experienced in an Eastern European country as a result of the establishment of a branch as opposed to a subsidiary in the country.

Box 3.15 VAT & Country Location / Structure of Operations

Respondent Profile: Mid-Sized Life Insurance

The respondent has established operations in a Member State, availing of the provisions of the Third Life Directive 92/96 to provide life insurance services on a cross-border (freedom of services) basis. As part of this arrangement, the company has outsourced a significant element of its processing activity and has, to date, availed of VAT exemption in respect of these outsourced activities. Following the ECJ case on *Andersen*[75], there is a distinct possibility that these services will be taxed. The respondent believes that this would make the current business proposition (in terms of location and using the community freedom to provide services on a cross-border basis) potentially unviable.

[74] ECJ judgement of 5 June 1997 in *Sparekassernes Datacenter v. Skatteministeriet*, Case C-2/95.
[75] ECJ judgement of 3 March 2005 in *Secretary of State for Finance v. Arthur Andersen & Co. Accountants*, Case C-472/03.

3.40 Key findings to emerge from the qualitative research were the following:

- choosing EU25 country locations based on VAT considerations is, by-and-large, the preserve of the major global financial services firms – with smaller firms (including those listed in the top 100 global Plcs) being motivated to a 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 global businesses, which can choose country locations based on VAT, the extent of this activity is relatively limited – with examples, by-and-large, constrained to jurisdictions with relatively favourable VAT Group rules or particularly advantageous place of supply 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;
- labour costs were clearly often a much greater consideration;
- 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 offshore certain shared service activities;
- 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 impacted VAT liabilities;
- in the case of one company, an acquisition-based strategy to growth meant that its EU25 corporate structure was dominated by subsidiaries as opposed to branches with very important implications for irrecoverable VAT costs and its competitiveness;
- in the case of another company, it was indicated that the company was suffering unnecessary corporate tax charges as a result of corporate structures which had been designed to avoid intra-group VAT charges.

3.41 Again, it is worth emphasising that strong views regarding the influence of VAT on corporate structures and country locations were the preserve of only the largest of the Case Study Companies – with smaller companies taking a more benign view.

3.8 VAT, Outsourcing[76] & Shared Services

3.42 Section 7 of the Case Study Template (see Annex II) questioned Case Study Companies as to the extent to which the VAT exemption on financial services was inhibiting outsourcing or shared service centre ambitions, as well as the extent to which they were availing of VAT Group registration, ECJ rulings or the exemption in article 13(A)(1)(f) of the Sixth EU VAT Directive to facilitate VAT efficient outsourcing or shared services.

Quantitative findings are presented in Table 3.8.

Table 3.8: % of Case Study Companies Agreeing with Statements

	Any Banking	Any Insurance	Any Investment Management	Total
Effective Outsourcing[77] will be Crucial to the Future Financial Performance of Financial Services Firms:	80%	100%	90%	86%
Our Company has Derived Considerable Value for Money from Outsourcing:	60%	50%	80%	64%
Our Company is Planning on Outsourcing Additional Activities in the Next Three Years:	53%	50%	80%	64%
Our Company has attempted to use the Decision of the Court of Justice to Contend that Some or All of Your Outsourced Services Qualify for Exemption from VAT:	80%	50%	70%	73%
The VAT Treatment of Financial Services in the EU25 has Frustrated our Company's Outsourcing Ambitions:	33%	50%	30%	36%
In our Company, the VAT Costs associated with Outsourcing have been the Difference between Successful and Non-Successful Business Cases for Outsourcing:	20%	33%	20%	23%
The VAT Treatment of Shared Service Centres within the EU25 has not deterred our Company from the Development of Shared Service Centres:	40%	33%	40%	41%
Our Company has used VAT Group Registration to Maximum Effect to Minimise the VAT Charge on Shared Services:	53%	67%	80%	59%
Our Company has Benefited from the Use of the Exemption in Article 13(A)(1)(f) of the Sixth EU VAT Directive:	33%	0%	10%	23%
The Number of our Activities provided by Shared Service Centres would be Significantly Greater if the VAT Treatment of Financial Services in the EU25 were Different:	47%	67%	70%	55%

[76] The term "outsourcing" as used in this Section is intended to refer to the putting in place of a contractual arrangement with a third party for the provision of services which were previously self-supplied. By contrast, the term "shared service centre" is used in reference to an arrangement whereby the supply of a given service is concentrated in a single entity which rests within the corporate structure, i.e. there is no third party involvement.
[77] The term "outsourcing" was not defined in the questionnaire, rather was open to the interpretation of respondents.

3.43 Key findings from Table 3.8 are the following:

- 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 use of *corporate* owned shared service centres or the transfer of one activity from one group corporate entity to another;
- 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 eight 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 non-application of the ruling in *SDC*[78]*;* c) the perceived stringent application of the rules attaching to the exemption for insurance services; and d) uncertainty regarding the likely VAT treatment of a proposed outsourcing arrangement;
- in addition, a further two companies indicated that while VAT had not constrained their outsourcing ambitions to date – this would change if the *Andersen*[79] 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 mentioned in this regard;
- Case Study Companies have been heavily reliant on VAT Group registration and the decisions of the ECJ in rendering their outsourced or shared services efficient from a VAT perspective, with *SDC*[80] being the most commonly cited and 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.

[78] ECJ judgement of 5 June 1997 in *Sparekassernes Datacenter v. Skatteministeriet*, Case C-2/95.
[79] ECJ judgement of 3 March 2005 in *Secretary of State for Finance v. Arthur Andersen & Co. Accountants*, Case C-472/03.
[80] ECJ judgement of 5 June 1997 in *Sparekassernes Datacenter v. Skatteministeriet*, Case C-2/95.

A selection of the qualitative feedback, again focusing on those respondents with particularly provocative views, is presented in Boxes 3.16 to 3.19.

Box 3.16 VAT, Outsourcing and Shared Services

Respondent Profile: Large Bank

This global provider of banking services felt that VAT constituted an important constraint to both outsourcing and shared services within its organisation, although was at pains to emphasise that VAT rarely if ever underpins the identification of a need to restructure corporate operations. Questioned as to whether VAT had actually made the difference between a successful and non-successful business case for outsourcing, the respondent indicated that this was not the case. Indeed, reference was made to the establishment of a shared services centre in Eastern Europe which carried an unavoidable VAT liability but was pursued on the basis of overall cost savings, including labour. By contrast, however, the company is of the view that Eastern European Member States would be in a position to compete more effectively with non-EU25 jurisdictions (e.g. India) for outsourced or shared services from its company if the VAT regime was less punitive with regard to financial services.

With regard to shared service centres in particular, the respondent indicated that while VAT had not constrained the establishment of shared services centres, it had constrained the range of services provided from such centres as well as the markets to which they have been provided. The company in question has used VAT Group registration extensively in Germany, the United Kingdom and Ireland – but had to abandon a Joint Venture initiative with a third-party service provider in recent times as a result of this provider's reluctance to form part of a UK VAT Group. In the absence of the Group, the proposed Joint Venture did not make sense from the financial services firm's perspective.

Box 3.17 VAT, Outsourcing and Shared Services

Respondent Profile: Large Insurance

This global provider of insurance services has not engaged in any outsourcing contracts, but feels that outsourcing and shared services will drive industry efficiency in the coming years and is, therefore, planning on outsourcing and developing shared service centres in the coming years.

With regard to shared service centres, the respondent indicated that the VAT treatment of financial services in the EU25 had certainly influenced their development, with only those services which are considered exempt traditionally provided to Group companies which fall outside of the VAT Group. Earlier this year, the company established a shared services centre in Eastern Europe – which will incur VAT charges, but is justified on the basis of potential labour cost savings alone.

Box 3.18 VAT, Outsourcing and Shared Services

Profile of Respondent: Large Bank

The respondent firm has engaged in extensive outsourcing, and has recently concluded contracts with service providers within the EU25 and beyond. In the case of certain contracts, the services provided are VAT exempt but the company is incurring VAT charges on other outsourced services. Labour cost and quality of service considerations, however, mean that the decision to outsource still makes sound commercial success. The company does not concur with the view that the VAT treatment of financial services in the EU25 has frustrated their outsourcing decisions, and has used a series of ECJ rulings, most notably *SDC*[81], in the United Kingdom with success.

The company has also a number of shared service centres, all of which have UK-based branches which form part of the UK VAT Group, thereby minimising VAT charges. The rationale underpinning the non-EU25 location of these shared service centres did not pertain to VAT, rather was almost entirely attributable to labour cost differentials.

The volume of company activities provided by shared service centres would, in the opinion of the respondent, be greater if the VAT treatment of financial services in the EU25 was more favourable.

Box 3.19 VAT, Outsourcing and Shared Services

Profile of Respondent: Mid-Sized Bank

The respondent made reference to the fact that, while its company had derived considerable value-for-money from outsourcing and shared services, it had been frustrated by VAT in certain of its projects. Explicit reference was made to a planned outsourcing project where unresolved uncertainty regarding likely VAT treatment meant that the project simply had to be abandoned. With regard to cost sharing, the respondent indicated that the company had benefited from the use of article 13(A)(1)(f) of the Sixth EU VAT Directive, but said that better use could be made of the exemption if Member States accepted that *commercial* or for-profit businesses could benefit from its use[82].

[81] ECJ judgement of 5 June 1997 in *Sparekassernes Datacenter v. Skatteministeriet*, Case C-2/95.
[82] As this exemption is included along with those other exemptions for activities in the public interest contained in article 13(A) of the Sixth EU VAT Directive.

3.44 Key findings to emerge from the qualitative research were the following:

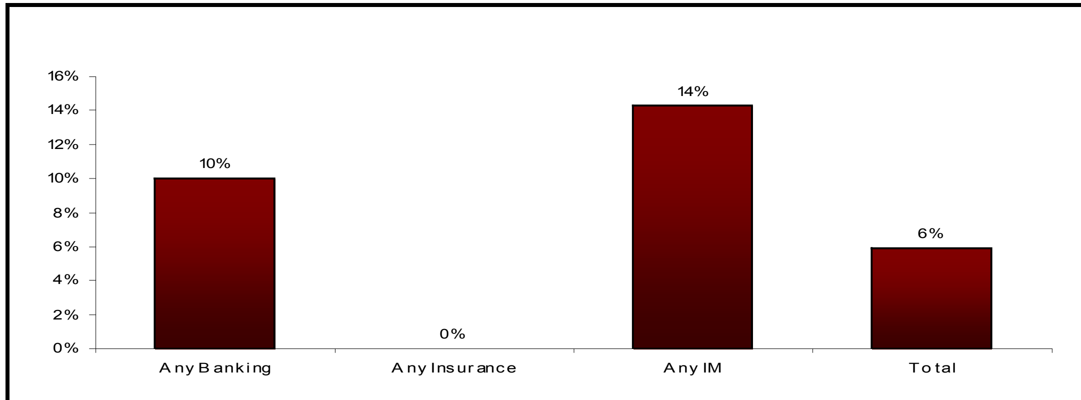
- just one example of a proposed outsourcing arrangement which was shelved or postponed as a result of VAT costs was identified in the course of the consultations with the Case Study Companies;
- however, an example of a proposed Joint Venture initiative which was to form part of a VAT Group collapsed on the basis of third-party unwillingness to form part of the VAT Group. In the absence of the VAT Group structure, the financial rationale for the establishment of the Joint Venture vehicle collapsed;
- similarly, it was found that the intra-group services provided by shared service centres were frequently either: a) limited to those services which were deemed VAT exempt on an EU25 basis; and/or b) limited to those corporate entities which formed part of a domestic or cross-border VAT Group;
- with regard to the latter, it emerged that those countries which had the most favourable VAT Group regulations were most likely to be home to companies which benefited from shared services, e.g. the United Kingdom;
- finally, and in a bid to present a balanced view, it is worth highlighting that outsourcing and shared service centres were simply not an issue for certain of the Case Study Companies – with operations being of a scale or structure that neither made commercial sense at the present time;
- similarly, factors such as the potential for labour cost savings featured more prominently than VAT in many outsourcing considerations.

3.9 VAT and Exploitation of Single Market Opportunities

3.45 The final section of the Case Study Template (see Annex II) questioned Case Study Companies as to the extent to which the VAT exemption on financial services had inhibited their company from the pursuit of new market opportunities within the EU25 or had dictated a market entry strategy which might have been considered less than optimal, e.g. establishment of a company branch as opposed to the appointment of a third party.

Findings with regard to the extent to which VAT may have inhibited the development of a new EU25 market are presented in Figure 3.7.

Figure 3.7: % Agreeing that VAT had Inhibited Development of New EU25 Market



3.46 In framing this question, the PwC project team were thinking of a situation where a relatively small firm might not be in a financial position to establish a subsidiary or branch in a new EU25 Member State, but would face an irrecoverable VAT liability if it chose to appoint a third-party intermediary as a short-term alternative. The only company which responded in the affirmative to this question was a major global banking interest. Questioned as to the rationale for a yes response, it emerged that the respondent was thinking in particular of shared service centre locations.

3.47 In consultations, not one small or mid-sized company suggested that VAT had frustrated their efforts at developing a new EU25 market.

3.48 The second question pertained to the influence exerted by VAT on the approach to entering a new EU25 market. Findings are presented in Figure 3.8.

Figure 3.8: % Agreeing that VAT had Dictated Sub-Optimal Market Entry Strategy

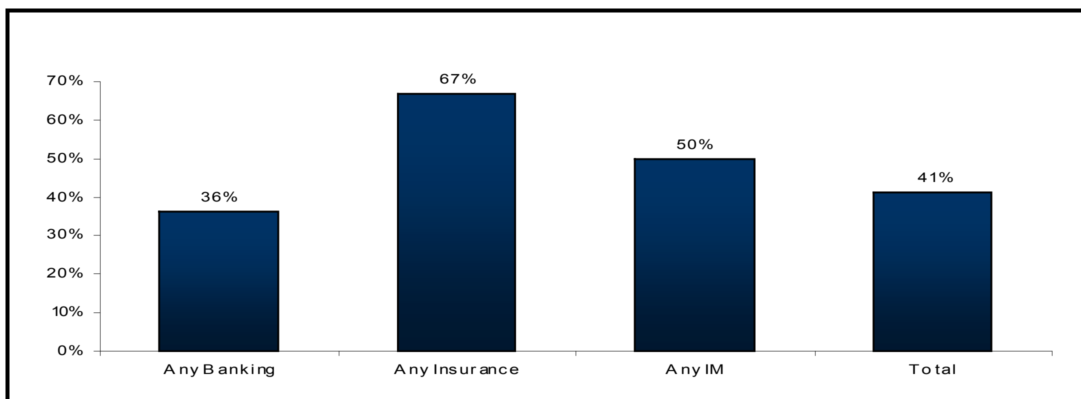


Figure 3.8 shows that more than 40% of Case Study Companies felt that VAT had dictated a less than optimal market entry strategy for a new EU25 market. Again, however, the profile of respondents answering in the affirmative is dominated by players of significant scale with multi-national interests.

3.49 The rationale behind their responses was occasionally client-specific, e.g. the requirement to enter into multiple contracts with an individual client to avoid VAT liability, VAT constraints to the establishment of a shared service centre for mortgage lending in one EU25 jurisdiction or the need to incorporate embedded VAT into service pricing. In a number of cases, however, a VAT-influenced corporate structure (i.e. the establishment of a branch of an EU25 corporate entity as opposed to a subsidiary) had created tensions or difficulties with financial regulatory authorities.

3.50 Not one of the smaller market players, i.e. less than €5 bn in annual revenues and without a major global parent, answered yes to this question.

3.51 The emphasis here has clearly been on the exploitation of demand opportunities associated with the Single Market. A number of companies identified VAT-related constraints to the exploitation of the supply-related opportunities associated with the Single Market, which were covered in Sections 3.8 and 3.9.

3.10 Key Chapter Findings

Key chapter findings are as follows:

3.52 Costs of Embedded VAT to EU25 Financial Services Companies

- 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;
- 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;
- Case Study Companies struggled to provide details of how irrecoverable VAT was distributed between service pricing and overhead allocation.

3.53 Unfair Competition within the EU25

- Case Study Companies do not feel, in general, that differences in the standard rates of VAT are a source of unfair advantage for financial services firms in certain EU25 jurisdictions;
- while differences in the VAT treatment of financial services were found to constitute a theoretical source of competitive advantage, other factors (perceived or otherwise) which presently require that many financial services providers have a local market presence mean that 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;
- countries with the most favourable VAT regimes from the perspective of the Case Study Companies were identified as the United Kingdom, Luxembourg, Ireland and Belgium. Differences in the definition of financial services, pro rata methodologies and VAT Group regulations were most commonly cited.

3.54 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.

3.55 Country Location of Operations

- choosing EU25 country locations based on VAT considerations is, by-and-large, 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 offshore certain shared service activities to jurisdictions outside of the EU25.

3.56 Corporate Structure of Case Study Companies

- 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.

3.57 Outsourcing and 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 use of *corporate* owned shared service centres or the transfer of one activity from one group corporate entity to another;
- 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 eight 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 non-application of the ruling in *SDC*[83]*;* c) the perceived stringent application of the rules attaching to the exemption for insurance services; and d) uncertainty regarding the likely VAT treatment of a proposed outsourcing arrangement;
- in addition, a further two companies indicated that while VAT had not constrained their outsourcing ambitions to date – this would change if the *Andersen*[84] 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 mentioned in this regard;
- Case Study Companies have been heavily reliant on VAT Group registration and the decisions of the ECJ in rendering their outsourced or shared services efficient from a VAT perspective, with *SDC*[85] being the most commonly cited and used ECJ ruling;

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[83] ECJ judgement of 5 June 1997 in *Sparekassernes Datacenter v. Skatteministeriet*, Case C-2/95.
[84] ECJ judgement of 3 March 2005 in *Secretary of State for Finance v. Arthur Andersen & Co. Accountants,* Case C-472/03.
[85] ECJ judgement of 5 June 1997 in *Sparekassernes Datacenter v. Skatteministeriet*, Case C-2/95.

- 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.

3.58 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 have taken advantage.

CHAPTER 4 REVIEW OF SECONDARY MATERIALS

4.1 Introduction

4.1 The primary objective of this Chapter is to determine the extent to which there is evidence of a VAT-related distortion in the financial services sector of the EU25 within secondary or existing data sources. Information contained in this Chapter, which is sector-wide or aggregate in nature, is intended to complement and supplement company-specific primary research findings presented in Chapter 3.

The remainder of this Chapter comprises five additional Sections, the next of which describes the research approach adopted and associated challenges.

Section 4.3 describes the size profile of the EU25 financial services sector vis-à-vis that in other jurisdictions – with size, which can clearly be the source of considerable efficiency gains, closely related to the question of whether European financial services firms have been constrained in the exploitation of Single Market opportunities.

The relative profitability and pricing practices of EU25 financial services firms is the subject of Section 4.4, while outsourcing or the relative dependence of the European financial services sector on self- as opposed to contracted-supply is the subject of Section 4.5.

Key chapter findings are presented in Section 4.6.

4.2 Research Approach and Challenges

4.2 The research approach adopted to the completion of this Chapter was two-fold, namely: a) a review of all relevant secondary materials and statistics; and b) consultations with a selection of global financial services and outsourcing experts. The following were the main sources of secondary information reviewed:

- OECD Banking Statistics (2005)[86];
- OECD Insurance Statistics (2005)[87];
- World Retail Banking Report (2006)[88];
- PwC, Offshoring in the Financial Services Industry (2005)[89];
- Datamonitor & Mintel Reports (Various Years)[90];
- European Central Bank, US Federal Reserve & Reserve Bank of Australia[91];
- Dow Jones & Reuters Company & Industry Databases[92].

4.3 While the research underpinning the preparation of this report Chapter was comprehensive, there were a series of challenges inherent to the exercise.

4.4 Primary among these challenges were the following:

- **data availability** – notwithstanding an extensive research process, timely and affordable data was found not to be available in respect of all aspects of the financial services industries which PwC wished to examine;
- particular data availability issues were found to exist in respect of smaller financial services and investment management companies;
- **data comparability** – while data within individual jurisdictions and/or regions was found to be broadly comparable, definitional differences meant that this was not always the case when multiple jurisdictions were being considered;
- **benchmarking** – in view of the challenges inherent to identifying distortions in isolation, it was necessary to benchmark the EU25 financial services sector against that of other developed economies/regions in order to determine if there was any basis for believing a distortion existed;
- while this approach has the obvious drawback of potentially concluding that no distortion exists when the financial services sector in the EU25 conforms with international *norms*, it was the only feasible approach when using secondary research materials;

[86] OECD 2004 - "Bank Profitability, Financial Statements of Banks, 1994-2003".
[87] OECD 2005 – "Insurance Statistics Yearbook, 1994-2003".
[88] EFMA, CapGemini, ING, 2005 – "World Retail Banking Report 2005".
[89] PwC/ Economist Intelligence Unit 2005, "Off shoring in the Financial Services Industry: Risks and Rewards" - http://www.pwcglobal.com/extweb/ncsurvres.nsf/docid/58BED7FBF2646C6BCA25707D002F698F.
[90] Including Mintel, 2005 – "European Banking Market, Special Report, November 2005".
[91] http://www.ecb.int http://www.rba.gov.au/ http://www.federalreserve.gov.
[92] Otherwise known as "Factivia".

- **causation** – the difficulty inherent in many evaluations of this nature, there are clear challenges inherent in determining the precise causes of identified structural or service differentials between the financial services sectors of different regions, e.g. the role played by VAT as opposed to regulatory factors.

4.5 These constraints, which are partially addressed through the primary research, should be borne in mind in reviewing the remainder of this Chapter.

4.3 Scale and Exploitation of Single Market Opportunities

4.6 A key concern of the European Commission, and one clearly expressed in the Terms of Reference for this assignment, is that the existing VAT treatment of financial services in the EU25 may be serving to inhibit the exploitation of Single Market opportunities by European financial services firms.

4.7 In very simple terms, such opportunities fall into two broad categories, namely:

- the exploitation of a larger market for the supply of inputs, including labour, with potentially favourable implications for cost efficiency;
- the exploitation of a larger Single Market demand for financial services, with potentially favourable implications for organisational scale.

4.8 The first point dealing with the relative cost efficiency and profitability of the EU25 financial service sector is the subject of Section 4.4 and is not addressed here.

4.9 With regard to demand, financial services firms within the EU25 could theoretically exploit Single Market (retail) demand opportunities in one of two ways – namely:

- through the provision of financial services in the EU25 jurisdiction where demand opportunities are to be exploited, be that directly through the acquisition of an existing financial services company, the establishment of a branch or subsidiary or indirectly via an intermediary;
- remotely or on a cross-border basis.

4.10 While the development of a Single Euro Payments Area (SEPA), or a financial services market which has limited regard to individual country borders within the Eurozone, is an objective of the European Central Bank[93] – a series of issues mean that this is not expected to be achieved in its entirety before 2010[94].

[93] ECB Improving Cross-Border Retail Payments – The Eurosystem's View – September 1999.
[94] ECB Towards a single euro payments area – fourth progress report, February 2006. http://www.ecb.int/press/pr/date/2006/html/pr060217.en.html.

4.11 However, the VAT costs associated with the use of intermediaries in new EU25 markets or the setting up of subsidiary companies could theoretically act as a constraint to the EU25 market expansion objectives of European financial services firms – with important implications for relative scale.

4.12 The importance of scale to sectoral competitiveness was highlighted by Internal Market and Services Commissioner, Charlie McCreevy, in late 2005 as follows:

"Given the fierce global competition that is emerging, we cannot afford to have 25 medium-sized markets made up of second-division champions. We want to ensure that we extract the still-to-be-realised benefits of scale that the European market of 450 million people can offer. Therefore we must tackle the obstacles identified"[95].

4.13 While VAT arrangements are clearly only one of many possible constraints to the full exploitation of Single Market opportunities for financial services, the existence of scale-related disadvantages vis-à-vis firms elsewhere in the developed world is a prerequisite to a conclusion that VAT has frustrated the relative efficiency of the EU25 financial services sector by inhibiting the full exploitation of market opportunities.

4.14 An analysis of scale differentials is essentially the purpose of this Section.

4.15 In advance of doing so, however, indicators of the levels of EU25 internationalisation of EU25-controlled banks and insurance firms are presented in Tables 4.1 and 4.2.

[95] IP/05/1386 - http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/05/1386&format=HTML&aged=0&language=EN&guiLanguage=fr.

Table 4.1: Number of EU25-Controlled Bank Branches in Non-HQ EU25 Jurisdictions, 2006

Credit Institutions	Number of HQs with Branches elsewhere in EU25[96]	Average Number of EU25 Branches per HQ Organisation	Number of EU25 Foreign[97] Branches
Ireland[98]	11	2	32
Austria	18	1	25
Belgium	7	3	41
Cyprus	3	1	4
Czech Republic	2	1	13
Denmark	6	2	16
Estonia	0	n.a.	7
Finland	3	3	21
France	46	2	53
Germany	53	2	69
Greece	6	1	19
Hungary	0	n.a.	0
Italy	17	2	61
Latvia	2	2	1
Lithuania	0	n.a.	2
Luxembourg	14	2	32
Malta	0	n.a.	0
The Netherlands	25	2	2
Poland	0	n.a.	9
Portugal	11	2	23
Slovakia	1	1	6
Slovenia	1	1	3
Spain	21	1	57
Sweden	16	2	22
United Kingdom	26	3	81
Total	289	2	599

Source: ECB MFI Database (April 2006) / PwC Derived

4.16 Table 4.1 shows that there are close to 600 foreign branches of EU25-owned companies operating throughout the EU25, with the United Kingdom, Germany and Italy being home to in excess of 60 EU25-owned bank branches (as opposed to subsidiaries) each. With the exception of a number of new Member States, all EU25 jurisdictions are home to at least one headquarter company with branches elsewhere within the region.

[96] Data are not precisely in line with those contained in the ECB MFI Database, reflecting a policy of eliminating any duplication of headquarters (with identical unique HQ identifiers) when counting the number of headquarter companies in any EU25 jurisdiction.
[97] The term “foreign” here refers to branches which are under the control of a company headquartered in any other country of the EU25.
[98] There are 11 banks headquartered out of Ireland which have branches elsewhere within the EU25. These headquarter banks have an average of 2 EU25 branches each. Ireland is home to 32 branches of banks with their headquarters elsewhere in the EU25, i.e. excluding Ireland.

Table 4.2: Gross Insurance Premiums ($ mn) accounted for by Foreign Company Subsidiaries, 2003

	Gross Premiums (Life & Non Life)	Foreign Companies	% Foreign
Austria	$18,386	$7,879	43%
Denmark	$18,845	$3,285	17%
Germany	$256,732	$34,008	13%
Italy	$127,726	$34,247	27%
Luxembourg	$8,328	$4,339	52%
The Netherlands	$55,901	$15,967	29%
Portugal	$11,674	$3,409	29%
Spain	$53,712	$7,801	15%
Sweden	$28,093	$2,945	10%
United Kingdom	$335,313	$122,575	37%
Total	$914,710	$236,454	26%

Source: OECD Insurance Statistics Yearbook, 1994 to 2003

4.17 Similarly, Table 4.2 shows a high level of penetration of foreign company subsidiaries (as opposed to branches) in the insurance markets of a selection of EU25 countries, i.e. EU25 countries for which relevant information was available.

In aggregate, foreign company subsidiaries were found to account for more than a quarter of the value of gross (life and non-life) premiums in those EU25 countries reviewed, with this rising to in excess of 35% in the United Kingdom, Austria and Luxembourg.

4.18 Focusing more specifically on issues pertaining to relative scale, Tables 4.3, 4.4 and 4.5 profile the level of representation of EU25-controlled companies among the largest 100 publicly quoted banking, insurance and investment sectors globally.

Table 4.3: Regional Location of 100 Largest Insurance Plcs Globally

	Number of Companies	Value of Sales	Average Sales
	#	$ mn	$ mn
EU25	34	$1,078,994	$31,735
United States	32	$542,065	$16,940
Rest of World	13	$101,237	$7,787
Canada	6	$94,726	$15,788
Australia	3	$22,510	$7,503
Japan	6	$95,441	$15,907
Non-EU25 Europe[99]	6	$128,298	$21,383
Total	100	$2,063,271	$20,633

Source: Dow Jones Reuters Business Interactive LLC (April 2006), PwC Derived

Table 4.4: Regional Location of 100 Largest Banking / Credit Plcs Globally

	Number of Companies	Value of Sales	Average Sales
	#	$ mn	$ mn
EU25	42	$719,985	$17,142
United States	27	$684,272	$25,343
Rest of World	14	$133,600	$9,543
Canada	6	$65,923	$10,987
Australia	3	$38,709	$12,903
Japan	6	$80,495	$13,416
Non-EU25 Europe[100]	2	$91,338	$45,669
Total	100	$1,814,321	$18,143

Source: Dow Jones Reuters Business Interactive LLC (April 2006), PwC Derived

Table 4.5: Regional Location of 100 Largest Investment / Securities Plcs Globally

	Number of Companies	Value of Sales	Average Sales
	#	$ mn	$ mn
EU25	21	$31,456	$1,498
United States	44	$287,284	$6,529
Rest of World	14	$61,052	$4,361
Canada	10	$35,765	$3,576
Australia	2	$5,098	$2,549
Japan	8	$31,456	$3,932
Non-EU25 Europe[101]	1	$1,476	$1,476
Total	100	$453,588	$4,536

Source: Dow Jones Reuters Business Interactive LLC (April 2006), PwC Derived

[99] i.e. Switzerland & Norway.
[100] i.e. Switzerland & Norway.
[101] i.e. Switzerland & Norway.

4.19 It is clear from the foregoing that EU25-controlled companies are very well represented at the higher levels of the global insurance and banking sectors, but less well represented in the investment/securities industry.

4.20 EU25 Member States account for 34 of the largest insurance Plcs in the world, with this standing at 42 in banking and 21 in investment/securities.

4.21 In terms of relative size, leading EU25 insurance firms are considerably larger on average than their US or Asian counterparts – with the average sales of those included in the Top 100 list standing at $31.7 bn in 2005 compared with $17 bn for their US equivalents. By contrast, the 2005 sales of EU25 banks included in Table 4.4 are smaller than those of their US equivalents ($17.1 bn vs. $25.3 bn), while those of investment/securities firms are considerably less ($1.5 bn vs. $6.5 bn).

