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**DIRECTORATE GENERAL TAXATION AND
CUSTOMS UNION**

HARMONISATION OF TURNOVER TAXES

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**BACKGROUND PAPER REQUESTED BY THE COUNCIL
PRESIDENCY**

ORIGIN: COMMISSION – DG TAXATION AND CUSTOMS UNION

SUBJECT: FINANCIAL AND INSURANCE SERVICES

The purpose of this background paper, which was established by DG Taxation and Customs Union ('Taxud') in response to a request by the Council Presidency, is to provide information on the reasoning underlying the Commission's proposals on the VAT treatment of financial and insurance services and to enhance access to information about Taxud's thinking in this area. It is intended to update this information and keep it, to the extent possible, timely and accurate. If errors are brought to our attention, we will try to correct them. However, DG Taxud accepts no responsibility or liability whatsoever with regard to the information in this document and this document does thus not necessarily reflect the official views of the Commission of the European Communities



1. PURPOSE OF THE DOCUMENT

The Council Presidency has requested DG Taxud to elaborate and present a background paper which gives more detailed information on the process of elaborating the proposals for modernising the VAT exemptions on financial and insurance services and on the new definitions of exempt insurance and financial services. The document should highlight in more detail the intentions and motives of the Commission, increasing thus transparency for Member States and economic operators. The Council Presidency considered this information - although of a more explanatory nature - vital for all stakeholders, Member States and economic operators, and, in particular, for the Council negotiations. After a first round of consultations with economic operators and with Member States the Council Presidency concluded that more details on how the legal provisions should be read and interpreted would be useful for further work and in particular for verifying in detail all provisions in the proposals.

2. PROCESS OF ELABORATING THE PROPOSALS

The process of elaborating the proposals consisted of a first analytical phase, a second phase of formulating the objectives and the priorities of the future proposal, a third phase of initial drafting during which also the basic approach behind the proposals was developed together with Member States in Working Party No 1 and a fourth phase of final drafting including inter-service consultation within the Commission.

2.1. ANALYTICAL PHASE

The analytical phase went from December 2004 starting with a Fiscalis seminar in Dublin and closed in December 2005 when the Commission services summarised their findings in working document 1802/06¹ This document recalled the reasons for the existence of the VAT exemptions, analysed the problem areas, described the existing jurisprudence of the European Court of Justice in that area as well as the advantages and disadvantages of possible solutions and consulted Member States and economic operators on the need to address possible distortions between operators established outside the EU and those established within the EU.

2.2. FORMULATING OBJECTIVES AND PRIORITIES - DEVELOPING OF BASIC APPROACH - DRAFT PROPOSAL FOR A DIRECTIVE

In a second phase between January 2006 and December 2006 the analytic findings in working document 1802/06² were consulted with Member States and economic operators (open consultation) and compared with a study commissioned to an international tax consultant on the impact of VAT in the decision making of economic operators³. It resulted from this consultation process that the proposal to be submitted by the Commission should target the following objectives:

- increase legal certainty for economic operators and tax administrations, improving budgetary security for Member States;

¹ This document was made public and is the basis for the public consultation organised by the Commission in 2006; the document can be found on the Taxud Website (publication date 09/06/2006) under: http://ec.europa.eu/taxation_customs/common/consultations/tax/article_2447_en.htm

² See footnote 1

³ The study can also be found on the Taxud Website (publication date: 02/11/2006) under: http://ec.europa.eu/taxation_customs/common/publications/studies/index_en.htm

- reduce the burden for economic operators and tax administrations.

For achieving these objectives, the following priorities were identified:

- Modernising the definitions of financial and insurance services exempted from VAT, adapting them to modern business practices;
- reducing the impact of non-deductible VAT on the costs of economic operators.

a) Modernising definitions of financial and insurance services exempted from VAT

In modernising the definitions it became quickly clear that there were certain parameters which had to be considered and which lead to the work focusing on certain solutions and to abandoning others:

(aa) Exemptions from Value Added Tax (VAT) must be interpreted strictly⁴, requiring modernised definitions allowing that strict interpretation. On the other hand the objective of modernisation requires definitions which are broad enough to cope with future developments of insurance and financial products. Both requirements are to some extent conflicting and needed a careful balance. The only way to achieve that balance was to base the definitions of exempt insurance and financial services in the Directive on **objective economic criteria** determining the nature and functioning of these services. Only objective economic criteria allowed for a more harmonised Community-wide application of definitions. Such economic criteria also allowed the definitions to cope with the development of new services in the area of insurances and financial services because new products can be covered by the exemptions if they fulfil the specified economic criteria.

(bb) However, that alone would not have been sufficient. In fact, one of the main problems of economic operators was that they had to consult with the Ministries of Finance in several Member States whether the services which they supplied, came under the exemption or were excluded. This resulted in time-consuming and costly procedures which often did not generate the necessary clarity and the legal certainty required by the economic operator concerned. Consulting costs were also considerable. Also local tax offices had to consult increasingly with their Ministries of Finance how they should proceed in certain cases, which caused considerable administrative charges and bound resources. In that situation the best option was to draft a **Regulation based on Article 397 of Directive 112/2006/EC** listing economic scenarios covered by the exemptions and those excluded from it.

It became also clear that it would be impossible to establish a catalogue of all economic scenarios because the economic operators estimated that the number of insurance and financial products available on the market would definitely exceed 5000; the description of economic scenarios in the Regulation thus had to be non-exhaustive.

⁴ Case C-359/97 Commission v United Kingdom, judgement of 12 September 2000, point 63

(cc) In addition and according to settled case-law, the exemptions for insurance and financial services have their own independent meaning in Community law and must therefore be given a Community definition; the purpose of Council Directive 2006/112/EC is to approximate the national provisions on value added tax. In order to avoid distortions of competition, it must be ensured in particular that exemptions are applied throughout the Community in a uniform manner. That objective is jeopardised if the exemptions are complemented by concepts of national law which may diverge from each other. It would appear that this is often the case where Member States have been entrusted with the definition of certain terms like "management" in applying the VAT exemption in question.⁵ Again this suggested that the best option was to draft a **Regulation based on Article 397 of Directive 112/2006/EC** listing in a non-exhaustive way economic scenarios covered by the exemptions and those excluded from it.

(dd) For achieving tax neutrality in accordance with the well-established jurisprudence of the European Court of Justice, the criteria used for the **definitions** had to be **linked to the nature of the services concerned** and not to the persons supplying them⁶. This creates consistency within the definitions, allowing a clear distinction between different services; inter alia insurance and financial services and ensuring at the same time equal treatment of smaller and bigger investors. It also ensures that the definitions capture mixed services properly.

(ee) The modernising of definitions should also attempt to achieve consistency with internal market provisions, in particular with the "Financial Services Action Plan (FSAP)" and the internal market rules for undertakings for collective investments in transferable securities. However, there are limits to this consistency. Many internal market provisions are motivated by more general objectives such as consumer protection aspects and the need to harmonise the regulatory framework for insurance and financial services providers. Where such objectives are pertinent, they generate a need for extensive definitions of insurance and financial services. Such tendencies conflict with the requirement for a strict interpretation of VAT exemptions. The modernised definitions of exempt insurance and financial services would therefore necessarily often be narrower than definitions provided for by the internal market rules.

(ff) As described in working document 1802/06, modernisation of definitions should in principle also address the problem of outsourcing (banks and insurances sub-contracting certain activities (e.g.: portfolio management) to independent third parties instead of providing them in-house). The main question to be resolved in this respect was to which extent the concept of outsourcing could be integrated in the definitions. Here the development of the basic approach was confronted with a jurisprudence of the European Court of Justice which was partly well-settled and partly still under construction. For the

⁵ (see Case C-169/04 *Abbey National Pic and Inscape Investment Fund v Commissioners of Customs & Excise*, OPINION OF ADVOCATE GENERAL KOKOTT delivered on 8 September 2005, points 36, 40 - 44, Case 348/87 *Stichting Uitvoering Financiële Acties* [1989] ECR 1737, paragraph 13, Case C-358/97 *Commission v Ireland* [2000] ECR I-6301, paragraph 51, and Case C-428/02 *Fonden Marselisborg Lystbådehavn* [2005] ECR I-0000, paragraph 27)

⁶ Now Article 135 (1) (c) and (f) of Council Directive 2006/112/EEC

exemption of Article 13(B)(d)(3) and (5) of the 6th Directive⁷ the Court held in particular in *SDC* that the transactions in question must be distinct in character in the sense of forming a distinct whole and be specific to and essential for the exempt transactions.⁸ In the *Abbey National Plc and Inscape Investment Fund* case⁹, the ECJ decided that the concept of ‘management of special investment funds’ referred to in Article 13(B)(d)(6) of the 6th Directive¹⁰ covered the services performed by a third-party manager in respect of the administrative management of the funds, if, viewed broadly, they form a distinct whole, and are specific to, and essential for, the management of those funds. On the other hand, in the same case the ECJ also decided that services corresponding to the functions of a depositary, such as those set out in Articles 7(1) and (3) and 14(1) and (3) of Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), were not covered by that concept. For some of the other exempt financial services (such as the granting of credit) no case-law was available yet. In WP 1 the Member States were against adopting an entirely new approach and in favour of keeping useful and well-established jurisprudence, developing and refining it further. However, this also meant that elder jurisprudence (particularly jurisprudence of the ECJ in earlier cases, when the structure of that jurisprudence was less evolved and less settled) had to be abandoned for creating the necessary evolution (In fact, the philosophy adopted could be summarised as creating "evolution instead of revolution").

In a first step the raw concept of "related services" was developed. Based on the *SDC* judgement and the *Abbey National Plc and Inscape Investment Fund* case "related services" distinct in character and specific to and essential for the exempt transactions were meant to be covered by the specific exemptions for insurance and financial services. On the other hand mere material or technical supplies, which in accordance with the above-mentioned jurisprudence were not covered by the exemption, had to be excluded. The ECJ jurisprudence also made clear that it did not want to go into further detail and that it is for the referring tribunal to establish whether the services in question in the main proceedings meet those criteria. It was therefore at this point that the legislator had to take the initiative and define which services are distinct in character and specific to and essential for the exempt transactions and which other services represented mere material or technical supplies. Against this background the modernised definitions had to integrate the basic concept of the ECJ jurisprudence at the level of Council Directive 112/2006/EC and then include in the implementing Regulation in a non-exhaustive way services fulfilling the criteria for coming under the exemption and also exclude services for which it could be established that they are mere material or technical supplies.

⁷ Now Article 135 (1) (c) and (f) of Council Directive 2006/112/EEC

⁸ Case C-2/95 *SDC* [1997] ECR I-3017, paragraph 32, paragraphs 53, 66 and 73, and Case C-235/00 *CSC Financial Services* [2001] ECR I-10237, paragraphs 26 to 28.

⁹ Case C-169/04

¹⁰ Now Article 135 (1) (g) of Council Directive 2006/112/EEC

In a second step this approach was refined to cover with more precision only the supply of any constituent element of an exempted insurance or financial service, which constitutes a distinct whole and has the specific and essential character of the exempt service. This concept made clear that only elements of exempted insurance or financial services qualify; elements which are not part of such services are excluded. Even more, it must be constituent; this is a first filter and means that it must have one or more "genetic markers" of an exempt service making it recognisable as an element of an exempt financial or insurance service. Where this recognition is not possible, the service does not qualify. The service passing this first filter must constitute a distinct whole and have the specific and essential character of an exempt service to qualify for the exemption.

Example 1: General book-keeping services have always been done within an insurance company by its employees. For cost reasons that book-keeping is outsourced to the insurance's tax consultant and is now being supplied and invoiced by the tax consultant to the insurance company; such services would not represent a constituent element of an insurance service; in fact, it does not have any "genetic marker" which would make it recognisable as such a part of an insurance service;

Example 2: A bank has developed and supplies as a part of its bank account operation services personalised security software to its account holders; this software interacts with the bank's computer systems and enables the account holders to make, via their own computer, currency exchanges on their specific account in a safe environment where third parties are blocked out; the supply of these account operation services would be exempted from VAT as a financial service under the new draft Articles 135 (1) (c) and 135a (5) of Council Directive 112/2006/EC and with it the supply of software as a constitutive but ancillary element of the account operation service.

With software development becoming more sophisticated and expensive, the bank decides to outsource banking software development; a software company now improves the software for bank account operations and invoices its services to the bank. The bank itself continues to supply this improved personalised security software as a part of its bank account operation services to its account holders.

Let's at first look at the relation between the software supplier and the bank: The improving of that banking software done by the software company is a service which remains a constituent element of bank account operations because its purpose remains to organise currency exchanges for bank account holders. As a sort of specialised software it still has a "genetic marker" linking it to an exempt financial service. However, it is no longer a part of such a financial service; it has been separated from that financial service and become a distinct whole and therefore a distinct service in its own. But it no longer has the specific and essential character of an exempt service (bank account service). On the contrary, it represents a mere technical supply and is therefore explicitly excluded from the VAT exemption under Article 13 (2) (i) of the draft Regulation.

In a second step let's look at the relation between the bank and its account holders: Here nothing has changed. The bank still supplies account operation services exempted from VAT as a financial service under the new draft Articles 135 (1) (c) and 135a (5) of

Council Directive 112/2006/EC, with it the supply of software as a constitutive but ancillary element of the account operation service.

Example 3: A bank provides its customers with shares and other securities; the portfolio of these investments can vary in accordance with the economic circumstances; the bank advises the portfolio holder on the composition of the portfolio and adapts its composition following the instructions of the customer. For every acquisition or sale of shares and securities the bank charges a fee to its customers. The price for the management of the portfolio which includes the monitoring of market developments as well as advice on its composition is included in these fees. The acquisition or sale of shares and securities are exempt financial services under the new draft Articles 135 (4) (e) and 135a (8) of Council Directive 112/2006/EC and with them the supply of portfolio management as a constitutive but ancillary element of these financial services.

With portfolio management becoming more complex and costly, the bank decides to outsource the portfolio management for securities to a third party; a specialised portfolio manager now exclusively and constantly analyses market developments and advises the bank on every single client portfolio. He also arranges the acquisition and sales of securities. The bank itself continues to supply these portfolio management services as a part of its supplies of securities to its customers.

