



May 3, 2021

The Honorable Paolo Gentiloni
European Commissioner for Economic and Financial Affairs,
Taxation and Customs
European Commission
Rue de la Loi/Wetstraat 200
1049 Brussels
Belgium

Re: Comments on the Inception Impact Assessment for the VAT rules for Financial and Insurance Services

This letter is in response to the European Commission's February 8, 2021 request for comments from interested stakeholder groups in its Inception Impact Assessment. The United States Council for International Business (USCIB)¹ welcomes the opportunity to provide these comments to facilitate the Commission's project on this important VAT reform for the taxation of financial and insurance services (FIS) transactions.

Current Rules

In the European Union FIS supplies are generally exempt from VAT. FIS providers cannot deduct input VAT. This results in the input VAT being a final cost for FIS providers. The VAT rules on FIS in place today were introduced more than 40 years ago. In those days the impact of the VAT exemption on financial sector businesses was limited. Today, the exemption rule as originally designed is no longer fit for purpose. There have been, and continue to be, significant developments in the FIS industry over time, such as globalization, increased competition, automation, outsourcing, regulatory developments, increasing complexity of financial products and new players in the sector (Fintech), which have largely served the interests of the sector, both businesses and consumers alike. The most important issues for considering for a redesign of the VAT rules are mentioned below.

Distortion of Competition and Lack of Tax Neutrality as Between Insourced and Outsourced Environments

Complex regulatory change, data security/ privacy considerations, increasing competition from new digital Fintech entrants and technological advancements (e.g. blockchain, Artificial Intelligence, Machine Learning, digital assets) are major drivers for FIS suppliers to consider outsourcing certain functions or links in the financial value chain - this with a view to innovating at scale and ensuring the necessary expertise to successfully and securely adopt new processes and technology in order to support the digital transformation of the world's economy. However, the current VAT rules make it financially disadvantageous for FIS suppliers to seek external partners and to leverage outsourcing to enable the

¹ USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide and works to facilitate international trade and investment.

transformation into the digital economy. This is because when a FIS supplier outsources its internal functions, it faces the incremental cost of non-deductible input VAT at the applicable standard rate within the EU range of 15% to 27% (based on current standard VAT rates). The COVID crisis and a low growth, low interest world exacerbates existing concerns that this incremental cost may act as a disincentive to FIS suppliers investing and leveraging external partners in more productive and technologically advanced ways of doing business. Lack of investment in turn may inhibit the development of the FIS industry in the EU and, over the longer term, put at risk the EU FIS sector's ability to:

1. deliver innovative and secure new digital FIS solutions to EU consumers at a leading pace to stimulate the further development of the EU economy;
2. deliver these new digital services at a competitive price,
3. compete effectively on the global stage, and
4. leverage EU resources and employment to drive digital transformation (the VAT burden will drive FIS sector to low labor cost countries like India)

The current VAT rules therefore lead to missed opportunities for FIS providers and persons who want to do business with FIS providers, and will impact the EU competitiveness significantly in the mid-term. The current rules also lead to inequality, because smaller FIS providers might not be able to insource as readily as larger financial institutions, creating a potential distortion of competition as between FIS providers.

Similar businesses are not treated equally

The world economy and certainly the FIS industry is rapidly evolving. Earlier attempts to reform the VAT rules for the FIS sector have not been successful. Such reform is now more urgent than ever. For example, the original definitions of the VAT exemptions in EU law have never been amended. New products and business structures in the sector need a new set of rules. The sector has had to rely increasingly on the European Court of Justice to interpret the 1977 regime as it applies to these new products and their supply chains, but the CJEU has legal limitations on making any material changes or additions to any part of the VAT Directive, including the FIS regime.