4.22 Table 4.6 develops the foregoing by placing the data presented in the foregoing tables into a wider sectoral context to determine the relative dominance or otherwise of EU25 Member States in the financial services sphere.

Table 4.6: Location of Banking & Insurance Top 100 Plcs in Wider Industry Perspective

% of Top 100 Plcs	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 Plc 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%

Source: Dow Jones Reuters Business Interactive LLC (April 2006), PwC Derived

Table 4.6 shows that the EU25 is relatively dominant in financial services sectors, relative to a selection of other sectors. More specifically, none of the other sectors reviewed account for as high a share of the top 100 global Plc sales in 2005 as either banking (40%) or insurance (52%). Therefore, and based solely on the foregoing analysis, it cannot be concluded that the EU25 financial services sector is presently suffering scale-related disadvantages.

4.23 This contention is supported by Table 4.7 which shows the consolidated asset base of the top 50 EU25-controlled banking firms, and Table 4.8 which presents a similar sales analysis for the top 50 EU25-controlled insurance public limited companies.

Table 4.7: Average Assets (€ mn) of Top 50 Banks in Europe, United States & Australia

	Europe Average[102]	US Average	Australia Average
	(Consolidated)	(Consolidated)	(Domestic)
	Total	Total	Total
Top 5	€950,062	€623,570	€127,055
Top 10	€825,377	€372,277	€73,214
Top 15	€738,192	€271,077	€52,090
Top 20	€666,744	€217,513	€40,909
Top 25	€605,711	€183,429	€33,613
Top 35	€505,117	€141,380	€24,595
Top 50	€387,823	€106,131	€17,400

Source: The Banker / Mintel, US Federal Reserve Board, Australian Prudential Regulation Authority

Table 4.8: Average $ Sales of Largest Plc Insurance Companies, Selected Regions, 2005

Average Sales	EU25	United States	Canada	Australia/New Zealand	Asia
Top 5	$98,542	$53,182	$18,111	$5,750	$17,444
Top 10	$76,996	$37,095	$10,308	$3,203	$12,620
Top 15	$60,244	$29,057	$6,914		$9,630
Top 20	$48,989	$24,233			$15,425
Top 35	$31,217	$15,748			$4,579
Top 50	$22,550	$11,620			$3,224

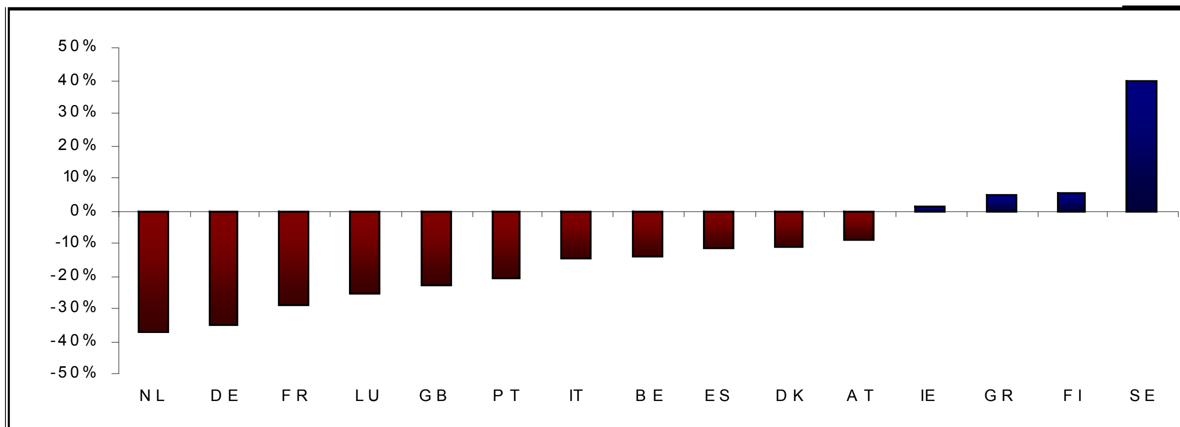
Source: Dow Jones Reuters Business Interactive LLC (April 2006), PwC Derived

4.24 Again, the scale of EU25-controlled banking and insurance firms would appear to compare very favourably with that of competitor regions such as the United States.

4.25 Moreover, and notwithstanding identified regulatory barriers to cross-border merger and acquisitions (M&A) activity within the EU25, data prepared by the European Central Bank in respect to the number of monetary financial institutions in the EU15 show that sectoral consolidation (with obviously favourable implications for enterprise scale) is ongoing (see Figure 4.1).

[102] The definition of Europe applied here includes two Swiss banks, namely UBS and Credit Suisse.

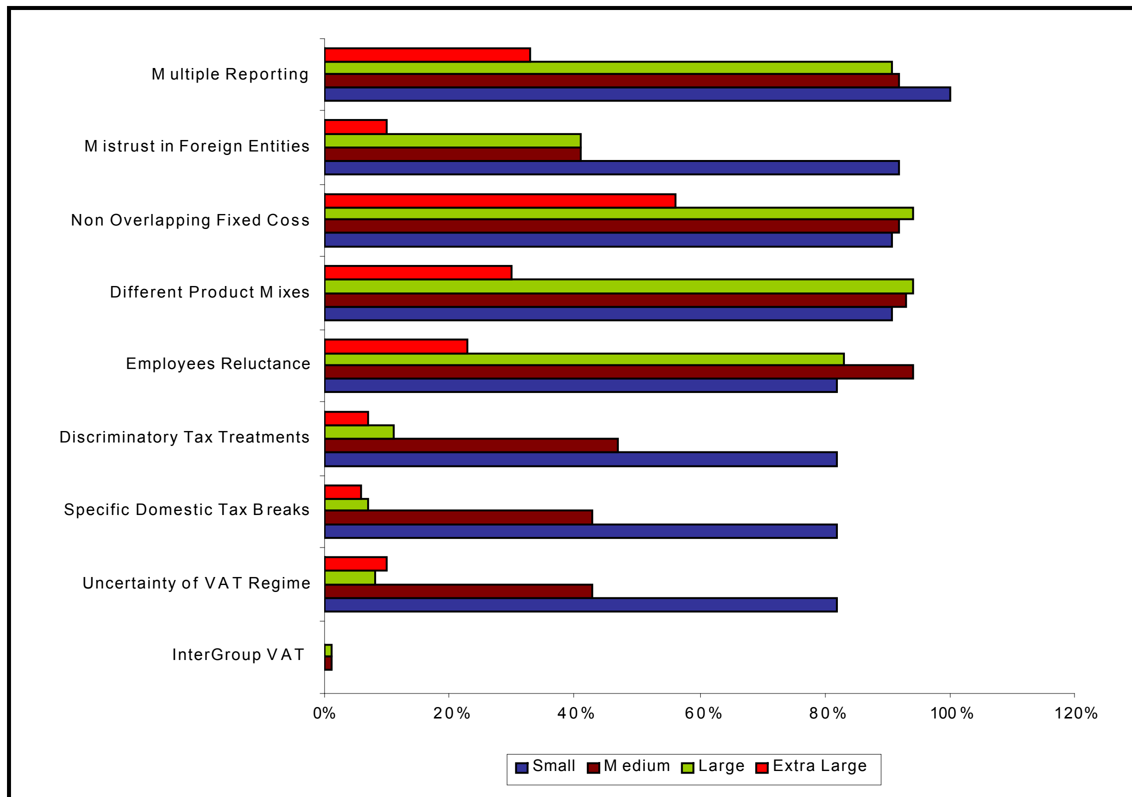
Figure 4.1: % Change in the Number of Credit Institutions in the EU15, 1999 to 2006



Source: ECB, MFI Statistical Reports, Selected Years

4.26 While the European financial services sector does not appear to suffer any apparent disadvantage of scale vis-à-vis that of other developed economies at present, a 2005 European Commission survey of financial services organisations found that certain aspects of the existing VAT regime may be constraining cross-border M&A activity.

Figure 4.2: % of EU25 Financial Services Firms indicating Barriers to Cross-Border M&A, 2005



Source: European Commission, Cross-Border Consolidation in the EU Financial Sector, SEC (2005) 1398[103]

[103] http://europa.eu.int/comm/internal_market/finances/docs/cross-sector/mergers/survey-results_en.pdf.

4.27 Uncertainty regarding the VAT treatment emerged as an important constraint to cross-border M&A activity, although the intra-group VAT treatment of merged entities did not feature in any of the responses. Supervisory and economic issues emerged in this survey as the predominant constraints to cross-border M&A in the EU25.

4.28 In summary, while European Commission survey work points to VAT as one of a series of potential constraints to cross-border M&A activity within the EU25, secondary research indicates that EU25-controlled financial services firms are not presently disadvantaged in terms of scale vis-à-vis their equivalents in non-EU25 jurisdictions. Whether this continues to be the case, or whether EU25 financial services firms would enjoy greater advantages of scale in the absence of the VAT exemption of financial services in the EU25, cannot, within the framework and scale of this Study, be determined.

4.4 Pricing Practices of EU25 Financial Services Firms & Profitability

4.29 As discussed previously, the existence of an embedded VAT cost may in theory result in higher charges to business users of financial services, *ceteris paribus*, or to a diminished profitability of financial services firms – depending on the extent to which firms seek to pass costs on to their customers or absorb these in their own cost base. The purpose of this Section is two-fold, namely:

- to determine the extent to which VAT-registered or business users of financial services within the EU25 pay higher prices for financial services than equivalent users in non-EU25 jurisdictions or regions;
- to determine the extent to which the financial services sector of the EU25 is more or less profitable than that of other jurisdictions or regions.

4.30 With regard to the former, comparable data on the pricing of services is available in respect of the banking sector only. The relative cost of financial services to retail VAT-registered users may be measured using either of two indicators, namely:

- net interest margin, or total interest income less interest costs expressed as a % of total interest income, i.e. the interest *mark up* applied by banks;
- the reported cost of finance to business customers.

4.31 Net interest margins would be higher in a situation where a bank was putting embedded VAT costs onto total interest expense plus margin to arrive at a price for a defined financial service – see Table 4.9.

Table 4.9: Embedded VAT and Net Interest Margin (Illustrative Example)

		Scenario 1	Scenario 2
		No Embedded VAT	Embedded VAT Added to Interest Margin
A = B + C + D	Total Income	100	110
B	Interest Expense	50	50
C	Embedded VAT Costs	0	10
D = A - B	Net Interest Income	50	60
E = D / A	Net Interest Margin	50%	55%

4.32 Comparable information on the net interest margins of the banking sector in the OECD is available from the OECD compendium of Banking Profitability Statistics for the period from 1997 to 2003. Details are provided in Table 4.10.

Table 4.10: Net Interest Margin[104] of Banking Sector in OECD Countries, 2003

	All Banks	All Commercial Banks	All Large Commercial Banks
Australia	40%	n.a.[105]	n.a.
Austria	33%	n.a.	n.a.
Belgium	17%	n.a.	17%
Canada	n.a.	50%	n.a.
Czech Republic	55%	n.a.	n.a.
Denmark	n.a.	n.a.	n.a.
Finland	48%	43%	n.a.
France	20%	17%	16%
Germany	31%	31%	25%
Greece	n.a.	57%	43%
Hungary	n.a.	43%	n.a.
Ireland	29%	n.a.	n.a.
Italy	58%	n.a.	n.a.
Japan	83%	n.a.	n.a.
Luxembourg	n.a.	12%	n.a.
The Netherlands	n.a.	n.a.	n.a.
New Zealand	36%	n.a.	n.a.
Norway	36%	33%	n.a.
Poland	54%	53%	n.a.
Portugal	n.a.	35%	n.a.
Spain	53%	48%	n.a.
Sweden	n.a.	38%	n.a.
Switzerland	42%	n.a.	37%
United Kingdom	n.a.	45%	n.a.
United States	n.a.	71%	71%
Available EU15	33%	33%	20%

Source: OECD, Bank Profitability, Financial Statements of Banks, 1994-2003

4.33 No discernible patterns emerge from the net interest margin statistics of the OECD, with net interest margins within the EU15 in 2003 clearly being subject to a high level of variation and this trend also apparent globally.

4.34 Taken in aggregate, however, there is no evidence in Table 4.10 of high embedded VAT costs being incorporated into the interest rates charged by EU15 banks – with the aggregated net interest margins of the banking sectors in EU15 countries being behind that of certain other OECD economies, most notably the United States.

4.35 If EU15 banks were pricing on the embedded VAT costs, one would expect the net interest margin (i.e. net interest/total interest income) to be higher.

4.36 An analysis of the net interest margins of a selection of the world's leading banking Plcs results in a similar conclusion (see Table 4.11).

[104] Net interest margin was computed as (Total Interest Income – Interest Expense)/ Total Interest Income.
[105] As used in this Table, n.a. means not available.

Table 4.11: Net Interest Margin[106] 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%

Source: Dow Jones Reuters Business Interactive LLC (April 2006), PwC Derived

4.37 Tables 4.12 and 4.13 provide an overview of the interest rates charged by banks to non-financial business customers in the United States and Eurozone respectively.

Table 4.12: Interest Rates Charged to Business Customers by US Commercial Banks, February 2006

All Commercial Banks, February 2006	Interest Rate	Federal Funds Rate	Difference
All Business Loans	6.32	4.5	1.82
All Business Loans (Variable)	5.63	4.5	1.13
All Business Loans (Variable & No Risk)	4.94	4.5	0.44
All Business Loans (Fixed & Moderate Risk)	6.4	4.5	1.9
All Business Loans (> $100,000 < $ 1 mn)	7.47	4.5	2.97
All Business Loans (> $ 1 mn < $ 10 mn)	6.51	4.5	2.01
All Business Loans (> $ 10 mn)	5.77	4.5	1.27

Source: US Federal Reserve Board, PwC Derived

[106] Net interest margin was computed as (Total Interest Income – Interest Expense)/ Total Interest Income.

Table 4.13: Interest Rates Charged to Business Customers by Eurozone Banks, January 2006

ECB, January 2006	Interest Rate	RFO	Difference
Bank Overdraft	5.24	2.25	2.99
Loans < € 1 mn			
1-5 Years (initial rate fixation)	4.59	2.25	2.34
Floating Rate and Up to 1 Year Initial Rate Fixation	4.07	2.25	1.82
Loans > € 1mn			
1-5 Years (initial rate fixation)	3.71	2.25	1.46
Floating Rate and Up to 1 Year Initial Rate Fixation	3.18	2.25	0.93

Source: European Central Bank, PwC Derived

4.38 In contrast to the data presented in Table 4.10, which partially indicated lower net interest margins in the case of EU15 banks, a comparison of data contained in Tables 4.12 and 4.13 points to no significant differences in the margins charged on loans to businesses between the United States and the Eurozone – although the cost of finance in the Eurozone is clearly now lower than in the case of the United States.

4.39 In this regard, however, it is important to note that the European Central Bank or Central Bank interest rates are clearly not the only determinant of the cost of funds provided by banks, nor are the data presented in Tables 4.12 and 4.13 perfectly comparable. For this reason, care should be exercised in drawing conclusions from this analysis.

4.40 Again, however, the OECD prepares periodic analyses of the relative profitability of the banking sector in its member countries. Details for 2003, the most recent year, are shown in Table 4.14.

Table 4.14: Net Profit Margin of Banking Sector in OECD Countries, 2003

Net Profit Margin	All Banks	All Commercial Banks	All Large Commercial Banks
Australia	6%	n.a.[107]	n.a.
Austria	1%	n.a.	n.a.
Belgium	1%	n.a.	10%
Canada	n.a.	17%	n.a.
Czech Republic	8%	n.a.	n.a.
Denmark	n.a.	n.a.	n.a.
Finland	33%	38%	n.a.
France	2%	8%	10%
Germany	2%	-6%	-12%
Greece	n.a.	15%	17%
Hungary	n.a.	17%	n.a.
Ireland	4%	n.a.	n.a.
Italy	4%	n.a.	n.a.
Japan	1%	n.a.	n.a.
Luxembourg	n.a.	9%	n.a.
The Netherlands	n.a.	n.a.	n.a.
New Zealand	6%	n.a.	n.a.
Norway	3%	7%	n.a.
Poland	5%	11%	n.a.
Portugal	n.a.	12%	n.a.
Spain	3%	17%	n.a.
Sweden	n.a.	17%	n.a.
Switzerland	3%	n.a.	15%
United Kingdom	n.a.	20%	n.a.
United States	n.a.	29%	30%
Available EU15	3%	12%	n.a.

Source: OECD, Bank Profitability, Financial Statements of Banks, 1994-2003

4.41 Table 4.14 indicates that the banking sector in EU15 countries is typically less profitable than that of other developed economies/regions – although rates of profitability are clearly subject to a high level of intra-European variation. In 2003, the average profitability of *all banks* in the EU15 was just 3% compared with 6% for Australia and New Zealand. The term *all banks*, however, incorporates all financial institutions – including those which are service as opposed to profit driven, e.g. credit unions or community-based banks. When commercial banks only are considered, the profit differential between the EU15 and other developed economies is less pronounced – although is still in evidence.

4.42 Very significant variations between individual countries in terms of sectoral profitability, however, raise some concerns about the strict comparability of OECD data on the profitability of banking sectors within the developed world.

[107] As used in this Table, n.a. stands for not available.

4.43 A more practical approach, and one which incorporates insurance as well as banking, is to examine the reported profit of the Top 100 global Plcs in banking and insurance – distinguishing by country of location. High level findings from this PwC analysis are presented in Tables 4.15 and 4.16.

Table 4.15: Net Profit Margin of Banking Sector, Top 90 Global Plcs[108], 2005

	EU25	United States	Australia/ New Zealand	Asia	Canada	RoW[109]	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%

Source: Dow Jones Reuters Business Interactive LLC (April 2006), PwC Derived

Table 4.16: Net Profit Margin of Insurance Sector, Top 96 Global Plcs[110], 2005

	EU25	United States	Australia/ New Zealand	Asia	Canada	RoW[111]	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%

Source: Dow Jones Reuters Business Interactive LLC (April 2006), PwC Derived

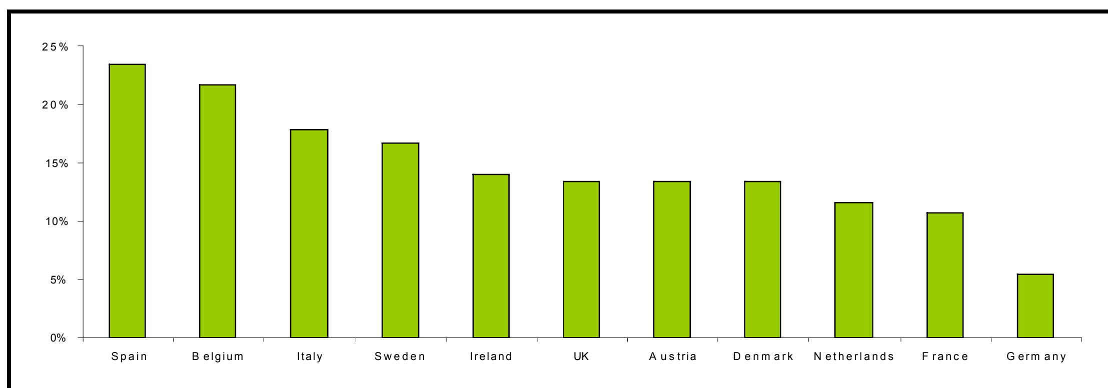
4.44 Table 4.15 shows that average net profit of Europe's largest banking Plcs is, at 12.4%, less than that for the top 90 banking Plcs globally (13.3%). Perhaps, more significantly, profit margins are considerably below those realised by US and Asian banking Plcs – which, after Europe, dominate the list of large global players.

4.45 A similar conclusion is in evidence in Table 4.16, 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.

[108] Profit margins were available in respect of 90 of the top 100 global Plcs falling under into the "banking/credit" sectoral classification.
[109] Rest of World – any country other than those listed.
[110] Profit margins were only available in respect of 96 of the top 100 global Plcs falling under into the "banking/credit" sectoral classification.
[111] Rest of World – any country other than those listed.

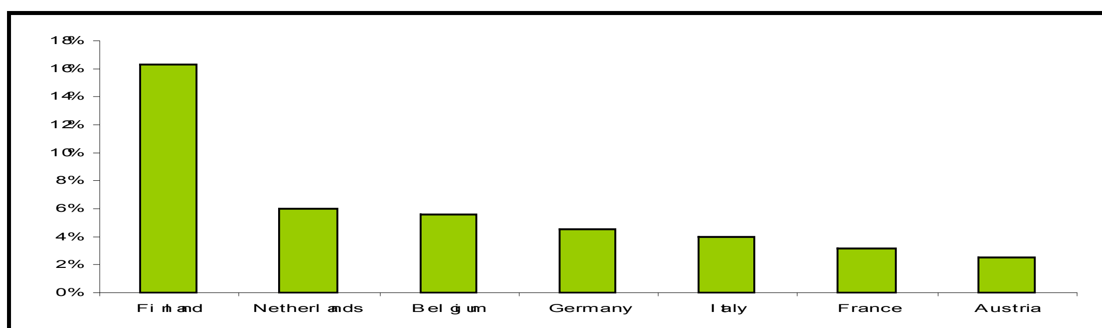
4.46 In order to help determine the extent to which relatively low profit margins, which can of course indicate highly competitive markets as well as distortions, were endemic to the EU25 or simply unduly influenced by a small number of large firms – net profit margins for the EU25 were disaggregated to individual country level. Details are provided for the banking and insurance sectors in Figures 4.3 and 4.4 respectively.

Figure 4.3: Net Profit Margins of Largest Global Banking Plcs located in EU25, 2005



Source: Dow Jones Reuters Business Interactive LLC (April 2006), PwC Derived

Figure 4.4: Net Profit Margins of Largest Global Insurance Plcs located in EU25, 2005



Source: Dow Jones Reuters Business Interactive LLC (April 2006), PwC Derived

4.47 Figure 4.3 shows a wide range of sectoral net profit margins across the EU25, with the aggregated net profit margins of leading banking Plcs in Spain, Belgium, Italy and Sweden exceeding the global average (13.3%) by very considerable margins.

4.48 Indeed, a relatively poor performing German banking sector would appear to account in large part for an overall relatively poor performance. Excluding Plcs with German headquarters, the aggregate profitability of major EU25 Plcs rises to 13.7%.

4.49 Excluding Finland (which is home to just one global insurance Plc), however, Figure 4.4 shows a relative uniform profit performance among major global insurance Plcs with their headquarters within the EU25 – suggesting that factors endemic to the external environment in the EU25 as opposed to individual companies or countries are to blame for profit differentials with the United States and other OECD regions.

4.50 In summary, there was no evidence from secondary research sources that business users of financial services are being charged higher prices than their US or other developed economy equivalents – i.e. the mark-up on interest charges is not noticeably higher in the EU25. Against this, however, there is tentative evidence in secondary research that the EU25 financial services sector is not as profitable as that in other OECD regions, e.g. the United States. Pan-European factors which might contribute to tighter profit margins are numerous, including the existence of an embedded VAT cost and more restrictive labour market regulations.

4.51 Significant differences between the profitability of financial services sectors within the EU25, as well as between individual EU25-controlled corporate entities, however, suggest that country specific as opposed to pan-European factors may be at play.

4.52 In summary, it is not possible to state definitively, from a review of secondary sources, to what extent embedded VAT costs are influencing the prices businesses in the EU25 are charged for financial services. By extension, it is not possible to be definitive whether a change in the existing VAT regime would have favourable implications for the prices charged to business customers.

4.5 Offshoring[112] & Outsourcing Among EU25 Financial Services Organisations

4.53 This Section seeks to determine the extent to which EU25 financial services firms are less inclined to engage in efficiency-seeking offshoring or outsourcing arrangements than their non-EU25 equivalents. Survey research undertaken by PwC in 2005, in conjunction with the Economist Intelligence Unit (EIU)[113], represents one of the most comprehensive studies ever undertaken in respect of the offshoring[114] and outsourcing behaviour of financial services firms.

4.54 Selected statistical detail is presented in Tables 4.17 to 4.20.

Table 4.17 shows the length of time which financial services companies have been offshoring, distinguishing by the region in which the company is headquartered.

Table 4.17: Length of Time which Company has been Offshoring

	Americas	Asia	Europe[115]
More than 10 Years	9%	11%	32%
6-10 Years	21%	25%	10%
5 Years	3%	17%	13%
4 Years	9%	8%	12%
3 Years	9%	6%	18%
2 Years	12%	14%	7%
1 Year or Less	6%	14%	3%
We Do not Offshore	32%	6%	5%
Total	100%	100%	100%

Source: PwC / EIU, Offshoring in the Financial Services Industry, Risk & Rewards, July 2005

4.55 The first finding of note from Table 4.17 is that a lower share of European respondents indicated that they are not presently offshoring (5%) than Asian (6%) or American (32%) respondents[116]. In addition, the share of European financial services firms which have been offshoring for more than ten years is, at 32%, considerably higher than the respective share for Asia (11%) or the Americas (9%).

[112] As a generic term, offshoring refers to the practice of relocating an existing activity out of the country in which it is presently provided. The term provides no indication of whether the activity in question is provided by the company itself or contracted to a third party. By contrast, the term "outsourcing" is used in reference to an arrangement whereby a firm contracts with a third party for the provision of a service which was previously provided in-house (unless otherwise specified). It is important to stress in this regard that outsourcing is not synonymous with offshoring – as is frequently assumed to be the case. Offshoring entails the sending of activities to another jurisdiction – and has no regard to whether these are provided internally or by a third party.

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

[114] Offshoring as used in this survey refers to the practice of changing the location of a given activity, e.g. relocation of back-office functions to the United Kingdom or India. Offshoring does not include domestic outsourcing, e.g. contracting activities to a third party provider in the same jurisdiction. Outsourcing as used here refers to the contracting of activities to a third party in a jurisdiction other than that in which the company in question is located, i.e. domestic outsourcing is excluded from consideration. While a large volume of offshored activity is outsourced, a very high proportion of outsourced activity is reported to remain within the original jurisdiction.

[115] Europe was defined by the survey respondents, who were asked to indicate if they were resident in Eastern Europe or Western Europe.

[116] The EIU/PwC survey was not, however, designed to measure inter-regional differences and there is some size bias in favour of European respondents which should be borne in mind in interpreting findings.

4.56 Table 4.18 presents an overview of the activities which are presently offshored by financial services firms resident in the Americas, Asia and Europe.

Table 4.18: Activities which are Presently Offshored & Will Continue to be Offshored

	Americas	Asia	Europe
Lower Value IT Activities	24%	39%	59%
Higher Value IT Activities	35%	30%	36%
Lower Value Customer Contact Activities	9%	14%	40%
Higher Value Customer Contact Activities	15%	3%	24%
Lower Value HR Activities	3%	22%	19%
Higher Value HR Activities	6%	8%	7%
Lower Value Finance Activities	9%	28%	19%
Higher Value Finance Activities	9%	14%	7%
Knowledge Based Activities	12%	11%	15%

Source: PwC / EIU, Offshoring in the Financial Services Industry, Risk & Rewards, July 2005

4.57 Lower value IT and customer contact activities are those activities most likely to be offshored by European financial services firms, with American and Asian firms being more inclined to offshore higher-value IT activities than their European equivalents. A relatively high reticence to offshore any form of higher-value activity is in evidence among European respondents – with the exception of knowledge-based activities.

Table 4.19 shows the preferred offshoring model of financial services firms by region.

Table 4.19: Offshoring Models Used by Activity & Region (Valid % of Respondents)

	Americas	Asia	Europe
Outsourcing			
Lower Value IT Activities	59%	52%	42%
Higher Value IT Activities	34%	30%	31%
Lower Value Back Office Processes	51%	38%	27%
Higher Value Back Office Processes	24%	15%	8%
Lower Value Front End Processes	28%	23%	26%
Higher Value Front End Processes	31%	16%	10%
Knowledge Based Activities	17%	10%	15%
Captive			
Lower Value IT Activities	41%	29%	42%
Higher Value IT Activities	38%	55%	43%
Lower Value Back Office Processes	35%	34%	55%
Higher Value Back Office Processes	55%	53%	65%
Lower Value Front End Processes	72%	56%	61%
Higher Value Front End Processes	64%	64%	70%
Knowledge Based Activities	78%	72%	69%
Other			
Lower Value IT Activities	0%	19%	16%
Higher Value IT Activities	28%	15%	26%
Lower Value Back Office Processes	13%	28%	18%
Higher Value Back Office Processes	20%	32%	27%
Lower Value Front End Processes	0%	21%	13%
Higher Value Front End Processes	5%	20%	20%
Knowledge Based Activities	5%	18%	15%
Total			
Lower Value IT Activities	100%	100%	100%
Higher Value IT Activities	100%	100%	100%
Lower Value Back Office Processes	100%	100%	100%
Higher Value Back Office Processes	100%	100%	100%
Lower Value Front End Processes	100%	100%	100%
Higher Value Front End Processes	100%	100%	100%
Knowledge Based Activities	100%	100%	100%

Source: PwC / EIU, Offshoring in the Financial Services Industry, Risk & Rewards, July 2005

4.58 Key points of note from Table 4.19 are the following:

- captive or in-house offshoring is the most popular model of offshoring among financial services firms, with this marginally more popular in the case of European financial services than American or Asian;
- outsourcing is the next most popular model of offshoring among American or Asian financial services firms, but would appear to enjoy equal status with Joint Venture and *Build Operate Transfer Models* in the case of Europe;
- those offshored activities which are most likely to be outsourced in the case of European financial services firms are IT activities and lower value front-office and back-office processes;
- factors underpinning differences in preferred model are not explained in the PwC / EIU report – although it is clear from the report that general tax and VAT considerations are more prevalent in the considerations of European financial services firms when choosing a location for offshoring than their American or Asian equivalents (see Table 4.20).

Table 4.20: Key Factors Considered in Choosing Location for Offshoring

	Americas	Asia	Europe
Political Stability	59%	72%	59%
Low Labour Costs	68%	57%	57%
High Level of Education	47%	51%	53%
Language Skills	50%	37%	52%
Quality of IT & Comms Infrastructure	50%	46%	45%
Tax or VAT Regime	9%	20%	38%
Macro-economic Stability	41%	34%	36%
Availability of Talent	47%	49%	31%

Source: PwC / EIU, Offshoring in the Financial Services Industry, Risk & Rewards, July 2005

4.59 Financial services firms' levels of satisfaction with the cost savings realised from offshoring are shown by region in Table 4.21.

