

VAT: MODERNISING VALUE ADDED TAX OBLIGATIONS FOR FINANCIAL SERVICES AND INSURANCE

Memorandum submitted in June 2006 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales to the European Commission in response to an invitation to comment in a consultation paper published on 14 March 2006

CONTENTS

| | Paragraph |
|---|------------------|
| INTRODUCTION | 1-2 |
| KEY POINT SUMMARY | 3 |
| GENERAL COMMENTS | 4-14 |
| THE HISTORY OF THE EXEMPTIONS FOR FINANCIAL AND INSURANCE SERVICES | 15-20 |
| ZERO RATING | 21-27 |
| THE OPTION TO TAX FOR BUSINESS TO BUSINESS SUPPLIES | 28-30 |
| OUTSOURCING | 31-35 |
| CROSS BORDER VAT BODIES | 36-37 |
| DEFINITION OF EXEMPT SERVICES | 38-41 |
| | Annex |
| WHO WE ARE | A |
| TEN TENETS FOR A BETTER TAX SYSTEM | B |

Tax Representation

VAT: MODERNISING VALUE ADDED TAX OBLIGATIONS FOR FINANCIAL SERVICES AND INSURANCE

INTRODUCTION

1. We are pleased to respond to the consultation paper on modernising Value Added Tax obligations for financial services and insurances published on 14 March 2006 by the European Commission. The consultation paper can be found at http://ec.europa.eu/taxation_customs/resources/documents/common/consultations/tax/modernising_VAT_en.pdf
2. Details about the Tax Faculty and the Institute of Chartered Accountants in England and Wales are set out in Annex A. Also attached at Annex B are our ten tenets for a better tax system against which we measure the effectiveness of tax changes.

KEY POINT SUMMARY

3. In brief:
 - Dealing with the problems caused by the exemptions for financial and insurance services is one of the most intractable tasks faced by the Commission. We acknowledge the considerable efforts made so far and we encourage the Commission to continue to search for solutions in this area.
 - We understand that the UK government is looking for a balanced set of proposals that will leave the tax yield broadly unchanged. Budgetary constraints rule out a number of the possibilities considered in the consultation paper.
 - We think that businesses in the financial and insurance markets are entitled to certainty just as the tax authorities are entitled to security of tax revenues. Accordingly some changes to the exemptions are necessary.
 - We see no complete solutions to the problems created by the exemptions that will be acceptable to business, governments and the taxpayer. As is often the case in taxation it is not possible to please everyone.
 - The only solution that is technically sound, eliminates the problems caused by the exemptions and meets all of the objectives of the Commission is the taxation of financial services. However, we recognise that there is no general support for such a change amongst all the stakeholders.
 - Our comments below concentrate on the technical aspects of the consultation paper. The financial and insurance industry representative bodies are better placed to explain how some of the potential changes will affect their members.
 - The financial and insurance sectors are of considerable importance to the UK economy. We think these sectors should be helped by reducing the burdens and uncertainties caused by the VAT system.

Tax Representation

GENERAL COMMENTS

4. The problems caused by the exemptions for financial services and insurance are well known and well researched. They are for example described in detail in the reports for the Commission carried out by Ernst & Young during the 1990s. It has long been recognised that exemptions in the production cycle cause serious faults and distortions in the VAT system.
5. Unlike the exemptions for health, education and services in the public interest which tend to be supplied to the final consumer, financial services and insurance are supplied to a considerable extent to the business sector. Consequently the exemptions cause double taxation and because of the cascade effect the final consumer of goods and services bears more tax than the official standard rate on the products purchased. In the UK measures to deal with this effect, such as the option to tax, have not been introduced and therefore the additional taxation is very large indeed.
6. There are many other difficulties for governments and businesses who have struggled for nearly 30 years to operate a seriously deficient regime. For more than 10 years the Commission has been carrying out research and considering how to deal with one of the most intractable problems it has faced. We do not think that the research has been wasted and by way of example the reports by Ernst & Young provide a very useful insight into the nature of financial and insurance intermediation services which will be of assistance when any changes to the treatment of such services are planned. It is of course important to preserve that archive and make it available when required.
7. Since the regime has been in force for 30 years and is now familiar to businesses and tax authorities, it is pertinent to consider whether the faults are serious enough to warrant major change. On this question we have seen constant disputes and litigation in the UK over many years. We have also seen very frequent changes in national legislation mainly to cope with the difficulties of calculating the VAT input tax deduction for businesses who supply both taxable and exempt services. Tax avoidance has also been a problem for the government throughout the period of the regime. There is ample evidence of this being a seriously dysfunctional regime.
8. We recognise the difficulties of making changes to the regime but the exemptions were drafted 30 years ago and are now outdated and do not accurately deal with all the modern transactions carried out now. Businesses in the financial and insurance sectors are entitled to certainty and some of the newer transactions do not easily fit into the current exemptions.
9. The financial services and insurance industries are especially important to the UK and EU economies and VAT causes a competitive disadvantage in cross border and non-EU business. Also the VAT compliance difficulties are an impediment to efficient operations.
10. For all these reasons we think that some changes must be made to the Directive. If the Directive is left unchanged, at some point the regime could result in some disruption in the financial markets particularly in relation to new products such as

Tax Representation

financial instruments. We think that the 'do nothing' choice is not really a sensible option.