Let's look at first at the relation between the portfolio manager and the bank: The portfolio management remains a constituent element of the supply of securities; without it no decision on the composition of the portfolio could be made and no sales or supplies of securities would be generated. It has two "genetic markers" linking it to the exempt supply of securities: the constant analyses of market developments and the advice on every single client portfolio. It is therefore a constituent element in the exempt supply of securities. However, it is no longer a part of such a financial service; it has been separated from that financial service and become a distinct whole and therefore a distinct service in its own. The main question is therefore whether portfolio management still has the specific and essential character of an exempt supply of securities. The answer is yes; in the concrete case it allows (for example) to manage the investment risks linked to the acquired securities and limit that risk by spreading the investment over several securities in the portfolio; it also allows to optimise the investment by eliminating less performing securities from the portfolio and replacing them by acquiring better performing securities; in the concrete case portfolio management thus possesses the specific and essential character of an exempt supply of securities.

However, the importance of portfolio management goes beyond that specific case; it is a typical and classic tool for the management of the investment risks for all exempt insurance and financial services; it allows the investor to pursue his own individual and specific investment strategy which can be risk-friendly or based on security aspects and it is a fundamental tool in controlling the investment and investment returns. Therefore it has the essential and specific character of all exempted insurance and financial services. Therefore Article 13 (1) (a) of the draft Regulation includes portfolio management in general as having the specific and essential character of an exempt financial and insurance service.

In a second step let's look at the relation between the bank and its customers: Here nothing has changed. The bank still supplies securities exempted from VAT as a financial services under the new draft 135 (4) (e) and 135a (8) of Council Directive 112/2006/EC and with it portfolio management as a constitutive but ancillary element of the supply of securities.

(gg) On the other hand it was not necessary to apply the concept of constituent elements to the management of investment funds. The term "management" being defined as "activities aimed at realising the investment objectives of the investment fund" allowed to list in the Regulation concrete management services which qualify for the exemption and others which do not. It sufficiently allows for the incorporating of activities which express a management activity. The interpretation is, however, limited by the purpose of the exemption which is the equal treatment of larger and smaller investors investing into vehicles supplied as exempt financial and insurance services.

(hh) Intermediation in insurance services and intermediation in financial services were to be treated equally because the market of insurance services increasingly overlapped with the market for financial services, requiring the same or similar forms of intermediation. Additional criteria complementing the jurisprudence of the ECJ and defining scenarios of intermediation had to be provided in the Regulation.

(ii) However, even where an outsourced service is covered by the modernised definition of exempt services, the fundamental problem of non-deductible input VAT is simply transferred to the supplier of the outsourced services. This supplier will see his right to deduct input tax being reduced, because he supplies a service which is exempt from VAT.

b) Reducing the impact of non-deductible VAT on the costs of economic operators

In the process of analysing feasible instruments for reducing the impact of non-deductible VAT on the costs economic operators, the element of budgetary security for Member States was also considered and at least currently non-suitable instruments were excluded:

(aa) Zero rating

In the discussions with Member States and economic operators zero rating was excluded as a realistic option although it carried the benefit of simplicity at first sight, reducing the impact of sticking tax (non deductible VAT) through enhanced recovery as well as reducing the administrative compliance costs. However, such a solution would have been inconsistent with the fundamental principles of VAT and in particular with the principle of neutrality. It would in fact have created substantial, if not uncontrollable, competitive distortions between financial and insurance operators on one side and "normal" businesses on the other side which could not be justified. In addition the reduced tax bill for the industry would have generated a negative budgetary result for Member States the amount of which would have been virtually impossible to determine.

(bb) Cross-border VAT grouping

The introduction of VAT grouping provisions for cross-border supplies of services would have failed to achieve tax neutrality. Various techniques applied in the different Member States such as national VAT grouping, differences in VAT rates as well as differences in applying the rules for the right to deduct input VAT lead to cost advantages for economic operators in those Member States where they are applied. Introducing VAT grouping provisions for cross-border supplies of services would have led to a situation where these advantages would have been rendered transferable between Member States with the consequence of violating the principle of tax neutrality and of causing competitive distortions. In addition the administrative charges for practising cross-border grouping were considered inconsistent with the objective to reduce the administrative costs for business and fiscal authorities. Cross-border grouping would have introduced a general principle of exemption for a specific group of economic operators. Where such a general principle is introduced, the principle of equal treatment would have required admitting it also for other economic operators leading to a general rupture in the fundamental principles of VAT and unforeseeable budgetary risks for Member States.

(cc) Limited and uniform threshold for input tax deductibility

The introduction of a limited and uniform threshold for input tax deductibility as it is currently practised in some third countries such as Australia and New Zealand would have been inconsistent with the principle of tax neutrality, requiring that input VAT should only be deductible in as much as taxable output is generated. Granting this possibility to a specific group of operators would again have required admitting it also for other economic operators leading to a general rupture in the fundamental principles of VAT and unforeseeable budgetary risks for Member States. In addition the economic structures in Member States was much more heterogeneous than in New Zealand and in Australia; against this background a uniform threshold would have increased economic distortions between Member States.

Against this background only two solutions which were consistent with the principle of tax neutrality and reduced the impact of non-deductible VAT on the costs of economic operators remained: Giving the economic operators concerned the option for taxation and co-operating on a cost-sharing basis which excludes the effect of input VAT in the costs.

(dd) Option to tax for the economic operator

The reasons for the Commission to propose an option to tax for the economic operators are numerous:

- VAT is a consumption tax; in the case of exempt financial and insurance services being supplied to other businesses hidden VAT is not created by consumption but by non-taxation; Member States do not have a right to that VAT income;
- The problems in determining the correct taxable amount for applying VAT to financial and insurance services and which have led to the VAT exemption in question persist. However, some suppliers of insurance and financial services are

able to determine the taxable amount for their services and apply VAT as any other ordinary economic operator supplying taxable services. The question whether a supplier of financial and insurance services is able to apply VAT depends on the individual capabilities of this operator, namely on the kind and the range of services he supplies, his management and, in particular, his IT-capabilities. As the individual capabilities of the economic operator concerned determine whether he is capable to apply VAT to his services, it is not possible to introduce VAT for certain categories of financial and insurance services and stay with the VAT exemption for other categories of financial and insurance services. On the contrary, it is only the economic operator himself who can decide whether he is capable to and wants to apply VAT to financial and insurance services supplied by him. Therefore the option for taxation being with the economic operator concerned is the only viable way forward.

- An economic operator whose IT-systems are capable to operate under normal VAT taxation rules, has a better control of his cost-centres and profits; such an operator knows exactly where his investments go and where he is making profits or losses; this is not only vital for his competitiveness but it is the key criterion for his excellent performance in a single-market environment with more competition; this excellent performance is of interest for all stakeholders. The option will thus contribute to economic operators becoming more competitive and performing better in the single market.
- An operator who is able to calculate input VAT on the basis of cost-centres and his output VAT as any other ordinary economic operator, creates a profile of transparency for the fiscal authorities reducing the potential for indirect and direct tax avoidance. This reduces the costs of the fiscal authorities for the fiscal monitoring of this operator, increases the trust between the operator and the tax authorities and potentially reduces the administrative burden for both, the economic operator and the tax authorities where the tax authorities could reduce the number of tax audits carried out on this operator.
- Suppliers of insurance and financial services are increasingly using advanced book-keeping tools for matching input costs precisely to the services they supply allowing them to calculate fees for these services which they could not before; this allows them to establish the taxable amount for these services easily; they are therefore capable to behave – as regards VAT – as any other taxable person supplying taxable services. There is no reason why they should not be able to opt for taxation and request being treated like any other economic operator supplying taxable services. In fact, none of the reasons having lead to the VAT exemption for insurance and financial services, such as the difficulty to establish the taxable amount of VAT, seems to apply.
- There are also numerous operators supplying highly standardized insurance and financial services with low profit margins; for those operators the cash flow disadvantage of not being able to recover input VAT on their investments generates a higher disadvantage than the benefit of not having to impose VAT on their taxable output; these operators are to a large extent the innovative driving

forces of this specific economic sector; inter alia they play a major role in the development of pan-European payment and banking systems. These operators need the right to opt for taxation to preserve and increase their competitiveness (which in turn benefits the EU's overall competitiveness in this field).

- One of the consequences of applying the option might be that economic operators start routing their supplies through two different legal persons depending on whether the supply is B2B or B2C. However this would generate additional costs for managing two different legal entities in a complex regulatory environment generating costs which in the view of the Commission seem to keep a theoretical potential for competitive distortions below a significant threshold.
- A potential conflict of objectives with national insurance premium taxes resulting in double taxation of insurance services is debatable – de facto such double-taxation already exists today due to hidden VAT costs. Applying VAT to insurance might in many circumstances rather decrease this double-taxation, notwithstanding the transparent charging of the two taxes. And even if there were to be a conflict, there are means to resolve it (e.g.: acceptance of double taxation by economic operator; temporary moratorium for national taxes etc.).
- In an overall perspective it might have been acceptable to grant Member States an option to provide their operators with an option to be taxed when financial and insurance services were predominantly supplied at purely local level. Given the progress in the creation of a true Single Market for financial services this is no longer the case and it is thus impossible to defend an unequal treatment of operators on this point across Member States.

There are some basic parameters which have a major influence on how the option for taxation could or should work:

- The principal objectives of the proposals are to create legal certainty and reduce the burden of economic operators and tax administrations. It is in this perspective that the option for taxation should work. The option should thus be simple to apply, it should be manageable for Member States and economic operators and not create a higher potential for tax avoidance or fraud.
- The basic idea behind the option is that an economic operator supplying financial or insurance services can opt for taxation, where he's capable to act like any other economic operator supplying taxable services.
- In accordance with Article 44 of Directive 2006/112/EC as amended by Council Directive 2008/8/EC¹¹ and applicable from 1 January 2010, the place of supply for financial and insurance services supplied to taxable persons acting as such (B2B supplies) will be the place where the recipient has established his business. However, if those services are supplied to a fixed establishment of the receiving

¹¹ OJ L 44 page 11 of 20.02.2008

taxable person which is located in a different place, the place of supply is where that fixed establishment is located (second sentence of Article 44). Where such B2B supplies are cross-border, Articles 196 and 192a provide that the reverse charge mechanism applies with the recipient taxable person becoming the person liable for VAT.

Example 4: Bank (A) established in France supplies financial services to another bank (B) established in the UK (B2B). The place of supply is in the UK and B becomes the person liable. As long as the service is exempt from VAT, no problems arise. However, this changes if A opts for taxation. In that case A will invoice without VAT because it is B who needs to report and pay VAT to the UK tax authorities. B and the UK tax authorities will need to know that A has opted for taxation, supplies a fully taxable service and that B must report VAT on this supply to the UK tax authorities (It is possible that B has also opted for taxation, which might generate a right to deduct for the input VAT which he reports on the supply from A).

Example 5: Bank (A) established in France supplies financial services to a permanent establishment located in France of another bank (B) established in the UK (B2B). The place of supply is in France because the permanent establishment is located in France and A is the person liable in accordance with the normal VAT rules. B will recover the input VAT invoiced by A in accordance with the normal rules.

- Under Article 45 of Directive 2006/112/EC as amended by Council Directive 2008/8/EC the place of supply of financial and insurance services to non-taxable persons (B2C) will be where the supplier has established his business. However, if those services are supplied by a fixed establishment of the supplier located in a different place, the place of supply is where that fixed establishment is located (second sentence of Article 45).

Example 6: Bank (A) established in France supplies financial services to a non-taxable person (private consumer) (B) established in the UK (B2C). The place of supply is in France and A is the person liable. In the case of A opting for taxation, A will thus invoice B with French VAT which B, being a consumer, cannot recover.

Example 7: Bank (A) established in France supplies financial services via its permanent establishment located in the UK to a non-taxable person (private consumer) (B) established also in the UK (B2C). The place of supply is in the UK because the p.e. is located in the UK, with A being the person liable in accordance with the normal VAT rules. In the case of A opting for taxation, A will thus invoice B with UK VAT which B, being a consumer, cannot recover.

- Under Article 46 of Directive 2006/112/EC as amended by Council Directive 2008/8/EC¹² and applicable from 1 January 2010, the place of supply of services rendered to a non-taxable person (B2C) by an intermediary acting in the name and on behalf of another person shall be the place where the underlying transaction is supplied.

Against this background the Commission services have arrived at the conclusion that an option for taxation being with the economic operator could work in practice where the following conditions are fulfilled:

- The right to exercise the option should be with the supplier who must be able to behave like any other ordinary economic operator supplying taxable services;
- the option should either be irreversible or at least binding for a longer period for preventing unnecessary administrative costs for fiscal administrations;
- exercising the option should lead to a situation where the entire business activities of the taxable person concerned become taxable, allowing to identify – in particular in cross-border scenarios - without doubt, that taxable services are supplied;
- there should be an additional reporting mechanism in Article 226 No 11 of Directive 2006/112/EC which ensures that the invoice clearly shows that the supplier has opted for taxation (with registration no), supplies fully taxable services and the reverse charge mechanism applies. One might also consider an additional exchange of information between the Member States.
- One might consider an additional joint liability of the supplier for VAT, where he fails to comply with his invoicing and reporting obligations.

(ee) Cost-sharing

The second solution respecting the principle of tax neutrality was co-operation on a cost sharing basis. This approach has absolutely nothing to do with VAT grouping according to Art. 11 of the VAT Directive (despite similar names in some languages)! Basically it just allows a group of economic operators to pool their investments.

Example 8: Three insurance companies need new software tools to comply with new regulatory requirements. They establish an independent group. This group buys the software with VAT from an independent provider. The software is then re-distributed from the group to its three members; each member will pay 1/3 of the price for the software. In fact the group itself will not charge any VAT to its members. Where the corresponding Member States agree, the group and one or more of its members can be established in different Member States.