Table 4.21: Levels of Satisfaction with Cost Savings Realised from Offshoring

	Americas	Asia	Europe
Very Satisfied	17%	17%	28%
Satisfied	57%	58%	54%
Total Satisfied	74%	75%	82%
Dissatisfied	17%	25%	15%
Very Dissatisfied	9%	0%	3%
Total Dissatisfied	26%	25%	18%
Total	100%	100%	100%

Source: PwC / EIU, Offshoring in the Financial Services Industry, Risk & Rewards, July 2005

4.60 Notwithstanding the potential VAT implications of offshoring, the % of European financial services firms declaring themselves satisfied with the cost savings realised from offshoring is higher (82%) than for American (74%) or Asian (75%) firms.

4.61 The pursuit of cost savings (in terms of labour or tax) is evident in the profile of countries to which the activities of European financial services firms are offshored or will be offshored into the future (see Table 4.22).

Table 4.22: Current & Future Locations of European Financial Services Offshoring

	Current Locations		Future Locations
1	India	1	China
2	Ireland	2	India
3	Hungary	3	Poland
4	Singapore	4	Brazil
5	Australia	5	Cayman Islands

Source: PwC / EIU, Offshoring in the Financial Services Industry, Risk & Rewards, July 2005

4.62 India is the most popular location for the offshoring of European financial services firms activities, followed by Ireland and Hungary. Going forward, China is expected to supersede India as the first country of choice, followed by India and then Poland.

4.63 In summary, the PwC/EIU analysis of financial services offshoring 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.

4.64 Subsequent research undertaken by the Economist Intelligence Unit into business process re-engineering in financial services firms[117] found that European financial services 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:

"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 complicated"[118].

[117] http://www.eds.com/services/innovation/downloads/bpt_financial.pdf.
[118] http://www.eds.com/services/innovation/downloads/bpt_financial.pdf (page 14).

4.65 Research undertaken by the Everest Group[119] into major outsourcing contracts signed by financial services companies between 1999 and 2004 also finds that North American banks and insurance companies are not alone in outsourcing:

"This is not a North American phenomenon. European banks and insurance companies have outsourced aggressively. Everest analysis found that North America only accounted for 36 percent of the $90.5 billion in total contract value for the five-year period. Europe, the Middle East and Africa (EMEA) accounted for 35 percent. Asia/Pacific did 13 percent of the volume with multi-regional transactions equalling 16 percent".

4.66 In contrast to the EIU research, however, the Everest Research found that North American financial services companies accounted for a greater share of large outsourcing contracts than their European equivalents. In addition, banks were found to be more proactive in outsourcing than their insurance equivalents globally.

4.67 An analysis of financial information available in respect of banking firms/sectors did not reveal any significant differences between United States and EU25 financial services firms in terms of the productivity or relative costs of labour (see Table 4.23 and 4.24), indicating that there are no major differences in outsourcing practices.

Table 4.23: Total Sales per Employee in Leading Banking Plcs by Region

	EU25	United States	Australia/ New Zealand	Asia	Canada	Rest of World	Total
Total Sales ($ mn)	$680,795	$516,623	$51,068	$101,666	$56,496	$136,963	$1,543,611
Employees	2,119,627	1,557,585	133,343	757,563	220,579	564,368	5,353,065
Sales per Employee	$321,186	$331,682	$382,984	$134,201	$256,128	$242,684	$288,360

Source: Dow Jones Reuters Business Interactive LLC (April 2006), PwC Derived

[119] http://www.outsourcing-journal.com/may2005-everest.html.

Table 4.24: Employee Costs as a % of Total Operating Costs, Banking Sector, OECD

	All Banks	All Commercial Banks	All Large Commercial Banks
Australia	41%	n.a.[120]	n.a.
Austria	50%	n.a.	n.a.
Belgium	55%	n.a.	59%
Canada	n.a.	55%	n.a.
Czech Republic	27%	n.a.	n.a.
Denmark	n.a.	n.a.	n.a.
Finland	38%	37%	n.a.
France	0%	n.a.	n.a.
Germany	54%	49%	52%
Greece	n.a.	58%	62%
Hungary	n.a.	44%	n.a.
Ireland	51%	n.a.	n.a.
Italy	55%	n.a.	n.a.
Japan	46%	n.a.	n.a.
Luxembourg	n.a.	57%	n.a.
The Netherlands	57%	n.a.	n.a.
New Zealand	n.a.	n.a.	n.a.
Norway	52%	54%	n.a.
Poland	48%	46%	n.a.
Portugal	n.a.	48%	n.a.
Spain	61%	60%	n.a.
Sweden	n.a.	53%	n.a.
Switzerland	63%	n.a.	68%
United Kingdom	n.a.	50%	n.a.
United States	n.a.	45%	43%
EU15	55%	52%	44%

Source: OECD, Bank Profitability, Financial Statements of Banks, 1994-2003

4.68 Similarly, a review of Datamonitor press releases in respect of the outsourcing behaviour of EU25 financial services firms for the past 12 months indicates that large financial services firms within the EU25 are engaged in considerable levels of outsourcing activity. A selection of these news releases is presented in Box 4.1.

[120] As used in this Table, n.a. stands for not available.

Box 4.1 Financial Services Outsourcing Datamonitor News Releases[121]

Company: **Selected European Insurance Companies**
Date: 30th of March 2006

*"**Aviva Plc**, the world's sixth largest insurance company, announced earlier this month that it has cut annual costs in general insurance by 250m pounds ($438m), specifically mentioning its decision to outsource hundreds of back-office and IT processing jobs to India as a key factor. The group has already outsourced 5,000 positions to India and has plans to take the number up to 8,000."*

*"**AXA**, which ranks as the largest insurance company in the world, has almost 2,000 employees working in its Indian IT and BPO services operation called AXA Business Services, ABS, and is aiming to grow this total to 3,000 by 2008. The unit was set up in 1997 and has two sites in Bangalore and one in Pune supporting the company's client-facing activities in France, the United Kingdom, the United States, Japan, and Australia."*

Company: **Deutsche Bank**
Date: 27th of March 2006

*"Deutsche Bank is outsourcing almost half of its back-office jobs in its sales and trading operation to **India** by the end of next year, according to a report in the Financial Times. The plan to move jobs overseas, where graduates can be hired for a fraction of the cost, is part of a reorganization that has already saved € 1.9 billion in costs. The move would triple the German bank's global markets staff offshore to nearly 2,000, the report said."*

Company: **La Caixa**
Date: 21st of December 2005

*"Business process **outsourcing** services (BPO) firm EDS has announced a deal with Spanish financial services company La Caixa to continue its provision of outsourced support services. The deal, worth around $238 million, will extend a relationship that has existed since 1996. According to the contract, EDS will provide IT technology and infrastructure to the Spanish firm while adding new services such as banking and insurance software development."*

Company: **ABN Amro**
Date: 2nd of September 2005

*"In one of the largest-ever overhauls of an IT department, financial services company ABN Amro is cutting 1,500 internal tech jobs, and transferring a further 2,000 to external vendors with which it has signed a total of $2.2bn in outsourcing contracts. Amsterdam-based ABN Amro hopes to cut IT costs by 258m euros ($320m) annually from 2007 by outsourcing its server and desktop infrastructure to IBM Global Services in a 1.5bn-euro ($1.9bn) deal, and handing over its applications maintenance to Tata Consultancy Services and Infosys Technologies in two contracts worth a minimum of 300m euros ($372m) combined. ABN Amro's **outsourcing** program might not end here. Gustavsson said that while the company will retain control of managing its **outsourcing** relationships and IT security functions, it is looking at different ways its telecoms and data networks, which could include **outsourcing**."*

Company: **Nordea**
Date: 2nd of September 2005
"Leading Scandinavian banking group Nordea has signed an agreement to outsource its paper document management services to Helsinki-based Itella. Itella, a Finland Post-owned financial administration solutions business, will handle the data capture, storage and archiving of documents relating to payment services, such as bank card slips and contracts. Under the terms of the agreement, 70 employees will be transferred to Itella. Nordea said the change will not lead to any redundancies. Last year Nordea outsourced the back-office handling of paper-based payments services at its Sweden unit to Stockholm BPO firm Tradimus and also closed down its Nordic equity research department and outsourced the operations to Standard & Poor's. "

Company: **Norwich Union**
Date: 2nd of June 2005

"Norwich Union has transferred another 70 jobs to India. Norwich Union Direct has transferred around 70 UK customer-facing positions to its Indian offshore operations. Despite concerns from customers, employees and trade unions, the cost benefits arising from offshoring mean that the strategy is sure to remain an attractive option for major insurers. The announcement that Norwich Union Direct has transferred more staff to India from its Glasgow base is further evidence of the growth of offshoring in the UK insurance sector. Its parent group Aviva has already publicly pledged to employ more than 7,000 people in its Indian and Sri Lankan operations by 2007. "

Company: **ING Groep NV**
Date: 14th of July 2005

"Dutch financial institution ING is planning to streamline the processes and organization of its Operations & IT division in the Benelux market. The move forms part of ING's strategy to continually reduce costs and improve efficiency to preserve its competitive position. The company estimates that the streamlining process will produce an annual cost reduction of 39m euros. However, the operation will mean that 450 employees who work in IT infrastructure for both ING's banking and insurance activities will become redundant. In Belgium the number of positions will decrease through natural attrition. ING said it will establish a mobility centre to support staff during their search for suitable jobs. ING also announced that it was looking into sourcing, in particular the possibilities of sourcing activities within ING or outsourcing activities to a third party."

Source: Datamonitor News & Comment

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

4.69 While the foregoing analysis suggests limited differences between EU25 and non-EU25 financial services firms in terms of outsourcing or offshoring behaviours, it is important to bear in mind that publicly available information sources such as those presented in this Chapter are heavily biased towards larger firms.

4.70 To the extent that smaller firms, with no international branch or subsidiary networks, may be more inclined to use local third-party providers for outsourced services, the influence of VAT costs on the outsourcing business case is likely to be more significant than in a situation where there are significant labour cost savings.

4.71 Unfortunately, secondary data which would allow for a comparison of the incidence of self-supply among smaller EU25 financial services firms vis-à-vis their US or Asian equivalents is not available. This information constraint should be noted.

4.6 Key Chapter Findings

4.72 The foregoing Sections presented an analysis of secondary information and data with a view to determining the extent to which there are evident differences between the financial services sector in the EU25 and that elsewhere in terms of:

- **scale** – with relative scale deficiencies closely related to the question of the extent to which financial services firms are frustrated in exploiting the demand opportunities associated with the Single Market;
- **interest margins** – with a view to determining if the interest margins charged by EU25 banks were higher as a result of a passing-off of embedded VAT costs to customers vis-à-vis banks in locations with no embedded VAT costs;
- **profit margins** – closely related to the foregoing, with a view to determining the extent to which the profit margins of EU25 financial services firms were lower as a result of absorbing embedded VAT into their overall cost base;
- **self-supply** – or the extent to which EU25 financial services firms are more inclined towards self- as opposed to outsourced supply as a result of the identified VAT disincentives to the engagement of third parties.

4.73 An analysis of secondary research findings found no material differences between the financial services sector in the EU25 and that of other developed economies in terms of: a) scale; b) interest margins; or c) self-supply, which would suggest that VAT was placing the EU25 sector at a disadvantage to competitors elsewhere. In considering this conclusion, however, it should be borne in mind that secondary research is clearly limited in terms of direct application to the current Study, i.e. secondary research findings were not designed for the purposes of this Study. Moreover, while the EU25 financial services sector may not deviate in these respects from that of other developed economies – this is not to say that EU25 financial services firms are not being constrained by VAT regulations[122]. These are challenges inherent to the use of any secondary materials/research and, for this reason, our research approach incorporates a significant primary research element.

[122] For example, while EU25 banks were found not to suffer scale disadvantages vis-à-vis their US counterparts – in a changed VAT regime, they might enjoy greater advantages of scale.

CHAPTER 5 COMMENTARY ON RESEARCH PHASE II FINDINGS

5.1 Introduction

5.1 This Chapter seeks to develop the analysis presented in Chapters 3 and 4 by providing a qualitative interpretation of research findings. Within the scheme of the wider report, the commentary contained in this Chapter is intended to provide a bridge between the research and solutions phases of the assignment and to ensure that the questions asked of PwC in the Study Terms of Reference are comprehensively addressed.

The remainder of this Chapter comprises three additional Sections, the first of which addresses the question whether there was found to be empirical evidence of VAT-related distortions in the financial services sector of the EU25. Section 5.3 considers the importance of identified distortions at present and going forward, while Section 5.4 provides details of the features of the existing VAT system which underpin identified distortions.

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

5.2.1 Introduction

5.2 The purpose of this Section is to present PwC's opinion on the incidence of VAT-related distortions in the EU25 market for financial services.

5.3 Distortions are discussed under a series of headings, broadly consistent with the outline of potential VAT-related distortions described in Chapter 2.

5.2.2 Pricing Practices & Profitability of EU25 Financial Services Providers

5.4 Case Study Companies were asked to provide details of the extent to which the net costs of embedded VAT were passed onto VAT-registered customers. Unfortunately, the greatest number of respondents was not in a position to do so – reflecting the fact that embedded VAT costs are treated by financial services firms as any other overhead cost.

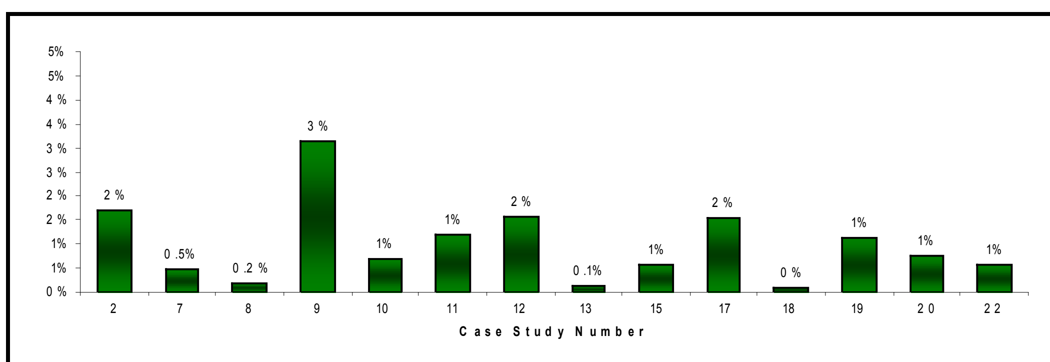
5.5 An analysis of secondary research materials on the pricing practices of EU25 financial services firms vis-à-vis their US equivalents indicated that EU25 buyers of financial services typically do not pay a higher mark-up on services than their non-EU25 equivalents – although there are clearly important challenges in drawing definitive conclusions in this regard.

5.6 By contrast, a detailed analysis of the profitability of the top 100 global financial services plcs, disaggregated by the location of their global headquarter, indicated that EU25 financial services firms tend to record lower profit margins than their equivalents in other developed economies.

5.7 Case study research also pointed to the potentially significant profit implications of the costs associated with irrecoverable VAT (see Figure 5.1)[123].

[123] Again, however, it should be borne in mind that most of the Case Study Companies provide services to non-registered customers. To the extent that this is the case, many Case Study Companies enjoy cost advantages as a result of being VAT exempt.

Figure 5.1: Implication of Irrecoverable VAT for Net Profit Margins of Case Study financial services Firms



5.8 While it is clear from the financial analysis undertaken by Case Study Companies that the costs of embedded VAT can have a significant negative impact on profitability, it is not possible to state definitively that VAT is the sole cause of the identified differential between the profit margins of EU25 and non-EU25 financial services firms.

5.9 Rather a number of factors, e.g. labour market regulations or the intensity of the competitive environment, could account for these differences.

5.10 It is, however, clear that embedded VAT costs have negative profit implications for financial services firms – specifically in relation to the provision of business to business services.

5.2.3 VAT as a Basis of Unfair Competition

5.11 The non-neutral nature of the VAT treatment of financial services in the EU25, i.e. the existence of an embedded VAT cost, means that potential exists in theory for certain providers of financial services to enjoy VAT-related cost advantages as a result of:

- a lower standard rate of VAT in the country from which services are provided;
- distinct treatment of financial services for VAT purposes.

5.12 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.

5.13 Certain investment management services, which are provided relatively easily on a cross-border basis as a result of their inherent nature and/or regulatory factors, were found to be the exception in this regard.

5.14 VAT, however was found to be a small source of cost advantage in a wider cost environment – with the cost advantages associated with a more relaxed regulatory regime, lower rates of corporate tax or lower labour costs reported to be much more significant.

5.15 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 Commission[124], coupled with the series of regulatory initiatives in this regard, means that complacency regarding the potential for VAT to create a less than level playing field for competing providers of financial services is inadvisable.

5.2.4 Country Location of Operations

5.16 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.

5.17 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. This influence stemmed from identified differences in the VAT treatment of financial services between EU25 jurisdictions (see Figure 3.6).

5.18 With regard to the former, relatively wide definitions of special investment funds in both Luxembourg and Ireland were reported to have facilitated both countries in the attraction of a significant number of investment management operations.

5.19 With regard to shared service centres, it was found that their establishment within individual jurisdictions was heavily influenced by the availability of VAT Grouping.

5.20 In addition, it was reported that outsourcing advisors are actively promoting the establishment of group procurement functions in jurisdictions with low standard rates of VAT. No evidence of take up of such initiatives, however, emerged from our case study research.

[124]"White Paper on Financial Services Policy (2005-2010)" at http://europa.eu.int/comm/internal_market/finances/ policy/index_en.htm.

5.21 Finally, it is worth highlighting in this context that existing restrictions on the remote sale of financial services into EU25 markets means that VAT-related considerations in choosing a country for the location of operations is by-and-large the preserve of the major international providers of financial services only, i.e. it is not a consideration for most smaller firms.

5.2.5 Outsourcing & Shared Service Centres

5.22 Research findings with regard to the incidence of outsourcing and shared service centres among financial services firms within the EU25 were somewhat mixed.

5.23 While an analysis of relevant 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 VAT in this regard[125].

5.24 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. This is evidenced in the facts that:

- 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 relevant tax authorities; or b) not taxed on a reverse charge basis.

5.25 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 making a decision to outsource financial services or to establish a shared services centre.

[125] In advance of expanding on this issue, however, it is worthwhile noting that questions of outsourcing and shared services are by-and-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 second implication is that EU25 financial services are constrained in terms of the range of functions which may, cost-efficiently, be outsourced or put into shared service centres.

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.

5.26 Again, it is worth noting, that local interpretations of ECJ rulings (e.g. *SDC*[126]) and the availability of VAT Grouping, will have an important bearing on the nature of services provided and the country location of corporate entities to which taxable services are provided.

5.2.6 Exploitation of Single Market Opportunities

5.27 PwC primary and secondary research provided no evidence that the VAT exemption on 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 providers of financial services firms.

Secondary research findings supported this conclusion.

5.28 However, and closely related to the commentary presented in the foregoing Section, the imposition of VAT charges on shared service centres (particularly those which operate on a cross-border basis) means that larger firms are being frustrated in attempting to take full advantage of intra-EU25 differences in the basic cost of service inputs – most notably labour.

5.2.7 Corporate Structures

5.29 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.

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

5.3 How Important are the Identified Distortions?

5.30 VAT-related distortions in the EU25 financial services market were identified in the previous Section. The impact of these distortions is the subject of this Section.

5.31 Key findings in this regard are as follows:

- 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 will likely 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.

5.4 What Features of the VAT System Underpin Distortions?

5.32 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.

5.33 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.

5.34 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 Court of Justice, e.g. *SDC*[127];
- 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.

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

5.5 VAT and a Single Market for Financial Services

5.35 Finally, and notwithstanding the fact that the issue has been raised throughout this Chapter, it is worth highlighting 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 within the Union is realised.

5.36 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 will be given explicit regard in the solutions phase – which is described in Chapters 6 to 8 inclusive.

RESEARCH PHASE III: VAT SOLUTIONS

CHAPTER 6 EVALUATION FRAMEWORK FOR SOLUTIONS

6.1 Introduction

6.1 This Chapter explains the criteria that will be used to evaluate the selected VAT solutions. Section 6.2 gives an overview of the criteria and Section 6.3 provides a short description of each of the evaluation criteria. In Section 6.4 we will explain the Evaluation Framework.

6.2 Overview of Evaluation Criteria

6.2 The evaluation criteria used for reviewing the proposed solutions are explained in more detail in the next section. The 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.

6.3 All criteria and solutions must be viewed in the context of and be compatible with, the long-term goals of the Commission as outlined in its Financial Services Action Plan[128] (see paragraph 6.32) and the contribution of taxation and customs policies to the Lisbon Strategy[129] (see paragraph 6.33). Furthermore, the equality of treatment between small, medium-sized and large economic operators should also be taken into account.

6.4 Grouping the evaluation criteria helps in reducing the risk of undue emphasis being placed on a particular factor which may appear relevant for more than one criterion. The criteria groups are explained below.

[128] "White Paper on Financial Services Policy (2005-2010)" at http://europa.eu.int/comm/internal_market/finances/policy/index_en.htm.
[129] 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.

6.2.1 Combating Distortions

6.5 The solutions should address the inefficiencies caused by the identified distortions, for example:

- legal uncertainty (paragraphs 3.43 and 5.25);
- impact on the cost efficiency of the EU25 financial services sector (paragraphs 3.18 and 5.6 to 5.10);
- actual distortions in an outsourcing context due to the limiting of the outsourced operations to operations that are in principle exempt from VAT (paragraphs 3.43, 3.44 and 5.24);
- impact on structure of operations and country of location (due to specific use of exemptions, interpretation of ECJ court cases, use of VAT Grouping arrangements and methods for calculating VAT recovery) (paragraphs 3.39, 3.40, 5.16 to 5.21 and 5.29);
- potential distortions resulting from a liberalised financial services market (paragraphs 3.48 and 5.15).

6.2.2 Ease of Implementation

6.6 The solutions should be easy to implement by EU Member States and economic operators within a reasonable time frame. In this respect, important elements are:

- impact of the solution on operators within the financial services sector (i.e. banking, insurance and investment management);
- impact of the solution on other economic operators;
- compliance and transition costs;
- level of administration and control;
- timeframe for implementation.

6.2.3 Future Proof

6.7 The solutions should keep pace with and facilitate the changes in the financial services industry.

6.8 As already identified in Chapters 3, 4 and 5, changes occurring today and expected in the future are:

- continued globalisation;
- Single Market for Financial Services (paragraphs 3.48, 4.6 to 4.13 and 5.15);
- broadening range of financial services;
- increasing complexity and convergence of financial services products;
- use of technology;
- use of outsourcing, co-sourcing, shared services and centres of excellence (Section 4.5).

6.9 Future proof is reached when the amended VAT framework will last for another 30 years. This has been addressed by the evaluation criteria in relation to durability, which should evaluate the long-term effect of the solution.

6.3 Budgetary Impact of VAT Solutions for Member States

6.10 The PwC project team has not retained the budgetary impact of the VAT solution for EU Member States as a separate evaluation criterion. The PwC project team has made this decision as within the scope of the Study insufficient macro-economic data were available to provide an accurate indication of the budgetary impact at the level of EU25 Member States. An accurate calculation would be needed requiring a separate study but approximate figures for the United Kingdom indicate that unrecoverable VAT accounts for roughly 20.3% of the total UK taxes paid by the sector[130].

6.3.1 Budgetary Impact in Case of Adoption of VAT Solutions

6.11 We want to highlight that budgetary impact will vary from one EU Member State to another and will depend on various factors such as the standard VAT rate, the existing VAT treatment of financial services, interdependency with other taxes such as payroll taxes, the impact on social security and unemployment costs, etc.

6.12 In 1998, Her Majesty's Revenue & Customs (HMRC) published a consultation document on the restriction of VAT Grouping to fully taxable bodies[131]. In 1998, the financial services industry represented approximately 27.2% of UK Gross Value Added[132] at basic prices. The VAT cost of not introducing the restriction was approximately 0.7% of potential VAT collected in an economy with a very large financial services industry. Losing the industry would have had a detrimental impact for the economy and related employment far higher than this portion of collected VAT. HMRC therefore accepted the VAT revenue loss as a result of allowing partly exempt businesses to form part of a VAT Group (to the extent it concerns normal operations of Grouping). In 1994, the Finnish government also did a study on the impact on VAT revenue coming from the introduction of VAT Grouping and came to a VAT loss of 0.09% of the total Finnish VAT revenue[133] (being FIM 40 mn of VAT loss compared to FIM 41,671 mn in net VAT receipts[134]).

[130] PricewaterhouseCoopers Total Tax Contribution Survey for the Hundred Group, 2005.
[131] Restriction of VAT Groups to fully taxable corporate bodies – HM Customs & Excise consultation document – June 1998.
[132] Gross Value Added is an important measure in the estimation of Gross Domestic Product (Gross Domestic Product equals Gross Domestic Value + taxes on products – subsidies).
[133] Government Bill for VAT Group Registration – HE76/1994 – p. 7.
[134] Being €6.7 mn of VAT loss compared to €7,621 mn in VAT receipts.

6.13 It is important to note that 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. Indirect employment can be created in other industries such as technology, telecommunications and other providers of outsourcing services. As far as indirect employment is concerned the impact also includes all suppliers of goods and services to the financial services industry (e.g. suppliers of construction and other real estate services, providers of meals, suppliers of hardware, suppliers of security services, etc.).

6.14 Such macro-economic effects are also described in a paper on the impact of the introduction of VAT Grouping on the Polish economy and government finances as a result of encouraging greater inward investment in the financial services industry[135]. The paper suggests that the introduction of VAT Grouping in Poland could generate around 10,000 new jobs over a three-year period and lead to improvement in Polish Gross Domestic Product (reflecting both the additional output in the newly developed outsourced services sector and the multiplier effects on demand for other goods and services).

6.15 Another example of VAT having a significant macro-economic impact relates to the amendment of the VAT treatment on temporary labour in the United Kingdom in 1995. From the time VAT for outsourcing of temporary labour was only charged on the commission (i.e. payment for value added) instead of on the total employment costs (i.e. wages plus commission), agencies outsourcing temporary labour experienced above-average growth (as temporary labour became less expensive for companies with partial or no VAT deduction).

6.16 It is clear that budgetary impact does not only concern the impact on VAT revenue but has wider macro-economic effects. As any further analysis on these effects is not in the scope of our Study, we are not able to make any accurate assessments. The latter would require a specific macro-economic study of the impact on EU25 budgets.

6.17 However, as budgetary impact will affect an individual Member States' willingness to accept a certain VAT solution, we include in Chapter 8 a very high level appreciation from our side (not supported by any economic analysis).

[135] Special report by International Tax and Investment Centre and Oxford Economic Forecasting on the impact of the introduction of VAT Groupings on the Polish economy – February 2006.

6.3.2 Budgetary Impact in Case of Status Quo or no Adoption of VAT Solutions

6.18 Another important element that should not be forgotten is the budgetary impact if there is no change to the current VAT treatment of financial services in the near future. From Research Phase II – Empirical Evidence, we derive that no change in the VAT treatment of financial services sector within EU25 means that (Chapters 3-5):

- 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 cost efficiency of non-EU global players;
- a more liberalised market will increase the potential for differences in the VAT treatment of financial services within EU25 to be used as a source of potential cost advantage, resulting in unfair competition and opportunities for arbitrage;
- 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 sub-optimal structures of operations often dictated by VAT (again having impact on their competitiveness);
- legal uncertainty from a VAT point of view, especially regarding cross-border transactions, could discourage the EU25 financial services sector from engaging in long-term 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.

6.19 From the above we conclude that a status quo, i.e. no change to the VAT treatment in the financial services sector in the short term, will also have a negative impact on EU25 budgets.

6.4 Definition of Individual Evaluation Criteria

6.4.1 Combating Distortions

6.4.1.1 Positive Impact on Cost Efficiency of EU25 Financial Services Providers

6.20 From the empirical evidence (paragraphs 3.18 and 5.6 to 5.10), it can be seen that, VAT is a considerable cost for financial services organisations within the EU (especially in relation to outsourcing and shared services). The evidence showed that assuming there is a direct correlation between the cost of irrecoverable VAT and profitability, the margins of the Case Study Companies may be improved by five to ten percent if embedded irrecoverable VAT was eliminated. The potential VAT solutions should not increase the VAT cost and so if a solution could improve cost efficiency by reducing irrecoverable or irrecovered VAT, it will receive a high score.

- Would the proposed solution improve cost efficiency of economic operators by eliminating irrecoverable VAT?
- Does the solution solve the problem of non-deductible VAT in outsourcing and shared services situations?
- Is the solution equally beneficial to small, medium-sized and large players?

6.4.1.2 Effectiveness in Combating Identified Distortions

6.21 The potential solutions should eliminate the distortions identified in Research Phase II – Empirical Evidence.

6.22 If a solution is highly effective in eliminating a single distortion but this distortion is considered as a minor distortion then the solution will be awarded a lower score. By contrast, a solution that is moderately effective in eliminating all identified distortions will be awarded a higher score.

6.23 The identified distortions were:

- legal uncertainty (paragraphs 3.43 and 5.25);
- impact on the cost efficiency of the EU25 financial services sector (paragraphs 3.18 and 5.6 to 5.10);
- actual distortions in an outsourcing context due to the limiting of the outsourced operations to operations that are in principle exempt from VAT (paragraphs 3.43, 3.44 and 5.24);
- impact on structure of operations and country of location (due to specific use of exemptions, interpretation of ECJ court cases, use of VAT Grouping arrangements and methods for calculating VAT recovery) (paragraphs 3.39, 3.40, 5.16 to 5.21 and 5.29);
- potential distortions resulting from a liberalised financial services market (paragraphs 3.48 and 5.15).

- Is the proposed solution proportionate with the scale of the distortions identified in Research Phase II - Empirical Evidence?
- Does the solution remove potential or actual distortions between suppliers of financial services and outsourcing services across the EU Member States?
- Does the solution remove potential or actual distortions between EU and non-EU players in the market equally for small, medium-sized and large players?