11. As a minimum we would recommend that the exemptions should be expanded to encompass a wider range of financial transactions to bring the legislation up to date. These would for example include transactions in derivatives. Such changes would have little or no budgetary consequences in the UK.
12. The UK government has already indicated that it is looking for solutions to the problems that will be revenue neutral overall and will not significantly affect the tax yield. We think it likely that other governments will take the same approach. The Commission recognises this in section 1.3 of the consultation paper on page 4. Unfortunately, that rules out as too costly a number of the possibilities considered in the consultation paper unless compensating additional tax charges can be found elsewhere. We think that if there were other opportunities elsewhere to raise more tax they would already have been found. Although we can see that a balanced set of proposals is desirable we do not think it will be possible to devise one that will be acceptable to all those with an interest in the outcome. In fact this has been the position for some time and that is why the Commission has been faced with a nearly impossible task.
13. It would be possible for example to eliminate double taxation and the cascade effect by zero-rating the provision of financial services and insurance to other taxable persons. In the past the Commission has been concerned about whether zero rating could open the door to avoidance and evasion. In relation to cross border transfers of goods, the VAT 'gap' has led to massive fraud and revenue loss. However, in relation to financial services and insurance, we think that the necessary safeguards can be put in place to police zero rating so that it can be operated securely and without tax loss.
14. However, the important question is not whether zero rating can be operated for such services but whether it is affordable for the UK. The cost to the UK exchequer could be as high as £3 billion. This is the irrecoverable VAT incurred by providers of financial and insurance services which is passed on as a hidden tax in prices for services to business customers. Such a large amount of tax relieved by zero rating could be financed by taxing financial and insurance services generally or by increasing the standard rate of VAT.

THE HISTORY OF THE EXEMPTIONS FOR FINANCIAL AND INSURANCE SERVICES

15. When the Sixth VAT Directive was being drafted financial and insurance services were exempted because a means could not be found to subject them to the tax. There was no difficulty in taxing explicit fees or commissions but it was thought that services provided for a margin could only be taxed if the margin could be calculated on a transaction by transaction basis and that is not usually possible. In order to fit in with the invoiced based VAT system it was considered necessary to calculate the consideration for each supply separately in order to allow business customers to recover the related input VAT.

Tax Representation

16. Ernst & Young were asked during the 1990s to consider this problem and to see whether a means could be found to subject financial services to VAT. Their solution was based on the constraint imposed on them that tax had to be charged on a transaction by transaction basis. The method they came up with was called the truncated cash flow system and that was field tested in the late 1990s. Although it was feasible and could be operated in practice it was perceived to be complicated.
17. At that time those involved in the field test came to the conclusion that if VAT were to be introduced the only way to do it would be to use zero rating instead of the truncated cash flow model. It is not correct to say (in paragraph 1.2 of the consultation paper) that the truncated cash flow model envisaged a general zero rating for business to business transactions. It was an alternative to it. Also there has been no field testing of zero rating so far as we are aware.
18. The use of zero rating solved the problem of how to devise a very simple way of introducing VAT on financial and insurance services. Supplies to other taxable persons (business to business supplies) can be zero rated and supplies to the final consumer can be taxed on a tax inclusive basis using margins calculated in aggregate periodically. There is no difficulty in calculating margins in aggregate periodically: businesses have to do that for reporting purposes. Tax inclusive pricing for services to the final consumer is also reasonably straightforward and most businesses have segmented their markets so that different parts of their businesses deal with business customers and personal customers.
19. There are no social or economic reasons for exempting financial services. The reason for the exemptions was a technical problem that has now been solved. Also the greater use of computers means that the calculation of VAT is not so much of a problem.
20. Whilst we understand that in the current climate the introduction of VAT on financial and insurance services has little support, it would probably produce for the UK exchequer little change or a modest increase in the tax yield. It would also meet all of the objectives of the Commission.

ZERO RATING

21. Zero rating for business to business transactions (like the cash flow model) overcomes the need to calculate the margin (the consideration) on a transaction by transaction basis. It is also very simple to operate.
22. Since zero rating will not result in a tax burden on the supplier and will not affect the amount of tax payable by the final consumer it appears that there will be fiscal neutrality if this solution is chosen.
23. In the largely regulated businesses of financial and insurance services zero rating can be policed and made a secure means of operating the system.