The following reasons have motivated the Commission services to propose this solution:

¹² OJ L 44 page 11 of 20.02.2008

- Such a system allows the introduction of a solution which is specific to the problems of insurance and financial services operators. Following the public consultation and the independent study these operators are working in a growingly complex regulatory environment. Within that environment their investments involve amounts and risks which are much higher than they are in other sectors (e.g.: Single European Payment Area (SEPA) investments, Capital tracking book-keeping requirements for allocated own capital, Risk Assessment Tools, Intermediation, etc.). The two dominant cost factors for this industry in the described environment are personnel costs and information technology (IT) costs. Cross-border cost-sharing is a means to reduce these risks and optimise their investments. This solution therefore appears particularly suitable to smaller and medium enterprises and also for intermediation. An independent cost-sharing group is also easier to supervise; in fact it can be managed by the Member States where the group is established, with this Member State informing those other Member States where the members of the group are established.
- This situation is different for fully taxable operators – the full input tax deduction available makes that they do not need this instrument; It is also different for other institutions the activities of which are VAT-exempt or out of scope as these are typically not active cross-border, e.g. public bodies, health professions etc. It is therefore justified to propose the measure for financial and insurance services only.
- Moreover cost-sharing prevents a situation where VAT advantages obtained in one Member State are made transferable between Member States.
- As exempted supplies are routed "one-way" within the group (i.e. from the group to its members but not the other way round and not between group members), this solution generates less tax risks and less administrative expenses for monitoring the economic operators concerned. In fact, the risk of possible "rate shopping" is negligible in comparison to the risk of unjustified input VAT deduction using VAT grouping (Art. 11 of the VAT Directive) with a fully taxable person being part of that grouping and used as the acquisition portal with a right to deduct. The reception of non-taxable services within the cost-sharing group reduce the right to deduct at the level of the group member where this member supplies taxable and non-taxable services; this is much easier to monitor than the establishing of the right to deduct in a VAT grouping!
- VAT grouping favours big operators and transactions between related persons and is unfavourable to the cost structure and the independence of smaller operators.

Under the new Article 137b Member States shall exempt services supplied by a group of taxable persons to members of the group where the following conditions are (all) fulfilled:

- (1) **the group itself and all its members are established or resident in the Community;**

This provision excludes persons being established outside the Community from being a member of such a group. One reason is that a certain density of administrative control is required which cannot be ascertained for third country operators without a significant increase in administrative charges for the fiscal administrations concerned. A second reason is that for most of the services, in particular IT-services and personnel leasing, supplied by the group to a member established in a third country, the place of supply would not be in the Community and therefore there is no real justification for applying a VAT exemption.

- (2) **the group carries out an autonomous activity and acts as an independent entity towards its members;**

The group must be regarded and act as an independent taxable person in the sense of Article 9 of Directive 2006/112/EC because only then it is possible to exempt the services supplied by the group.

- (3) **members of the group are supplying services which are exempt under Article 135(1)(a) to (g) or other services in respect of which they are not taxable persons;**

It is not necessary that all members of the group supply exempt financial and insurance services or services in respect of which they are not taxable persons. On the contrary, centralised cost sharing is even more interesting for some groups of economic operators, where the costs could also be shared with members not exclusively supplying exempt financial and insurance services. However, where a member of the group is not supplying such services or supplies both, exempt and non-exempt services, it is obvious that the group must then share and invoice its costs with VAT to those members. In fact, where the member of the group only supplies taxable services, this member has a right to deduct and there is neither a need nor a justification for applying a tax exemption. Similar arguments apply in cases where the member of the group supplies partly taxable and partly exempt services. Such a member of the group has a right to deduct in respect of it supplying taxable services. His pro-rata determines the amount of deductible VAT. There is therefore no reason to apply an exemption for the costs invoiced by the group to such a member, notwithstanding the fact that it would be inconsistent with the objective of simplification. The group should therefore invoice the costs with VAT to such members of the group.

The group itself would acquire a right to deduct input VAT in as much as it shares and invoices its costs with VAT.

- (4) **the services are supplied by the group only to its members and are necessary to allow members to supply services which are exempt pursuant to Article 135(1)(a) to (g);**

The entire concept and the justification of VAT exempt cost-sharing is that the costs are first paid by the group ideally using better economies of scale and are then broken down from the group to its members, reducing thus the costs for the individual members of the group and consequently also the impact of hidden and non-recoverable VAT buried in

these costs. This concept is easy to control for the fiscal administrations concerned, because the number of recipients is limited and known in advance. The group itself can carry out its activity with limited administrative charges because it must not differentiate between turnover in and outside the group. This simplicity should be maintained to meet the basic objective not to increase administrative charges for fiscal administrations and economic operators.

Example 9: Four insurance companies found a group in the form of a software company; this company supplies software services to the four insurance companies but also software services with VAT to two banks which are not members of the group. This is not admissible and the exemption cannot be granted. In fact, the services are no longer exclusively supplied to members of the group but to outsiders. This increases the administrative charges for the fiscal authorities because they need to differentiate between taxable and non-taxable supplies of the group.

The services of the group must also be necessary to supply exempt financial and insurance services. This reflects the need for a specific solution for smaller and medium size financial services and insurance operators whose investments (in particular in staff and IT-technology) are particularly high and who might have difficulties opting for taxation, where the benefits of opting for taxation are compensated by the administrative burden related to the option or where the option for other reasons (e.g.: organisational) is not the best solution. Against this background the requirement that the services of the group must be necessary to supply exempt financial and insurance services reflects that the need for exempt cost-sharing must be substantiated. This need is pertinent where the economic operator can demonstrate that a majority of members in the group supplies exclusively exempt financial and insurance services, that the costs shared with VAT to other members of the group are smaller than those shared without VAT and that this inclusion of taxable cost sharing does not conflict with the objective not to increase administrative charges for fiscal administrations and economic operators.

Example 10: Three insurance companies supplying partly exempted insurance services and partly taxable services (e.g.: consulting) want to set up a cost-sharing group. In such a case the group would have to invoice its services in any case with VAT (see above (3)). There is therefore no need for a group which shares costs exempt from VAT.

Example 11: Three insurance companies supplying 90% exempted insurance services and 10% taxable services (e.g.: consulting) and one bank supplying exclusively exempt financial services want to set up a cost-sharing group. It is unknown whether the costs shared with VAT to members of the group are smaller than those shared without VAT. Although the taxable activities are random, there is no need for a group which shares costs exempt from VAT. As the Group would have to invoice with VAT to the three insurance companies their pro-rata determines the amount of deductible VAT. There is a need only for the bank in the group; however. A need for exempt cost-sharing is thus not pertinent because no majority of member supplies entirely exempt financial and insurance services. Also, the administrative charges of the fiscal administration for monitoring the correct application of the exemption appear to conflict with the objective not to increase administrative charges for fiscal administrations and economic operators.

Example 12: Three insurance companies supplying 100% exempted insurance services and one service company supplying exclusively taxable services want to set up a cost-sharing group. The costs shared with VAT with the service company in the group are smaller than those shared without VAT with the three insurance companies. A need for exempt cost-sharing is pertinent because a majority of members supplies entirely exempt financial and insurance services. The costs shared with VAT are smaller than the costs shared without VAT. Also, the administrative charges of the fiscal administration for monitoring the correct application of the exemption appear not to conflict with the objective not to increase administrative charges for fiscal administrations and economic operators.

- (5) **the group claims from its members only the exact reimbursement of their share of the joint expenses, excluding any transfer-pricing adjustments made for the purposes of direct taxation.**

The reason for this requirement here is that the group does not make profits and that the benefits of achieving a better economy of scale using a group are transferred to the members of the group reducing their costs for supplying exempt financial and insurance services.

2.3. EXPLANATORY NOTES - DRAFT PROPOSAL FOR A REGULATION

(aa) Insurance and reinsurance

In accordance with Article 135a (1) "insurance and reinsurance" means a commitment whereby a person is obliged, in return for a payment, to provide another person, in the event of materialisation of a risk, with an indemnity or a benefit as determined by the commitment. A risk is the possibility of suffering harm, loss or danger and the insurance reduces or eliminates that risk by providing indemnity or a benefit. Both, the risks addressed by the insurance and the indemnity or the benefit are determined in the insurance contract.

Article 135a (1) is complemented by Article 2 of the Regulation which resolves the following cases:

The definition of "insurance and reinsurance" provided for in point (1) of Article 135a of Directive 2006/112/EC shall cover at least the following:

- (1) Life insurance, whether individual or group life policies, and insured pensions and annuities where the insurance, pension or annuity covers mortality or longevity risks, including diagnosis of a terminal illness, diagnosis of a critical illness, disability due to ill health, permanent disability, accidental death, and requirement for long term care

These are policies where the insured risk is based on the life (lives) of (a) person(s), usually mortality, and diagnosis of a terminal illness, diagnosis of a critical illness, disability due to ill health, permanent disability, accidental death, and requirement for long term care. Such insurances cover also group policies. A group life policy is a life policy that insures more than one life and pays benefits on the death of each of the lives. Individual proof of insurability is not normally a consideration in the underwriting.

Rather, the underwriter considers the size and turnover of the group, and the financial strength of the group. Contract provisions will attempt to exclude the possibility of adverse selection. Group life insurance often has a provision that a member exiting the group has the right to buy individual insurance coverage. Another substantial risk covered by such policies is that of longevity of a person;

(2) sickness disability and unemployment insurance

Such policies insure against other life risks such as sickness disability and unemployment and cover against the possibility of being unable to work. The self-employed, in particular, may choose to protect against the risk that illness or disability may make it impossible for them to earn their living. Such policies are commonly known as permanent health insurance or income protection;

(3) health insurance

Such policies cover the cost of private medical treatments where other programs do not pay for them or result in quicker health care where better facilities are available. In some circumstances a cash payment is made. Such insurance can be rather general but also cover specific health risks such as workers' compensation insurances, replacing all or part of a worker's wages lost and accompanying medical expense incurred because of a job-related injury;

(4) peril insurance, including coverage against fire, flooding, natural disasters, accidents, breakdown of machinery, crime and terrorism

They cover some of the most substantial risks for economic operators and consumers. Such policies can target fire, water or even snow risks as well as natural disasters like earthquakes or flooding, accidents like nuclear incidents, accidents of means of transport, transport or travelling accidents or and crime risks such as vandalism, theft, fraud, forgery or terrorism. They may include breakdown of machinery or means of transport;

(5) liability insurance

These are policies covering legal claims against the insured which usually constitute a substantial risk. Many types of insurance include an aspect of liability coverage. The range of liability risks can reach from a homeowner's insurance policy provide liability coverage which protects the insured in the event of a claim brought by someone who slips and falls on the property to environmental liability risks protecting the insured from bodily injury, property damage and cleanup costs as a result of the dispersal, release or escape of pollutants or professional liability insurances protecting professional practitioners such as architects, lawyers, notaries, doctors, and accountants against potential negligence claims made by their patients/clients. Such professional liability insurance may take on different names depending on the profession. The protection offered by a liability insurance policy can be twofold: a legal defence in the event of a lawsuit commenced against the policyholder and indemnification (payment on behalf of the insured) with respect to a settlement or court verdict. Liability policies typically cover only the negligence of the insured, and will not apply to results of wilful or intentional acts by the insured;

(6) insurance against financial loss

These policies usually cover substantial risks; they can protect persons against various risks of financial losses. For example, insurance might cover the failure of a creditor to pay money it owes to the insured, performance risks of financial products or the risk of a person to fail in performing its obligations under a contract; they include financial loss and inconvenience risks insurance supplied within a block insurance policy; such policies cover cases where a taxable person, not being an insurer, procures for his customers who are the insured, in the context of a block policy of which he is the holder, insurance cover from an insurer who assumes the risk covered;

(7) retrocession, co-insurance and pooling of insurance or reinsurance

Reinsurances usually provide policies to other insurance companies, allowing them to reduce their risks and protect themselves from very large losses. Such policies may also involve retrocession, which is the transfer of the entire risk to a reinsurance company. Vice versa a reinsurer may also be a direct writer of insurance risks as well. Reinsurance can cover a proportion or all of the risk or it can just cover claims over a certain amount. Such services include the pooling of insurances for huge risks. Within such a pool suppliers of insurance usually underwrite for a certain percentage of the risk or for a specific amount. However, it may also happen that a supplier of insurance opts to cover certain risks alone because he is specialised in these risks. In such pooling scenarios usually one insurance company takes the lead;

There are other services which are not explicitly resolved by the provisions of the Regulation and which have been discussed with Member States for verifying how the rules are to be applied:

(8) extension of the warranty claim period for supplied goods

In accordance with national law the producers or suppliers of goods have warranty obligations in respect of the buyers of goods; often the warranty period is contractually extended beyond the period provided for by law and the question arises whether such extensions represent the supply of insurance services. In the view of DG Taxud, such extensions are usually insurance services, where they cover a risk and fulfil the other conditions of Article 135a (1). Such a risk could – for example – be the engine failure of a car engine where the benefit consists of the insurance provider taking over the cost for changing or repairing the engine and/ or reimbursing the costs for a replacement car for the time the damaged engine is repaired or exchanged.

(9) Insurance against risks resulting from the failure to meet production deadlines

In various industries (inter alia in the film industry) contracts provide for serious penalties for non-performance or breach of contracts (e.g.: non-timely production of a film, the exceeding of production budget thresholds etc.); contracts which partly or wholly transfer the risk of having to pay these penalties cover in the view of DG Taxud a risk and involve the supply of insurance services where they fulfil the other conditions of Article 135a (1).

(10) Loan loss insurance

Contracts where – for example - the risk of the debtor going bankrupt is taken over by a person with the obligation to pay the debt of debtor and/ or the additional costs related to that bankruptcy, cover in the view of DG Taxud a risk and involve the supply of insurance services where they fulfil the other conditions of Article 135a (1).

(bb) Insurance elements set out separately

Where a complex transaction includes an element of insurance which is set out separately, the insurance shall be a distinct service exempted under Article 135 (1b) of Directive 2006/112/EC. The Regulation does not contain any implementing provisions in this respect. In fact it is self-explanatory that the intention here is to grant the economic operator concerned the possibility to get insurance services under the exemption if he's able and willing to be more transparent on the elements of which the price for his goods or services is composed and where he accepts the administrative charges of supplying taxable and exempt services with corresponding consequences for his right to deduct input VAT.