6.4.2 Ease of Implementation

6.4.2.1 Pan-sectoral Application of the Proposed Solution

6.24 The solution should have a beneficial impact on all financial services sectors, i.e. banking, insurance and investment management or at least it should not disadvantage one sector over another or over providers supplying combined services. Market trends show that financial products are converging: an insurance product includes a savings element or an asset management component and banks become *bancassurers*. A solution will receive a high score where it can be applied in all sectors.

- Does the proposed solution have a beneficial impact on all financial services sectors (i.e. banking, insurance and investment management) or only on one specific sector (taking into account the specific characteristics of the various sub-sectors)?
- Does the solution allow convergence in the industry?
- Is the solution independent from the size of the financial services provider?

6.4.2.2 No Unequal Impact of the Proposed Solution

6.25 Although our Study is focussed on solutions to eliminate identified distortions for economic operators within the financial services sector, it is important that solutions do not lead to unequal VAT treatment between economic operators in financial services, on the one hand, and other business operators, on the other hand (e.g. through a more favourable treatment of the financial sector over other sectors).

6.26 The solution should not have negative effects for other economic operators and if this is the case then it will be awarded a low score. VAT solutions that solve identified distortions for economic operators and at the same time also have a positive impact for other economic operators (e.g. use of VAT Grouping will decrease administrative formalities for other economic operators and could also have a positive cash-flow effect for them) will be awarded a high score.

- Is the proposed solution likely to lead to unequal VAT treatment between economic operators in financial services, on the one hand, and other business operators, on the other hand (for instance, through a more favourable treatment of the financial sector vis-à-vis other sectors)?
- Does the solution entail negative effects for other economic operators?

6.4.2.3 Ease of Administration and Control for Revenue Authorities

6.27 EU Member States will be more likely to accept a certain VAT solution if the costs to administer VAT and to perform effective and efficient inspections (e.g. using e-auditing as well as the need for co-operation and exchange of information between revenue authorities) will not increase. An easy to administer VAT solution will minimise work for revenue authorities in terms of supervision and inspections. Where legal certainty is available both for the revenue authorities and operators, the collections will improve as the number of disputes will decrease accordingly. The required level of interaction with other EU25 and non-EU25 revenue authorities should also decrease. A low score will be awarded if administrative requirements are significantly increased and the cost of control and collection is increasing.

- Will the solution lead to additional administrative work in terms of processing of data from VAT returns and listings?
- Will the solution cause additional work for revenue authorities in terms of supervision?
- Does the solution minimise tax evasion risks (link with the scope for the abuse of provisions)?
- Does the solution allow easy and cost-efficient controls by the revenue authorities (for instance, use of e-auditing techniques[136] and cooperation and exchange of information between revenue authorities)?
- Does the solution, due to legal certainty, improve the collection by the revenue authorities?
- Does the solution, in order to be controlled effectively, require additional interaction with other EU25 and non-EU25 revenue authorities[137]?

6.4.2.4 Ease of Administration for Economic Operators

6.28 Proposed solutions should be easy to administer in day-to-day business practice and should not increase the burden of VAT compliance requirements and costs in the hands of economic operators disproportionately compared to the benefit of the solution. It will be equally important to determine to what extent economic operators need to amend their back-office operations and/or increase the number of Full Time Equivalents needed to perform the back-office operations.

6.29 The proposed solution should also be integrated with the existing risk management policy and internal controls of the economic operator. A low score will be awarded, if administrative requirements are significantly increased.

- Will the proposed solution cause extra administrative work for economic operators (for instance, an increase in VAT compliance formalities)?
- Will the operation and the management of the VAT solution and the related compliance require additional headcount as an overhead to the business?
- Is the solution practical and easy to handle, even in day-to-day practice, for all sectors in the financial services industry and for all sizes of businesses?
- Does the solution mean that economic operators will have to adapt their internal VAT processes (in areas such as risk management, VAT controls, VAT process flows, etc.)?
- Can the implementation of the solutions be fully automated?

[136] Risk management guide for tax administrations – Fiscalis Risk Analysis Project Group – July 2006 - http://ec.europa.eu/taxation_customs/taxation/tax_cooperation/gen_overview/index_en.htm.; OECD – guidance on tax compliance for business and accounting software – Committee on Fiscal Affairs – 23 May 2005 - http://www.oecd.org/searchResult/0,2665,en_2649_201185_1_1_1_1_1,00.html.

[137] Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee concerning the need to develop a co-ordinated strategy to improve the fight against fiscal fraud – COM(2006) 254 of 31 May 2006 - http://ec.europa.eu/taxation_customs/common/publications/com_reports/taxation/index_en.htm.

6.4.2.5 Limited Timeframe for Implementation

6.30 A VAT solution should be easy to implement by EU Member States and economic operators within a reasonable timeframe. VAT solutions that can be implemented in the short term should result in minimum transition costs both for Member States and economic operators. A high score will be awarded to a solution that can be implemented within a short time period, being 18 months.

- What is the average timeframe needed to implement the proposed solution?

6.4.3 Future Proof

6.4.3.1 Exploitation and Contribution towards Single Market Opportunities (EU Financial Services Action Plan and Lisbon Objectives)

6.31 The VAT solution should be compatible with the Single Market policy. As stated in the FSAP[138] and the Lisbon Objectives[139], a Single Market is essential for the EU's global competitiveness.

6.32 Therefore, the proposed solutions should be measured against the objectives set by the European Commission in its FSAP. These are to:

- consolidate dynamically towards an integrated, open, inclusive, competitive and economically efficient EU financial market;
- remove the remaining economically significant barriers, so that financial services can be provided and capital can circulate freely throughout the EU at the lowest possible cost;
- implement, enforce and continuously evaluate the existing legislation and apply the better regulation agenda rigorously to future initiatives;
- enhance supervisory cooperation and convergence in the EU;
- deepen relations with other global financial marketplaces and strengthen European influence globally.

[138] "White Paper on Financial Services Policy (2005-2010)" at http://europa.eu.int/comm/internal_market/finances/policy/index_en.htm.

[139] 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.

6.33 Furthermore, the solutions should also be measured against the objectives set by the European Commission in its contribution of taxation and customs policies to the Lisbon Strategy. These are to:

- extend and deepen the internal market;
- ensure open and competitive markets inside and outside the EU;
- improve European and national legislation.

6.34 Scoring is based on the extent to which a solution is compatible with the FSAP[140] and Lisbon Objectives[141].

- Is the proposed solution consistent with the objectives of the European Commission's FSAP and Lisbon Strategy?
- Is the solution consistent with the evolution of the legislative and regulatory framework for the financial services industry?

6.4.3.2 Efficiency in Combating Identified Distortions

6.35 Efficiency is a measure of value-for-money, which relates closely to the notion of proportionality, i.e. is the proposed solution of a scale that is justified given the nature of the distortion. Money as determined here is a combination of costs associated with the actual introduction of the solution for economic operators. Important elements of this criterion are the level of transition costs and the need to adapt existing reporting and data processing systems. This could also include changes to the current ERP, accounting, billing and reporting systems to be able to implement a certain VAT solution and whether the VAT solution can be implemented via an automated VAT logic and be easily interfaced with the accounting set up (for instance, via VAT condition tables in ERP systems).

[140] "White Paper on Financial Services Policy (2005-2010)" at http://europa.eu.int/comm/internal_market/finances/policy/index_en.htm.
[141] 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.

- Is the proposed solution of a scale that is justified given the nature of the actual or potential distortions?
- Do the existing reporting and VAT filing obligations have to be modified to allow a proper functioning of the proposed solution?
- Will the solution entail major transition costs?
- Does the solution mean that economic operators will have to adapt the current VAT logic in their ERP, accounting, billing and reporting systems (for instance, use of VAT condition tables, customer tax classifications, set-up of accounts, need to issue invoices, etc.)?
- Can the implementation of the solutions be fully automated?

6.4.3.3 Legal Certainty for Economic Operators facilitating Long-Term Business Plans and Investments

6.36 The VAT solution should be clear, straightforward and there should be no scope for differing interpretations (for instance on the VAT treatment of outsourced services). This should, in turn, facilitate long-term business plans and investments.

6.37 The solution should reduce risks of conflicts not only between businesses and authorities, but also between different authorities and between businesses (suppliers and customers). A solution which provides certainty will be awarded a high score.

6.38 The provisions should be able to cope with any change in the industry. As the pace of change is accelerating, the amended VAT provisions should be sustainable over the next 30 years as any change to the Sixth EU VAT Directive requires unanimity[142].

[142] Article 93 of EC Treaty- http://europa.eu.int/eur-lex/en/treaties/dat/C_2002325EN.003301.html.

- Does the proposed solution provide legal certainty facilitating long-term business plans and investments?
- To what extent will the solution provide legal certainty for economic operators?
- To what extent will the solution enable economic operators to have a clear view of the VAT treatment of certain transactions before they conclude them (no postponing of or refraining from important decisions due to legal uncertainty from a VAT point of view)?
- To what extent will the solution enable economic operators to make justified business decisions regarding their go to market strategy (financial services provided) and their operations/infrastructure (organisation of front-end, back-end, outsourcing or not, use of shared services or not, legal structure, etc.) where the business case is certain also from a VAT point of view?
- To what extent will the solution enable economic operators to gain more certainty on cross-border transactions (by avoiding double or non-taxation)?
- To what extent will the solution enable a uniform interpretation and application of relevant ECJ cases for current and future business plans (an indicative listing of ECJ cases is provided in Annex I to this report)?
- To what extent is the solution capable of coping with – at this time even indefinable – changes in business models, front-office and back-office changes, new go to market strategies and new offerings?
- To what extent is any such development in the industry capable of being implemented without needing to amend the Sixth EU VAT Directive i.e. can the Directive – if amended – remain unchanged for the next decades?

6.4.3.4 No scope for Abuse of Provisions

6.39 The VAT solution should be transparent and should not leave room for abuse. This makes a solution unacceptable both to Member States and to compliant economic operators. The latter do not want to be faced with uncertainty and competition from operators abusing rights leading to stricter and more costly inspections to the detriment of compliant businesses. It should ensure that tax audit processes can be carried out with reliability and in such a way that costs to both revenue authorities and businesses can be minimised.

6.40 In this respect, we also refer to the Communication[143] of the European Commission on the need for a coherent European strategy to combat tax fraud (without increasing the burden on the tax-payer). The European Commission wants to work on the following domains:

- improve administrative cooperation between Member States (more efficient cooperation mechanism, strengthening of current legislation on assistance in the recovery of taxes, improved risk management and set-up of a forum for discussion at Community level);
- look for specific measures (improve exchange of information, increase tax declaration obligations for companies considered to represent a risk, etc.);
- increase cooperation with third countries;
- modify the current VAT system.

- Does the proposed solution safeguard the tax revenues of the EU Member States, i.e. does it minimise the risk of abuse?
- Is the solution simple and transparent enough to guarantee revenue authorities sufficient auditability of economic operators (link with ease of administration for revenue authorities)?
- Is the solution likely to lead to *abuse of rights* by using schemes as stated in the *Halifax*[144]*, University of Huddersfield*[145] and *BUPA*[146] cases?
- Is the solution likely to lead to an increased need for VAT inspections by the revenue authorities?
- Is any potential abuse easy to detect?

[143] Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee concerning the need to develop a co-ordinated strategy to improve the fight against fiscal fraud – COM(2006) 254 of 31 May 2006 - http://ec.europa.eu/taxation_customs/common/publications/com_reports/taxation/index_en.htm.
[144] ECJ judgement of 21 February 2006 in *Halifax plc and others v. Commissioners of Customs and Excise*, Case C-255/02.
[145] ECJ judgement of 21 February 2006 in *University of Huddersfield Higher Education Corporation v. Commissioners of Customs and Excise*, Case C-223/03.
[146] ECJ judgement of 21 February 2006 in *BUPA Hospitals Ltd, Goldsborough Developments Ltd v. Commissioners of Customs and Excise*, Case C-419/02.

6.4.3.5 Consistency with VAT Principles

6.41 Each of the proposed VAT solutions should be compatible with the basic principles of VAT (broad-based, neutrality, proportionality and non-distortionary) (paragraphs 2.12 and 2.13). Moreover, the proposed solutions should be consistent with governing EU VAT Directives and ECJ case law. A solution will be scored according to the extent to which it is compatible with the principles of the VAT system, EU VAT Directives and ECJ case law.

- Is the proposed solution compatible with the overall principles of the VAT system?
- Is the solution consistent with governing EU VAT Directives and, in particular, compatible with the framework of existing exemptions contained in the Sixth EU VAT Directive?
- Is the solution consistent with ECJ case law?

6.4.3.6 Durability of Impacts

6.42 The VAT solution should not require constant changes or updates of legislation, since frequent changes make tax law more complex and reduce legal certainty for both the Member States and economic operators. The VAT solution should be a flexible solution allowing VAT legislation to keep pace with rapid changes in technology, products and the financial services market. This is an important criterion as it is linked with the call for more legal certainty from the financial services sector, allowing them to adopt long-term business strategies. It is also an important factor for the Member States as stable legislation reduces litigation, the costs of administering and controlling the tax environment.

- Can the VAT solution cope with rapid changes in technology and new, emerging business products?
- Does the VAT solution enable a flexible attitude towards the evolving financial services market?
- Will the proposed solutions withstand significant changes in the structure and nature of the financial services sector in the EU25?

6.5 The Evaluation Framework

6.43 These evaluation criteria have been used in order to have a systematic and fair evaluation of the VAT solutions explained in Chapter 7. The evaluation system should provide a clear understanding of why a certain VAT solution appears more favourable than another. In Chapter 7, we will give an overview of potential solutions. In Chapter 8, we will explain in more detail a number of solutions based on the scoring they received in the Evaluation Framework.

CHAPTER 7 DESCRIPTION OF PROPOSED SOLUTIONS

7.1 Introduction

7.1 This Chapter presents potential solutions taking into account the conclusions from our primary and secondary research as mentioned in Chapters 3, 4 and 5.

7.2 This document comprises four Sections. Section 7.2 presents the VAT solutions based on fundamental VAT principles. Section 7.3 provides an overview of VAT solutions that could be applied for all financial services sub-sectors (banking, insurance and investment funds). In Section 7.4, we will examine solutions applying to specific industries within financial services. Finally, in Section 7.5 we will comment on the importance of pan-European guidance.

7.3 It may be the case that certain solutions will complement each other and could be viewed as a single solution. This has been identified, where appropriate, in the description of the solutions.

7.4 The key to any proposed solution is its uniform application across EU Member States.

7.5 All solutions are only applicable to B2B supplies. Solutions for B2C do not fall within the scope of this Study.

7.6 A consideration of the practicalities of each solution is set out in this Chapter. However, a full evaluation of each solution is contained in Chapter 8.

7.7 Where relevant, we have included tables in this Chapter to illustrate the results of a survey performed by PwC within its VAT Financial Services and Insurance Network. We have asked our network to confirm the position (officially) taken by the EU Member States either in their law, secondary legislation and/or in publicly available guidance.

7.8 It should be noted that in many cases, there is no or only limited public guidance available meaning that the precise VAT treatment is uncertain. This was often the case in the Member States that joined the EU on 1 May 2004[147]. When there was no or only limited guidance on the VAT treatment, we refer in the tables to no/limited Member State guidance.

7.9 For the sake of clarity, when we refer to outsourcing we include within that term the consolidation of back-office functions within the same group.

7.2 Solutions Based on Fundamental VAT Principles

7.2.1 Extension of the Scope of Exemption for B2B Supplies

7.10 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. The actual extension to the exemptions could be done in two ways.

7.11 The exemptions could be extended to apply to transactions further down the supply chain so that currently taxable supplies become VAT exempt. This would mean that financial services companies incur less VAT on bought in services and so there will be less embedded VAT in the system that currently leads to higher prices. In other words, this solution would reduce the inherent VAT costs built up in the financial services and insurance sectors. Furthermore, the exemptions could be clarified to ensure that they are applied consistently across Member States and this may involve an extension to the exemption in some Member States. This would address the uneven playing field that exists in the EU25 and ensure that taxpayers have more certainty in respect of the likely VAT treatment of a transaction across Member States. This clarification of the exemptions is developed and discussed in more detail in Section 7.4 through Industry Specific Solutions.

[147] The 10 new Member States were Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia – results for the 10 new Member States have been specified between brackets in the various Tables.

7.12 From case study research, as set out in Chapter 3, it appeared that the VAT system causes distortion in the context of outsourcing and shared services/centralised functions (especially cross-border) by effectively forcing organisations that have made a corporate decision to outsource aspects of their operational activity to limit those (outsourced) activities to those that are as a rule exempt from VAT (clearing and settlement activities, for example). This suggests that VAT may hinder the decision to outsource, since the potential VAT cost outweighs other commercial benefits. Table 7.1 illustrates the impact of VAT on outsourcing and shared service centres:

Table 7.1: % of Case Study Companies Agreeing with Statements

	Any Banking	Any Insurance	Any Investment Management	Total
Within the EU25, our Company has been directly influenced by VAT Costs in making Decisions regarding the Country Location of Operations:	27%	33%	30%	32%
Within the EU25, VAT has had no direct Bearing on the Decisions our Company has made regarding the Country Location of Company Operations:	47%	17%	30%	41%
Within the EU25, the Country Location of our Company Operations is less than optimal owing to the Need to locate Operations in such a Way as to achieve VAT Savings:	27%	33%	30%	32%
Within the EU25, VAT Considerations have had a direct Bearing on our Corporate Structures:	53%	50%	60%	55%
Within the EU25, our Corporate Structures are less than optimal owing to the Need to structure Operations to achieve VAT Savings:	40%	33%	50%	36%
Within a Global Context, the VAT Treatment of Financial Services in the EU25 is considerably less favourable than certain non-EU25 Jurisdictions:	60%	17%	30%	45%
The VAT Exemption of Financial Services had disadvantaged EU25 Member States in the Attraction of Investment from our Company vis-à-vis non-EU25 Jurisdictions:	27%	33%	30%	32%

7.13 It is clear from the above, that there has been a fundamental shift in business models since the Sixth EU VAT Directive was first introduced. Back in 1977, article 6(3) was drafted into the Sixth EU VAT Directive to address potential distortions in the case of insourcing. Article 6(3) currently states that *Member States may treat as a supply of services for consideration, the supply by a taxable person of a service for the purposes of his undertaking where VAT on such a service would not be wholly deductible had it been supplied by another taxable person.*

Example

7.14 Article 6(3) of the Sixth EU VAT Directive has not been implemented by all Member States and does not directly apply in the financial services sector. In the United Kingdom, the provisions of article 6(3) have been implemented, but only where a specific Treasury Order (Statutory Instrument) has been made. In practice, such orders are very specific and limited in application. In the United Kingdom, there have been self-supply charges in relation to stationery, certain motor cars (e.g. demonstration models), construction services and certain non-residential building developments. However, many of the provisions have now been abolished.

7.15 Article 6(3) was introduced to address the concern that businesses could undertake activities in-house to avoid VAT and to tax such activities in the same way as outsourced services to avoid distortion of competition. However, it is now outsourcing rather than insourcing that frequently raises VAT issues for taxpayers and tax authorities alike. The most common problem is whether an outsourced service should be subject to VAT or not. Extending the scope of the exemptions for B2B supplies to cover transactions further down the supply chain would help reduce distortions in the VAT system now caused by outsourcing, in the way that article 6(3) was drafted to address past concerns in respect of distortions caused by insourcing.

7.16 The question of the scope of the exemption in the context of outsourcing has already been addressed in various rulings by the ECJ. However, Table 7.2 indicates that European case law is not being interpreted in the same way across Member States which gives rise to legal uncertainty and distortions (e.g. the interpretation of *SDC*[148] in the banking sector).

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

Table 7.2: Application of VAT Exemption in case of Outsourcing and Use of Sub-Intermediaries (25 Member States)

Experience with Application of VAT Exemption for Outsourcing	Yes	No	No/limited Guidance	Total
Are Local VAT Authorities in your Country acquainted with the Application of a VAT Exemption (based on Article 13(B)(d) of the Sixth EU VAT Directive) in case of Outsourcing of Activities?	13 (4)	4 (2)	8 (4)	25
Application of VAT Exemption for Outsourcing	**Yes**	**No**	**No/limited Guidance**	**Total**
Has, to your Knowledge, a VAT Exemption (based on article 13(B)(d) of the Sixth EU VAT Directive) already been applied in case of Outsourced Back-Office Activities, related to:				
▪ Payment and Receipt Transactions (SDC[149])	13 (2)	7 (5)	5 (3)	25
▪ Transactions in Securities (CSC[150])	10 (2)	8 (5)	7 (3)	25
▪ Other (Taksatorringen[151] / Andersen[152])	4	10 (6)	11 (4)	25
Application of VAT Exemption to Sub-intermediaries	**Yes**	**No**	**No/limited Guidance**	**Total**
Is an Exemption applicable in the case of sub-Intermediaries in:				
▪ Insurance Transactions (CPP[153], Skandia[154], Andersen[155])	17 (6)	3	5 (4)	25
▪ Granting of Credit (Volker Ludwig[156])	15 (5)	5 (1)	5 (4)	25
▪ Payment and Receipt Transactions	18 (6)	1	6 (4)	25
▪ Deposit and Current Accounts	17 (6)	2	6 (4)	25
▪ Transactions in Securities (CSC[157])	19 (7)	2	4 (3)	25

Source: PwC Survey October 2006

7.17 The table shows that the exemptions are not evenly applied across Member States. Any extension to the scope of the exemption should be based on a clear definition/description as to what services are and are not covered by the revised exemption so that all Member States recognise when a service falls within the exemptions. We expand upon this in more detail in Section 7.4. If such detail is drafted into the Sixth EU VAT Directive, or as part of pan-European guidance (Section 7.5), then this may address the current inconsistencies between Member States.

7.18 In a similar manner, a review of the scope of the exemptions could be extended, clarified and updated by revising the current provisions under article 13(B)(d) in the Sixth EU VAT Directive in line with judgements of the European Court of Justice in the cases of *SDC*[158], *CSC Financial Services*[159] *and Abbey National*[160] to incorporate the definitions reached in these judgements, such as distinct, specific in character and essential to.

[149] ECJ judgement of 5 June 1997 in *Sparekassernes Datacenter v. Skatteministeriet*, Case C-2/95.
[150] ECJ judgement of 13 December 2001 in *The Commissioners of Customs and Excise v. CSC Financial Services Limited*, Case C-235/00.
[151] ECJ judgement of 20 November 2003 in *Assurandor-Societetet v. Skatteministeriet*, Case C-8/01.
[152] ECJ judgement of 3 March 2005 in *Secretary of State for Finance v. Arthur Andersen & Co. Accountants,* Case C-472/03.
[153] ECJ judgement of 25 February 1999 in *Card Protection Plan Ltd v. Commissioners of Customs and Excise*, Case C-349/96.
[154] ECJ judgement of 8 March 2001 in *Forsakringsaktiebolaget Skandia (publ),* Case C-240/99.
[155] ECJ judgement of 3 March 2005 in *Secretary of State for Finance v. Arthur Andersen & Co. Accountants,* Case C-472/03.
[156] ECJ judgement of 23 November 2005 in *Volker Ludwig v. Finanzamt Luckenwalde*, Case C-453/05, Reference for a preliminary ruling.
[157] ECJ judgement of 13 December 2001 in *The Commissioners of Customs and Excise v. CSC Financial Services Limited*, Case C-235/00.
[158] ECJ judgement of 5 June 1997 in *Sparekassernes Datacenter v. Skatteministeriet*, Case C-2/95.
[159] ECJ judgement of 13 December 2001 in *The Commissioners of Customs and Excise v. CSC Financial Services Limited*, Case C-235/00.
[160] ECJ judgement of 4 May 2006 in Abbey *National plc & Inscape Investment Fund v. Commissioners of Customs and Excise*, Case C-169/04.

7.19 Broadening the exemption beyond that envisaged in articles 13(B)(a) and (d) could be addressed by defining that the exemption is applicable as long as the outsourced financial and insurance intermediary transactions are not to be considered as mere material or technical services.

7.20 However, this will not address the VAT cost associated with outsourcing where the exemption would not be possible under the current provisions of articles 13(B)(a) and (d). This difficulty has been highlighted by the *Andersen*[161] judgement in which the ECJ interpreted the current exemption very narrowly in relation to the outsourcing of insurance related services. The judgement has had an impact in those Member States that previously applied the exemption broadly and has made certain existing outsourcing models unsustainable due to the likely VAT cost going forward, particularly where contracts are unable to be renegotiated. Extending the scope of exemptions to include, for example claims handling services (whether or not the intermediary has not negotiated the initial contract) and other services provided after insurance policies are written, would reduce the VAT cost so that such outsourced functions would not attract a VAT cost that could impact on the business decision to outsource. In addition, the insurance exemption could be applied to the activity undertaken rather than to the identity of the supplier – see Section 7.4.1. This would prevent definitional problems associated with identifying an insurance agent/intermediary and would ensure that the provisions do not discriminate against certain economic operators.

7.21 Extending the scope of the exemptions would reduce embedded VAT and could have a positive impact on the smooth functioning of the market. This solution could also be combined with the option to tax for B2B supplies and could maximise flexibility for economic operators, allowing them to choose the most efficient method of taxing their economic activities. However, it should be noted that this solution will not totally eliminate embedded VAT since it would still exist at the level of the outsourcer who is likely to incur VAT in making supplies now covered by the extended exemption.

[161] ECJ judgement of 3 March 2005 in *Secretary of State for Finance v. Arthur Andersen & Co. Accountants,* Case C-472/03.

7.2.2 Reduction of the Scope of Exemption for B2B Supplies

7.22 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 in the sector. Irrecoverable input VAT would decrease as financial and insurance service providers will be making more taxable supplies and can therefore recover more input tax through direct attribution and through an improved overhead VAT recovery rate. This solution would therefore reduce the level of embedded VAT in the system, which previously led to higher prices (paragraphs 3.18 and 5.6 to 5.10). This could mean that the financial and insurance markets function more efficiently or that industry profitability increases.

7.23 In order to broaden the tax base, it will be necessary to decide which services should be excluded from the exemptions. This will be a particularly complex exercise and due consideration will need to be given to a range of factors. We illustrate this with some examples which highlight some of the challenges that will need to be addressed.

Examples

7.24 *In the past, it was suggested that banking transactions, the principal one being of course lending, could also be subject to taxation. Having regard for the need to have readily available information upon which to base the value of the supply, one would automatically look at the gross interest received, but in doing so one is in effect taxing inflation, not the real interest rate (the gross interest rate less the inherent inflation rate).*

7.25 *It is clear that issues arise if one taxes interest charged to businesses (as this could cause a cascade effect). Similar valuation issues arise with swaps, derivatives and foreign exchange (see First National Bank of Chicago[162]).*

7.26 *Even general insurance (namely property and casualty insurance) could attract VAT at the standard rate. This would even be the case for life and health insurance as these are wrapped around savings products and since the insurers are being more commonly required to separate out the premium for life cover and the savings element.*

7.27 *Accordingly, the data are already available to determine which part of the insurance premium should be subject to VAT (namely only the non-savings element as the savings element should be exempt or even out of scope of VAT).*

7.28 To the extent that the financial service is not really *financial*, but is professional (e.g. corporate finance services), one could see how this would work from a practical point of view. It would decrease distortions caused by an exemption in the supply chain, to the extent that this service would be used for taxable activities by the customer of the service.

[162] ECJ judgement of 14 July 1998 in *Commissioners of Customs and Excise v. First National Bank of Chicago*, Case C-172/96.

7.29 The impact on national tax authorities would be that there would be an increase in taxable revenues since specified services would move from being exempt to taxable. Obviously there would be some set off due to the increase in recoverable input tax associated with the now taxable supplies. It is also possible that some partially exempt operators would become fully taxable businesses, which may ease the administrative burden for national tax authorities. The precise impact is impossible to quantify at this stage since it would depend on the extent that the tax base is broadened.

7.30 This solution would require careful consideration as to where the exemptions should be narrowed. This solution could therefore be supported by pan-European guidance, as set out in Section 7.5 below.

7.2.3 Option to Tax for B2B Supplies

7.31 This solution would give financial services operators the option to tax their services when provided to other taxable persons. This is an alternative to widening the exemption or could indeed complement the updating/widening of the exemption (Section 7.2.1 above). While the extension of the exemption would ensure that no or less input VAT is incurred in the case of outsourcing, the option to tax would enable the recovery of input tax as it could be attributed to an onward taxable supply.

7.32 For this solution, we are only referring to the option to tax in respect of B2B supplies. It would also be possible to consider the application of this solution to B2C supplies, however this is not within the remit of this Study.

7.33 The option to tax for financial services is allowed under article 13(C)(b) of the Sixth EU VAT Directive, and currently, 5 countries have implemented this option. It should be noted that article 13(C)(b) does not currently apply to insurance transactions.

7.34 The experience and application of the option to tax for financial services in those countries that have implemented it is both interesting and diverse, and should be considered before deciding to choose this solution. For example, it is possible to make payment and receipt transactions (including negotiation) subject to an option to tax which is already the case in Belgium[163]. Furthermore, in Lithuania[164], taxable persons can opt to tax for the granting of loans. In France[165] and Estonia[166], the option to tax is allowed for most financial services. In Germany[167], the option is also allowed for most financial services.

Examples

*7.35 In **Belgium**, the option to tax is limited to payment and receipt transactions (including negotiation). The option applies to all payment and receipt transactions effected by the taxable person and is irrevocable. In Belgium, the system proves to work rather well.*

*7.36 The **German** VAT legislation provides that the option to tax only applies to a catalogue of services supplied B2B, as set out in Sec 4, No 8 of the German VAT Act. The option is allowed for each single transaction and there is no formal procedure. More specifically, there is no agreement required from the tax authorities and the option is effected by accounting for VAT on the supply.*

The option can be applied for:

- *granting of credits and intermediary services;*
- *transactions of legal tender;*
- *dealings in debt, cheques and other commercial papers;*
- *deposit and current account transactions, including payment and remittance transactions, and the collection of commercial papers;*
- *dealings in negotiable instruments and options;*
- *transactions in connection with the participation in companies and other associations;*
- *undertaking liabilities, accepting guarantees and other similar collateral securities; and*
- *intermediary services in respect of the above.*

*7.37 In **France**, the option applies to services provided to business and non-business recipients but the system is more rigid compared to the flexible German system. In France, the option applies globally to all transactions for which the option is possible. With effect from 1 January 2005, the option may be revoked after a 5-year period.*

7.38 Under this solution, article 13(C)(b) of the Sixth EU VAT Directive would no longer be an option for Member States. The article currently allows Member States to allow the option to tax, and to restrict the scope and details of its use. The Sixth EU VAT Directive would therefore need to be amended to ensure that all Member States allow taxpayers the right of option. This would help to achieve consistency and thus neutrality across Member States.