The current rules can also lead to unequal treatment of the sector in an international context. Non-EU businesses selling FIS into the EU can have a competitive advantage depending on rules of the VAT regime in their country of establishment. FIS providers established in the EU selling their services domestically or in other EU Member States bear the non-deductible input VAT cost whereas their non-EU competitors can do business into the EU free of VAT. This competitive disadvantage for EU suppliers vis-a-vis non-EU suppliers into the EU has increased due to Brexit. The UK has always been one of the leading financial centers globally. As a result of Brexit, a significant volume of UK FIS transactions will become out of scope of the EU VAT regime. It can be expected that the UK will move quickly to design a successor VAT regime to the EU harmonized system for FIS in a way consistent with its strategy to promote its finance sector as being more competitive and investor friendly than the EU.

The current VAT exemptions lead to complexity and ongoing tax controversy

The current rules lead to companies adopting artificial contractual or legal structures to avoid as much as possible the incurrence of non-deductible input VAT. Tax authorities might then challenge such

structures as tax avoidance, leading to controversy. Furthermore, the current rules trigger complex VAT obligations, especially for taxpayers providing both taxable and exempt services. Allocating costs to the taxable or exempt part of the business can be very burdensome as well as operating allocation keys to allocate costs used for both taxed and exempt activities. This complexity also increases the time the tax authorities must invest in taxpayer audits.

Possible solutions

Overarching Principles

We have set out below the principles against which we believe the EU Commission should assess potential solutions or changes in the VAT rules applicable to FIS. These principles are broadly aligned with the widely accepted OECD Ottawa Taxation Framework principles of tax policy.

- **Neutrality:** The principle of fiscal neutrality is the principle of equality applied in VAT matters. It means that:
 - businesses in a similar situation should be treated equally, regardless of their location or precise business model,
 - the rules should focus on the type of services or products provided instead of the means through which they are provided (i.e., level of human intervention vs. digitalization does not change the nature of the supply), and
 - businesses should not bear the final cost of VAT which is intended to be resolved through the VAT system deductions and refund mechanism.
- **Efficiency:** Compliance costs for businesses and administrative costs for the tax authorities should be minimized as much as possible. Tax rules should be simplified as much as possible without compromising the efficient collection of treasury revenues.
- **Certainty and simplicity:** The principle of legal certainty requires that tax legislation be clear, precise, and predictable. Individuals must be able to ascertain unequivocally what their rights and obligations are and take the appropriate steps to meet their tax liability and compliance obligations.
- **Effectiveness and fairness:** Taxation should produce the prescribed amount of tax in reasonably timely fashion. The potential for tax evasion and avoidance should be minimized while keeping counteracting measures proportionate to the frequency and materiality of the violations concerned.
- **Flexibility:** The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments and do not lead, over time, to VAT considerations driving business decisions.

The main policy options for FIS VAT reform are assessed below, with the above principles in mind.

Updating the definitions

USCIB is supportive of a thorough update of the definitions underlying the VAT rules for FIS. Such an update would increase legal certainty. A set of up-to-date, rational and harmonized definitions would be a great starting point for reform, though more work will be needed beyond this. Eliminating the exemptions will address better the concerns of the FIS industry as it will avoid the cascading effect of an exemption in B2B supplies. If an exemption is kept for some FIS services, there should be a flexible option for taxation available to FIS providers. The option should be available on a transaction-by-transaction basis.

The financial industry is a highly regulated sector. Some commentators suggest linking the exemption rules to certain sector regulation. However, we do not recommend this approach. Sector regulation is constantly evolving and multi-layered. One kind of FIS business might be fully regulated while another kind might only need a specific license for one aspect of its business. Determining which regulation will trigger liability under an exemption rule and which regulation does not will be a complex exercise. Furthermore, having non-tax, financial regulation impacting the VAT rules would be in conflict with the very nature of VAT. VAT is a general consumption tax on the supply of goods and services and is in principle not bound by the legal form of a transaction nor any non-tax legislation. Regulation constantly needs to be adjusted to the market. Market regulators might not have the same priorities and principles and might not make the same choices as fiscal regulators would. This could again lead to similar businesses being treated unequally.

Eliminating the exemption

Literature and case-law mention two reasons why the exemption for FIS has been introduced:

- the difficulty in calculating the taxable amount; and
- avoiding a VAT cost for consumers.