(cc) granting of credit

Under Article 135a (2) of Directive 2006/112/EC "granting of credit" means the lending of money or the promise to lend money.

Article 135a (2) is complemented by Article 3 of the Regulation which resolves the following cases:

1. The definition of the "granting of credit" provided for in point (2) of Article 135a of Directive 2006/112/EC shall cover the provision of at least the following:

- (a) loans, whether syndicated or not, including loans granted as a financing element in conjunction with the supply of goods or services provided the financing element is not an integral part of the consideration;

Under a loan money is lent and usually paid back in instalments. A syndicated loan (or "syndicated bank facility") is a large loan in which a group of banks work together to provide funds for a borrower. There is usually one lead bank (the "Arranger" or "Agent") that takes a percentage of the loan and syndicates the rest to other banks. A syndicated loan is the opposite of a bilateral loan, which only involves one borrower and one lender (often a bank or financial institution.); loans can also be granted as a financing element in conjunction with the supply of goods or services. Where such a financing element remains visible not becoming a part of the remuneration for the goods or services and where it is available separately, it usually constitutes an aim in itself for the client;

- (b) loans secured on real property, including mortgage loans;

This provision is self-explanatory;

- (c) loans secured on movable property, including pawn broking;

Pawn broking is the customer bringing his own goods to the shop, where they are held as collateral against a loan. If the customer repays the loan within the period their goods are returned. The customer will pay interest on the loan. If the customer does not repay the loan within the period, the shop will sell the goods. The loan itself is the lending of money;

- (d) credit arrangements under which a person is entitled to dispose of funds up to a fixed amount;

Such arrangements include overdraft and overrunning facilities, global credits and Overdraft loans. Overdraft facilities are based on an explicit credit agreement whereby the possibility is granted to dispose of funds in current account which exceed the current balance in that account and where the amount of credit has to be repaid on demand; such overdraft facilities thus involve the lending of money; overrunning facilities are based on a tacit credit agreement whereby the possibility is granted to dispose of funds in current accounts which exceed the available balance or the ceiling of a global credit; as such they involve the lending of money; global credits are credit arrangements where the client is entitled to drawdown at his disposal until the total amount of credit under the agreement is utilised; overdraft loans are also called "bounce protection" plans; they are offered by banks to low-income consumers. In exchange for covering account overdrafts up to a set limit, banks charge bounced check fee. Some banks also charge a per day fee until the consumer's account has a positive balance. In addition to writing checks, customers can borrow against their bounce protection limit using their debit cards and by making withdrawals. Such services are lending of money;

Such arrangements include credit card scenarios. Credit card services consist of a system of payment named after a small plastic card to users of the system. Credit card services are different from debit card services because money is not removed from the user's account after every transaction. In the case of credit cards the issuer lends money to the user. A credit card may allow the user to revolve his balance at the cost of having interest charged. However, there are also credit card services which require the user to pay his balance in full each month; in such cases the credit card is often called charge card. Also for such charge cards the balance is credited until the end of the month with interest being charged. Such services are lending of money but do not include the supply of blank cards.

2. The definition of the "granting of credit" provided for in point (2) of Article 135a of Directive 2006/112/EC shall not cover the following:

- (a) agreements under which payment by instalments, or an extended period for payment, is provided for in respect of the supply of goods or services;

This is an implementing provision to Article 135 (1c) stipulating that where the supply of goods or services includes the granting of credit which is not set out separately, the grant of credit shall not be a distinct service exempted under Article 135 (1) (b) of Directive 2006/112/EC and to Article 135a (2) of that same Directive. The granting of payment by instalments or of an allowed period for payment for the supply of services and goods, the financing element is a part of the remuneration for the services or goods: Although

involving a financing element, payment by instalments or an allowed period for payment for the supply of services and goods are a part of the remuneration for the services or goods and not available separately. For the customer of the goods or services they usually do not constitute an aim in themselves;

- (b) the grant of credit in connection with hire purchase and lease purchase arrangements where the consideration for that credit constitutes an integral part of the consideration for the hire purchase and lease purchase;

This is an implementing provision to Article 135 (1c) stipulating that where the supply of goods or services includes the granting of credit which is not set out separately, the grant of credit shall not be a distinct service exempted under Article 135 (1) (b) of Directive 2006/112/EC and to Article 135a (2) of that same Directive.

Hire purchase services usually apply in cases where a buyer cannot afford to pay the asked price for an item of property as a lump sum but can afford to pay a percentage as a deposit; a hire-purchase contract allows the buyer to hire the goods for a monthly rent. When a sum equal to the original full price plus interest has been paid in equal instalments, the buyer may then exercise an option to buy the goods at a predetermined price (usually a nominal sum) or return the goods to the owner. Also in these cases the financing element remains for the client an invisible part of the remuneration which he pays either for becoming the owner of the goods at the end of the contract or for hiring the goods; this financing element is not available separately and therefore does not constitute an aim in itself for him;

Lease purchase is a method of financing, similar to hire purchase, via a finance company, normally for a vehicle. Instead of spreading the whole payment over several years, there is a short term lease, followed by an option to buy. There is also sometimes an initial deposit. The monthly payment is determined by the sale price of the vehicle, the amount of any deposit paid, the period of the lease contract plus the proposed annual mileage/kilometre and the estimated future value of the vehicle at the end of the term. An optional payment equivalent to the estimated future value is payable at the end of the contract, at which time the vehicle becomes the property of the lessee. In some cases the lease purchase contract anticipates at the outset that title will pass after the period of leasing; in other cases the transfer of ownership is left optional. In all these cases the financing element remains for the client an invisible part of the remuneration which he pays either for becoming the owner of the goods at the end of the contract or for hiring the goods; this financing element is not available separately and therefore does not constitute an aim in itself for him;

- (c) the provision of debit and prepaid card services.

Debit card services cover scenarios where funds are directly withdrawn from the card holders monetary account when the debit card is used for the acquisition of goods or services; in most cases it also allows the card holder also to withdraw himself cash from his monetary account. Such card services do not provide for a lending of money;

Prepaid card services cover scenarios where the card holder spends money which has been "stored" via a prior uploading of the card by the card-holder or someone else; such card services do not provide for a lending of money.

3. There is the issue of "time to pay/ deferment of payments" which is not explicitly resolved by the provisions of the Regulation and which has been discussed with Member States for verifying how the rules are to be applied. Usually such services are part of the price paid for the supply of goods or services. It is for that reason that Article 135 (1c) of the draft Directive provides for that where the supply of goods or services includes the granting of credit which is not set out separately, the grant of credit shall not be a distinct service exempted under Article 135 (1) (b) of the draft Directive.

However, in scenarios where such time to pay/ deferment of payments is not accessory to another supply but a separate and distinct service on its own, it could in the view of DG Taxud represent the lending of money even if this lending only consists in the debtor being able to keep his own money for the agreed period.

(dd) guaranteeing of debts

Under Article 135a (3) of Directive 2006/112/EC "guaranteeing of debts" means the acceptance of liability for the debt of another person. This provision is complemented by Article 4 of the Regulation which provides for the following:

1. The definition of the "guaranteeing of debts" provided for in point (3) of Article 135a of Directive 2006/112/EC shall cover the provision of at least the following¹³:

(a) credit default swaps;

Credit default swaps have the effect of transferring the credit exposure of credits between parties. It is an agreement between a protection buyer and a protection seller whereby the buyer pays a periodic fee in return for a contingent payment by the seller upon a credit happening in the reference entity. Most CDS contracts are physically settled, where upon a credit event the protection seller must pay the par amount of the contract against the protection buyer's obligation to deliver a bond or loan of the name against which protection is being sold. The typical term of a CDS contract is five years, although being an over-the-counter derivative almost any maturity is possible. Against this background a CDS is a typical financial instrument for the guaranteeing of debts;

(b) customs bonds.

Customs bonds represent a guarantee for credited customs duties and taxes in default;

2. The definition of the "guaranteeing of debts" provided for in point (3) of Article 135a of Directive 2006/112/EC shall not cover the following:

¹³ Financial futures, options and interest swaps are dealt with in Article 19 of the Regulation

- (a) the provision of warranties for the repair and replacement of faulty goods;

Warranties for the repair and replacement of faulty goods are services not directly linked to a credit but to goods;

- (b) the handing over of assets to be used as collateral for a debt not resulting from the granting of credit;

Such services do not have a financial character but concern the handing over of real values such as mortgages, performance guarantees or cessions of a trademark or assets of intellectual property as means of safeguarding other debts than those resulting from loans.

- (c) the provision of guarantees as security for any outstanding rental payment or payment resulting from defaults on rental payments;

Rental guarantees provide the outstanding rental payments or pay a particular sum of money, if the tenant defaults on the rental payments; they are accessory to rental debts which are not credits;

- (d) the provision of export credit guarantees;

Export Credit Guarantee represent a form of an official guarantee to reimburse an exporter should a purchaser default on payment for exported goods but may fulfil the conditions for insurances;

- (e) the assumption of obligations of a non-pecuniary nature.

Such an obligation could for example consist in the renovating a building, which lacks the character of a financial transaction¹⁴.

(ee) financial deposit

Under Article 135a (4) of Directive 2006/112/EC "financial deposit" means a deposit of money held on behalf of the depositor who retains rights to the deposits, which must be repaid under the legal and contractual conditions applicable. This provision is complemented by Article 5 of the Regulation which provides for the following:

1. The definition of "financial deposit" provided for in point (4) of Article 135a of Directive 2006/112/EC shall cover at least the following:

- (a) sight deposits (deposits on call);

Sight deposits (deposits on call) are funds which can be transferred immediately and without restriction to another account or which can be converted into cash;

¹⁴ Judgement of the Court of 17 April 2007 (Case C-455/05), Velvet & Steel Immobilien

- (b) saving deposits;

Savings deposits are funds in accounts maintained inter alia by commercial banks, savings and loan associations, credit unions, and mutual savings banks that pay interest but can not be used directly as money (by, for example, writing cheques). These saving deposits let customers set aside a portion of their liquid assets that could be used to make purchases while earning a monetary return;

- (c) time and term deposits;

A time deposit (also known as a term deposit) is a deposit at a banking institution that cannot be withdrawn for a certain "term" or period of time. When the term is over it can be withdrawn or it can be held for another term. Generally speaking, the longer the term the better is the yield on the money. A certificate of deposit is a time-deposit product;

- (d) deposits in the form of saving certificates;

Deposits in form of saving certificates are deposits of money in an account. They include Fixed Interest Savings Certificates which are lump sum investments that earn guaranteed rates of interest over set periods of time, called 'terms';

- (e) saving bonds;

Saving bonds are deposits of money in an account. Savings bonds are often fixed rate investments that offer a guaranteed fixed interest rate for the term of the investment, which is typically 1, 2 or 5 years. The terms of the bond will state how money may be deposited, i.e. whether deposits can be made as a lump sum and/or on a regular basis. There is usually a requirement to keep the money invested for the full term of the bond in order to benefit from the higher interest rates offered. Withdrawals are usually not permitted;

- (f) deposits made in return for a guaranteed annuity or an accumulated cash balance upon retirement, including deposits made under a pension saving plan;

Deposits made in return for a guaranteed annuity or for an accumulated cash balance upon retirement are deposits of money in an account. Such deposits (often organised in form of a pension saving plan) are made for pension purposes, typically payments are made in the form of a guaranteed annuity to a retired or disabled employee. Some retirement plan (or superannuation) designs accumulate a cash balance (through a variety of mechanisms) that a retiree can draw upon at retirement, rather than promising annuity payments. These are often also called pensions. In either case, a pension created by an employer for the benefit of an employee is commonly referred to as an occupational or employer pension. Labour unions, the government, or other organizations may also fund pensions. Occupational pensions are a form of deferred compensation, usually advantageous to employee and employer for tax reasons;

- (g) capital redemption bonds;

Capital Redemption Bonds are deposits of money in an account. They consist of one or more fixed sums paid under a contract pursuant to which one or more specified amounts are paid out at some later time or times, on the basis of an actuarial calculation. Typically the contracts take the form of an annuity certain, where a capital sum is used to buy an annuity for a fixed term not contingent on life, or a sinking fund where regular sums are paid in to secure a capital sum at some later date, for example against the need to find a premium payment to renew a lease;

- (h) insured pensions and annuities where the mortality or longevity risk covered is merely ancillary.

Insured pensions with ancillary mortality or longevity risk being covered are deposits of money in an account. Such cases premiums are received to provide a capital sum to pay a pension. In most cases on maturity a certain percentage of the fund can be taken as a lump sum and the remainder invested in an annuity. In some cases it is possible to defer the annuity and in some special cases alternatives to an annuity can be used. Insured pensions without mortality or longevity risk are therefore deposits of money;

Annuities with ancillary mortality or longevity risk are payments made under a legal obligation and are "pure income profit". They can be characterised as "annual", so being capable of recurrence on a periodic basis by reference to an annual time frame. Although the purchase sum passes absolutely to the provider of the annuity and no debtor/creditor relationship is created in relation to that sum, it is replaced by the annuity. The annuitant's right is to demand payments when due and represents the way in which the annuitant retains rights to his deposit. Annuities used for pensions are commonly called a purchased life annuity. The payments for the annuity are not instalments of pre-existing debt.

2. The definition of "financial deposit" provided for in point (4) of Article 135a of Directive 2006/112/EC shall not cover the following:

- (a) the deposit for safekeeping of collectors' items or of instruments evidencing rights, claims or titles;

Such services are safe-keeping services and do not involve the depositing of money;

- (b) hiring of security boxes and securitised space and location.

These are services which do not involve the deposit of money in an account and are comparable to the hire of safes, which is a service excluded from the exemption under point (d) in Article 135 paragraph 2. of the Directive.