[163] Article 44(3)(8), Belgian VAT Code.
[164] Article 28 (7), Lithuanian VAT Code.
[165] Article 260 B, French Tax Code.
[166] Article 16, Section 3.3, Estonian VAT Code.
[167] Section 9, Para 1, German VAT Code.

7.39 It would of course be necessary to establish to what transactions the option to tax can be applied and by which economic operators. In so doing, it is worth considering article 26b(C) of the Sixth EU VAT Directive and the special scheme for investment gold which includes an option to tax as follows:

"Member States shall allow taxable persons who produce investment gold or transform any gold into investment gold a right of option for taxation of supplies of investment gold to another taxable person which would otherwise be exempt.

Member States may allow taxable persons who in their trade normally supply gold for industrial purposes, a right of option for taxation of supplies of investment gold to another taxable person, which would otherwise be exempt. Member States may restrict the scope of this option.

Where the supplier has exercised a right of option for taxation pursuant to the first or second paragraph, Member States shall allow a right of option for taxation for the agent in respect of the services mentioned.

Member States shall specify the details of the use of these options, and shall inform the Commission of the rules of application for the exercise of these options in that Member State".

7.40 As is clear from the above text, article 26b(C) of the Sixth EU VAT Directive allows Member States to specify the use of the options and so there is no level playing field across the EU25. This could be addressed by a common set of rules to determine the application and implementation of the option to tax under this solution so that there is consistency on a European level and therefore certainty for business operators. This would present some obvious challenges. For example, there is no common taxable base or approach at present in the EU. This means that there will be technical work to be done before the solution can be implemented, for example, including a consistent definition and application of business to business (B2B). In this respect, B2B could be defined as supplies to taxable persons in accordance with the proposal for a directive to change the place of supply of services as follows:[168]

[168] Amended 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.

"For the purposes 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. These provisions, in accordance with normal rules, do not extend to supplies of services received by a taxable person for his own personal use or that of his staff".

7.41 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 would allow operators to recover any associated input tax incurred in making supplies that are subject to the option. It would also be possible to combine the option to tax solution with other solutions such as the extension of the exemption, in order to present a wide reaching solution to address the current distortions caused by VAT in the EU25 market for financial services.

7.42 It should however be noted that there are certain limitations to this solution, including the fact that the option to tax can easily be applied to fee based transactions but is difficult and therefore less appropriate for margin based transactions.

7.2.4 Zero Rating of Specific Financial Transactions

7.43 This solution is based on zero rating specific financial services transactions. The solution would mean that financial services providers would not have to charge VAT on certain supplies covered by the zero rating provisions, but could recover any associated input tax. This solution would reduce embedded VAT and prevent irrecoverable VAT from distorting business decisions. It should be noted that the zero rating provisions would apply to any business operator that makes B2B supplies covered by the regime and is not therefore exclusive to traditional financial services operators in terms of both those making and receiving the relevant supplies.

7.44 The zero rating solution is based on the experience of an existing non-EU regime – that of New Zealand. It is important to consider the type of services that can be covered by the zero rating provisions and the range of restrictions over its application.

Example: New Zealand

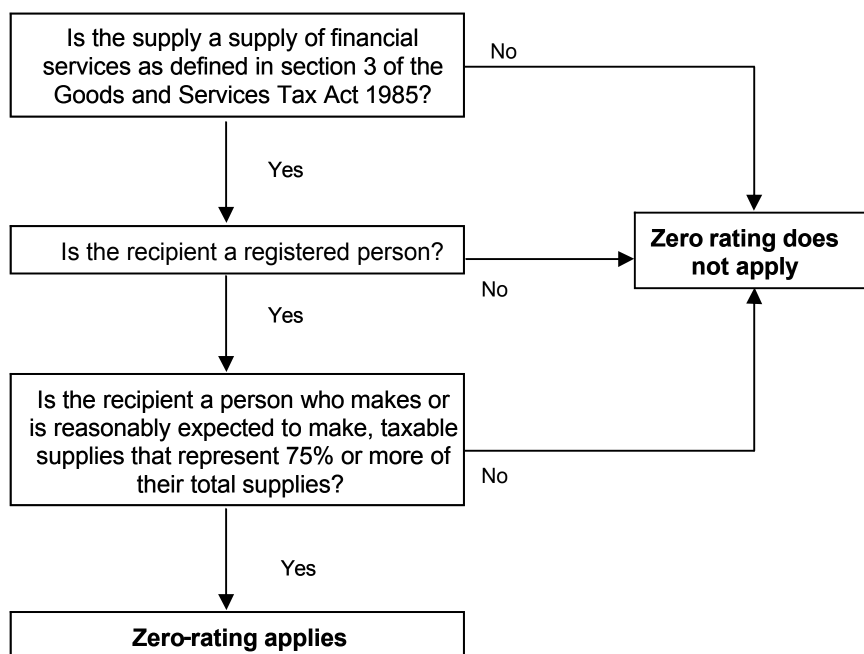
7.45 *Zero rating business-to-business financial services transactions was introduced in New Zealand from 1 January 2005 and further details are included below.*

Legislation in New Zealand

7.46 *In accordance with New Zealand legislation, the financial services providers should give written notice to the revenue authorities in order to apply zero rating on supplies of financial services and/or to be eligible to deduct input GST for supplies of financial services made to other financial services providers. If the compliance costs of applying zero rating outweigh the benefits, it is clear providers can choose not to apply for zero rating.*

In Figure 7.1 the working of the zero rating system is illustrated.

Figure 7.1: Application of Zero Rating (New Zealand)



Source: GST guidelines for working with the new zero rating rules for financial services, October 2004, Policy Advice Division of the Inland Revenue Department (New Zealand)

7.47 *In order to check whether zero rating can be applied the following criteria have to be met:*

- *the type of transaction qualifies as a financial service for the purposes of the GST Act*[169]*;*
- *the recipient is a GST-registered person making taxable supplies representing 75% or more of its total supplies.*

7.48 *The latter criterion must be determined by the supplier of the financial services, as this status has an impact on the supplier's ability to claim an input credit for GST on costs.*

[169] For the purposes of the GST Act, the term financial services generally applies to the following types of transactions: dealings with money, certain dealings with securities, the provision of credit and loans, the provision of life insurance (including superannuation), the provision of non-deliverable futures contracts and financial options, the payment and collection of interest, dividends and amounts relating to transactions involving securities, and intermediation and brokerage services relating to the supply of debt, equity and life insurance. Examples of financial services include: paying or collecting any amount of interest, providing or brokering mortgages and other loans, issuing securities such as stocks and shares, providing credit under a credit contract, exchanging currency.
Services that are not treated as financial services include debt collection, equipment leasing, credit control, sales ledger and accounting services, investment guidance, fire and general insurance and the provision of advice.

7.49 *More specifically, the recipients of the financial services need to be customers who:*

- *are registered for GST if the level of taxable supplies made by the customer in a given 12-month period is equal to or exceeds 75 percent of their total supplies for the period;*
- *may not meet the 75 percent threshold but are part of a group that does meet the threshold in a given 12-month period (for example the treasury or finance function of a group of companies who receives financial services).*

7.50 *In practice, it is rather difficult to determine whether the customer actually meets the 75% criterion. In order to assure that zero rating can be applied, in principle, a transaction-by-transaction approach should be followed by the service provider. However, in case a number of financial services are likely to be supplied to the same customer and/or the cash flows arising under a financial services transaction are uncertain, applying the zero rating rules on a transaction-by-transaction basis is likely to be difficult.*

7.51 *Therefore, the services provider can opt for a customer account approach. In this way, the supplier will establish the customer's eligibility to receive zero rated financial services at the time the account is created (provided that the customer's eligibility is reviewed periodically).*

7.52 *Taking into account the difficulties that may arise when service providers need to obtain information from customers in relation to their level of taxable supplies, service providers are allowed to make use of ANZSIC codes*[170]*.*

7.53 *Apart from the administrative costs for applying zero rating, it should be noted that financial services supplied to another financial services provider generally cannot be zero rated because most financial service providers will not satisfy the requirement that 75 % of their supplies are taxable supplies.*

7.54 *Therefore, the GST Act in New Zealand provides for a complex GST deduction in relation to supplies of financial services made to another financial services provider*[171]*.*

7.55 *Although in New Zealand an additional GST deduction has been foreseen for financial services providers, zero rating financial and insurance services in a B2B context could already mitigate the problem of non-deductible VAT for the financial sector to a large extent.*

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[170] Australian and New Zealand Standard Industrial Classification codes. A full list of ANSZIC codes may be found on the Statistics New Zealand Website:
http://www.stats.govt.nz/domino/external/web/carsweb.nsf/94772cd5918085044c2567e6007eec2c/5b3e1b99a0d86615cc256cec007e6b14?OpenDocument.

[171] Sections 20(C) and 20(D) of the GST Act.

7.56 In considering this solution, it will be necessary to consider whether to apply the zero rating broadly to specific financial services transactions, or narrowly. If the zero rating is applied broadly then a wide range of previously exempt services would now be subject to the zero rate. This could lead to budgetary imbalances for Member States and it may therefore be preferable to consider a more limited application of the zero rate. For example, the solution could be limited by introducing it in a closed economic system[172] such as the exchange market. This would be comparable to the UK Terminal Markets Order which currently allows commodity trading through specified UK exchanges to be zero rated. Alternatively, consideration could be given to adopting a black or closed box arrangement that covers an identifiable and contained market. In this case, zero rating would not apply, but rather transactions would not be considered supplies until the commodities leave the Terminal Markets. It may be that the solution is most appropriate to the banking sector where zero rating could cover swaps, derivatives and foreign exchange transactions undertaken on regulated markets.

7.57 The solution would not eliminate embedded VAT but would reduce it to the extent that the zero rating provisions are introduced. It is also interesting to note that zero rating has been put forward as the preferred regime for financial services in designing the new Hong Kong GST regime. It was clear from the consultation process[173], that zero rating for financial services is preferable to the exemption applied in Europe. An identified advantage of zero rating, is its application to both fee based and margin based transactions, which makes this solution broader in scope than the option to tax solution above that is only easily applicable to fee based transactions, as discussed in Section 7.2.3 above.

7.2.5 Mandatory Domestic VAT Grouping

7.58 This solution would ensure that all Member States allow VAT Grouping where the eligibility tests are met in accordance with EU law. A common set of VAT Grouping rules could be built into the Sixth EU VAT Directive, with local discretion for anti-avoidance purposes. This would ensure that VAT Grouping is applied consistently across Member States and thus addresses the uneven playing field that currently exists. Our case study research showed that the availability of VAT Grouping in certain Member States makes those locations particularly attractive to financial and insurance services operators – see Table 3.5.

[172] The concept of a closed economic system has already been introduced on the gold bullion market (see article 26b(G) of the Sixth EU VAT Directive).

[173] Hong Kong GST public consultation document -http://www.taxreform.gov.hk/eng/document.htm.

7.59 VAT Group registration (in accordance with article 4(4) of the Sixth EU VAT Directive) is currently allowed in 12 out of 25 Member States and cross-border VAT Grouping is only allowed in 2 of those 12 (within carefully defined circumstances). Table 7.3 illustrates this:

Table 7.3: Application of VAT Grouping (25 Member States)[174]

Domestic VAT Grouping	Cross-border VAT Grouping	No VAT Grouping
Austria	The Netherlands	Belgium
Cyprus	United Kingdom	Czech Republic
Denmark		France
Estonia		Greece
Finland (limited to financial services sector)		Latvia
Germany		Lithuania
Hungary (limited to financial services sector)		Luxembourg
Ireland		Malta
Italy		Poland
The Netherlands		Portugal
Sweden (limited to financial services sector)		Slovakia
United Kingdom		Slovenia
		Spain

Source: PwC Survey October 2006

7.60 Where Member States do not currently allow VAT Grouping, there is a VAT cost on inter-company 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.

7.61 Mandatory VAT Grouping would allow financial and insurance institutions to manage VAT across their business as they expand either by internal growth or by acquisitions. This would help to address the current imbalance that exists between branch and subsidiary operations and ensure that business operators can structure their business as they grow, without having to let VAT affect their decisions. For example, a bank that acquires a new business and runs it as a subsidiary can choose to VAT Group the new entity, assuming all grouping conditions are met. Without a VAT Group, charges between the two entities may be subject to VAT which could become an unnecessary cost to the business.

7.62 To make VAT Grouping mandatory, i.e. to require Member States to permit VAT Grouping if the taxpayer requests it (not to make it mandatory on taxpayers), an amendment would be required to the Sixth EU VAT Directive which currently gives Member States the option to allow VAT Grouping.

[174] This table reflects the status as in the law of the Member States and disregards any pending proposals to introduce VAT Grouping at the date of concluding the Study.

Article 4(4) of the Sixth EU VAT Directive could read:

"*Subject to the consultations provided for in article 29, each Member State* ***shall*** *treat* ***at the request of the taxable persons*** *as a single taxable person persons established in the territory of the country who, while legally independent, are closely bound to one another by financial, economic and organisational links*".

7.63 This amendment would allow taxable persons established in any Member State to have the option to VAT Group with other closely linked entities in the same Member State. In order to ensure consistency across Member States, guidance could be given to determine the precise interpretation of financial, economic and organisational links.

7.64 An alternative solution would be to make VAT Grouping mandatory on taxpayers. This would not give flexibility to economic operators. However, mandatory VAT Grouping for taxpayers is still preferable to no VAT Grouping in order to combat the identified distortions.

7.65 The implications of VAT Grouping can be identified as follows:

- a VAT Group is treated as a single taxable person and so supplies between members of a VAT Group are disregarded for VAT purposes;
- all supplies are treated as being made by the representative member of the VAT Group (the Group simply specifies on application who will be the representative member);
- all VAT Group members are jointly and severally liable for any VAT due from the representative member.

7.66 The advantages of VAT Grouping include:

- a taxpayer will prepare and submit a single VAT return for all VAT Group members;
- VAT Grouping may reduce administration costs for taxpayers;
- the tax authorities can have a direct relationship with the representative member of the VAT Group as opposed to all Group members;
- it is easier for the tax authorities to audit the representative member of the VAT Group as opposed to all Group members individually;
- joint and several liability of all VAT Group Members for any VAT due from the representative member which is a benefit for the tax authorities.

7.67 To prevent inconsistency in application, additional criteria imposed by individual Member States which restrict the eligibility for VAT Grouping (e.g. depending on the legal personality of a corporate entity or on the nature of services provided by a corporate entity) should not be allowed. This would ensure that a level playing field exists, subject to any specific discretion for Member States to introduce targeted anti-avoidance provisions.

7.68 There may be concerns that VAT Groups can be abused by taxpayers to avoid paying VAT. However, this risk can be overcome through targeted anti-avoidance provisions, as shown in a number of Member States that currently allow VAT Grouping.

Examples

7.69 *In the United Kingdom, the tax authorities have the power to reject an application for VAT Grouping and to remove a company from a VAT Group for Protection of Revenue. They also have 90 days following acceptance of a VAT Group application to reject the application[175]. The tax authorities also have the power to make directions in relation to "relevant events" in a Group if the events give rise to a VAT advantage. Such directions can be retrospective in effect. A relevant event can include transactions undertaken and Group members joining or leaving the Group. The anti-avoidance provisions effectively allow the UK tax authorities to reconstruct the VAT position where there is a VAT advantage. The powers can be used in relation to a service provider and a recipient in the same VAT Group and could therefore apply to certain outsourcing arrangements[176].*

7.70 *In Ireland, the tax authorities can impose VAT Grouping in certain circumstances for administration purposes[177]. The legislation was updated by the Finance Act 2006, so that VAT Grouping may be imposed also if it is expedient for the collection of the tax.*

7.71 This solution should not impose significant administrative requirements on Member States so that it is more likely to be considered by them as a viable option. It should also be recognised that this solution would have implications outside of the financial and insurance services sector since mandatory VAT Grouping would be available for all companies that meet the eligibility criteria. Mandatory VAT Grouping would ensure that taxpayers can avoid VAT costs on charges between corporate Group members and would therefore counteract the problem of internally generated embedded VAT.

[175] S. 43B(5), the Value Added Tax Act 1994.
[176] Sch. 9A, the Value Added Tax Act 1994.
[177] S. 8(8), the Value Added Tax Act 1972 (as amended).

7.2.6 Cross-Border VAT Grouping

7.72 This solution extends Section 7.2.5 above to apply mandatory VAT Grouping on a cross-border basis. The addition of, or creation of, VAT on cross-border charges prevents the successful operation of the Single Market. This solution therefore recognises that financial and insurance services companies increasingly operate on a cross-border level and that VAT can be a significant barrier to the efficient functioning of the European market, and cause an unnecessary VAT cost to businesses that structure their European corporate group in a certain way. For example, VAT is often due on charges between cross-border subsidiaries.

7.73 Mandatory cross-border VAT Grouping 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. At present, head office to branch and branch to branch operations, where the branch belongs to the same head office, can obtain cross-border VAT relief but subsidiary operations do not. This is because transactions between various branches of a company or between a head office and its branches are outside the scope of VAT (see *FCE Bank plc*[178]) since a branch is not a legal personality distinct from the company of which it forms part.

7.74 The case concerned a UK company that carries out exempt financial services and its Italian branch which receives services (notably supplies of staff) from its UK head office. In reaching its judgement, the ECJ stated that a branch does not itself bear the economic risks associated with carrying on the business of a credit institution. The bank, as a legal person, bears that risk and is therefore the subject of supervision of its financial strength and solvency in the Member State of origin. A branch would also not normally have any endowment capital and therefore assumes no risk, although we refer to our comment in respect of Belgium below. Consequently, the risk associated with the economic activity undertaken lies wholly with the company of which it is part.

[178] ECJ judgement of 23 March 2006 in *Ministero dell'Economia e delle Finanze, Agenzia delle Entrate v. FCE Bank plc*, Case C-210/04.

7.75 It should also be noted that, despite the ECJ ruling, there are certain commentators that interpret the decision in a different manner and still believe that in specific circumstances there can be a supply for VAT purposes between a head office and a branch.

7.76 For example, in Belgium, a branch of a non-EU corporate body is obliged to have endowment capital[179], and applying the endowment capital principle above, the branch for these purposes, could be considered to assume a certain level of risk and could therefore be seen to be an independent person for VAT purposes.

7.77 It may therefore appear that VAT could have an impact on the decision to set up branch or subsidiary operations. However, empirical evidence has shown that financial services and insurance players often grow through acquisitions instead of organic growth, and so the VAT solution of setting up branches is not available, as identified in Chapter 3 (paragraph 3.4).

7.78 At present, only 2 Member States (the United Kingdom and the Netherlands) allow cross-border VAT Groups, although admittedly, 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. Mandatory cross-border VAT Grouping would offer flexibility and legal certainty to economic operators.

7.79 Specific anti-avoidance measures incorporated into the proposal to prevent abuse should make it easier for Member States to accept this solution. Anti-avoidance measures could be based on current criteria in the United Kingdom. For example, there is anti-avoidance legislation to prevent overseas group members buying in services and then on supplying them VAT free within the UK VAT Group[180]. The anti-avoidance measures apply to specified services that would be subject to VAT and include the assignment of copyright, advertising services, data processing and legal services. Where the precise conditions are met, the supply is not disregarded and is treated as a taxable supply in the United Kingdom by the representative member of the VAT Group to itself. However, the deemed supply cannot be taken into account when determining its allowable input tax.

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[179] Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC - Article 6.1 stipulates that Host Member States may no longer require authorization, as provided for in article 4 of Directive 77/780/EEC, or endowment capital for branches of credit institutions authorized in other Member States. The establishment and supervision of such branches shall be effected as prescribed in articles 13, 19 and 21 of this Directive. Transposed into Belgian law in the Banking Act of 22 March 1993 Section 79(1)(4°).

[180] S. 43(2A), the Value Added Tax Act 1994.

7.80 Cross-border VAT Grouping could therefore be a solution to the creation of VAT in multi-national financial services operations. It would need to be mandatory upon Member States but could be at the option of the economic operator. The rules would need to be carefully drafted and not capable of amendment or qualification by Member States.

7.81 This solution may also be combined with, for example, more refined input VAT recovery calculations to allow economic operators the ability to manage their VAT affairs in a more common way across the EU25. This could support the shift towards input VAT recovery on the basis of use across Europe by multinational businesses.

7.3 Pan-European Financial Services Solutions

7.82 This Section considers solutions that would apply equally to all financial services sub-sectors. There are three main solutions considered, cost sharing, simplification and/or flexibility for VAT recovery methodologies and the uniform limited input VAT credit.

7.3.1 Cost Sharing

7.83 This solution is based on the provision of clear and definitive guidance in respect of the VAT treatment of cost sharing arrangements. This may take the form of firm confirmation on the application of the exemption under article 13(A)(1)(f) of the EU Sixth VAT Directive, or it may take the form of direct application of the ECJ decision in *EDM*[181] so that true cost sharing arrangements are outside the scope of VAT. It should however be recognised that various commentators interpret the decision in *EDM*[182] in different ways and some form of clarification of the decision would be required.

7.84 This solution would directly address the imposition of VAT in cost sharing arrangements which is common across the EU25. This solution would also address the current uneven application and implementation of the exemption under article 13(A)(1)(f) across Member States. The diverse VAT treatment of cost sharing arrangements across Member States causes uncertainty, and may prevent business decisions from being made due to the potential VAT cost that could arise. The heading of article 13 refers to *Exemptions within the territory of the country*. This could suggest that the exemption is only applicable on a national level rather than cross-border and is an immediate point of confusion which should be clarified.

7.85 The exemption specifically under article 13(A)(1)(f) is currently set out as follows, and applies to:

"services supplied by independent groups of persons, whose activities are exempt from or are not subject to VAT, for the purpose of rendering their members the services directly necessary for the exercise of their activity, where these groups merely claim from their members exact reimbursement of their share of the joint expenses, provided that such exemption is not likely to produce distortion of competition"[183].

[181] ECJ judgement of 29 April 2004 in *Empresa de Desenvolvimento Mineiro SGPS SA (EDM) v. Fazenda Pública*, Case C-77/01.
[182] ECJ judgement of 29 April 2004 in *Empresa de Desenvolvimento Mineiro SGPS SA (EDM) v. Fazenda Pública*, Case C-77/01.
[183] The wording of article 13(A)(1)(f) as stated here is not an exact replica of the English language version of the Sixth EU VAT Directive but a more accurate English translation of the French version. The current English language version does not make sense and is defective, a fact recognised by the proposed recast of the Sixth EU VAT Directive – Proposal for a Council Directive on the common system of VAT (Recast) – COM(200) 246 final – 15 April 2004 - http://ec.europa.eu/prelex/detail_dossier_real.cfm?CL=en&DosId=190390.

7.86 Article 13(A)(1)(f) is a mandatory provision[184]. The article is not however implemented in nine Member States. Table 7.4 below illustrates the current application in Member States.

Table 7.4: Overview of Application and Scope of Cost Sharing (25 Member States)

Introduction of Cost Sharing Provision	Yes	No	No/limited Guidance	Not applicable	Total
Is a VAT Exempt Cost Sharing Provision taken up in Local VAT Legislation?	16 (5)	9 (5)	0	0	25
Application of cost sharing in Practice	**Yes**	**No**	**No/limited Guidance**	**Not applicable**	**Total**
Is VAT Exempt Cost Sharing allowed in your Country according to Administrative Practice (e.g. for the Financial Sector)?	11 (2)	11 (5)	3 (3)	0	25
Scope of Cost Sharing in Practice	**Yes**	**No**	**No/limited Guidance**	**Not applicable**	**Total**
Is VAT Exempt Cost Sharing allowed for the following Services:					
▪ IT-Related Services	8 (1)	1	5 (4)	11 (5)	25
▪ Administrative / Back-Office Services	8	0	6 (5)	11 (5)	25
Application of Cost Sharing Cross-border in Practice	**Yes**	**No**	**No/limited Guidance**	**Not applicable**	**Total**
Is VAT Exempt Cross-border Cost Sharing allowed?	3	1	10 (5)	11 (5)	25
Mark-up in case of Cost Sharing Cross-border	**Yes**	**No**	**No/limited Guidance**	**Not applicable**	**Total**
If VAT Exempt Cost Sharing is possible, can this be done with a *Mark-Up*?	1	10 (3)	3 (2)	11 (5)	25
Exemption in case of Inter-company Charges Cross-border	**Yes**	**No**	**No/limited Guidance**	**Not applicable**	**Total**
Can Cross-border Inter-company Charges of Shared Services be VAT Exempt (in the Sense of ECJ Case *EDM*[185])?	6 (1)	9 (3)	10 (6)	0	25

Source: PwC Survey October 2006

7.87 The provision is currently included under article 13(A) of the Sixth EU VAT Directive, which deals with exemptions for activities in the public interest rather than under article 13(B) of the Sixth EU VAT Directive. This leads to confusion regarding its application for tax authorities and taxpayers because it is not immediately obvious that cost sharing arrangements undertaken by financial and insurance services operators are in the public interest.

[184] Based on the PwC Survey, cost sharing is allowed in theory in the following Member States: Austria, Belgium, Cyprus, Denmark, Estonia, France, Ireland, Italy, Lithuania, Luxemburg, Portugal, The Netherlands, Slovenia, Spain, Sweden and Malta.
[185] ECJ judgement of 29 April 2004 in *Empresa de Desenvolvimento Mineiro SGPS SA (EDM) v. Fazenda Pública*, Case C-77/01.

7.88 Clear guidance indicating that this article is applicable in a business environment could therefore be beneficial. Justification for this guidance may be found in the ECJ decision in *Taksatorringen*[186] since it is possible to conclude that the ECJ did not appear to take issue with the public interest point. The heading of article 13(A) of the Sixth EU VAT Directive, the wording of which is *Exemptions for certain activities in the public interest*, does not therefore in itself entail restrictions on the possibilities of exemption provided for by that provision. In the *Hoffmann case*[187], it was confirmed that the commercial nature of an activity does not preclude it from being an activity in the public interest in the context of article 13(A) of the Sixth EU VAT Directive.

7.89 Consequently, the provisions of this article could be available for any costs and services in the financial services and insurance sector. It may therefore be that clarification of the application of 13(A)(1)(f) is required. This could be done through pan-European guidance, as set out in Section 7.5 below, by amending the heading of 13(A) or by inserting the cost sharing provision under article 13(B) *Other exemptions* of the Sixth EU VAT Directive.

7.90 Pan-European guidance could also be used to clarify the interaction of article 13(A)(1)(f) with transfer pricing guidelines. Difficulties of interpretation arise with article 13(A)(1)(f) because the provision states that for the exemption to apply, groups can merely claim from their members exact reimbursement of their share of the joint expenses. However, there is a general perception that transfer pricing rules require a mark-up rather than a strict reimbursement of joint expenses. However, the OECD transfer pricing guidelines for Multinational Enterprises and Tax Administration[188] in fact allow a reimbursement at cost, as commonly enacted in local law. In the United Kingdom for example, the OECD model is set out in ICTA 1988, Schedule 28AA.

7.91 In any event it appears that to overcome the current uncertainty surrounding article 13(A)(1)(f) guidance is needed to ensure that the provisions are applied consistently across Member States. Clarification of article 13(A)(1)(f) has become all the more necessary following the decision in *EDM*[189], and in fact to some observers, the decision has called into question whether there is in fact any need for an exemption when there is European case law that sets out when cost sharing arrangements are outside the scope of VAT.

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[186] ECJ judgement of 20 November 2003 in *Assurandor-Societetet v. Skatteministeriet*, Case C-8/01.
[187] ECJ judgement of 3 April 2003 in *Criminal proceedings v. Matthias Hoffmann*, Case C-144/00.
[188] In this paragraph the OECD transfer pricing guidelines means all the documents published by the Organisation for Economic Co-operation and Development, at any time before 1st May 1998, as part of their Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations; and such documents published by that Organisation on or after that date as many for the purposes of this Schedule be designated, by an order made by the Treasury, as comprised in the transfer pricing guidelines.
[189] ECJ judgement of 29 April 2004 in *Empresa de Desenvolvimento Mineiro SGPS SA (EDM) v. Fazenda Pública*, Case C-77/01.

7.92 In *EDM*[190], the ECJ ruled that operations carried out by members of a consortium in accordance with the provisions of a consortium contract and corresponding to the share assigned to each of them, did not constitute supplies of goods or services effected for consideration within the meaning of article 2(1). In other words, cost sharing arrangements meeting the conditions set down in the ruling may be outside the scope of VAT. On the other hand, where the performance of more of the operations than the share thereof fixed by the said contract for a consortium member involves payment by the other members against the operations exceeding that share, those operations do constitute a supply for consideration.

7.93 The ECJ has essentially ruled that operations performed in connection with a consortium, for its account, by each of its members are not generally different from those carried out by a business for its own account and are to be treated in the same way. Whilst the cost sharing relief under article 13(A)(1)(f) requires certain stringent criteria to be met, it appears that *EDM*[191] suggests that any cost sharing arrangement meeting the conditions set out in the judgment may be outside the scope of VAT. This may suggest that there is not actually any need to retain the exemption under article 13(A)(1)(f).

7.94 The decision in *EDM*[192] supports the Dutch practice of *costs for joint account*[193] and similar rules in Belgium, both of which are set out below:

[190] ECJ judgement of 29 April 2004 in *Empresa de Desenvolvimento Mineiro SGPS SA (EDM) v. Fazenda Pública*, Case C-77/01.
[191] ECJ judgement of 29 April 2004 in *Empresa de Desenvolvimento Mineiro SGPS SA (EDM) v. Fazenda Pública*, Case C-77/01.
[192] ECJ judgement of 29 April 2004 in *Empresa de Desenvolvimento Mineiro SGPS SA (EDM) v. Fazenda Pública*, Case C-77/01.
[193] Hoge Raad, 23 April 1997, BNB 1997/301.