Both objectives as well as the principles of tax policy will have to be observed when considering the future status of the exemption. In this respect, there are four options:

- Keep the exemption
- Tax FIS at a zero rate
- Tax FIS at the standard rate
- Tax FIS at a reduced rate

Any of the latter three options will allow FIS providers to deduct input VAT. If deemed necessary, a distinction could be made between FIS provided to taxable persons (B2B) and FIS provided to non-taxable persons (B2C). However, it is worth noting that this distinction adds a layer of complexity for suppliers who must then determine the status of their customers. It is more helpful to make a distinction between margin-based services, which can only be taxed using special methods because it is difficult to determine the taxable amount, and fee-based services where a taxable amount per transaction can be identified.

We recommend the following solution:

- margin-based services:
 - B2B: standard rate
 - B2C: standard rate
- fee-based services:
 - B2B: standard rate
 - B2C: standard rate

For margin-based services, practical proxy rates should be introduced to avoid difficulties in calculating the taxable amount, for example: the average net bank margin on loans *times* the VAT rate.

Zero-rating FIS would provide further simplification, certainly for margin-based services, and avoid a VAT cost for consumers. This solution is preferred but might not be achievable because of its budgetary impact. However, we encourage the Commission to look further into this possibility.

Removing the current exemption shapes up well against the principles noted above. It would restore the neutrality of the tax as a tax on consumption, with businesses in the industry able to deduct input tax, in line with non-EU businesses. This would create a level playing field for EU FIS businesses, particularly those competing with near-shore rivals.

This would in turn be a major simplifier for businesses in FIS as they would no longer face the difficult VAT obligations of partial deduction and would not be required to make VAT planning such a major factor in business structuring decisions.

Certainty of the law and the ability for it to respond to new business models would be improved as there would no need to rely on the definition of exempt FIS. A (most likely) simpler rule set would replace this to determine whether a service is fee- or margin-based. While this may bring some complexities, we anticipate significantly fewer challenges than today. We propose that the EU Commission set up a working group with the FIS industry to clearly determine the best way to define margin- vs fee- based services.

Avoiding non-deductible input VAT on intercompany transactions

FIS providers do not only suffer non-deductible input VAT on supplies of goods and services bought from third parties. Intercompany charges within the same group of entities also create non-deductible input VAT. There are two mechanisms mentioned in the inception impact assessment to avoid non-deductible VAT on intercompany transactions: VAT grouping and Independent Group of Persons (IGP).

Today, both solutions are of limited use. The solutions can only be applied to intercompany transactions that take place within the same Member State, i.e., between or among two or more taxpayers registered in the same Member State. VAT grouping is by law limited to transactions within the same Member State. The IGP exemption cannot be reconciled with international transfer pricing rules. The CJEU has further limited the scope of both solutions by deciding that branches in a Member State other than the Member State of the recipient in the transaction (e.g., the group parent) should be considered outside the VAT group of their parent and vice versa and that the IGP exemption is not available for FIS.

Entities established in different Member States should be allowed to form a VAT group. Today's limitation to one Member State cannot be reconciled with the freedom of establishment principle in the founding EU treaties and the definition of 'taxable person' in the VAT Directive.

While expanded application of VAT grouping and IGP rules may help to alleviate non-recoverable VAT costs linked to inter-company transactions, these two mechanisms in isolation will not address the neutrality and distortion of competition issues linked to outsourcing.

Simplify partial VAT deduction

A business providing exempt services as well as taxable services has the difficult task to allocate its purchased goods and services to one of these categories to allocate deductible and non-deductible input VAT. Cost allocation keys are to be applied for goods and services used by both categories.

Safe harbor percentages developed with the FIS industry could provide legal certainty and reduce compliance costs. However, we suggest making these percentages optional, not mandatory. There is a high risk that because of the complexity of the FIS industry and the unique position of each individual

taxpayer, the percentages will not always provide a fair outcome. Furthermore, simplifying partial VAT deduction will not address the neutrality and distortion of competition issues linked to outsourcing.

We appreciate the opportunity to submit this consultation letter and are available to discuss with you at your convenience the issues described in this letter in further detail.

Sincerely,

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