- (ff) account operation

Under Article 135a (5) of Directive 2006/112/EC "account operation" means the operation of a monetary account for a customer. This provision is complemented by Article 6 of the Regulation which provides for the following:

The definition of "account operation" provided for in point (5) of Article 135a of Directive 2006/112/EC shall cover at least the following:

- (1) the operation of deposit accounts;

A deposit account is an account at a banking institution that allows money to be held on behalf of the account holder;

- (2) the operation of current accounts;

A current account is a deposit account offering various flexible payment methods to allow customers to distribute money directly to others. Most current accounts have a check book, offer the facility to arrange standing orders, direct debits and payment via a debit card. Current accounts may also allow borrowing via an overdraft facility. Current accounts providers include banks, building societies and credit unions. Since the internet revolution most retail banking institutions offer access to current accounts via online banking;

- (3) the deposit, transfer and withdrawal of money to or from a bank account, whether electronic or not;

Deposit, transfer and withdrawal of money to or from a bank account are classic services for the operation of a monetary account;

- (4) cheque services related to a specific account;

Checks are negotiable instruments instructing a financial institution to pay a specific amount of a specific currency from a specific demand account held in the maker/depositor's name with that institution. Both the maker and payee may be natural persons or legal entities. Checks are means to arrange payments via a specific account;

- (5) standing orders;

A standing order is an instruction a bank account holder gives to his bank to pay a set amount at regular intervals to another account. The instruction is sometimes known as a banker's order. They are typically used to pay rent, mortgage or other fixed regular payments. Because the amounts paid are fixed, a standing order is not usually suitable for paying variable bills such as credit card, or gas and electricity bills;

- (6) direct debits;

Direct debit is a payment method that allows an organisation to instruct their bank to collect varying amounts directly from customers' accounts. There are generally two ways to set up a direct debit. One method requires the customer to instruct his or her bank to honour debit notes from the organisation, the other one just requires the customer to give an authorisation to the organisation making the collections. The availability of these methods varies between countries and banks;

- (7) the access to and the operation of internet and telephone banking;

Internet or Online banking describes the use of a bank's secure website to view for a specific account balances and statements perform transactions and payments, and various other facilities, especially for banking outside bank hours and banking from anywhere where internet access is available. Telephone banking is the term applied to specific provision of banking services over the telephone in relation to a specific account. In many cases such calls are to a call centre or automated service, although some institutions continue to answer such calls in their branches. Often call centre opening times are considerably longer than branches, and some firms provide these services on a 24 hour basis;

(8) debit and smart card services related to a specific account;

A debit card removes money from the user's account after every transaction. Cards are related to a specific account. In many countries the debit card is multipurpose, acting as the automated teller machine card for withdrawing cash and as a cheque guarantee card. Merchants can also offer "cash back/ cash out" facilities to customers, where a customer can withdraw cash along with his purchase. The use of debit cards has become widespread in many countries and has overtaken the cheque and in some instances cash transactions by volume. Debit cards are used widely for telephone and Internet purchases;

Smart card services use bank cards with a microchip which can be up-loaded with a maximum amount from the monetary account of the account holder and which are then used to pay for small purchases such as a newspaper, cakes from the baker, car parking, a telephone call in a public telephone box etc. These are usually small amounts for which coins would have been used in the past. An example of such smart card services is the Belgian Proton system;

(9) the clearance and the transfer of funds between financial operators;

Inter-bank electronic clearance services organise the transfer of funds between accounts; and include the transfer and clearing of funds transferred for the settlement of credit card accounts; they also include the transfer and clearing of funds between monetary accounts of credit card operators and between monetary accounts of credit card operators and economic operators having accepted a credit card payment or cash out;

(10) the transfer of funds from a specific account into other money media such as telephone cards, credits for mobile phones and other media which allow payment for goods and services;

Debits and credits of other e-money media organise the transfer of funds from a specific monetary account into other money media such as telephone cards, credits for mobile phones and other media which allow payment for goods and services;

(11) sorting and counting of money related to a specific account;

Such activities cover the sorting of coins and bank notes in the form of withdrawal from an account or for the deposit on an account;

(12) the arrangement of credit facilities;

In some cases such credit facilities are granted for a specific monetary account and for remuneration without the client using these facilities because he does not need them in a concrete case but might in the future and therefore arranges them for use when needed. In such cases they are not covered by the exemption for "granting of credits".

(gg) exchange of currency

Under Article 135a (6) of Directive 2006/112/EC "exchange of currency" means the supply of services whereby a person changes the currency of bank notes or coins normally used as legal tender, of deposits or of money in a monetary account on the basis of rates of exchange between currencies of countries; This provision is complemented by Article 7 of the Regulation which provides for the following:

The definition of "exchange of currency" provided for in point (6) of Article 135a of Directive 2006/112/EC shall not cover the following:

(1) transactions involving collectors' items, such as gold, silver or other metal coins or bank notes normally not used as legal tender or coins of numismatic interest;

Such commodities are not used as legal tender and must therefore be excluded from the definition of "exchange of currency ";

(2) the exchange of currencies not of legal tender

Such services include the exchange of virtual currencies. These are currencies which are not backed by a government, they are thus not legal tender, for example units of account and usually apply in a limited environment; they are often tokens issued by businesses to encourage consumer loyalty, for example bonus vouchers, collectable points which can be exchanged against goods or services, etc.;

(hh) provision of cash

Under Article 135a (6) of Directive 2006/112/EC "cash" means bank notes and coins normally used as legal tender or negotiable means of payment. This provision is complemented by Article 8 of the Regulation which provides for the following:

The "provision of cash" as referred to in point (d) of Article 135(1) of Directive 2006/112/EC shall cover at least the following:

(a) cash dispensing, whether manual or automatic;

Cash dispensing is the manual or automatic distribution of bank notes and coins or the storage of e-money in appropriate cards or other e-money storage devices using for example debit and credit card services, nowadays such dispensing of cash is increasingly done with machines. With a cash dispenser, the customer identifies himself with a magnetic stripe or chip device, which allows him to withdraw money from the dispenser or upload money value into another electronic device or the same card. Such services

ensure the availability of cash where it is needed and contribute to the functioning of money. In an increasing number of cases such dispensing activities also allow clients to store money value in e-money storage devices (inter alia cards and mobile phones); such storage can be linked to an account and would be covered by the exemption for account operation services; in other cases cash is inserted into the machine, which will then upload the e-money storage device with this amount; it is also possible that foreign currency bank notes and coins are inserted into the machine for uploading a local currency amount into the e-money storage device. In such cases the dispensing fulfils the basic functions of "cash services" and the functioning of money by altering the financial situation. There should not be difference in treatment between cash and book-money where the nature of the service is the same. Cash dispensing should therefore be covered by the exemption for "currency exchange services" and "cash services";

(b) traveller cheque services;

Traveller cheque services involve the supply of a pre-printed, fixed amount cheque designed to allow the person signing it to obtain cash or to make an unconditional payment to someone else as a result of having paid the issuing financial institution for that privilege. Such a cheque can usually be replaced if lost or stolen and is often used by people on vacation in place of cash;

(c) cheque services not related to a specific account;

Checks are not always related to a specific account, as negotiable instruments they can also be used to obtain cash or for an unconditional payment;

(d) letters of credit;

Letters of credit are documents providing a payment undertaking to a beneficiary against complying documents as stated in the credit.

(e) the exchange of bank notes and coins within the same currency.

These are also classic cash services, where bank notes are changes into coins or vice versa.

2. The "provision of cash" as referred to in point (d) of Article 135(1) of Directive 2006/112/EC shall not cover the following:

(a) transactions involving collectors' items, such as gold, silver or other metal coins or bank notes normally not used as legal tender or coins of numismatic interest;

Such commodities are not used as legal tender and must therefore be excluded from the definition of "provision of cash";

(b) dispensing of currencies not of legal tender.

These are currencies which are not backed by a government, are not legal tender, for example units of account and usually apply in a limited environment; they are often

tokens issued by businesses to encourage consumer loyalty, for example bonus vouchers, collectable points which can be exchanged against goods or services, etc.;

(ii) supply of securities

Under Article 135a (8) of Directive 2006/112/EC "supply of securities" means the supply of tradable instruments other than an instrument establishing title to goods or to the rights referred to in Article 15(2), representing financial value and reflecting any one or more of the following:

- (a) an equity ownership position in a company or other association;
- (b) a creditor's position for debts;
- (c) unit ownership in undertakings for collective investment in the securities referred to in points (a) or (b), in other exempted financial instruments referred to in points (a) to (d) of Article 135(1) or in other undertakings for collective investment;

This provision is complemented by Article 9 of the Regulation which provides for the following:

The definition of the "supply of securities" provided for in point (8) of Article 135a of Directive 2006/112/EC shall cover the provision of at least the following:

- (1) equity securities, including shares;

An equity security is a share in the capital stock of a company (typically common stock, although preferred equity is also a form of capital stock). The holder of equity is a shareholder, owning a share, or fractional part of the issuer. Equity securities are not entitled to any payment. In bankruptcy, they share only in the residual interest of the issuer after all obligations have been paid out to creditors. However, equity generally entitles the holder to a pro rata portion of control of the company, meaning that a holder of a majority of the equity is usually entitled to control the issuer. Equity also enjoys the right to profits and capital gain and equity holders are entitled to the "upside" of the business and to control the business. A share is one of a finite number of equal portions in the capital of a company, entitling the owner to a proportion of distributed, non-reinvested profits known as dividends and to a portion of the value of the company in case of liquidation.

- (2) instruments recording the promise of repayment of a debt, including debentures, bonds and corporate bonds, promissory notes, Euro debt securities and other tradable commercial papers;

Debt securities typically require regular payments (interest) to the holder, equity securities are not entitled to any payment. Holders of debt securities receive only interest and repayment of principal regardless of how well the issuer performs financially. Furthermore, debt securities do not have voting rights outside of bankruptcy. They exist in various forms:

(a) **Debentures:** A debenture is a long-term debt instrument used by governments and large companies to obtain funds. It is similar to a bond except the securitization conditions are different. A debenture is usually unsecured in the sense that there are no liens or pledges on specific assets. It is however, secured by all properties not otherwise pledged. In the case of bankruptcy debenture holders are considered general creditors. The advantage of debentures to the issuer is they leave specific assets unencumbered, and thereby leave them open for subsequent financing. Debentures are generally freely transferable by the debenture holder;

(b) **Bonds and corporate bonds:** A bond is a debt security, in which the authorised issuer owes the holders a debt and is obliged to repay the principal and interest (the coupon) at a later date, termed maturity. Other stipulations may also be attached to the bond issue, such as the obligation for the issuer to provide certain information to the bond holder, or limitations on the behaviour of the issuer. Bonds are generally issued for a fixed term (the maturity) longer than ten years. Corporate bonds represent the debt of commercial or industrial entities. Government bonds are medium or long term debt securities issued by sovereign governments or their agencies. Typically they carry a lower rate of interest than corporate bonds, and serve as a source of finance for governments. Sub-sovereign government bonds represent the debt of state, provincial, territorial, municipal or other governmental units other than sovereign governments. Supranational bonds represent the debt of international organizations such as the World Bank, the International Monetary Fund, regional multilateral development banks and others. Insured Investment bonds are also included if not covered by a preceding exemption. These are investment bonds carrying some life cover although they are primarily investment vehicles. The life cover can be as low as around one per cent over and above the “bid value” of the investment units within the policy. That means that the value that the sale of investment units in the bond realises on death is added to, so that 101 per cent of that value is actually payable. The percentage of protection cover will vary depending on the bond;

(c) **Promissory notes and other tradable commercial papers:** A promissory note, also referred to as a note payable in accounting, is a contract detailing the terms of a promise by one party (the maker) to pay a sum of money to the other (the payee). The obligation may arise from the repayment of another form of debt than a loan. For example, in the sale of a business, the purchase price might be a combination of an immediate cash payment and one or more promissory notes for the balance. The terms of a note typically include the principal amount, the interest rate if any, and the maturity date. Sometimes there will be provisions concerning the payee's rights in the event of a default, which may include foreclosure of the maker's interest. Demand promissory notes are notes that do not carry a specific maturity date, but are due on demand of the lender. Usually the lender will only give the borrower a few days notice before the payment is due. Commercial papers are money market securities issued by large banks and corporations. They are generally not used to finance long-term investments but rather for purchases of inventory or to manage working capital. It is commonly bought by money funds (the issuing amounts are often too high for individual investors), and are generally regarded as a very safe investment. As a relatively low risk option, commercial paper returns are not large. Securities include other tradable commercial papers for debts are bills of

exchange (drafts), checks, and certificates of deposit where not covered by a preceding definitions of exempt services;

(d) Euro debt securities: Euro debt securities come under the definition of exempt securities; Euro debt securities are securities issued internationally outside their domestic market in a denomination different from that of the issuer's domicile. They include Eurobonds and Euronotes. Eurobonds are characteristically underwritten, and not secured, and interest is paid gross. A Euronote may take the form of Euro-commercial paper (ECP) or Euro-certificates of deposit.

(3) hybrid securities, including preference shares, equity warrants, convertible instruments in the form of bonds or preferred stock which may be converted into the common stock of the issuing company;

Hybrid securities combine characteristics of equity and debt securities; they exist in a variety of forms:

(a) Preference shares: Preference shares form an intermediate class of security between equities and debt. If the issuer is liquidated, they carry the right to receive interest and/or a return of capital in priority to ordinary shareholders. However, from a legal perspective, they are capital stock and therefore may entitle holders to some degree of control depending on whether they contain voting rights;

(b) Convertibles: Convertibles are bonds or preferred stock which can be converted, at the election of the holder of the convertibles, into the common stock of the issuing company. The convertibility, however, may be forced if the convertible is a callable bond, and the issuer calls the bond. The bondholder has, for example, about 1 month to convert it, or the company will call the bond by giving the holder the call price, which may be less than the value of the converted stock. This is referred to as a forced conversion;

(c) Equity warrants: Equity warrants are options issued by the company which allow the holder of the warrant to purchase a specific number of shares at a specified price within a specified time. They are often issued together with bonds or existing equities, and are, sometimes, detachable from them and separately tradable. When the holder of the warrant exercises it, he pays the money directly to the company, and the company issues new shares to holder. Warrants, like other convertible securities, increases the number of shares outstanding, and are usually accounted for in financial reports as fully diluted earnings per share, which assumes that all warrants and convertibles will be exercised.