Example

*7.95 In **The Netherlands**, the "costs for joint account" rules cannot be found in Dutch VAT law as such, but are based on jurisprudence upheld by the High Court, that make the arrangements fall outside the scope of VAT. The requirements for applying the Dutch "costs for joint account" rules are as follows:*

1. *the costs must be made by at least two parties and for joint account;*
2. *this mutual understanding between parties should be laid down in a cost sharing agreement to be signed by parties upfront;*
3. *the type of costs should be clearly mentioned in the agreement (e.g. labour costs of certain staff, costs of certain assets, costs of a certain department, rental costs, etc.);*
4. *the periodical recharge must be solely based on a predetermined key (e.g. a percentage), which is mentioned in the agreement (no retroactive adjustment possible). It is possible to use different predetermined keys per different type of costs, provided that this is clearly stated in the agreement;*
5. *the recharge takes place without any profit margin. Please note that it is possible to include the administration costs with regard to the cost sharing agreement in the periodical recharge;*
6. *all parties will carry risk for the costs on the same proportionate basis that has been predetermined. The agreement can therefore only cover future costs. It is not possible to issue credit notes or discounts for the amounts recharged either during the course of the agreement or after the end of the cost share period, unless the way in which the recharge was originally calculated was wrong, i.e. different to the percentage as set out in the agreement. A predetermined key based on hourly rates and time spent is not possible.*

*7.96 In **Belgium**, the rules for setting up a cost sharing structure are defined in circular letter no. 3 of 1996.*

7.97 In short, the requirements to apply the VAT exemption for cost sharing (as defined in article 44, §2, 1bis of the Belgian VAT Code) are the following where a cost sharing vehicle distinct from its members is established:

1. *the activities of the cost sharing vehicle should be limited to services only and should be rendered to all members (i.e. services cannot be rendered to non-members);*
2. *the services rendered should be similar for all members and in the interest of the various members meaning that they should actually be required to enable the various members to perform their activities (i.e. it is not allowed to render specific services to one member only);*
3. *the members can be natural or legal persons, but should perform activities that are out of scope of VAT or VAT exempt (without right to deduct VAT). However, where the annual taxable turnover does not amount to more than 10% of the annual total turnover at member level, each member can also qualify for the VAT cost sharing exemption;*
4. *the members are required to perform similar activities and/or belong to similar financial, economic, professional or social sectors;*
5. *the remuneration or retribution assigned to each member must consist in a re-charge according to the member's share in the joint expenses;*
6. *the cost sharing entity or vehicle must dispose of joint personnel (i.e. personnel which is hired jointly by all members or personnel which is hired by one or more members for the account of all members which needs to be evidenced in writing). In practice, this can cause some difficulty from an employment law point of view when companies considering setting up a cost sharing structure are not willing and/or able to attribute part of their personnel to a legally distinct cost sharing vehicle;*
7. *provided the conditions are met to apply the VAT exemption from a Belgian VAT perspective as set out in circular letter no. 3 of 1996, in theory the Belgian cost sharing exemption can also be applied cross-border since it is applicable to all members even if they are established in other Member States.*

7.98 The VAT treatment of cost sharing arrangements is uneven across Member States. This solution would ensure that guidance is given as to the application and possible interaction of article 13(A)(1)(f) and *EDM*[194]. It is clear from the current uncertainty that some positive measures should be taken in this area to offer guidance to taxpayers.

7.3.2 More Refined Input VAT Recovery Calculations

7.99 This solution is based on more refined input VAT recovery calculations on a pan-European level. The lack of harmonised methods to determine input tax recovery causes problems for taxpayers. The diversity in the scope and complexity of methodologies ranges from inflexible single pro rata calculations to complex sectorised methods and leads to legal uncertainty, increased complexity (especially when a taxpayer is established in more than one Member State), potential distortion of competition between taxpayers established in different Member States and high compliance costs. The case of *Société Monte Dei Paschi*[195] illustrated the fact that different input VAT recovery regimes exist in Italy, where it was headquartered and in France, where it had a representative office.

7.100 We recognise that refining input VAT recovery calculations could take a number of forms. For example, it may simply mean allowing a simplified fixed recovery method for taxpayers (as identified in Section 7.3.3 as a separate solution). Alternatively, it could mean allowing all taxpayers the option of a special method of recovery in addition to the general pro rata, or it may mean providing firm guidance on the actual calculation of the pro rata. In any event, the key to the solution is that there is consistency on a European level to simplify the cross-border application of input VAT recovery calculation and to therefore reduce uncertainty and compliance costs for financial services operators. Furthermore, the solution should also respect tax neutrality.

[194] ECJ judgement of 29 April 2004 in *Empresa de Desenvolvimento Mineiro SGPS SA (EDM) v. Fazenda Pública*, Case C-77/01.
[195] ECJ judgement of 13 July 2000 in *Ministre du Budget, Ministre de l'Economie et des Finances v. Société Monte Dei Paschi Di Siena*, Case C-136/99.

7.101 At present, some Member States allow a VAT deduction based on special input VAT recovery methods (depending on the methodology agreed with the local tax authorities), whilst other Member States only accept a scheme based on the general pro rata deduction method and the direct allocation method. For the sake of clarity, a special input VAT recovery method can be based on any proposed metric of calculation as long as it allows a fair and reasonable recovery of input tax and is agreed with the tax authorities. Certain special input VAT recovery methods allow different methods of recovery to be agreed for different parts of the taxpayers business. This is sometimes referred to as a sectorised partial exemption special method.

7.102 The freedom given to Member States by article 17(5) of the Sixth EU VAT Directive to allow other deduction methods is a source of complexity. Table 7.5 shows the diversity of input VAT recovery calculations across the EU.

Table 7.5: Calculation of Deductible Proportion of VAT (25 Member States)

Application of General Pro Rata Calculation	**Yes**	**No**	**Not applicable**	**Total**
Is a System of a general Pro Rata Calculation (Annual VAT Taxable Turnover / Total Turnover) applicable in your Country?	23 (10)	2	0	25
Application of Direct Attribution	**Yes**	**No**	**Not applicable**	**Total**
Is a System of Attribution of the Goods and Services to a Taxable or Non-Taxable Sector applicable in your Country?	24 (10)	1	0	25
Implementation of Article 17(5)(a)	**Yes**	**No**	**Not applicable**	**Total**
Can a Taxable Person be authorized to determine a Proportion for each Sector of his Business?	18 (5)	7 (5)	0	25
Implementation of Article 17(5)(b)	**Yes**	**No**	**Not applicable**	**Total**
Can a Taxable Person be compelled to determine a Proportion for each Sector of his Business?	15 (2)	10 (8)	0	25
Implementation of Article 17(5)(c)	**Yes**	**No**	**Not applicable**	**Total**
Can a Taxable Person be compelled to make the Deduction on the basis of the Use of all or Part of the Goods and Services?	18 (6)	6 (4)	1	25

Source: PwC Survey October 2006

7.103 One potential method of simplification would be to allow taxpayers the option to apply a fixed method of recovery (also identified as a separate solution in Section 7.3.3).

7.104 We can refer in this respect to the method used in Singapore, where recovery rates are reviewed yearly and each category of financial institutions has its own recovery rate[196].

[196] See also: http://www.iras.gov.sg/ESVPortal/gst/gst_c.4.9.4.e_amt+of+input+tax+allowable.asp.

Example: Singapore

*7.105 **Singapore** recognised that exempt supplies made by financial institutions to other GST-registered businesses should not include hidden GST. It therefore introduced mechanisms to protect their financial services industry.*

7.106 It should be noted that exemptions in Singapore are more limited than in the EU. There is a specific list of exempt financial services which includes amongst others the operation of any current, savings or current account, the provision of a loan, advance or credit, foreign exchange and the issue and sale of shares and life insurance. There are no "making of arrangements" provisions included in the list of exempt financial services. Singapore levies GST on fee-based services such as fees for financial advice, credit card subscriptions i.e. any services consisting of arranging, broking, underwriting or advising on any of the exempt financial services in return for a brokerage fee, commission or similar consideration. Without the relief mechanisms this could lead to an increase in the hidden GST within financial services, which would have an adverse impact on the banking and financial sectors.

7.107 To get around this problem two alternative solutions are in place. The first is to use fixed input tax recovery rates. These are based on industry statistics collected by the Monetary Authority of Singapore (MAS) and are reviewed on an annual basis. We understand that the idea is to reflect the percentage of work done for other GST-registered businesses. The statistics used and the method for calculating the percentages is not made public and so further analysis may be required in order to identify how the statistics are used.

7.108 Different rates are applied to different types of financial institutions, depending on their banking licence. As agreed with the industry, the following groups of financial institutions would use the fixed input tax recovery rates to their total input tax (excluding disallowed expenses)[197]:

- *finance companies (42%)*
- *full licensed banks (76%)*
- *wholesale (restricted) banks (96%)*
- *offshore banks (98%)*
- *merchants banks (96%)*

7.109 The alternative solution is for businesses that can track their transactions and customers. They can use a partial exemption apportionment method that recognises supplies to other GST-registered businesses as providing an entitlement to input tax recovery. This, in effect, produces an input tax recovery formula, where X is the input tax recovery, which looks like:

$$X = \text{Residual Input Tax} * \frac{\text{Taxable supplies + exempt supplies to GST-registered persons}}{\text{Total supplies}}$$

7.110 This is a special method and would need approval from the Inland Revenue Authority of Singapore (IRAS) before it can be used.

7.111 It is worth noting that if there is a GST Group where the Group members are entitled to different fixed recovery rates, the whole Group must use the recovery rate of the Group member which is the lowest.

[197] GST Input Tax Recovery rates with effect from 1 April 2005 up to 31 March 2006 have been indicated between brackets.

7.112 It may be that such a method of fixed input tax recovery may be more beneficial to smaller firms who do not have the resources available to operate a complicated pro rata or special method. However, special methods should equally be available to any business independent of their size. The important point for any method is to provide the taxpayer with a fair and reasonable recovery of input tax for the business it operates. It should also be noted that a fixed recovery percentage could be easier on the tax authorities to agree and review with the taxpayer and so may also reduce compliance costs for taxpayers and tax authorities alike, as with the Singapore model above.

7.113 In order to provide consistency and uniformity of treatment across Europe, a potential solution would be to allow all taxpayers the option of agreeing a special method of input tax recovery, as defined in article 17(5) of the Sixth EU VAT Directive. Any methodology should limit the burden of compliance to a minimum, and it may be that an updated Sixth EU VAT Directive sets certain parameters for the operation of the special method. This would ensure that taxpayers in all Member States are clear about the options they have available in agreeing a special method with their local tax authorities.

7.114 Alternatively, pan-European guidance could be used to identify the scope and application of common special methods to be used by taxpayers in all Member States. The most favourable method of implementation is likely to be by regulation under article 29a of the Sixth EU VAT Directive, since a regulation would not need to be implemented by Member States and would have direct effect. This would make the solution easier to implement and would reduce the discretion of Member States.

7.115 Another solution to refine input VAT recovery calculations would be to address the current uncertainty around the actual calculation or definition of taxable turnover. At present, there is little consistency across Member States. In fact, Table 7.6 illustrates that there is not one activity where the calculation of taxable turnover is identical across all Member States.

Table 7.6: Calculation of Taxable Turnover (25 Member States)

Loans and Deposits	Gross Amount (Capital + Interest)	Net Amount (Interest only)	Net Interest (received – paid)	No/limited Guidance	Total
What is the Taxable Amount included in the Pro Rata in respect of Loans/Deposits?	n.a.[198]	18 (8)	2	5 (2)	25
Leasing	**Gross Amount (Capital + Interest)**	**Net Amount (interest only)**	**Net Interest (received – paid)**	**No/limited Guidance**	**Total**
What is the Taxable Amount included in the Pro Rata in respect of Leasing?	13 (4)	7 (3)	n.a.	5 (3)	25
Currency transactions	**Positive Results**	**Positive + Negative Results**	**No/limited Guidance**	**Not Applicable**	**Total**
What is the Taxable Amount included in the Pro Rata in respect of Currency Transactions?	5 (2)	9 (1)	11 (7)	n.a.	25
Derivatives	**Positive Results**	**Positive + Negative Results**	**No/limited Guidance**	**Not Applicable**	**Total**
What is the Taxable Amount included in the Pro Rata in respect of Derivatives?	5 (1)	6 (1)	14 (8)	n.a.	25
Securities	**Yes**	**No**	**No/limited Guidance**	**Not Applicable**	**Total**
Is the Surplus Value in case of the Sale of Securities included in the Pro Rata?	10 (1)	6 (4)	8 (4)	1 (1)	25

Source: PwC Survey October 2006

7.116 The proposed solution in this case would be to provide guidance on the calculation of taxable turnover. This would offer taxpayers and tax authorities alike, certainty in respect of determining values to be used in calculating taxable turnover. One example of clear guidance can be found in Denmark. Section 38(1) of the Danish VAT Act provides clear guidelines in line with jurisprudence of the ECJ (see *First National Bank of Chicago*[199]). Such guidance could be applied across Member States, rather than just on a national level.

Legislation in Denmark[200]

7.117 In Denmark, a bank's turnover in relation to borrowing and lending must be calculated for VAT purposes as the interest differential.

7.118 The reason is that it only makes financial sense to offer a service consisting of receiving deposits if the deposits can be used for lending or investment activity. Therefore, the borrowing and lending/investment activity are directly and naturally linked to each other and consequently the turnover within the meaning of the VAT Act can only consist of the amount which the financial business actually has at its disposal.

[198] As used in this Table, n.a. means not available.
[199] ECJ judgement of 14 July 1998 in *Commissioners of Customs and Excise v. First National Bank of Chicago*, Case C-172/96.
[200] Official guidelines issued by the Danish Customs and Tax Administration for the calculation of partial deduction for banks pursuant to section 38(1) of the Danish VAT Act, SKM2004.464.TSS, 25 November 2004.

7.119 As stated in the ECJ judgement First National Bank of Chicago[201], concerning certain exchange transactions, the turnover must therefore be calculated as the gross margin on the transactions for a certain period. The gross margin on the borrowing and lending activity is calculated as the amount which is the net income in the bank's accounts.

7.120 The same goes for both realised and unrealised profits and losses as well as resale profits on securities and foreign exchange business. Only the result from trade in securities and foreign currency should be included in the calculation of the turnover in section 38(1) of the VAT Act.

7.3.3 Uniform Limited Input Tax Credit

7.121 This solution is based on a Uniform Limited Input Tax Credit (referred to as ULITC) and would be similar to that introduced in certain non-EU tax regimes (Reduced Input Tax Credit - RITC system in Australia). The solution allows a fixed level of recovery of input tax for financial and insurance services operators, which can apply to all purchases or to a predefined range of costs. The solution could therefore reduce the amount of irrecoverable VAT that becomes embedded in financial and insurance companies by allowing a certain level of input tax recovery on a range of predefined incoming services.

7.122 In order to explain precisely what this solution is designed to achieve, and how the solution will work, it is useful to consider the processes behind the introduction of the RITC in Australia.

Example: Australia

*7.123 The objective of the RITC scheme in **Australia** is to eliminate the bias to vertical integration (self-supplying inputs) and to facilitate outsourcing presumably from a cost efficiency perspective. Vertical integration was seen to place a higher effective tax burden on smaller financial supply providers who were required to outsource proportionately more of their business inputs due to resource constraints, and therefore, incur higher GST costs. This would impact the relative competitiveness of different segments of the financial sector, effectively discriminating against smaller providers.*

7.124 In addition, the bias to vertical integration was at odds with the trend in the global financial services sector towards outsourcing. Thus, it was unpopular with large players in the industry who had already implemented global outsourcing arrangements and would artificially increase the cost of providing financial services in Australia. The application of a RITC regime applying to specific services that are capable of insourcing was seen as an effective way to reduce this bias.

7.125 In determining the rate of RITC, it was acknowledged that the size of the RITC should reflect the value added by an outsourced service provider. In broad terms, this is the wages and profit element of the service. Whilst the relative size of these elements may differ depending on the service, a single rate of RITC was adopted for simplicity. A relatively high rate of RITC was chosen (75%) due to the significant proportion of labour costs typically incurred in providing the RITC services.

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[201] ECJ judgement of 14 July 1998 in *Commissioners of Customs and Excise v. First National Bank of Chicago*, Case C-172/96.

7.126 In Australia, the Goods and Services Act 1999 was introduced on 1 June 2000.

7.127 One of the aspects of the GST, consisting in the introduction of the so-called RITC regime, has been well received by the majority of industry bodies involved in financial services transactions.

7.128 RITC regime means that where an entity is normally not entitled to input tax recovery for purchasing services because it is making exempt financial supplies, that entity is entitled to 75 percent of the full input tax amount if the service falls within the range of categories of acquisitions known as "reduced credit acquisitions".

7.129 The inputs that give rise to a RITC are itemised in regulations, but include the following categories[202]:

- *transaction banking and cash management services;*
- *payment and fund transfer services;*
- *securities transactions services;*
- *loan services;*
- *debt collection services;*
- *trade finance services;*
- *capital market and financial instruments services;*
- *funds management services;*
- *insurance brokerage and claims handling services;*
- *trustee and custodial services;*
- *supplies for which financial supply facilitators are paid a commission.*

7.130 Advantages of the Australian RITC mechanism:

- *the RITC regime removes the necessity to make supplies to financial institutions VAT exempt. Tax compliance is therefore easier for suppliers to financial institutions, which remain fully taxable;*
- *the recipient is responsible to determine the RITC rather than placing the burden on the supplier;*
- *the RITC regime is compatible with the existing VAT framework (i.e. direct attribution and allocation). For example, the RITC can apply to supplies used for taxable and exempt purposes. The recipient firstly works out the extent of taxable use (an apportionment is made) and then applies the reduced input tax credit to the extent of exempt use. Thus, if an entity makes 50% taxable and 50% exempt supplies, then it can claim back 87.5% of the GST incurred by applying the RITC (say 75%) to the remaining 50% exempt use.*

[202] Regulation 70-5.02, the Australian GST Regulations.

7.131 Disadvantages of the Australian RITC mechanism:

- *clear definitions and guidance are required to determine when the RITC will apply and to what kinds of goods/services;*
- *the Australian RITC regime requires unanimous support from all States and Territories before the law can be amended. Similar principles apply in the EU;*
- *an apportionment is required to overhead expenditure before the RITC can apply;*
- *it is the recipient that makes an apportionment between taxable and exempt use and then applies the RITC. This allows recipients to manipulate the apportionment in favour of taxable use to maximise input VAT recovery;*
- *the RITC does not apply to all services that may lead to irrecoverable input VAT. For example, the RITC may not apply to the recharge of shared service centre costs from a group company (but outside the GST Group);*
- *there is no scientific basis for determining the RITC. It is therefore difficult to know what the correct RITC should be. The credit of 75% was chosen after consultation with the industry. It was agreed that if the service was provided in-house, there would be a GST cost on overheads and some directly attributable costs, and therefore a 100% credit would be inappropriate.*

7.132 While some elements of the services may qualify for exemption in their own right under the Sixth EU VAT Directive, the RITC scheme is an interesting concept and may contribute to the elimination of the bias towards vertical integration.

7.133 The ULITC can thus be seen to operate in a number of different ways depending on the precise method of implementation. For this solution to be adopted in the EU25, Member States would need to consider the rate of ULITC that is relevant for the precise service. For example, outsourced call centre services may be labour intensive and so a rate of 80% may be appropriate, whereas an outsourced data service may be less labour intensive (since the activity may rely more heavily on IT) and therefore a rate of 40% may be more appropriate. The practical aspects of this solution also need to be considered. It would be necessary to ensure that taxpayers could modify their IT systems to accommodate the ULITC without excessive additional expense. To ease this process, it may be preferable to limit the number of rates for different types of service. In setting rates, an independent statistical survey should be undertaken to identify the proportion of labour costs for each ULITC service, in the same way as the statistical analysis performed for the Singapore model identified in Section 7.3.2 above.

7.4 Industry Specific Solutions

7.134 In this Section, the aim is not to provide specific modified definitions, but simply to provide some indication as to where legislative amendments or revised definitions/guidance should be given.

7.135 In the first instance, the aim is to focus on clarifying the application and scope of the exemptions as defined in the Sixth EU VAT Directive and therefore we have chosen to deal with specific industry sectors for simplicity. In considering revised definitions, alignment with existing regulatory frameworks should assist the clarification process, for example, the Insurance Directive[203] and the UCITS III Directive[204].

7.4.1 Insurance - Article 13(B)(a)

7.136 This solution proposes amendments to the wording of article 13(B)(a). The solution is designed to create certainty and a consistent VAT treatment for insurance agents and brokers and the scope of insurance related services. This industry specific solution can be considered in two ways. Firstly, to extend the scope of the insurance exemption. Secondly, to tax insurance premium income.

[203] Council Directive 77/92/EEC of 13 December 1976 on measures to facilitate the effective exercise of freedom of establishment and freedom to provide services in respect of the activities of insurance agents and brokers (ex ISIC Group 630) and, in particular, transitional measures in respect of those activities - http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31977L0092:EN:NOT.
[204] Directive 2001/107/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) with a view to regulating management companies and simplified prospectuses - http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32001L0107:EN:HTML.

7.4.1.1 Extending the Scope of the Insurance Exemption

Table 7.7 shows the current VAT treatment of intermediary services in the insurance sector.

Table 7.7: Overview of VAT Treatment in Insurance Sector (25 Member States)

Capacity of Insurance Intermediary	Any intermediary	Regulated Intermediary	No/limited Guidance	Total
Does the Exemption apply only to regulated Insurance Intermediaries i.e. Brokers and Agents, or does it apply to any Intermediaries, whether regulated or not?	19 (6)	5 (3)	1 (1)	25
Scope of Exemption for Insurance Intermediaries	**Yes**	**No**	**No/limited Guidance**	**Total**
In order to benefit from Exemption, does the insurance Broker/Agent have to intervene in the Conclusion of Contracts with a Professional Insurance Company?	15 (6)	6 (2)	4 (2)	25
Use of Sub-Intermediaries	**Yes**	**No**	**No/limited Guidance**	**Total**
Is an Exemption applicable in the case of Sub-Intermediaries in Insurance Transactions?	17 (6)	3	5 (4)	25

Source: PwC Survey October 2006

7.137 One solution would be to delete the requirement from article 13(B)(a) for services to be performed by insurance brokers and agents. Amendments to article 13(B)(a) that focus the exemption on the actual service performed rather than the person providing the service would be in line with European case law which suggests the VAT liability should be attached to the service, and not the service provider.

7.138 An alternative suggestion would be to broaden the concept of insurance agents and brokers to insurance (sub)intermediaries in general by stipulating that the exemption is applicable even in cases where the insurance intermediary does not have a direct contractual relationship with the insured. In this regard, the judgement in *Taksatorringen*[205] could provide some guidance. In *Taksatorringen*[206], it was not explicitly specified that an insurance agent's professional relationship should be directly with both the insurer and the insured party, and this principle could be extended to apply to sub-intermediaries too.

[205] ECJ judgement of 20 November 2003 in *Assurandor-Societetet v. Skatteministeriet*, Case C-8/01.
[206] ECJ judgement of 20 November 2003 in *Assurandor-Societetet v. Skatteministeriet*, Case C-8/01.

7.139 Another potential change would be to broaden article 13(B)(a) 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. This could apply to back-office activities/outsourced functions, as described in the *Andersen case*[207], and to claims handling services and policy administration, which could qualify as exempt insurance services whatever the stage of the policy. It would be possible to apply the revised exemption to any back-office function capable of being performed in-house by an insurer.

7.4.1.2 Taxing Insurance Premium Income

7.140 A sector-specific solution to assist in reducing the burden of irrecoverable VAT for the insurance sector would be to tax premium income, and in particular, general insurance premiums in respect of B2B supplies. This solution would prevent irrecoverable VAT from becoming embedded in the operation of the general insurance markets. This could apply to group life insurance policies for employers but not to life products for individuals which in many cases are akin to savings products.

7.141 One consequence of taxing insurance premium income for VAT purposes will be its impact on Insurance Premium Tax (IPT). A review of IPT is not within the scope of the Study but would be required in order to determine how IPT and article 33 of the Sixth EU VAT Directive may be affected or require amendment to take into account any change in the VAT treatment of insurance transactions. In particular, with any solution involving the taxation of insurance contracts at a positive rate, it would be inappropriate for Member States to continue to levy IPT in addition to VAT, whether at a state or national level.

[207] The “back-office” activities in question are described as follows in the order for reference: the acceptance of applications for insurance, the handling of amendments to contracts and premiums, the issuing, management and rescission of policies, the management of claims, the setting and paying of commission to insurance agents, the organisation and management of information technology, the supply of information and the drafting of reports for insured parties and third parties. When the information supplied by an applicant for insurance shows that a medical examination is necessary, the decision on acceptance of the risk is made by UL, otherwise that decision is made by ACMC and binds UL. AIS is in charge of almost all contact with the insurance agents.

7.142 It should also be noted that IPT can be an area of risk for insurers. This is because the IPT rules differ across Member States and there are often *no de minimis* limits. IPT is a tax payable by the insurer and is tied to the location of the risk that is being insured. This presents a particular problem for an insurer in a Member State that writes a multi-territory policy (insuring risks in various Member States). This often leaves the insurer in a position where he may be liable to register and account for IPT in each Member State that the policy covers, and yet there is no common set of IPT rules to assist the insurer (although Member States widely draw on the definition of risk in the Second Non-Life EU Directive[208]). Where the insurer fails to account for IPT, local rules may dictate that the intermediary or the insured may also be held liable for the IPT not paid which could also damage the reputation of the insurer. Any consideration to tax insurance contracts through the VAT system could therefore also positively address the current uncertainty in respect of IPT.

7.143 There are a range of insurance specific solutions that could apply to the industry. Any industry specific solution could also be supplemented by pan-European guidance, as set out in Section 7.5.

7.4.2 Banks - Articles 13(B)(d)(1) to (5)

7.144 This solution proposes amendments to articles 13(B)(d)(1) to (5) to modernise the definitions of the financial services that fall to be VAT exempt. Member States do not currently interpret articles 13(B)(d)(1) to (5) consistently. The problem arises in part because financial services products have become more complex since the Sixth EU VAT Directive was introduced in 1977. For example, swap transactions, futures and other hedging arrangements are not specifically included in article 13(B)(d) of the Sixth EU VAT Directive, since they were unrecognised financial activities back in 1977.

[208] Second Council Directive 88/357/EEC of 22 June 1988 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance and laying down provisions to facilitate the effective exercise of freedom to provide services and amending Directive 73/239/EEC - http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31988L0357:EN:HTML.

Table 7.8 shows that, while most Member States exempt the financial services listed, there are differences with some Member States treating some services as taxable.

Table 7.8: Overview of VAT Treatment of Financial Services and Products in Banking Sector (25 Member States)

Banking Sector	Exempt	Taxable/Tax Option	Outside Scope	No/limited Guidance	Total
Granting of Credit	22 (8)	3 (2)	0	0	25
Management of Credit	20 (7)	3 (2)	0	2 (1)	25
Intermediary Credit Negotiation	20 (6)	3 (2)	0	2 (2)	25
Deposit	21 (8)	4 (2)	0	0	25
Intermediary Deposit	19 (8)	4 (1)	0	2 (1)	25
Payment Transactions	20 (8)	5 (2)	0	0	25
Transfers in Receivables/Debts	21 (8)	4 (2)	0	0	25
Registration of securities	16 (5)	4 (1)	1 (1)	4 (3)	25
Securitisation of Portfolio	11 (4)	0	6 (3)	8 (3)	25
Commodity Derivatives	9 (3)	6 (3)	0	10 (4)	25
FOREX Hedging Transactions	18 (5)	2 (1)	0	5 (4)	25
Clearing of Securities	18 (6)	3 (1)	0	4 (3)	25
Settlement of Securities	18 (6)	3 (1)	0	4 (3)	25
Depositary Services	6 (2)	12 (5)	0	7 (3)	25

Source: PwC Survey October 2006

7.145 The extent of uncertainty in the banking sector across the EU25 is in part because of the lack of firm public guidance provided by the authorities on the application of the exemption to specific banking activities in Member States. However, it should also be noted that other factors may contribute to the uncertainty, including the lack of specialist banking activities in some Member States.

7.146 One solution would be to revise items (1) to (5) of article 13(B)(d) of the Sixth EU VAT Directive to include the more complex transactions which have been developed. This would lead to more certainty for economic operators and harmonisation of treatment across the Member States. It would also be possible to widen the exemption to not just include transactions as principal but to exempt the actual means of distribution. This would address the fact that the banking industry has evolved considerably since the introduction of the Sixth EU VAT Directive.

7.147 This solution could also involve a comprehensive rewrite of items 1 to 5, which would include a significant expansion in the scope and detail of services to be covered by the exemption. Alternatively, the actual text of items 1 to 5 could be significantly simplified, with details of the precise services to be covered by specific and detailed definitions to be found in up to date pan-European guidance, as set out in Section 7.5.

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

7.148 This solution would be based on clarification of article 13(B)(d)(6) in respect of the management of special investment funds. This solution could consolidate recent European jurisprudence including the decisions in *BBL*[209] and *Abbey National*[210]. The precise solution here is therefore to implement ECJ case law and to apply the Directive as implemented into the Member States' law correctly and consistently. There should be a single set of rules in the EU25 evenly applied to ensure that identical activities in the funds sector receive the same VAT treatment in different Member States.