Tax Representation

24. On the basis that zero rating will apply by reference to the type of services provided and not the type of supplier we see no unequal treatment or discrimination against suppliers of other services. There may be difficulties where zero rated services and standard rated services are supplied to business customers and possibly both types of services to the same customers. However, since the input VAT is likely to be recoverable and there is therefore unlikely to be any tax at stake, we expect practical solutions could be found to this problem.
25. If zero rating is introduced for services to other taxable persons leaving services to the final consumer exempt this will have two main consequences. First double taxation and the cascade effect will be eliminated but the tax yield will fall substantially. We are not able to quantify that fall because businesses would remain partly exempt and to some extent would still be unable to recover all the input VAT they suffer. The second major consequence is that (apart from double taxation and the cascade effect) most of the other problems with the exemptions would largely remain.
26. Quite apart from the budgetary constraints we see zero rating whilst continuing with the exemptions for services to the final consumer as a technically flawed solution. But it is considerably better than the existing regime and it is possible to operate a system that is not ideal.
27. Nevertheless we expect zero rating for business to business transactions, whilst leaving the exemptions in place for the final consumer, to be ruled out by the UK government on budgetary grounds.

OPTION TO TAX FOR BUSINESS TO BUSINESS SUPPLIES

28. In theory there is a need to calculate the consideration using the option to tax in relation to margin services. This also applies to services such as lending. However, if the VAT to be charged is fully recoverable it could be argued that it does not matter whether the tax is calculated on the margin or on the actual interest charged to the customer. Nevertheless we expect problems to arise in relation to margin services if this change is made.
29. Allowing the option to tax for business to business services could have very similar revenue effects to zero rating. The tax yield would fall significantly and we expect it to be ruled out by the UK government for that reason. We note that it has always been open to Member States to introduce the option to tax financial and insurance services under Article 13(C) and the UK government has always refused to do it.
30. Most of the problems caused by the exemptions would remain under this solution. Partial exemption would continue to be a major source of difficulty.

OUTSOURCING

31. Two means of dealing with the problems arising from outsourcing are considered in the consultation paper. The first is to extend the scope of the exemptions to persons

Tax Representation

who supply services to financial and insurance service providers. The second is to allow a larger VAT input tax deduction for certain specified acquisitions.

32. We can see technical problems with both of these possibilities and we think they are unlikely to be acceptable to all the stakeholders. The UK government is likely to rule them out for both technical and budgetary reasons.
33. Extending the exemptions so that bought in services are not subject to VAT would mean that a new category of supplies would be exempt only when supplied to certain types of business customers. We think this would add to the problems caused by the exemptions without solving any of them. If we have understood the suggestion properly, it would simply shift the irrecoverable VAT up the chain of supply. That would mean that the suppliers of services to banks and insurance companies would also become exempt or partly exempt. Irrecoverable input tax suffered by such suppliers would be recovered in higher prices with the result that the price to banks and insurance companies would be little different except in the case of labour intensive services. For this reason and the other disadvantages listed in the consultation paper we do not see this suggestion as one worth pursuing.
34. Similarly we do not see additional input tax recovery on specified supplies as a technically sound solution even though it has worked in practice elsewhere. The disadvantages listed in the consultation document are considerable impediments. The definitional problem of deciding which services should benefit from this treatment is a major obstacle. However, this suggestion is preferable to extending the exemptions and despite its flaws could probably be made to work. The budgetary cost would depend on which services are specified and so it may be possible to introduce some measure of relief at limited cost.
35. Although we have concentrated on the technical aspects of these suggestions we point out that outsourcing is useful in improving the efficiency and competitiveness of businesses in the financial and insurance sectors. Given the success of these businesses in winning global business for the UK and the EU and their importance to the economy, we think this should weigh heavily in deciding what measures to introduce.

CROSS BORDER VAT BODIES

36. We agree that the creation of cross border VAT bodies merits further consideration. Assisting businesses to operate efficiently across the EU is in accordance with the objectives of the Community. We look forward to seeing further developments on this subject.
37. We would also like to see progress on the One Stop System to allow those who wish to operate through a single company to register in a single Member State. We appreciate that this is a separate issue and that businesses that use a single company do not generally have sticking tax on supplies between branches. However it is an issue related to encouraging the development of the Single Market.

Tax Representation

DEFINITION OF EXEMPT SERVICES

38. We agree that it is necessary to update the Directive so that it deals clearly with the type of supplies now carried out in the financial and insurance sectors. In particular provision should be made for transactions related to derivatives and various types of financial instruments which are in use today.
39. Providing specific exemptions for those matters currently treated as exempt will provide certainty without changing the tax yield. There are good arguments for taking the process further to exempt certain other services that are currently standard rated, such as the management of credit by someone other than the person who granted it. That would have a modest effect on tax yield but would enable the businesses in the sector to operate more efficiently and effectively on the world stage.
40. There have been a number of disputes about the borderline between exemption and standard rating. The presence of exemptions or zero rating tends to produce such disputes. If the definition of the exemptions is changed so that the borderline is redrawn there may be further litigation over whether particular supplies are subject to VAT. This is inevitable but the need for change should mean that it is a risk worth taking.
41. We see amendments to the exemptions to bring them up to date as the subject of a separate project which we hope will go ahead. We would like to be involved in the detailed consideration of the revisions to the exemptions at the appropriate time.

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ICAEW AND THE TAX FACULTY: WHO WE ARE

1. The Institute of Chartered Accountants in England and Wales ('ICAEW') is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
2. Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members and students, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.
3. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter 'TAXline' to more than 11,000 members of the ICAEW who pay an additional subscription.

THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.
4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99.