(4) instruments recording unit ownership in undertakings for collective investment such as open and closed-ended funds, exchange traded funds, mutual and pension funds, hedge funds and real estate investment funds.

Instruments recording unit ownership in undertakings for collective investment: An undertaking for collective investment (investment fund) is a collective investment scheme for investing money with other people to participate in a wider range of investments than may be feasible for an individual investor and to share the costs of doing so. Such collective investments aim either targeting specific geographic regions such as emerging Europe or specified themes such as technology. Services generating unit ownership in such funds are exempt supplies of securities where these funds invest into exempt securities; other exempted financial instruments referred to in Article 135(1) (a) to (d) or other investment funds. Such funds exist in various forms:

(a) Open-ended funds, also referred to as unit trusts, Open-ended investment companies or SICAVs (Société d'investissement à capital variable) and pooled funds (fonds communs de placement), which are basically open partnerships, as well as other common funds and registered UCITS vehicles ("Undertakings for Collective Investment in Transferable Securities") are covered by the definition of investment funds because they represent a collective investment which can issue and redeem shares at any time making them a tradable instrument; an investor can purchase shares in such funds directly from the mutual fund company or through a brokerage house; they are mutual funds equitably divided into shares or units which vary in direct proportion to the variation of the value of the funds net asset value. Every time money is invested, new shares or units are created to match the prevailing share price and each time shares are redeemed, the assets sold match the prevailing share price. In this way there is no supply or demand created for shares and they remain a direct reflection of the underlying asset;

(b) Exchange Traded Funds (ETFs) are covered by the definition of investment funds because they are open ended mutual funds which can be traded at any time and they are typical funds investing into equities because typically ETFs replicate a stock market index such as Euro Stocks or a market sector such as clean energy technologies. ETFs include index-linked and actively managed funds regardless of whether they pursue dynamic or rather static indexing investment strategies;

(c) Closed-ended funds are covered by the definition of investment funds because they follow the same investment principles and usually the shares of these funds are traded on an exchange or directly through the fund manager to create a secondary market subject to market forces and in accordance with demand they are traded at a premium or at a discount to their net asset value;¹⁵

(d) Mutual funds: Mutual funds are forms of collective investment which pool money from many investors and then invest their money in securities realising capital gain or loss and collecting dividend or interest income; these investment proceeds are then passed on to the individual investors;

(e) Pension funds: A pension fund is a pool of assets forming an independent legal entity which are bought with the contributions to a pension plan for the exclusive purpose of financing pension plan benefits. This includes private and public open

¹⁵ Judgement of the Court of 28 June 2007 (Case C-363/05, JP Morgan

pension funds with no restriction on membership and closed pension funds limited to certain categories of members, such as single and multi-employer pension funds, related members and individual pension funds;

(f) Hedge funds: A hedge fund is an investment fund charging performance fees and typically only opens to a limited range of investors, in some countries only open to accredited investors. Though these funds do not necessarily hedge their investments against adverse market moves the term is used to distinguish them from regulated retail investment funds;

(g) Real estate investment funds: A real estate investment trust is a corporation investing in real estate that reduces or eliminates corporate income taxes. In return REITs are usually required to distribute a certain percentage, usually 90% of their income, which then may be taxable in the hands of the investors. The REIT structure was designed to provide a similar structure for investment in real estate as mutual funds provide for investments in shares.

(jj) intermediation in insurance and financial transactions

Under Article 135a (9) of Directive 2006/112/EC "intermediation in insurance and financial transactions" means the supply of services rendered to, and remunerated by, a contractual party as a distinct act of mediation in relation to the insurance or financial transactions referred to in points (a) to (e) of Article 135(1), by a third party intermediary.

These provisions focus exclusively on those services where the mediator is remunerated by a contractual party; such a party can be the supplier or the client of an exempt insurance or financial service supply, but also any third person. That explains that also sub-contracting scenarios of intermediation are covered by the exemption.

This provision is complemented by Articles 10 and 11 of the Regulation which provide for the following:

1. For the purposes of point (9) of Article 135a of Directive 2006/112/EC, an activity shall constitute a distinct act of mediation at least where one or more of the following conditions is fulfilled:

(a) the intermediary has the authority to bind the supplier or the customer of the exempt insurance or financial service;

The second criterion to be applied is to examine whether the service provided contained the possibility to oblige the supplier or the client of the exempt insurance or financial service contractually; where this is the case, the service qualifies as intermediation; where this is not the case, the second criterion under b) needs to be verified.

- (b) the activity may result in the creation, continuation, alteration or extinction of parties' rights and obligations in respect of an exempt insurance or financial service;

The second positive criterion is to verify whether the services may create, continue, alter or extinguish parties' rights and obligations in respect of an exempt insurance or financial service; where this can be established, the services qualifies as exempt intermediation. These are services which have a direct impact on rights and obligations of parties and establish a causal link, because without that intermediation these changes in the financial situation would not have taken place. The same principles apply where intermediation leads to the client abandoning his withdrawal from a contract and him continuing his contract. In fact, in modern intermediation, the activities for accompanying clients in continuing their contracts have even become more important than intermediation for the conclusion of contracts; where this cannot be established the next criterion must be verified

- (c) the activity consists in the provision of advice which reflects specialised knowledge regarding an exempt insurance or financial service.

This criterion verifies whether the service provided contains a certain level of advice reflecting a superior know-how of the mediator; where this is the case, the service qualifies as intermediation;

2. Where in situations other than those covered by paragraph 1, a service is standardised in such a way that a person may provide it on the basis of prior instructions, it shall not constitute a distinct act of mediation for the purposes of point (9) of Article 135a of Directive 2006/112/EC.

For other services the forth – negative - criterion applies and it must be verified whether the service provided was standardised to the extent that, for example, a student could provide it on the basis of prior instructions; in this case the service does not qualify as exempt intermediation. However, there will certainly be cases which are not covered by any of the positive and negative criteria and which qualify for the exempt intermediation.

3. The definition of "intermediation in insurance and financial transactions" provided for in point (9) of Article 135a of Directive 2006/112/EC shall cover at least the following:

- (a) the supply of services involving negotiation on the conditions of the product;

Services involving negotiation on the conditions of the product: such services are usually activities requiring special know-how of a mediator and a need for making choices which require that know-how; they cover scenarios where, for example a weekly travel magazine negotiates with an insurer special rates of insurance cover for its subscribers against sickness travel cancellation. The magazine sets out the full details of what is covered or excluded and the price of the insurance. The subscribers can then either complete a coupon in the magazine and send it with a cheque to the insurer or telephone the insurer quoting a reference published in the magazine with their credit card details. The magazine receives commission for each policy taken up plus a separate payment for

agreeing to help market the product. In such a scenario the commission reflects the supply of intermediation services;

- (b) stock and mortgage brokering.

Stock brokering services usually cover scenarios where the broker sells or buys stock on behalf of a customer. The stock broker matches up stock buyers and sellers. A transaction on a stock exchange must be made between two members of the exchange, typically a broker. In addition to actually trading stocks for their clients, stock brokers may also offer advice to their clients on which stocks, mutual funds, etc. to buy. A Stock broker also sells or buys stock on behalf of a customer. The same principles apply, of course, where other persons than stockbrokers are supplying the same services;

4. The definition of "intermediation in insurance and financial transactions" provided for in point (9) of Article 135a of Directive 2006/112/EC shall not cover the following:

- (a) standardised services provided by call-centres;

Such services include services with automated procedures for the calculating of insurance coverage costs or casts for financial; they are automated contact points for scenarios where a supplier of insurance or financial services advertises standardised contracts, for example a critical illness cover. The advert contains a telephone number for potential customers to use. The insurer pays an outsourcer to handle calls from potential policyholders responding to the advertisement. The outsourcer has to explain the scope of the policy and, after inputting details provided by the callers, use an automated computer program to calculate the cost of insurance cover. The outsourcer has to pass the name of the person who wishes to be insured to the insurer who after carrying out further checks places the insured on risk. The outsourcer is not supplying intermediation services because in such scenarios there is no distinct act of mediation requiring know-how of a mediator and no need for making choices which require that know-how; on supplying telephone or call-centre services the outsourcer acts rather like an automated administrative front-desk of the supplier by just going through the standard list with potential client;

- (b) brand hosting, web-hosting, other web-services or hosting service;

Brand hosting are services supplied by persons who do not interfere in the process of establishing a link between the suppliers of exempt services and their clients; basically they supply platform services where, for example, a bank advertises travel insurance underwritten by an unrelated insurer but using the bank's name. When the customers telephone for a quote, although they are told that they have contacted the bank, the call operators are actually employed by the insurer whose employees carry out all the administration including putting the policyholder on risk. The bank receives both a fixed fee plus a payment for each successful sale. Such services basically have the character of platform marketing by using a trademark or brand different from that of the actual supplier. There is no distinct act of mediation;

Web-hosting, other web-services or hosting service cover services such as the following: Under web-hosting an airline web site offering cheap flights might for example contain a button via which a customer can purchase travel insurance; clicking on the web site will lead the customer to an insurer's web site. The website receives commission for each click through, whether insurance is taken up or not. The service provided by the website is not intermediation. Other web-services are, for example, services where a car retailer's web site offers goods. As an added extra the customer can purchase liability insurance by clicking on the web site, which then leads the customer to an insurer's web site. The website is paid an agreed fee to host the insurer's click through but receives no additional payment whether insurance is taken up or not. In other hosting services, for example, a supermarket provides leaflets for motor insurance with both a website address and a telephone number. If the customer telephones the person receiving the call, who is employed by the insurer, can identify that the number telephoned is the one on the leaflet provided by the super market. The supermarket receives a fee for each sale. In all these scenarios there is no distinct act of mediation

(c) advertising and other information services.

Advertising services are marketing services which do not require a distinct act of mediation; such services would cover scenarios where a shop provides leaflets for credit services with both a website address and a telephone number. If the customer telephones the person receiving the call, who is employed by the bank, can identify that the number telephoned is the one on the leaflet provided by the shop. The shop receives a fee for each concluded contract. In other cases the customer uses the web site; the details are collected by the shop and passed on to the bank. A fee is again received for every sale. Such services are not intermediation;

Other information services provide information about a financial or insurance product and, as the case may be, receiving and processing applications for subscription, without issuing them. Such services are administrative handout or information transfer activities which do not represent a distinct act of mediation.

(kk) Investment funds

Under Article 135a (10) and (11) of Directive 2006/112/EC

- "investment funds" means undertakings for collective investment in the exempted financial instruments referred to in points (a) to (e) of Article 135(1) and in real estate and

- "management of investment funds" means activities aimed at realising the investment objectives of the investment fund concerned.

These provisions are complemented by Article 12 of the Regulation which provides for the following:

1. The definition of "management of investment funds" provided for in point (11) of Article 135a of Directive 2006/112/EC shall cover at least the following:

(a) strategic and tactical asset management and asset allocation, including currency and risk management;

Strategic and tactical asset management and asset allocation plays a role in portfolio construction for institutional investors and in funds in particular. When market volatility spikes, the natural reaction for investors often is to run for the exits. Strategic and tactical asset allocation basically consists of establishing a larger plan, a longer-term view and a steady hand which to overcome shorter term volatility of markets and create new opportunities to maximise returns; this technique adopts a longer term investment view while paying close attention to an investor's cash flow requirements and securing positive absolute returns through a wide range of short-term strategies. It consists of the following elements:

- Plotting the client's investment position: the risk/return objective, risk tolerance, liability and cash flow profiles and the regulatory framework for example;
- Mapping the route to the investment objective: For a fund, whether it is a defined contribution (DC) or defined benefit (DB) scheme is a further factor in deciding how to allocate assets strategically;
- Assessment of "Assets' past performance, the impact of market shocks, risk tolerance levels, economic fundamentals;
- Determining the diversified investment portfolio on the basis of expected long-term returns, asset correlations and estimates of risk, analysing the "DNA" of assets, their growth potential, their short-term volatility characteristics, their diversification benefits as well as their hedging characteristics.

Logically, there is usually room in such a portfolio for short-term strategies to add "alpha" returns. These can come, for instance, from the fund manager's skill to actively exploit return differentials between and across asset classes, markets, investment styles, currencies and commodities. This can be done through tactically pairing short and long positions with a horizon of up to one year. This, in other words, is tactical asset allocation. In general this involves having a global scope and using a wide range of opportunities with a large, diversified array of risk/return cycles. The focus is mostly on markets and indices rather than on individual stocks, adding that instruments such as futures and exchange-traded funds allow for low-cost and scalable, liquid and flexible exposure.

A key feature for recognising strategic and tactical asset management and asset allocation is that it is not too concerned with low-probability events. Its stance is to accept volatility and construct "all-weather" portfolios where a steady-hand policy limits portfolio turnover and management costs and where volatility translates into opportunities to actively earn returns from market inefficiencies.

- (b) operational asset management, including stock selection, decision making and implementation, decisions to buy and sell investments, netting of trades, pre-trade broker liaison, administration and control of trades and post-trade liaison with brokers and custodian;

Operational investment management is the professional management of various securities (shares, bonds etc) assets (e.g. real estate) in funds to meet specified

investment goals for the benefit of the investors. The term asset management is used to refer to the investment management of collective investments, whilst the more generic fund management may refer to all forms of institutional investment as well as investment management for private investors. It includes elements of financial analysis, asset selection, stock selection, plan implementation and ongoing monitoring of investments.