7.149 A commonly identified problem for Case Study Companies was the uneven playing field in the investment funds arena and particularly the broad scope of the exemption in some territories, as set out in Chapter 2 (paragraph 2.18). Table 7.9 also illustrates this point:

Table 7.9: VAT Treatment of Financial Services in the Funds Sector (25 Member States)

Investment Management Sector	Exempt	Taxable/Tax Option	Outside Scope	No/limited Guidance	Total
Management of Securities	6 (1)	15 (5)	0	4 (4)	25
Management of Special Investment Funds	20 (7)	3 (1)	0	2 (2)	25
Global Custody	11 (5)	5 (1)	0	9 (4)	25
Fund Administration	15 (5)	7 (3)	0	3 (2)	25
Investment Advice	9 (3)	13 (7)	0	3	25
Rebalancing Fees	13 (5)	0	1 (1)	11 (4)	25
Bookkeeping	9 (3)	15 (6)	0	1 (1)	25
Net Asset Value Computation	11 (4)	11 (5)	0	3 (1)	25
Accountancy Fees	9 (3)	15 (6)	0	1 (1)	25

Source: PwC Survey October 2006

[209] ECJ judgement of 21 October 2004 in *Bank Brussel Lambert NV (BBL) v. Belgian State*, Case C-8/03.
[210] ECJ judgement of 4 May 2006 in Abbey *National plc & Inscape Investment Fund v. Commissioners of Customs and Excise*, Case C-169/04.

7.150 The different VAT treatment across Member States means that certain countries are seen as a more favourable location than others. This point was made particularly clear in our case study research (paragraphs 3.26 to 3.30). It would therefore be necessary for this solution to provide clear guidance as to when the exemption will apply so that Member States are encouraged to apply the law consistently, for example, in respect of the application of ECJ cases such as *Abbey National*[211] and *BBL*[212].

7.151 Research carried out in the problem definition phase (Table 7.10 below) showed that factors such as the inconsistent definition and application of terms such as *taxable person*, place of supply, and the scope of the exemption are all sources of intra-EU distortions. The ECJ case *BBL*[213] illustrated the complexity of the investment management sector when looking at services supplied on a cross-border basis. *BBL*[214] which is established in Belgium, supplied assistance, information and advisory services to various SICAVs (open ended investment companies or OEICs) established in Luxembourg. The key question referred to the ECJ was whether a SICAV is a taxable person for VAT purposes and, if so, where services supplied to them are treated as supplied. The ECJ ruled that a SICAV is a taxable person, and that the services provided by *BBL*[215] were to be treated as supplied in Luxembourg in accordance with article 9(2)(e) of the Sixth EU VAT Directive.

7.152 Furthermore, as regards the place of supply rules, it is interesting to highlight that both in Germany and Portugal, the management of investment funds is deemed to be located in the country where the service provider is located. The question is whether both countries can keep this position taking into account the proposal for amending the Sixth EU VAT Directive as regards the place of supply of services[216]. Table 7.10 further illustrates the difference in treatment in Member States:

[211] ECJ judgement of 4 May 2006 in Abbey *National plc & Inscape Investment Fund v. Commissioners of Customs and Excise*, Case C-169/04.
[212] ECJ judgement of 21 October 2004 in *Bank Brussel Lambert NV (BBL) v. Belgian State*, Case C-8/03.
[213] ECJ judgement of 21 October 2004 in *Bank Brussel Lambert NV (BBL) v. Belgian State*, Case C-8/03.
[214] ECJ judgement of 21 October 2004 in *Bank Brussel Lambert NV (BBL) v. Belgian State*, Case C-8/03.
[215] ECJ judgement of 21 October 2004 in *Bank Brussel Lambert NV (BBL) v. Belgian State*, Case C-8/03.
[216] Amended proposal for a Council Directive amending Directive 77/388/EEC as regards the place of supply of services and Regulation (EC) No 1798/2003 as regards the exchange of information, 29 May 2006.

Table 7.10: VAT Treatment of Financial Services in Funds Sector (25 Member States)

Capacity of Investment Funds	Yes	No	No/limited Guidance	Total
Does your Country consider an Investment Fund as being a Taxable Person?	12 (4)	4 (1)	9 (5)	25
Scope of Exemption for Investment Funds	**Wide Range**	**Regulated UCITS III**	**No/limited Guidance**	**Total**
Does a VAT Exemption apply to a wide Range of Funds or in a Restricted Way to a narrow Range of Regulated Funds (according to the UCITS III Directive)?	11 (3)	8 (2)	6 (5)	25
Place of Supply of Management of Investment Funds	**Service Provider**	**Recipient**	**No/limited Guidance**	**Total**
In which Member State is the Place of Supply of the Management of Investment Funds located?	2	18 (7)	5 (3)	25

Source: PwC Survey October 2006

7.153 A funds specific solution would create certainty for the industry and the tax authorities. It would integrate the recent ECJ cases in respect of the VAT treatment of investment management services. This solution could take the form of amendments to the Sixth EU VAT Directive possibly accompanied by pan-European guidance as suggested in Section 7.5 hereafter.

7.5 Pan-European Guidance

7.154 Whatever solutions are found to the distortions identified in Research Phase II – Empirical Evidence, the uniform and strict application of those solutions is essential. The chosen solutions could therefore be enhanced by the creation of a *blue book*, or European VAT commentary, clarifying EU and national VAT legislation, interpretations of the definition and scope of exemptions and the implementation and application of ECJ case law.

7.155 The *blue book* should contain the detailed interpretation and application of the Sixth EU VAT Directive provisions as it applies to specific transactions to eliminate national differences in implementation.

7.156 Establishing a *blue book* would not only promote legal certainty across the EU25 in respect of EU and national legislation and ECJ case law and interpretations, but would also facilitate open discussion and communication intra-EU with respect to modernising VAT in the financial services sector, thus keeping up with any changes within the industry without having to make detailed or regular revisions to the Sixth EU VAT Directive itself.

7.157 In order to produce and maintain the pan-European guidance, we would suggest as a first step, the creation of a VAT forum/working party. The VAT forum could include industry experts (such as the European Banking Federation, Comité Européen des Assurances, Investment Management Association, European Fund and Management Association, etc.), individual recognised VAT experts both from the profession and the industry, as well as the European Commission and local tax authorities. The VAT forum could be modelled on the EU Joint Transfer Pricing Forum, discussed in paragraph 7.161 below.

7.158 The VAT forum could be responsible for agreeing pan-European guidance on financial services VAT issues and for documenting the proposed guidelines in a form of *blue book* or guidance paper.

7.159 The preferred method of implementation would be for the VAT forum/working party to submit these proposed guidelines to the VAT Committee, who would then make proposals to the Council under article 29 of the Sixth EU VAT Directive. The proposals would basically consist of an amalgam of all financial services VAT matters upon which the VAT forum, and then essentially the VAT Committee, have previously reached unanimity, and therefore capable of being adopted by the Council.

7.160 The Council could then implement the proposal by Regulation under article 29a, so that the guidance has immediate direct effect in Member States. This would be advantageous because Member States would not have to implement the guidance on a local level, which means that taxpayers could simply rely on the European *blue book*.

7.161 For the sake of clarity, we set out below the current provisions of article 29 of the Sixth EU VAT Directive:

Article 29

"1. An Advisory Committee on value added tax, hereinafter called "the Committee" is hereby set up.

2. The Committee shall consist of representatives of the Member States and of the Commission. The chairman of the Committee shall be a representative of the Commission. Secretarial services for the Committee shall be provided by the Commission.

3. The Committee shall adopt its own rules of procedure.

4. In addition to points subject to the consultation provided for under this Directive, the Committee shall examine questions raised by its chairman, on his own initiative or at the request of the representative of a Member State, which concern the application of the Community provisions on value added tax."

Article 29a – Implementing measures

"The Council, acting unanimously on a proposal from the Commission, shall adopt the measures necessary to implement this Directive."

7.162 A two-stage approach could be adopted to draft the proposed *blue book* or guidance paper.

7.163 The first stage would be for the working party to agree pan-European guidance on the less contentious financial services VAT issues. For example, it may be possible to take the UK *blue book* and agree 60% of the technical content with the VAT forum. This process would undoubtedly involve some negotiations between the various stakeholders, however an agreed position would be achievable. This would allow the less contentious issues to be consolidated into pan-European guidance and then recommended to the VAT Committee for consideration under article 29, as discussed above.

The second stage would be for the working party to agree pan-European guidance for the remaining 40% of the more contentious areas of financial services VAT. This process will take longer to achieve with complex discussions between interested stakeholders. It may also be the case that for certain issues, the working party will be unable to achieve a consensus. In such cases, it may be the case that specific sub-committees are established to consider the issues further. General guidelines may then be drawn up by the sub-committee to set out the common view and then clear notes are made to identify those stakeholders that dispute the majority opinion. This process could draw on that applied by the OECD and the Australian National Tax Liaison Group, as discussed below. As with stage one, any agreed guidance would then be recommended to the VAT Committee for consideration under article 29 with a view to the Council implementing the proposal by Regulation.

7.164 It should be noted that the VAT forum/working party and the VAT Committee under article 29 will not be making proposals to change law, all they will be doing is explaining and expanding upon the interpretation of law as it currently stands.

7.165 In order to consider the *blue book* solution and the VAT forum further, it is useful to consider existing guidance and practices currently published in certain jurisdictions.

Example: Current Practice in Ireland and the Netherlands

7.166 In Ireland, the Taxation Administration Liaison Committee (TALC[217]) is formed of representatives from the Irish tax authorities and professional organisations for law, tax and accounting. TALC contains a number of sub-groups, one of which is the indirect tax group. Its function is to discuss matters of mutual interest in relation to the administration of VAT, for example, issues of interpretation. The group facilitates the dissemination of guidance in respect of areas of mutual concern, i.e. to business and the Revenue Commissioners alike. The minutes of their meetings are available to taxpayers and the tax authorities may issue a briefing document. However, TALC does not have any statutory powers. The group will only discuss non-contentious issues of general interest to taxpayers, the tax authorities and industry bodies. There may be no resolution on a particular issue but part of TALC's function is to facilitate a discussion forum.

7.167 The Dutch State Secretary issued a decree (Banking Resolution II) on 25 July 1979. This contains a list of services a credit institution may provide and includes details of the VAT treatment. Another decree was issued by the Dutch State Secretary on 9 November 1982 regarding the pro rata calculation in the Netherlands in relation to services provided by credit institutions. This decree explains the method by which such institutions can calculate their amount of recoverable VAT.

[217] www.revenue.ie/wnew/talcmin.htm.

Example: EU-wide tax forum – EU Joint Transfer Pricing Forum

7.168 An example of an EU-wide tax platform is the EU Joint Transfer Pricing Forum[218] (JTPF) which examines issues that could be addressed without legislation. The Forum was formally established by the Commission in June 2002 and consists of one expert from the tax administrations of each Member State plus 10 experts from business. Representatives from applicant countries and the OECD secretariat attend as observers. As also reflected in the Council conclusions, the JTPF should work on the basis of consensus and should produce pragmatic, non-legislative solutions to the practical problems posed by transfer pricing practices in the EU. The JTPF met for the first time in October 2002 and established a two-year work programme. Considering the constructive results and the important outstanding issues remaining on the JTPF's work programme, in December 2004, the Commission extended the JTPF's mandate for a further two years.

Example: OECD

7.169 An example of an organisation working on a global scale is The Organisation for Economic Co-operation and Development (OECD). The OECD is an organisation of 30 member countries who work together to address the economic, social and governance challenges of globalisation as well as to exploit its opportunities. The Organisation provides a platform where its members can compare policy experiences, seek answers to common problems, identify best practices and co-ordinate domestic and international policies. It is a forum to improve policy framework and implement "soft law" – non-binding instruments such as the OECD Corporate Governance Principles and can on occasion lead to formal agreements or treaties. The member countries exchange information and an analysis is provided by a secretariat in Paris. The Secretariat collects data, monitors trends, and analyses and forecasts economic developments. It also researches social changes or evolving patterns in, for example, trade, technology, and taxation. The work of the Secretariat parallels the work of committees, with each directorate servicing one or more committees, as well as committee working parties and sub-groups. The committees as well as the sub-groups meet periodically to review the work undertaken.

7.170 To assist the OECD working parties, the OECD can choose to meet with revenue authority delegates and business representatives through several Technical Advisory Groups (TAGs) and other working groups. This has been the case in order to progress the Taxation Framework Conditions on e-commerce. Currently two different working groups composed of government officials and business representatives do preparatory work regarding consumption taxes, regarding Tax Electronic Audits and VAT/GST Guidelines[219].

7.171 The prepared work (draft guidances) is submitted to the Committee on Fiscal Affairs, which consists only of government representatives who finally approve/disapprove of the prepared guidance.

Example: non-EU forum - Australia

7.172 In Australia, the National Tax Liaison Group (NTLG) consults with the Australian Tax Office (ATO).

7.173 The NTLG is a committee that consults with the ATO and other professional bodies on proposed legislative changes and on broad issues of procedures and policy in tax administration.

7.174 The NTLG comprises various sub-committees to discuss advanced technical issues.

[218] www.ec.europa.eu/taxation_customs/taxation/company_tax/transfer_pricing/forum/index_en.htm.
[219] OECD – guidance on tax compliance for business and accounting software – Committee on Fiscal Affairs – 23 May 2005 - http://www.oecd.org/searchResult/0,2665,en_2649_201185_1_1_1_1_1,00.html - OECD, Consumption Tax Trends, VAT/GST and excise rates, trends and administration issues, 2005 edition, Paris, 2006, p.10 – the application of Consumption Taxes to the Trade in International Services and Intangibles, OECD 14 July, 2004 and OECD, Consumption Tax Trends, VAT/GST and excise rates, trends and administration issues, 2006 edition, Paris, 2006.

7.175 For the pan-European guidance to be effective, it will be necessary for Member States to adopt the *blue book* and to routinely apply the new guidelines consistently. The European Commission would ultimately need to ensure that the pan-European guidance is enforced. However, there may be a role for the VAT forum or a specialist sub-committee to feed back on the successful application of the agreed guidelines in Member States.

7.176 This *blue book* solution should not be seen as a unique proposal. In fact, we believe that pan-European guidance could enhance all other solutions identified, and crucially support the uniform application of the exemptions across the EU25. However we do believe that, even if no other solutions are considered, or if there is no change to the financial services and insurance provisions in the Sixth EU VAT Directive, then at the very least, pan-European guidance is essential to begin to address the current inconsistent VAT treatment of financial services in the EU25.

7.177 Pan-European guidance could also be beneficial to the national tax authorities since it may reduce the need for litigation and the need to make frequent rulings or decisions. The tax authorities could instead refer to the relevant areas of pan-European guidance to apply the correct VAT treatment to a particular transaction.

CHAPTER 8 EVALUATION OF SOLUTIONS

8.1 Introduction

8.1 In this Chapter a number of solutions have been selected for more detailed evaluation in order to score how viable the solutions are. Solutions were selected according to the scoring allocated in the evaluation table, as explained in Section 8.2 below. For each solution evaluated in this Chapter, we have expanded on the key strengths and weaknesses. It is also 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 implementation across Member States, and that all solutions are solely in respect of B2B supplies.

8.2 In this Chapter three groups of solutions have been selected for further analysis.

8.3 Firstly, *Liability Based Solutions* that will amend the VAT liability attached to certain types of solutions. Secondly, solutions solving the undesirable accumulation of input VAT, referred to as *Input Based Solutions,* leading to an improved and refined input tax recovery. Thirdly, solutions avoiding extra VAT costs in cases where financial services companies want to reorganise or centralise their business in order to operate more efficiently, for example establishing shared service centres, forming cross-border business units or centres of excellence. This is referred to as *Structure Based Solutions*. The three groups of solutions should address these considerations.

8.4 By grouping the solutions in this way, a link between solutions can be made. As briefly mentioned in the previous Chapter, 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. For this reason, we have combined the solutions within each grouping and analysed the strengths and weaknesses of the combined solutions. Although, it should be noted that some solutions may complement others outside the groupings we have evaluated. These are commented on further in the evaluation of the solutions.

8.5 The *Pan-European Guidance Solution* (Section 7.5) is not included in one of the three groups mentioned above, as it would support all the solutions. This solution is, therefore, evaluated separately in Section 8.3.4 although it is considered earlier in the Chapter in each of the combinations.

8.6 The solutions selected are consistent with the findings of the empirical research so that they should address the problems and distortions identified in the primary and secondary Research Phases. The evaluation criteria explained in Chapter 6 are based on the findings of the Research Phases, which ensures that the highest scoring solutions from the evaluation table will be those which best address the problems and distortions. This has allowed the effectiveness of solutions to be ranked and specific advantages and disadvantages of solutions to be identified. The evaluation table is explained in Section 8.2.

8.7 It should be noted that the three groups of solutions offer the best opportunities for addressing the current distortions. Following extensive reflections, it was decided that reducing the scope of the exemption and zero rating of specific financial transactions would not be taken forward for further evaluation in this Chapter. The extension of the scope of the exemption is considered as part of the industry specific solutions within this Chapter (Section 7.4).

8.2 Methodology

8.2.1 General

8.8 In order to rank the various solutions in a systematic way, an Evaluation Framework has been used. The Evaluation Framework was created to help us objectively evaluate each solution. In this framework, all solutions have been scored in relation to the various criteria set out in Chapter 6. This methodology allows the most beneficial solutions to be clearly identified.

8.9 As well as showing an overall score, solution scores for groups of criteria (combating distortions, ease of implementation and future proof) have also been identified, in part, to avoid double counting which could distort the results.

8.10 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.

8.11 Each solution has been given a score between 1 and 5 where 5 indicates a positive effect of a solution and 1 indicates a negative effect. If a solution will eliminate identified distortions, it will receive an average score close to 5 for that evaluation criterion, for example, the industry specific solution scores a 5 for scope for abuse, which means that it is envisaged that this solution will not be open to abuse. The score measures the extent to which a solution meets the evaluation criteria.

8.12 Whilst the approach explained above has facilitated an objective method of evaluating the solutions, it should be noted that, in scoring the solutions, there is an element of subjectivity, as this is unavoidable.

8.13 Based on the scoring of the various solutions, the ranking is shown in Table 8.1 below.

Table 8.1: Ranking of Single Solutions

Solution	Ranking
Mandatory Domestic VAT Grouping	1
Cross-Border VAT Grouping	2
Uniform Limited Input Tax Credit	3
More Refined Input VAT Recovery Calculations	4
Option to Tax for B2B Supplies	5
Pan-European Guidance[220]	6
Industry Specific Solutions	7
Cost Sharing	7
Extension of the Scope of the Exemption for B2B Supplies	8

We have also suggested to combine some solutions (referred to as Combined Solutions). This results in the following ranking as shown in Table 8.2.

Table 8.2: Ranking of Single and Combined Solutions[221]

Solution	Ranking
Mandatory Domestic VAT Grouping	1
VAT Grouping (Domestic and Cross-border) and Cost Sharing	2
More Refined Input VAT Recovery Calculations with Uniform Limited Input Tax Credit	2
Cross-Border VAT Grouping	3
Uniform Limited Input Tax Credit	4
More Refined Input VAT Recovery Calculations	5
Extending/Clarifying the Exemption with the Option to Tax for B2B Supplies	5
Option to Tax for B2B Supplies	6
Pan-European Guidance[222]	7
Industry Specific Solutions	8
Cost Sharing	8
Extension of the Scope of the Exemption for B2B Supplies	9

In Table 8.3 an overview of the scores and assessments is provided both for the Single and Combined Solutions. The details of the individual evaluations are provided as from Section 8.3 onwards.

[220] The reflected ranking of the Pan-European Guidance Solution is relative as it supports all mentioned solutions. Although the Pan-European Guidance Solution appears to score low on the listing of solutions in Table 8.2, in absolute terms, it actually scores much higher when viewed in combination with other solutions.
[221] The solutions with background colours are Combined Solutions.
[222] The reflected ranking of the Pan-European Guidance Solution is relative as it supports all mentioned solutions. Although the Pan-European Guidance Solution appears to score low on the listing of solutions in Table 8.2, in absolute terms, it actually scores much higher when viewed in combination with other solutions.

Table 8.3: Evaluation of Single and Combined Solutions[223]

Evaluation Criteria	Liability Based Solutions			Input Tax Based Solutions		
	Industry Specific Solutions	Option to Tax for B2B Supplies	Extending / Clarifying the Exemption with the Option to Tax for B2B Supplies*	More Refined Input VAT Recovery Calculations	Uniform Limited Input Tax Credit (ULITC)	More Refined Input VAT Recovery Calculations with Uniform Limited Input Tax Credit*
Combating Distortions						
Positive Impact on Cost Efficiency of EU25 Financial Services Providers	3.00	5.00	5.00	3.00	4.00	5.00
Effectiveness in Combating Identified Distortions	4.00	5.00	5.00	5.00	4.00	5.00
Absolute Scoring	7.00	10.00	10.00	8.00	8.00	10.00
Average	3.50	5.00	5.00	4.00	4.00	5.00
Ease of Implementation						
Pan-sectoral Application of the Proposed Solution	5.00	3.00	4.00	5.00	5.00	5.00
No Unequal Impact of the Proposed Solution	4.00	5.00	5.00	5.00	5.00	5.00
Ease of Administration and Control for Revenue Authorities	4.00	3.00	4.00	4.00	4.00	4.00
Ease of Administration for Economic Operators	4.00	4.00	4.00	4.00	5.00	4.00
Limited Timeframe for Implementation	2.00	3.00	3.00	4.00	3.00	3.00
Absolute Scoring	19.00	18.00	20.00	22.00	22.00	21.00
Average	3.80	3.60	4.00	4.40	4.40	4.20
Future Proof						
Exploitation and Contribution towards Single Market Opportunities	3.00	5.00	4.00	4.00	4.00	4.00
Efficiency in Combating Identified Distortions	3.00	4.00	5.00	4.00	5.00	5.00
Legal Certainty for Economic Operators allowing Long Term Business Plans and Investments	4.00	4.00	4.00	4.00	5.00	5.00
No Scope for Abuse of Provisions	5.00	4.00	4.00	5.00	4.00	5.00
Consistency with VAT Principles	5.00	5.00	5.00	5.00	5.00	5.00
Durability of Impacts	4.00	5.00	4.00	4.00	4.00	4.00
Absolute Scoring	24.00	27.00	26.00	26.00	27.00	28.00
Average	**4.00**	4.50	4.33	4.33	4.50	4.67
Overall absolute scoring	**50.00**	**55.00**	**56.00**	**56.00**	**57.00**	**59.00**
Overall Score	**3.85**	**4.23**	**4.31**	**4.31**	**4.38**	**4.54**
Assessment	**Attractive**	**Highly Attractive**	**Highly Attractive**	**Highly Attractive**	**Highly Attractive**	**Highly Attractive**

[223] The solutions with a (*) and background colours are Combined Solutions.

Table 8.3: Evaluation of Single and Combined Solutions (continued)[224]

Evaluation Criteria	Structure Based Solutions				Pan-European Guidance	Extension of the Scope of the Exemption for B2B Supplies
	Mandatory Domestic VAT Grouping	Cross-Border VAT Grouping	Cost Sharing	VAT Grouping (Domestic and Cross-Border) and Cost Sharing*		
Combating Distortions						
Positive Impact on Cost Efficiency of EU25 Financial Services Providers	4.50	4.50	4.00	5.00	4.00	3.50
Effectiveness in Combating Identified Distortions	5.00	5.00	4.00	5.00	4.00	3.50
Absolute Scoring	9.50	9.50	8.00	10.00	8.00	7.00
Average	4.75	4.75	4.00	5.00	4.00	3.50
Ease of Implementation						
Pan-sectoral Application of the Proposed Solution	5.00	5.00	5.00	5.00	5.00	3.50
No Unequal Impact of the Proposed Solution	5.00	5.00	3.00	5.00	5.00	3.50
Ease of Administration and Control for Revenue Authorities	4.00	4.00	3.00	4.00	4.00	3.50
Ease of Administration for Economic Operators	5.00	5.00	3.00	4.00	4.00	3.50
Limited Timeframe for Implementation	3.00	3.00	4.00	3.00	3.00	2.50
Absolute Scoring	22.00	22.00	18.00	21.00	21.00	16.50
Average	4.40	4.40	3.60	4.20	4.20	3.30
Future Proof						
Exploitation and Contribution towards Single Market Opportunities	5.00	5.00	4.00	5.00	4.00	3.50
Efficiency in Combating Identified Distortions	5.00	5.00	4.00	5.00	4.00	3.50
Legal Certainty for Economic Operators allowing Long Term Business Plans and Investments	5.00	5.00	4.00	5.00	4.00	4.00
No Scope for Abuse of Provisions	4.00	3.00	3.00	3.00	5.00	4.00
Consistency with VAT Principles	5.00	4.00	5.00	5.00	5.00	1.00
Durability of Impacts	5.00	5.00	4.00	5.00	3.00	4.00
Absolute Scoring	29.00	27.00	24.00	28.00	25.00	20.00
Average	4.83	4.50	4.00	4.67	4.17	3.33
Overall absolute scoring	**60.50**	**58.50**	**50.00**	**59.00**	**54.00**	**43.50**
Overall Score	**4.65**	**4.50**	**3.85**	**4.54**	**4.15**	**3.35**
Assessment	**Highly Attractive**	**Highly Attractive**	**Attractive**	**Highly Attractive**	**Highly Attractive**	

[224] The solutions with a (*) and background colours are Combined Solutions.

8.2.2 Budgetary Impact

8.14 We refer in this respect to Sections 6.3.1 and 6.3.2 of Chapter 6 and have summarised our key points below.

8.15 Budgetary impact will vary from one EU Member State to another and will depend on various factors such as the standard VAT rate, existing VAT treatment of financial services, interdependency with other taxes such as payroll taxes, impact on social security and unemployment costs, etc.

8.16 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. It is clear that budgetary impact does not only concern impact on VAT revenue but has wider macro-economic effects.

8.17 From Research Phase II – Empirical Evidence (Chapters 3-5), we derive that no change in the VAT treatment of financial services within EU25 will have a negative impact on EU25 budgets, as detailed in paragraph 6.18 of Chapter 6.

8.18 As any further analysis on these effects is not in scope of our Study, we are not able to make any accurate assessments. The latter would require a specific macro-economic study on the impact on EU25 budgets.

8.3 Selected solutions

8.3.1 Liability Based Solutions

8.3.1.1 Industry Specific Solutions

Table 8.4 presents an overview of the evaluation of the Industry Specific Solutions (Section 7.4).

Table 8.4: Evaluation of Industry Specific Solutions

Industry Specific Solutions	
Combating Distortions	**3.50**
Positive Impact on Cost Efficiency	3.00
Effectiveness in Combating Identified Distortions	4.00
Ease of Implementation	**3.80**
Pan-sectoral Application of Proposed Solution	5.00
No unequal Impact of Proposed Solution	4.00
Ease of Administration and Control for Revenue Authorities	4.00
Ease of Administration for Economic Operators	4.00
Limited Timeframe for Implementation	2.00
Future Proof	**4.00**
Exploitation and Contribution towards Single Market	3.00
Efficiency in combating Identified Distortions	3.00
Legal Certainty for Economic Operators	4.00
No Scope for Abuse of Provisions	5.00
Consistency with VAT Principles	5.00
Durability of Impacts	4.00
Overall Score	**3.85**
Assessment	**Attractive**

8.19 The Industry Specific Solutions would clarify the application and scope of the exemptions as defined in the Sixth EU VAT Directive and therefore address the distortions that currently exist. For the purpose of evaluation, this does not include the solution suggested in Chapter 7 that refers to the taxing of premium income (Section 7.4.1.2).

8.20 Key strengths of the Industry Specific Solutions as set out in Table 8.4 are the following:

- as illustrated in Section 7.4, there are differences across Member States in relation to how the financial and insurance exemption is applied, which has led to legal uncertainty for businesses. For the insurance industry, the uncertainty has affected outsourcing decisions. In the funds and banking sector the difference regarding the scope of the exemption has led to more favourable treatment in some Member States. Clarifying the application of the exemption, would go some way to removing the uncertainty (Sections 6.4.1.2 and 6.4.3.3). However, the ultimate success of these solutions will depend on their uniform application across Member States;
- by definition, the solution will apply to all sectors of financial services (Section 6.4.2.1);
- a resultant benefit of these solutions would be to facilitate the outsourcing of activities in the financial services and insurance sector, allowing EU25 financial services and insurance businesses to be competitive in a global market whilst supporting the Single Market for Financial Services (in line with the *FSAP*[225]) (Section 6.4.3.1);
- these solutions also address the implications and application of ECJ decisions (for example *SDC*[226], *CSC*[227], *Andersen*[228], *Kretztechnik*[229] and *Abbey National*[230]) as the exemptions would be more clearly defined (Section 6.4.3.5);
- it should remove incentives to locate in one Member State over another due to favourable VAT treatment in relation to the scope of exemptions (for example, in the funds industry). Again, this relies on uniform application by Member States.

8.21 Key weaknesses are the following:

- these solutions are likely to require detailed analysis in respect of the application of the exemption and so will take time to implement (Section 6.4.2.5);
- changing or clarifying the Sixth EU VAT Directive will not immediately remove the distortions that currently exist. It will be necessary for all Member States to consistently apply the law in order to move towards a level playing field (Section 6.4.1.2).

[225] "White Paper on Financial Services Policy (2005-2010)" at http://europa.eu.int/comm/internal_market/finances/policy/index_en.htm.
[226] ECJ judgement of 5 June 1997 in *Sparekassernes Datacenter v. Skatteministeriet*, Case C-2/95.
[227] ECJ judgement of 13 December 2001 in *The Commissioners of Customs and Excise v. CSC Financial Services Limited*, Case C-235/00.
[228] ECJ judgement of 3 March 2005 in *Secretary of State for Finance v. Arthur Andersen & Co. Accountants,* Case C-472/03.
[229] ECJ judgement of 26 May 2005 in *Kretztechnik AG v. Finanzamt Linz*, Case C-465/03.
[230] ECJ judgement of 4 May 2006 in Abbey *National plc & Inscape Investment Fund v. Commissioners of Customs and Excise*, Case C-169/04.

8.3.1.2 Option to Tax for B2B Supplies

Table 8.5 presents an overview of the evaluation of the Option to Tax for B2B Supplies Solution (Section 7.2.3).

Table 8.5: Evaluation of Option to Tax for B2B Supplies for Financial Services

Option to Tax for B2B Supplies	
Combating Distortions	**5.00**
Positive Impact on Cost Efficiency	5.00
Effectiveness in Combating Identified Distortions	5.00
Ease of Implementation	**3.60**
Pan-sectoral Application of Proposed Solution	3.00
No unequal Impact of Proposed Solution	5.00
Ease of Administration and Control for Revenue Authorities	3.00
Ease of Administration for Economic Operators	4.00
Limited Timeframe for Implementation	3.00
Future Proof	**4.50**
Exploitation and Contribution towards Single Market	5.00
Efficiency in combating Identified Distortions	4.00
Legal Certainty for Economic Operators	4.00
No Scope for Abuse of Provisions	4.00
Consistency with VAT Principles	5.00
Durability of Impacts	5.00
Overall Score	**4.23**
Assessment	**Highly Attractive**

8.22 This solution would allow economic operators in all Member States the option to tax their B2B supplies of financial services. The option to tax would enable the recovery of input tax as it could be attributed to an onward taxable supply (paragraph 7.31).