(c) guarantee provision, including the operation of a hedging portfolio;

The best way to understand the provision of guarantee and operating a hedging portfolio is to think of it as insurance against a negative event. This doesn't prevent a negative event from happening, but if it does happen and you're properly guaranteed (hedged), the impact of the event is reduced. So, guaranteeing (hedging) occurs almost everywhere, and we see it everyday. Fund managers use guaranteeing (hedging) techniques to reduce their exposure to various risks. In financial markets, however, hedging becomes more complicated than simply paying an insurance company a fee every year. Guaranteeing (hedging) against investment risks means that the fund manager uses instruments in the market to offset the risk of any adverse price movements. In other words, fund managers guaranty (hedge) one investment by making another. Technically, to hedge you would invest in two securities with negative correlations. Of course, one still has to pay for this type of insurance in one form or another. A reduction in risk will always mean a reduction in potential profits. So, hedging, for the most part, is a technique not by which one will make money but by which one can reduce potential loss. One will have typically have reduced the profit that the fund could have made, and if the investment loses money, the hedge will be successful and reduce that loss.

(d) administration of shares or units, including distribution and trustee liaison;

(e) arranging and processing loans of stocks and bonds;

(f) fund order processing, including automated processing;

(g) market and company analysis;

(h) performance measurement, including the provision of investment performance reports and attribution analysis of returns;

A mutual fund's performance can be measured in several different ways, depending on its investment objectives. Whether a fund aims for long term growth, current income, or a combination of the two, managers can track fund performance and judge profitability by:

- Following changes in share price or net asset value (NAV)
- Calculating total return
- Figuring yield

While each calculation enables the fund manager to compare a fund's performance to similar funds offered by different companies, there is no simple calculation for comparing funds to individual securities, because each return is figured differently depending on the type of investment.

- (i) the provision of valuations, tax refund claims and management information and the calculation of the net asset value;
- (j) safe custody, security safe-keeping and control;
- (k) oversight of the fund by the depositary;
- (l) payment of income to customers and proxy voting.

2. The definition of "management of investment funds" provided for in point (11) of Article 135a of Directive 2006/112/EC shall not cover the following:

- (a) external audit of the fund, marketing and management of fund overheads;

These are services for the control and supervision of the fund's activities;

- (b) development of systems, such as planning and implementation of new technology, major enhancements to existing systems and systems maintenance;

This includes services like planning and implementation of new IT (information technology) and major enhancements to existing systems, systems maintenance such as operational and technical maintenance of existing IT;

- (c) services relating to regulatory compliance.

These are services supplied in accordance with the regulatory requirements regarding the conduct of business or sale of investment funds; they are services which ensure the proper monitoring of funds and are thus part of services for the control and supervision of their activities;

(II) Constituent elements

Under Article 135 (1a) of Directive 2006/112/EC the exemption for financial and insurance services also applies to the supply of any constituent element of an insurance or financial service, which constitutes a distinct whole and has the specific and essential character of the exempt service. This provision is complemented by Article 13 - 20 of the Regulation which provide for the following:

Article 13

1. For the purposes of Article 135(1a) of Directive 2006/112/EC, at least the following shall be considered to have the specific and essential character of an exempt service:

- (a) portfolio management;

These are services for the financial constitution, operation and termination of a bouquet of exempt insurance and/ or financial products to meet specified investment goals for the

benefit of the investors; it allows, for example, to manage the investment risks linked to the acquired securities and limit that risk by spreading the investment over several securities in the portfolio; it also allows to optimise the investment by eliminating less performing securities from the portfolio and replacing them by acquiring better performing securities; in the concrete case portfolio management thus possesses the specific and essential character of an exempt supply of securities. However, the importance of portfolio management goes beyond such specific case scenarios; it is a typical and classic tool for the management of the investment risks for all exempt insurance and financial services; it allows the investor to pursue his own individual and specific investment strategy which can be risk-friendly or based on security aspects and it is a fundamental tool in controlling the investment and investment returns. Therefore it has the essential and specific character of all exempted insurance and financial services.

- (b) the issuance of contracts and certificates evidencing the title of the customer of an exempt insurance or financial service;

Issuing of contracts and certificates are services for supplying the paper or electronic versions of contracts for the supply of contracts which enable the client of an exempt insurance or financial service to prove his title to the exempt insurance or financial product;

- (c) the cession, renewal, amendment and rescission of contracts relating to an exempt insurance or financial service;

Services for the cession of contract are services changing the creditor or debtor position of a contract for the supply of exempt insurance or financial services; Services for the renewal of contracts are services for the extending of a contract for the supply of exempt insurance or financial services to another contract period; Services for amendments including prolongations of contracts are services for changing provisions of a contract for the supply of exempt insurance or financial services; rescissions services are services for terminating the duration or application of a contract for the supply of exempt insurance or financial services; such services change the legal situation of the contract concerned;

- (d) credit rating services, including the assessment of the credit worthiness of a supplier or customer of insurance or financial services;

Credit rating services, including assessing credit worthiness are services issuing opinions on the creditworthiness of a particular issuer or customer of insurance and financial instruments, assessing the likelihood that a person will default either on its financial obligations generally or on a particular debt relating to the supply of an exempt insurance or financial service;

- (e) valuation of financial collateral.

Such services evaluate the value of a financial collateral for being supplied with an exempt insurance or financial service; such services have an impact if and to which extent the financial and legal situation can change; they are usually decisive on whether a supplier can accept that collateral and supply the exempt service, for example a credit or an insurance and under which conditions he can accept the risk of supplying an exempt

insurance or financial service or whether he must use additional means; such services are similar to credit rating;

2. For the purposes of Article 135(1a) of Directive 2006/112/EC, the following shall not be considered to have the specific and essential character of an exempt service:

(a) safekeeping;

Safekeeping consists of logistic storing services; these are mere physical, technical and administrative service, which do not alter the legal or financial situation;

(b) administrative tasks;

Such services involve handling activities¹⁶ such as the acceptance of applications for insurances and financial services, the setting and paying of commission to mediators, the organisation and management of information technology, the supply of information and the drafting of reports for contract parties; they include services like sending out of documentation to policy- and contract holders, record policy and contract as well as client details in systems and dealing with policy and contract holder queries or queries of economic operators participating in the exempt supply; such services are mere material or technical supplies which do not change the legal or financial situation;

(c) debt collection or recovery;

Debt collection and recovery are services which are usually but not exclusively supplied to the suppliers of exempt insurance services, typically in situations where the client or the debtor of these exempt services does not fully comply with his payment obligations or has become illiquid; in such cases the supplier of the exempt insurance or financial services in default, for example the grantor of a credit, remains in the creditor's position; such services are mere material or technical supplies which do not change the legal or financial situation between the supplier and the client of the exempt financial or insurance services;

(d) legal services, accountancy, audit and bookkeeping;

Legal services are services for the legal and/or fiscal advice and consultation; accountancy services are services for the measurement, disclosure or provision of assurance about financial information primarily used by managers and other decision makers to make resource allocation decisions within companies or organisations; book-keeping is the recording of all financial transactions undertaken by an individual or organisation;

(e) services relating to regulatory compliance;

¹⁶ Judgement of the Court of 3 March 2005 (Case C-472/03) Arthur Andersen

These are inter alia services for complying with capital, financing, book-keeping, transparency, registration and solvency requirements, they include the reviewing of procedures;

- (f) identity verification, money laundering and anti-fraud checks;

Identity verification and money laundering checks and anti-fraud checks are services preventing a criminal misuse of insurance and financial products for purposes other than those agreed upon and help keeping deposits within agreed contractual parameters;

- (g) data collection services for the recycling of banknotes and coins;

Such services are provided for by the European Central Bank and national Central Banks. Central Banks have introduced a framework for the recycling of banknotes under which credit institutions and other professional cash handlers, as addressees by the Framework, shall regularly supply National Central Banks with general information on recycling and cash centres, statistics on the volume of cash operations, information on machines used for recycling purposes and automated teller machines; and information on remote bank branches with a very low level of cash operations, where fitness checks are carried out manually;

- (h) marketing, research, identification and development of new products or opportunities;

Research consists of services for the fundamental technical and economic and analysis of insurance and financial services and the company providing them; identification and development of new products/opportunities usually involve looking at market trends and the fiscal regime to identify new selling opportunities; these services are in general analytical and of a preparatory nature and have a vague character which makes it difficult to link them specifically to an exempt insurance or financial services product. They may involve the design of a new products or the tweaking of a current products for a particular market to supply services which comply with the needs of clients. However, being supplied at a preparatory stage, these services do not change the legal or financial situation;

- (i) the supply and design of software;

Software design and supply of software consists of the provision of computer programs that control the operation of the computer hardware. In this context the software is generally specific to the requirements of the insurance or banking business and is not generally available. Such services give the operators an information technology tool enabling him to supply insurance and financial services with the help of this software;

- (j) hire of security boxes and other secured spaces;

These are services which are related to safe hiring services, which are excluded under Article 135 point 2. (d) of the Directive; such services are mere material or technical supplies which do not change the legal or financial situation between the supplier and the client of the exempt financial or insurance services;

- (k) services which grant the right or the option of receiving goods or services.

These usually involve the supply of derivatives, for example commodity derivatives, which contain the possibility that either the supplier or the acquirer of that derivative becomes the owner of the underlying goods or taxable services;

Article 14

1. The following shall be considered to be services having the specific and essential character of "insurance and reinsurance" as defined in point (1) of Article 135a of Directive 2006/112/EC:

- (a) underwriting of risk;

Such services consist of an assessment of the insurance risk and the underwriting of the insurance proposals, putting the insurer "on risk"; the risk passes from the insured to the insurer. Without such services no insurance commitment would be established; these services change the legal and financial situation;

- (b) risk and investment management;

Risk management consists of the review of the insurer's exposure to risk and verifying options such as reinsurance, product mix or derivatives to reduce them to the required level; without such services the insurer could not accept the risk; these services change financial situation in a way which allows the insurer to take over the risk; these services are at the heart of creating a financial situation allowing the insurer to accept a risk; investment management consists of the management of the investment portfolio to ensure that the investment return matches the liabilities of the insurer; in fact, it is the return from the investment portfolio and the amount of the earned premium which are essential for the insurer in supplying the policy and accepting the risk transfer;

- (c) claims handling;

Claims handling services consist of reviewing claims received to ensure they are covered by the policy, clearing and settlement, including agreeing the amount of the claim with policyholder and paying the claim. In reality this service requires the claim handler to have the full picture of contractual obligations and contractual insurance standards involved; on this basis the claims handler verifies whether the reported facts are coming under the risk profile covered by the policy (it is there where the claim handler's know-how lies!) and oblige the insurer to compensate; the claims handler then negotiates the amount with the policy holder and pays the agreed amount. Claims handling does not involve a risk transfer but it is so closely linked to risk covered by the insurance that it still and recognisably has the specific and essential character of the exempt insurance service. (Some lawyers in the Commission's Legal Service were sceptic about this approach.)

- (d) the issuance of non-tradable insurance derivatives.

These are services supplying a financial contract whose payoffs over a period of time are derived from the performance of insurance commitments. This performance can determine both, the amount and the timing of the payoffs; these payoffs can be in cash or in the delivery of the underlying insurance commitment/(s).

2. Damage assessment shall not be considered to be a service having the specific and essential character of "insurance and reinsurance" as defined in point (1) of Article 135a of Directive 2006/112/EC.

These services consist of estimating the damage of an event and compiling a report containing a description of the total expenses involved in repairing the damage and/ or the amount to be paid as indemnification.

Article 15

The following shall be considered to be services having the specific and essential character of "granting of credit" as defined in point (2) of Article 135a of Directive 2006/112/EC:

(1) the measurement, the prediction and the control of credit risks and losses due to credit risk, including credit strategy;

These are services required for assessing whether it is possible to enter into a credit contract and under which conditions; during the period of application of the contract these services allow the tracking of the constantly changing financial situation and possibly also the legal situation with the instalments being paid or not being paid as provided for by the contract. These services are often referred to as consumer/retail credit risk management; A common method for predicting credit risk is through the credit scorecard. The scorecard is a statistically based model for attributing a number (score) to a customer (or an account) which indicates the predicted probability that the customer will exhibit a certain behaviour. In calculating the score, a range of data sources may be used, including data from an application form, from credit reference agencies or from products the customer already holds with the lender. Credit strategy is concerned with turning predictions of customer behaviour (as provided by scorecards) into decisions. To turn an application score into a Yes/No decision "cut-offs" are generally used. A cut-off is a score at and above which customers have their application accepted and below which applications are declined;

(2) underwriting of credits;

These are services for taking decisions on credit applications on behalf of the grantor along pre-agreed lines. Not all decisions can be made easily. This may be for a number of reasons; insufficient data, regulatory requirements, or a borderline decision. In such cases highly trained professionals called underwriters manually review the case and make a decision. This is more common in highly regulated products such as mortgages, especially when large sums are involved. Such services also have a direct impact on whether a supplier can accept the risk of granting credit;

- (3) record keeping, arrangement and monitoring of payments made for a credit;

During the period of application of the contract these services allow the tracking of the constantly changing financial situation and possibly also the legal situation with the instalments being paid or not being paid as provided for by the contract. Where instalments are not paid as provided for, the creditor might opt for exercising his right of claiming back the credited amount immediately or to commercialise distrainers;

- (4) the issuance of credit derivatives;

These are services supplying a financial contract whose payoffs over a period of time are derived from the performance of credits. This performance can determine both, the amount and the timing of the payoffs; these payoffs can be in cash or in the cession of the underlying credit/(s);

- (5) valuation of non-financial collateral.

Such services consist of the valuation of real values such as mortgages, motor cars, trademarks etc.; these are services required for assessing whether it is possible to enter into a credit contract and under which conditions or whether he can continue the contract; as such they change the change the legal and financial situation of a credit.

Article 16

1. The following shall be considered to be services having the specific and essential character of "guaranteeing of debts" as defined in point (3) of Article 135a of Directive 2006/112/EC:

- (a) arrangement and monitoring of means for guaranteeing a debt;

These are services which the supplier carries out as a part of fulfilling his contractual obligations and prove his rights under the contracts; they change the financial and legal situation;

- (b) credit guaranteeing derivatives.

These are services supplying a financial contract whose payoffs over a period of time are derived from the performance of credits. This performance can determine both, the amount and the timing of the payoffs; these payoffs can be in cash or in the cession of the underlying credit/(s);

2. The sale of repossessions after mortgage default shall not be considered to be a service having the specific and essential character of "guaranteeing of debts" as defined in point (3) of Article 135a of Directive 2006/112/EC.

Sales of repossessions after mortgage default represent the utilisation of the means used for safeguarding a credit when a granted credit has become default;

Article 17

The following shall be considered to be services having the specific and essential character of transactions concerning "financial deposit" as defined in point (4) of Article 135a of Directive 2006/112/EC:

- (1) sorting and counting of money for the purpose of making a deposit;

Such services contribute directly to the deposit being made and the correct amount being registered; they change the financial situation and affect the responsibility of the person accepting the deposit;

- (2) reporting on the balances of deposits and calculation of interest, production of statements of account and carrying out of commitment overviews;

These are services carried out in executing direct contractual obligations which affect the legal responsibilities under contract; they also allow monitoring the changing financial situation;

- (3) calculation of tax and fees with regard to the cancellation of pension saving plans;

Pension saving plans are long-term financial deposits services where the compounded interests, preferential tax treatments and low fees for the bank are characteristic elements. Therefore the clients of such deposit services are in a long-term contractual obligation. Where such a savings plan is cancelled the long-term structure of the investment is given up and complex interest calculations, extrapolating the beneficial long-term tax effects as well as corrections of the initial fees become necessary. Such calculations of tax and fees with regard to the cancellation of pension saving plans are services supplied for ensuring that pension saving plans can be terminated properly and that the deposited money can be paid out as agreed in the contract. Such calculations services therefore still and recognisably have the specific and essential character of the exempt pension saving plan service. (Some lawyers in the Commission's Legal Service were sceptic about this approach.)

- (4) budgeting of accounts, including economic feasibility studies for appraisal of customers' requirements;

These services are supplied for ensuring that the deposits are properly composed and structured in accordance with the needs of a specific client; they change the financial situation for the client and reduce the legal responsibilities of the service provider;

- (5) safekeeping of certificates for deposits;

These are services ensuring that CDs are presented at the date of maturity and either liquidated or used for making another deposit or an investment. In this sense safekeeping contributes to realising the objective of the deposit. In some cases suppliers of "deposit services" pool the supply of specific deposits;

- (6) automated acceptance of money for deposits;

Accepting of money for deposits usually consists of services supplied by help of machines which allow clients to make deposits outside the normal office hours such as night-safes allowing to deposit the daily intake or other machines allowing the deposit of cash money; they change the financial situation;

- (7) the issuance of deposit derivatives.

These are services supplying a financial contract whose payoffs over a period of time are derived from the performance of one or more deposits. This performance can determine both, the amount and the timing of the payoffs; these payoffs can be in cash or in the cession of the underlying deposit/(s).

Article 18

1. The following shall be considered to be services having the specific and essential character of "account operation" as defined in point (5) of Article 135a of Directive 2006/112/EC:

- (a) services between operators for the transfer of funds between monetary accounts and clearing of the transfer;

These are services such as merchant transaction services, credit card terminal services and interchange services; by accepting a customer's plastic cards, merchants pay electronic transaction fees imposed by credit-debit card associations. Credit card terminal services organise the onward supply of the credit card transaction and are a necessary step to complete the payment process; Interchange services is a term used in the payment card industry to describe the service of accepting their credit and debit cards for purchases; the card-[issuing bank] in a payment transaction deducts the interchange fee from the amount it pays the [acquiring bank] that handles a credit or debit card transaction for a merchant. The acquiring bank then pays the merchant the amount of the transaction minus both the interchange fee and an additional, smaller fee for the acquiring bank. Interchange fees have a complex pricing structure, which is based on the card brand, the type of credit or debit card, the type and size of the accepting merchant, and the type of transaction (e.g. online, in-store, phone order). Further complicating the rates schedules, interchange fees are typically a flat fee plus a percentage of the total purchase price (including taxes). Often the fee averages approximately 2% of transaction value. Such services are linked to the bank account of the merchant and enable the transfer of funds and the clearing of the transactions. These are services changing the financial and legal situation;

- (b) membership, joining or subscription services for payment cards or systems for an account;

Such services give access to a system of account operation services;

- (c) control services with safety features for the proper processing of transfers of funds between monetary accounts;

These services reduce the legal and pecuniary responsibility of the processor;

- (d) the issuance of customer and merchant statements;

The issue of customer and merchant statements for accounts ensures essential information on the functioning of the accounts and appropriate communication between the supplier of account operation services and the client; they change the legal situation by reducing the responsibilities of parties involved and prevent disputes on the financial situation by settling it;

- (e) verification of payments;

These are services ensure the proper functioning of transfers of funds via accounts and reduce the legal exposure of the supplier of account operation services;

- (f) the issuance of cheque books for a specific account.

The issuing of cheques books for a specific account allows the client to organise another form payment via this account; they extend the scope of financial transactions.

2. The following shall not be considered to be services having the specific and essential character of "account operation" as defined in point (5) of Article 135a of Directive 2006/112/EC:

- (a) general printing of cheque books;

These are services where cheques are printed and where the individual account to which they relate is not yet added to the cheques;

- (b) the supply of blank cards;

These services consist of supplying cards which are not yet individualised as referring to a specific customer and his account;

- (c) internet hosting;

Internet hosting fees are paid for general services which are offered for a variety of businesses and purposes; they are not related to specific accounts;

- (d) the rental of terminals and other machinery for the processing of card payments.

These are general services improving the conditions under which "account operation services" can be supplied; such processing equipment is used in a variety of business sectors with varying software and their supply does not alter the financial or legal situation in respect of a specific monetary account.

Article 19

1. The following shall be considered to be services having the specific and essential character of "exchange of currency" or "provision of cash" as referred to in point (d) of Article 135(1) of Directive 2006/112/EC:

- (a) the issuance of customer and merchant statements for the exchange and the distribution of bank notes and coins;

These are services carried out for ensuring the correctness of transactions and they settle the legal responsibilities and the financial situation;

- (b) operating services for cash machines supplied between financial institutions;

Operating services for cash machines are comparable to exempt interchange services supplied between credit card operators; they are supplied to ensure the transfer and clearing between financial institutions of funds dispensed by cash machines. This includes settlement of accounts following the distribution of banknotes and coins (e.g.: credit card exchange services following the distribution of cash money via a cash machine or manually and where not already covered by bank account operation services). Such services are not only essential and specific elements of exempted cash services but the core element of modern cash services. (Some lawyers in the Commission's Legal Service were sceptic about this approach.)

- (c) the issuance of spots, forward transactions, futures, currency swaps, foreign exchange options and forex swaps;

These are supplies of derivatives. A spot transaction is a two-day delivery transaction. This trade represents a "direct exchange" between two currencies, has the shortest time frame, involves cash rather than a contract; and interest is not included in the agreed-upon transaction. Another way to deal with the foreign exchange risk is to engage in a forward transaction. In this transaction, money does not actually change hands until some agreed upon future date. A buyer and seller agree on an exchange rate for any date in the future, and the transaction occurs on that date, regardless of what the market rates are then. The duration of the trade can be a few days, months or years. Foreign currency futures are usually forward transactions with standard contract sizes and maturity dates — for example, 500,000 EURO for next November at an agreed rate. Futures are standardized and are usually traded on an exchange created for this purpose. The average contract length is roughly 3 months. Futures contracts are usually inclusive of any interest amounts. Another common type of forward transaction is the currency swap. In such a swap, two parties exchange currencies for a certain length of time and agree to reverse the transaction at a later date. These are not contracts and are not traded through an exchange. A foreign exchange option is a derivative where the owner has the right but not the obligation to exchange money denominated in one currency into another currency at a pre-agreed exchange rate on a specified date. A Forex swap is an over the counter short term interest rate derivative. It consists of a spot foreign exchange transaction entered into at exactly the same time and for the same quantity as a forward foreign exchange transaction. The forward portion is the reverse of the spot transaction, where

the spot purchase is offset by a forward selling. In this reason, surplus funds in one currency are for a while swapped into another currency for better use of liquidity. Protects against adverse movements in the forex rate, but favourable moves are renounced. The fixed rate in this transaction is the forward rate that is locked in by the forward contract. The floating rate will be the overnight rate that is realized on a daily basis by the spot transaction. Typically, the floating side of these trades is indexed to the Overnight Index Swap (OIS) rate. This rate is an average of the rates that are paid based on a survey;

(d) the issuance of exchange derivatives.

These are services supplying a financial contract whose payoffs over a period of time are derived from the performance of one or more currency exchange contracts. This performance can determine both, the amount and the timing of the payoffs; these payoffs can be in cash or in becoming the debtor or the creditor of the underlying currency exchange contract/(s).

2. The following shall not be considered to be services having the specific and essential character of "exchange of currency" or "provision of cash" as referred to in point (d) of Article 135(1) of Directive 2006/112/EC:

(a) safekeeping and storage of money;

Safekeeping and storage of money represent the supply of mere physical, technical or administrative services, which do not alter the legal or financial situation¹⁷ without altering the financial or legal situation in respect of currency exchange or cash services;

(b) courier and security transport services;

Such services do not consist in payments from one economic operator to another but rather ensure that, for example, the bank concerned disposes of sufficient cash for its over-the-counter-business or that cash in excess is transferred to a safe deposit. They represent the supply of mere physical, technical or administrative services, which do not alter the legal or financial situation¹⁸;

(c) the publication of information on exchange rates;

Publishing of information on exchange rates represent the supply of mere physical, technical or administrative services, which do not alter the legal or financial situation;

(d) the installation of cash machines.

Installing of cash machines only helps improving the conditions under which "currency exchange services" and "cash services" are supplied; they represent the supply of mere

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physical, technical or administrative services, which do not alter the legal or financial situation.

Article 20

The following shall be considered to be services having the specific and essential character of the "supply of securities" as defined in point (8) of Article 135a of Directive 2006/112/EC:

- (1) the issuance of options, futures and forward contracts for securities;

These are supplies of derivatives; in finance options are types of derivative contracts, including call options and put options, where the future payoffs to the buyer and seller of the contract are determined by the price of another security, such as a common stock. More specifically, a call option is an agreement in which the buyer (holder) has the right (but not the obligation) to exercise by buying an asset at a set price (strike price) on (for a European style option) or not later than (for an American style option) a future date (the exercise date or expiration); and the seller (writer) has the obligation to honour the terms of the contract. A put option is an agreement in which the buyer has the right (but not the obligation) to exercise by selling an asset at the strike price on or before a future date; and the seller has the obligation to honour the terms of the contract;

The supply of futures for securities is specific to and essential for the "supply of securities"; in finance, a futures contract is a standardized contract, traded on a futures exchange, to buy or sell a certain underlying security at a certain date in the future, at a specified price. The future date is called the delivery date or final settlement date. The pre-set price is called the futures price. The price of the underlying security on the delivery date is called the settlement price. The settlement price, normally, converges towards the futures price on the delivery date. A futures contract gives the holder the obligation to buy or sell, which differs from an options contract and which gives the holder the right, but not the obligation. In other words, the owner of an options contract may exercise the contract. Both parties of a "futures contract" must fulfil the contract on the settlement date;

The supply of forward contracts for securities is the supply of a service containing an agreement between two parties to buy or sell a security at a pre-agreed future point in time. Therefore, the trade date and delivery date are separated. One party agrees to buy, the other to sell, for a forward price agreed in advance. In a forward transaction, no actual cash changes hands. If the transaction is collateralized, exchange of margin will take place according to a pre-agreed rule or schedule. Otherwise no security of any kind actually changes hands, until the maturity of the contract. The forward price of such a contract is commonly contrasted with the spot price, which is the price at which the security changes hands. The difference between the spot and the forward price is the forward premium or forward discount. A standardized forward contract that is traded on an exchange is called a futures contract;

- (2) the issuance of equity swaps and other total return swaps in securities;

In the case of Equity SWAPS these are services where the underlying asset is a stock, a basket of stocks, or a stock index. Compared to actually owning the stock, in this case there is no obligation to pay anything up front, but there are also no voting or other rights that stock holders do have. A total return swap is a swap in which party A pays the total return of an asset, and party B makes periodic interest payments. The total return is the capital gain or loss, plus any interest or dividend payments. If the total return is negative, then party A receives this amount from party B. The parties have exposure to the return of the underlying stock or index, without having to hold the underlying assets. The profit or loss of party B is the same for him as actually owning the underlying asset.

Total return swap (also known as total rate of return swap, or TRORS) is a contract in which one party receives interest payments on a reference asset plus any capital gains and losses over the payment period, while the other receives a specified fixed or floating cash flow unrelated to the credit worthiness of the reference asset, especially where the payments are based on the same notional amount. The reference asset may be any asset, index, or basket of assets. The TRORS, then, allows one party to derive the economic benefit of owning an asset without putting that asset on its balance sheet, and allows the other (which does retain that asset on its balance sheet) to buy protection against a potential decline in its value;

- (3) the issuance of tradable debt derivatives, including interest rate swaps;

These are services supplying a financial contract whose payoffs over a period of time are derived from the performance of one or more tradable debt contracts. This performance can determine both, the amount and the timing of the payoffs; these payoffs can be in cash or in becoming the debtor or the creditor of the underlying securities, currency exchange contracts, deposits, credits or insurances; such services include the supply of commodity derivatives and indices derivatives which are not excluded by the Regulation;

- (4) performance measurement, rating, prediction and control of securities;

Performance measurement, prediction and control of securities are essentially services for managing the investment risk involved in the supply of securities; they determine the quality of a security over a specified period in time and determine its market value and – possibly – its share in an investment portfolio; it is an essential element of supplying a security and it relates to securities only. It also allows optimising investments by eliminating less performing securities from the portfolio and replacing them by acquiring better performing securities. We think that these elements reflect the specific and essential character of an exempt supply of a security. (Some lawyers in the Commission's Legal Service were sceptic about this approach.)

- (5) arrangement and monitoring of transactions under the security agreement, including possible voting rights.

Such services enable the client to exercise his rights in the company or association in which he holds an equity share; they change the legal situation by reducing the legal liability of the supplier and establish the financial situation.