8.23 Key strengths of the Option to Tax Solution, as set out in Table 8.5, are the following:

- the solution would be effective in combating distortions arising from embedded VAT in pricing through greater input tax recovery (Section 6.4.1.2);
- the solution would result in greater consistency with VAT principles as improved recovery of input tax will remove barriers to outsourcing (Section 6.4.3.5);
- the option to tax will be durable and assist in removing barriers to the Single Market for Financial Services (Section 6.4.3.1);
- the option to tax would give flexibility to economic operators and could avoid businesses choosing to locate in one Member State over another (Section 6.4.1.2);
- provided there is flexibility in the application for economic operators, once implemented, the option to tax should be easy to operate for both economic operators and revenue authorities (Sections 6.4.2.3 and 6.4.2.4).

8.24 Key weaknesses are the following:

- the solution would increase the administrative burden for economic operators (Section 6.4.2.4). For example, there could be an additional reverse charge liability for recipients of services on which the option applies and there would be an increase in data requirements. However, this should be a short-term issue and the long-term benefits of the solution should outweigh the initial administrative burden. In addition, current regulatory requirements mean that a significant amount of data must be recorded in any case;
- the solution would impose greater administrative and control requirements on revenue authorities (Section 6.4.2.3). This would be the same as for economic operators but, as stated above, it should not be an ongoing issue;
- distortions could be introduced where businesses are pressured not to opt to tax their services by their customers or that, where there is no threat of competition, businesses may opt to improve their own VAT recovery at the expense of customers with a low VAT recovery;
- whilst the option to tax for financial services is used in some Member States, the majority do not employ it (paragraphs 7.34 to 7.37) and it is perceived that the timeframe for implementation may be quite long as detailed, uniform provisions will have to be agreed. However, this should be controlled by the experience of the countries that have implemented the option for financial services (Section 6.4.2.5);
- the countries which have implemented the option to tax employ different procedures regarding, for example, the basis of the option, transactions within the scope of the option and revocation of the option (paragraphs 7.34 to 7.37). Taking this into account, uniform provisions for the option to tax would be technically difficult to agree and implement (Sections 6.4.1.2 and 6.4.3.3);
- an important issue is the determination of the taxable base. Uniform procedures would need to be implemented to determine the value on which the option would apply and a limit to the transactions to which the option could apply would need to be set out (Sections 6.4.1.2 and 6.4.3.3);
- the option to tax, as currently set out in article 13(C)(b) of the Sixth EU VAT Directive, does not currently apply to insurance (Section 6.4.2.1).

8.3.1.3 Extending / Clarifying the Exemption with Option to Tax for B2B Supplies

Table 8.6 presents an overview of the evaluation of the Combined Solutions Extending / Clarifying the Exemption with the Option to Tax for B2B Supplies (Sections 7.2.1 and 7.2.3).

Table 8.6: Evaluation of Extending / Clarifying the Exemption with Option to Tax for B2B Supplies

Extending / Clarifying the Exemption with Option to Tax for B2B Supplies	
Combating Distortions	**5.00**
Positive Impact on Cost Efficiency	5.00
Effectiveness in Combating Identified Distortions	5.00
Ease of Implementation	**4.00**
Pan-sectoral Application of Proposed Solution	4.00
No unequal Impact of Proposed Solution	5.00
Ease of Administration and Control for Revenue Authorities	4.00
Ease of Administration for Economic Operators	4.00
Limited Timeframe for Implementation	3.00
Future Proof	**4.33**
Exploitation and Contribution towards Single Market	4.00
Efficiency in combating Identified Distortions	5.00
Legal Certainty for Economic Operators	4.00
No Scope for Abuse of Provisions	4.00
Consistency with VAT Principles	5.00
Durability of Impacts	4.00
Overall Score	**4.31**
Assessment	**Highly Attractive**

8.25 Key strengths in relation to this Combined Solution are outlined below:

- as stated, the exemption can lead to embedded VAT costs (Section 6.4.1.2). By extending the exemption with an option to tax, the taxpayer has the choice of how best to structure the business, allowing the business to maximise its competitive position;
- the combination of the two solutions of Clarifying / Extending the Exemption with the Option to Tax for B2B Supplies (Sections 7.2.1 and 7.2.3) and the Pan-European Guidance Solution (Section 7.5) strengthens the likelihood of achieving the objectives of consistency and certainty (Sections 6.4.1.2 and 6.4.3.3);
- the Pan-European Guidance Solution (Section 7.5) could be implemented more quickly than Industry Specific Solutions (Section 7.4) and so could go some way to clarifying the scope of the exemptions before it was included in the amended Sixth EU VAT Directive (Section 6.4.2.5);
- the Pan-European Guidance Solution (Section 7.5) could help to mitigate the implementation difficulties associated with the option to tax by explaining uniform procedures and application (Sections 6.4.1.2 and 6.4.3.3).

8.26 Key weaknesses are outlined below:

- the option to tax should be supported with an input tax recovery system which allows a simple methodology for recovery otherwise the benefit of the option could be lost. However, the More Refined Input VAT Recovery Calculations Solution explained at Section 7.3.2 could compliment this combination of solutions to ensure VAT recovery in relation to opted supplies.

8.3.2 Input Tax Based Solutions

8.3.2.1 More Refined Input VAT Recovery Calculations

Table 8.7 presents an overview of the evaluation of the More Refined Input VAT Recovery Calculations Solution when applied pan-EU25 (Section 7.3.2).

Table 8.7: Evaluation of More Refined Input VAT Recovery Calculations

More Refined Input VAT Recovery Calculations	
Combating Distortions	**4.00**
Positive Impact on Cost Efficiency	3.00
Effectiveness in Combating Identified Distortions	5.00
Ease of Implementation	**4.40**
Pan-sectoral Application of Proposed Solution	5.00
No unequal Impact of Proposed Solution	5.00
Ease of Administration and Control for Revenue Authorities	4.00
Ease of Administration for Economic Operators	4.00
Limited Timeframe for Implementation	4.00
Future Proof	**4.33**
Exploitation and Contribution towards Single Market	4.00
Efficiency in combating Identified Distortions	4.00
Legal Certainty for Economic Operators	4.00
No Scope for Abuse of Provisions	5.00
Consistency with VAT Principles	5.00
Durability of Impacts	4.00
Overall Score	**4.31**
Assessment	**Highly Attractive**

8.27 This solution would allow the use of More Refined Input VAT Recovery Calculations on a pan-European level.

8.28 Key strengths of the More Refined Input VAT Recovery Calculations as set out in Table 8.7, are as follows:

- at its most basic, the harmonisation and simplification of pro rata methodologies across the EU25 would serve to eliminate the VAT-based cost advantage presently enjoyed by certain financial services operators solely as a result of location (Section 6.4.1.2);
- the solution addresses the fact that not all Member states currently allow an analytical approach to pro rata calculations and so the solution would return the VAT system to the core of the Sixth EU VAT Directive where taxpayers can recover input tax used in making taxable supplies (Section 6.4.3.5);
- in addition, and reflected in high administration and legal certainty scores, the introduction of this option should serve to reduce the administrative costs presently faced by financial services firms in reporting to predefined and distinct standards across the EU25 as well as promote higher levels of certainty (Sections 6.4.1.2, 6.4.2.4 and 6.4.3.3);
- implementation of this solution should take a relatively short time if it was by way of a regulation under article 29a of the Sixth EU VAT Directive, and, as a regulation it would have direct effect so it would not require implementation in Member States' legislation (Section 6.4.2.5);
- with regard to revenue authorities, the proposed solution should not facilitate a higher incidence of abuse (Section 6.4.3.4);
- more refined pro rata calculations offer various pro rata methodologies to businesses of different sizes (Sections 6.4.2.1 and 6.4.2.2). However, the success of the solution will depend on the uniform application across Member States so that all taxpayers in EU25 have the same opportunities (Sections 6.4.1.2 and 6.4.3.3).

8.29 Key weaknesses are as follows:

- reflecting the fact that this option does not address the entirety of actual or potential distortions, it does not attain the highest score for effectiveness (Section 6.4.1.2). The score also reflects the imbalance across Member States, as some already provide for a refined VAT recovery system (paragraphs 7.102 and 7.103).

8.3.2.2 Uniform Limited Input Tax Credit

Table 8.8 presents an overview of the evaluation of the attractiveness of introducing a Uniform Limited Input Tax Credit (ULITC) system (Section 7.3.3). The Table also shows the evaluation of the Reduced Input Tax Credit (RITC) system used in Australia (paragraphs 7.124 to 7.132) in order to make a comparison with the proposed ULITC Solution.

Table 8.8: Evaluation of Uniform Limited Input Tax Credit (ULITC) and the Reduced Input Tax Credit (RITC)

Uniform Limited Input Tax Credit (ULITC) and Reduced Input Tax Credit (RITC)	ULITC	RITC
Combating Distortions	**4.00**	**3.50**
Positive Impact on Cost Efficiency	4.00	4.00
Effectiveness in Combating Identified Distortions	4.00	3.00
Ease of Implementation	**4.40**	**3.20**
Pan-sectoral Application of Proposed Solution	5.00	3.00
No unequal Impact of Proposed Solution	5.00	3.00
Ease of Administration and Control for Revenue Authorities	4.00	4.00
Ease of Administration for Economic Operators	5.00	3.00
Limited Timeframe for Implementation	3.00	3.00
Future Proof	**4.50**	**3.50**
Exploitation and Contribution towards Single Market	4.00	3.00
Efficiency in combating Identified Distortions	5.00	3.00
Legal Certainty for Economic Operators	5.00	3.00
No Scope for Abuse of Provisions	4.00	2.00
Consistency with VAT Principles	5.00	4.00
Durability of Impacts	4.00	4.00
Overall Score	**4.38**	**3.40**
Assessment	**Highly Attractive**	**Attractive**

8.30 This solution would allow financial services businesses to recover specified VAT at predetermined and uniform rates.

8.31 Key strengths of the ULITC Solution in respect of outsourcing are the following:

- a ULITC system could remove the present bias in favour of vertical integration on the part of financial services firms, as was the reason for its introduction in Australia (Section 6.4.1.2);
- additional strengths include the fact that this solution has a broad-based application, i.e. applies to all financial services sectors, and will ensure a high degree of legal certainty for economic operators when interacting with revenue authorities (Section 6.4.2.1);
- experience of the RITC system in Australia should allow for easier implementation of the ULITC solution (Section 6.4.2.5);
- taking into account the Singapore model, as described in Chapter 7 (paragraphs 7.105 to 7.112), a statistical method could be used to identify fixed rates so as avoiding the problem with the RITC in determining the correct rate.

8.32 Key weaknesses are as follows:

- the ULITC system would add a new part to the VAT system for EU25 Member States. Clear guidelines should be available to secure uniform application (Sections 6.4.1.2 and 6.4.3.3);
- there could be some difficulty defining the scope of application of this solution, more specifically, determining the inputs to which the fixed rates should apply. However, using the Singapore model as an example (paragraphs 7.105 to 7.112), these difficulties could be mitigated by applying the rates to specific types of financial institutions. An alternative would be to apply specific rates to specific services although the services would have to be carefully defined to avoid uneven application (Section 6.4.2.5).

8.3.2.3 More Refined Input VAT Recovery Calculations with Uniform Limited Input Tax Credit

Table 8.9 presents an evaluation of the Combined Solution More Refined Input VAT Recovery Calculations with Uniform Limited Input Tax Credit (ULITC) (Sections 7.3.2 and 7.3.3).

Table 8.9: Evaluation of More Refined Input VAT Recovery Calculations with Uniform Limited Input Tax Credit

More Refined Input VAT Recovery Calculations with Uniform Limited Input Tax Credit	
Combating Distortions	**5.00**
Positive Impact on Cost Efficiency	5.00
Effectiveness in Combating Identified Distortions	5.00
Ease of Implementation	**4.20**
Pan-sectoral Application of Proposed Solution	5.00
No unequal Impact of Proposed Solution	5.00
Ease of Administration and Control for Revenue Authorities	4.00
Ease of Administration for Economic Operators	4.00
Limited Timeframe for Implementation	3.00
Future Proof	**4.67**
Exploitation and Contribution towards Single Market	4.00
Efficiency in combating Identified Distortions	5.00
Legal Certainty for Economic Operators	5.00
No Scope for Abuse of Provisions	5.00
Consistency with VAT Principles	5.00
Durability of Impacts	4.00
Overall Score	**4.54**
Assessment	**Highly Attractive**

8.33 Key strengths of this Combined Solution are outlined below:

- this combination would provide options to economic operators, particularly for medium-sized players who may not have the resources to operate a special method but would qualify for the ULITC (Section 6.4.2.1);
- as combined solutions, they are more effective in combating distortions (Section 6.4.1.2). Assuming there is uniform application, there would be no benefit in respect of pro rata, of one Member State over another, and limited benefits for larger or smaller businesses, as the ULITC would be an alternative to the pro rata, open for all sizes of business;
- the Pan-European Guidance Solution (Section 7.5) should explain the application and scope of these solutions so that the perceived complexity of implementation may be reduced (Sections 6.4.2.3 and 6.4.2.4).

8.34 Key weaknesses are outlined below:

- both solutions could be complex to operate, as reflected in the evaluation table scoring. The complexity could become more significant if the solutions were combined (Sections 6.4.2.3 and 6.4.2.4).

8.3.3 Structure Based Solutions

8.3.3.1 Mandatory Domestic VAT Grouping

Table 8.10 presents an overview of the evaluation of Mandatory Domestic VAT Grouping (Section 7.2.5).

Table 8.10: Evaluation of Mandatory Domestic VAT Grouping

Mandatory Domestic VAT Grouping	
Combating Distortions	**4.75**
Positive Impact on Cost Efficiency	4.50
Effectiveness in Combating Identified Distortions	5.00
Ease of Implementation	**4.40**
Pan-sectoral Application of Proposed Solution	5.00
No unequal Impact of Proposed Solution	5.00
Ease of Administration and Control for Revenue Authorities	4.00
Ease of Administration for Economic Operators	5.00
Limited Timeframe for Implementation	3.00
Future Proof	**4.83**
Exploitation and Contribution towards Single Market	5.00
Efficiency in combating Identified Distortions	5.00
Legal Certainty for Economic Operators	5.00
No Scope for Abuse of Provisions	4.00
Consistency with VAT Principles	5.00
Durability of Impacts	5.00
Overall Score	**4.65**
Assessment	**Highly Attractive**

8.35 Mandatory Domestic VAT Grouping (paragraph 7.64) – i.e. mandatory to Member States to implement – provides that there would be no taxable transactions between Group members (paragraph 7.65). It would therefore reward cooperation within a Group of legal entities, and thus enhance the efficient allocation of capital and human resources.

8.36 Key strengths of the Mandatory Domestic VAT Grouping Solution, as set out in Table 8.10, are the following:

- the pan-European availability of a VAT Grouping facility would eliminate identified potential distortions within the EU25 financial services sector (Section 6.4.1.2), where companies headquartered in Member States with a domestic VAT Grouping regime incur lower irrecoverable VAT and are more inclined towards the aggregated supply of certain shared services;
- it is a broad-based solution – article 4(4) in conjunction with article 4(1) of the Sixth EU VAT Directive contain strong historic principles and have a pan-sectoral application (Section 6.4.2.1), with favourable implications in relation to durability and legal certainty (Sections 6.4.1.2 and 6.4.3.6). This is provided that there will be clarity regarding the conditions for VAT Grouping;
- it will apply as a solution not only to the financial services sector, as reflected in its scoring for equal impact (Section 6.4.2.2);
- domestic VAT Grouping is presently permitted in twelve EU25 Member States and few, if any, administrative difficulties have been reported. This would be expected as administrative simplification – for both taxable persons and tax authorities – is one of the features of VAT Grouping (Section 6.4.2.4). Reflecting this, this option scores highly on administrative ease criteria for economic operators. The minimal administrative requirements for Member States should make this solution a viable consideration, for example, reduced compliance requirements (one VAT return filed for one VAT Group) would also benefit tax authorities (Section 6.4.2.3) as well as economic operators (Section 6.4.2.4);
- it addresses what is now an apparent contradiction in the financial services market. The EU regulatory environment in parts of the financial services industry requires the existence of separate entities where to do so creates a distortive effect. The financial services regulation requiring different investment vehicles and legal entities combined with the lack of VAT Grouping in a majority of countries, creates VAT costs unnecessarily within the European financial services sector and inhibits growth;
- the concept is technically well developed (Section 6.4.3.5);
- the introduction of the Mandatory Domestic VAT Grouping Solution should have a neutral effect for Member States, as it will be implemented by all and so one Member State would not be advantaged or disadvantaged over another;
- the solution offers a choice to economic operators as to whether to VAT Group or not, although, even if it is mandatory for taxpayers, the benefits of the solution would in combating distortions outweigh the impact on flexibility for economic operators (Sections 6.4.1.2 and 6.4.2.4).

8.37 Key weaknesses are the following:

- experience from a few Member States which allow VAT Grouping suggests that there is some scope for abuse (Section 6.4.3.4), although there is considerable experience of managing potential abuse. This could be mitigated by allowing Member States to implement specific anti-abuse provisions (paragraphs 7.68 to 7.70).

8.3.3.2 Cross-Border VAT Grouping

Table 8.11 presents an overview of the evaluation of the Cross-Border VAT Grouping Solution (Section 7.2.6).

Table 8.11: Evaluation of Cross-Border VAT Grouping

Cross-Border VAT Grouping	
Combating Distortions	**4.75**
Positive Impact on Cost Efficiency	4.50
Effectiveness in Combating Identified Distortions	5.00
Ease of Implementation	**4.40**
Pan-sectoral Application of Proposed Solution	5.00
No unequal Impact of Proposed Solution	5.00
Ease of Administration and Control for Revenue Authorities	4.00
Ease of Administration for Economic Operators	5.00
Limited Timeframe for Implementation	3.00
Future Proof	**4.50**
Exploitation and Contribution towards Single Market	5.00
Efficiency in combating Identified Distortions	5.00
Legal Certainty for Economic Operators	5.00
No Scope for Abuse of Provisions	3.00
Consistency with VAT Principles	4.00
Durability of Impacts	5.00
Overall Score	**4.50**
Assessment	**Highly Attractive**

8.38 This solution would allow cross-border VAT Grouping across the EU25.

8.39 Key strengths of the Cross-Border VAT Grouping Solution as set out in Table 8.11 are the following:

- cross-border VAT Grouping fits in with the system of the Sixth EU VAT Directive and the group idea where the Group forms a single company (Section 6.4.3.5);
- cross-border VAT Grouping would not only support the financial services sector, but all other industries as well, and would therefore not have an unequal impact (Sections 6.4.2.1 and 6.4.2.2);
- cross-border VAT Grouping would be a significant step towards the objectives as laid down in the *FSAP*[231] and *Lisbon*[232] *agenda*, i.e. the creation of an attractive marketplace where economies of scale are not limited to Member States' borders (Section 6.4.3.1);
- it would improve the competitiveness of European based companies, as VAT costs, cash flow costs and/or operational costs may be reduced when a cross-border VAT Group is formed (Section 6.4.1.1 and 6.4.2.4);
- cross-border VAT Grouping would eliminate identified and potential distortions within the EU25 resulting from the creation of VAT on cross-border charges and would encourage the use of shared services (Section 6.4.1.2);
- cross-border VAT Grouping is a broad-based and pan-sectoral solution with favourable implications for durability and legal certainty (Sections 6.4.1.2, 6.4.3.3 and 6.4.3.6) ;
- cross-border VAT Grouping would remove the lack of parity of treatment between branch and subsidiary corporate structures;
- it would allow businesses, particularly in the insurance sector, that are required to operate from separate entities, to comply with industry regulations without creating an additional VAT cost (Section 6.4.1.1);
- cross-border VAT Grouping would facilitate the restructuring and cooperation operations involving companies from different Member States (Section 6.4.1.2);
- cross-border VAT Grouping would remove some tax barriers for the creation of true European companies *(Societas Europaea).*

[231] "White Paper on Financial Services Policy (2005-2010)" at http://europa.eu.int/comm/internal_market/finances/policy/index_en.htm.

[232] 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.

8.40 Key weaknesses are the following:

- cross-border VAT Grouping across all Member States is a new concept, unlike domestic VAT Grouping. However, limiting VAT Grouping to only domestic companies is in contravention of article 43 of the EC Treaty[233], i.e. the freedom of establishment and this fact could help to clear the way for introducing cross-border VAT Grouping;
- the timescale for agreeing the provisions and procedures for mandatory cross-border Grouping (for Member States) on a uniform basis, could be longer term but this would not be the case if there is momentum from all Member States towards implementation of the solution (Section 6.4.2.5);
- it will be necessary to align the criteria Member States set for forming VAT Groups (Sections 6.4.1.2 and 6.4.3.3);
- if the criteria for forming VAT Groups are not aligned between Member States, or if cross-border VAT Grouping is not allowed in all Member States, double taxation or double non-taxation may occur (Sections 6.4.1.2 and 6.4.3.3);
- cross-border VAT Grouping requires acceptance of a cross-border pro rata system so that it can function correctly within an EU VAT system;
- experience of domestic VAT Grouping suggests there is some scope for abuse (Section 6.4.3.4), although the experience of combating abuse for domestic Groups will be useful. Moreover, Member States are given the opportunity to ensure that a VAT Group does not create an unjustified advantage or disadvantage for taxable persons[234].

[233] http://europa.eu.int/eur-lex/en/treaties/dat/C_2002325EN.003301.html.
[234] Council Directive 2006/69/EC of 24 July 2006 amending Directive 77/388/EC as regards certain measures to simplify the procedure for charging VAT and to assist in countering tax evasion or avoidance and repealing certain decisions granting derogations - http://ec.europa.eu/taxation_customs/common/legislation/legislation/taxation/index_en.htm.

8.3.3.3 Cost Sharing

Table 8.12 presents an overview of the evaluation of the Cost Sharing Solution (Section 7.3.1).

Table 8.12: Evaluation of Cost Sharing

Cost Sharing	
Combating Distortions	**4.00**
Positive Impact on Cost Efficiency	4.00
Effectiveness in Combating Identified Distortions	4.00
Ease of Implementation	**3.60**
Pan-sectoral Application of Proposed Solution	5.00
No unequal Impact of Proposed Solution	3.00
Ease of Administration and Control for Revenue Authorities	3.00
Ease of Administration for Economic Operators	3.00
Limited Timeframe for Implementation	4.00
Future Proof	**4.00**
Exploitation and Contribution towards Single Market	4.00
Efficiency in combating Identified Distortions	4.00
Legal Certainty for Economic Operators	4.00
No Scope for Abuse of Provisions	3.00
Consistency with VAT Principles	5.00
Durability of Impacts	4.00
Overall Score	**3.85**
Assessment	**Attractive**

8.41 Article 13(A)(1)(f) of the Sixth EU VAT Directive is mandatory (paragraph 7.86) and should, therefore, be implemented and interpreted uniformly in all Member States. Other cost sharing principles, such as those established in *EDM*[235] (paragraphs 7.92 to 7.94) should be mandatory and uniform across Member States.

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

8.42 Key strengths of the Cost Sharing Solution, as set out in Table 8.12, are the following:

- this solution should be straightforward to implement as it is already provided for in the Sixth EU VAT Directive and there is experience of its operation in practice in several Member States. This is particularly the case for an *EDM*[236] approach where case law is in existence (Section 6.4.2.5);
- it is a pan-sectoral solution, which would be valuable to other sectors (Sections 6.4.2.1 and 6.4.2.2);
- it is in line with VAT principles in that it promotes VAT neutrality and it would remove the distortions created where some Member States allow a cost sharing arrangement and some do not (Section 6.4.3.5);
- it is in line with ECJ decisions (e.g. *EDM*[237] *and Taksatorringen*[238]), which decided that article 13(A)(1)(f) of the Sixth EU VAT Directive can apply in a business environment and that other cost sharing approaches are valid. It would ensure the uniform application of article 13(A)(1)(f) (Section 6.4.3.5);
- it is an extension to the VAT Grouping solutions as it has the same effect but the entities do not have to be connected, allowing businesses to structure themselves efficiently without additional VAT cost as a consideration, thus going some way to removing the uneven playing field between EU and non-EU businesses (Section 6.4.1.2).

8.43 Key weaknesses are the following:

- it may take time to implement the provision for cost sharing uniformly, as clear guidelines on the scope and application would be essential (Section 6.4.2.5);
- the solution will only be available to those operators that are in a position to cost share (Sections 6.4.2.1 and 6.4.2.2).

[236] ECJ judgement of 29 April 2004 in *Empresa de Desenvolvimento Mineiro SGPS SA (EDM) v. Fazenda Pública*, Case C-77/01.
[237] ECJ judgement of 29 April 2004 in *Empresa de Desenvolvimento Mineiro SGPS SA (EDM) v. Fazenda Pública*, Case C-77/01.
[238] ECJ judgement of 20 November 2003 in *Assurandor-Societetet v. Skatteministeriet*, Case C-8/01.

8.3.3.4 VAT Grouping (Domestic and Cross-Border) and Cost Sharing

Table 8.13 presents an overview of the evaluation of the Solution combining VAT Grouping (Domestic and Cross-Border) and Cost Sharing (Sections 7.2.5, 7.2.6 and 7.3.1).

Table 8.13: Evaluation of VAT Grouping (Domestic and Cross-Border) and Cost Sharing

VAT Grouping (Domestic and Cross-Border) and Cost Sharing	
Combating Distortions	**5.00**
Positive Impact on Cost Efficiency	5.00
Effectiveness in Combating Identified Distortions	5.00
Ease of Implementation	**4.20**
Pan-sectoral Application of Proposed Solution	5.00
No unequal Impact of Proposed Solution	5.00
Ease of Administration and Control for Revenue Authorities	4.00
Ease of Administration for Economic Operators	4.00
Limited Timeframe for Implementation	3.00
Future Proof	**4.67**
Exploitation and Contribution towards Single Market	5.00
Efficiency in combating Identified Distortions	5.00
Legal Certainty for Economic Operators	5.00
No Scope for Abuse of Provisions	3.00
Consistency with VAT Principles	5.00
Durability of Impacts	5.00
Overall Score	**4.54**
Assessment	**Highly Attractive**

8.44 Key strengths of this combination of solutions are:

- by providing a combination of *Structure Based Solutions*, businesses should be able to:

  - structure their business to maximise their competitive position in the global market (Section 6.4.1.1);
  - comply with regulatory requirements;
  - operate effectively in a Single Market for Financial Services without the burden of additional VAT costs for financial services businesses (Section 6.4.3.1);

- the Pan-European Guidance Solution (Section 7.5) should clearly set out the requirements of the *Structure Based Solutions*, which should minimise scope for abuse by economic operators and facilitate uniform application across Member States (Sections 6.4.1.2 and 6.4.3.4).

8.45 Key weaknesses are:

- these solutions could rebalance the tax revenue between tax authorities, where VAT which would be due in one Member State would no longer apply under a Group structure. This effect would become more significant if the solutions were combined (Section 6.4.1.1).

8.3.4 Pan-European Guidance

Table 8.14 presents an overview of the evaluation of the Pan-European Guidance Solution (Section 7.5).

Table 8.14: Evaluation of Pan-European Guidance

Pan-European Guidance	
Combating Distortions	**4.00**
Positive Impact on Cost Efficiency	4.00
Effectiveness in Combating Identified Distortions	4.00
Ease of Implementation	**4.20**
Pan-sectoral Application of Proposed Solution	5.00
No unequal Impact of Proposed Solution	5.00
Ease of Administration and Control for Revenue Authorities	4.00
Ease of Administration for Economic Operators	4.00
Limited Timeframe for Implementation	3.00
Future Proof	**4.17**
Exploitation and Contribution towards Single Market	4.00
Efficiency in combating Identified Distortions	4.00
Legal Certainty for Economic Operators	4.00
No Scope for Abuse of Provisions	5.00
Consistency with VAT Principles	5.00
Durability of Impacts	3.00
Overall Score	**4.15**
Assessment	**Highly Attractive**

8.46 This solution would provide a European VAT commentary clarifying EU and national VAT legislation and interpretation and application of ECJ decisions. The evaluation of this solution includes the formation of a VAT forum, the production of the guidance and its maintenance.

8.47 Key strengths of the Pan-European Guidance Solution, as set out in Table 8.14, are the following:

- pan-European guidance would support the move towards a more uniform application of VAT liabilities across the EU25, a problem which currently hinders the move towards a Single Market for Financial Services (Section 6.4.3.1);
- it can have a broad application across the whole of the financial services sector and be available for any provider of financial services (Sections 6.4.2.1 and 6.4.2.2);
- it creates certainty of treatment for taxpayers and revenue authorities and thus assists in long-term budgeting and planning (Sections 6.4.1.2 and 6.4.3.3);
- it removes scope for abuse of provisions through openness in the process of creating the document and certainty and consistency of treatment (Section 6.4.3.4). Any deviation from the principles in the guidance will be quickly and easily identifiable;
- it can support other solutions to ensure uniform application but is also a solution that can be valuable to support the current position to provide some instant clarification prior to implementation of other solutions, for example, for the application of article 13(A)(1)(f) of the Sixth EU VAT Directive, as explained in Section 7.3.1 (Sections 6.4.1.2 and 6.4.3.3).

8.48 Key weaknesses are the following:

- the Pan-European Guidance Solution (Section 7.5) will need to be maintained and updated on a regular basis to keep up to date with developments in case law (Section 6.4.3.6);
- there could be difficulties in relation to translation of the guidance, where there may be scope for misinterpretation (Sections 6.4.1.2 and 6.4.3.3);
- a forum will need to be formed to decide on the content and amendments to the guidance. A complex issue will be to reach an agreement on who should have authority in this respect and the level of control given to the forum (Section 6.4.2.5).