European Commission

BRUXELLES

Milan, 30 April 2021

<u>Feedback on the European Commission's initiative to review the VAT rules for financial and insurance services</u>

The Italian Private Banking Association (AIPB) is an association which brings together the main national and international operators of Private Banking, Universities, Research centres, Service companies, Industry Associations, Tax and Legal firms, promoting the Private Banking culture and addressing families and individuals with significant assets and complex investment needs.

We highly value the possibility to provide our views on the current VAT rules for financial and insurance services and their functioning as well as on possible changes to these rules.

The current VAT rules for financial and insurance services are believed to be complex, difficult to apply in practice for the imprecise and obsolete definitions of "financial services" and to not have kept pace with the developments of new products and services in the financial industry, undermining severely the principle of VAT neutrality and causing especially legal uncertainty. Moreover, this seems to have led to an increase of litigation before the CJEU, high administrative and regulatory costs, and distortions of competition because of the inconsistent understanding and application of such rules by Member States.

In regard to the lack of VAT neutrality, the exemption regime applied to financial and insurance services is not linked to a right to deduct input VAT paid on goods and services purchased in order to carry out the supply of such services. This necessarily deprives the tax of its neutrality and VAT becomes a considerable cost for providers of financial and insurance services, which in turn is largely passed on to customers (in the form of so-called "hidden VAT"). Hidden VAT incorporated in the prices of financial and insurance services rendered to business recipients cannot be recovered by the latter and implies an increase of their production costs, which, in turn, leads to an increase of the sale price of their own supplies (giving rise to the so-called "cascading" effect).

To address the problem of hidden VAT, from the roadmap of the Commission we understand that the two measures presented as main policy options consist of (i) removing the existing exemption in order to tax financial and insurance services, or (ii) keeping the exemption, but modifying its scope through taxing only some types of services.

In our opinion, the issue has to be analysed from two different perspectives, since economic effects of the VAT exemption depend on the stage of the process of production or distribution at which the exemption itself applies. On the one hand, there are B2B transactions, which could certainly benefit from the abolition or restriction of the VAT exemption[1]; on the other hand, there are B2C transactions

[1] VAT registered buyers of financial services enjoing a full right of VAT deduction derive no benefits from the VAT exemption. These entities could indeed have deducted input VAT against their output VAT. On the contrary, they suffer

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for which replacing the VAT exemption with taxation (especially standard rate taxation) will not likely have positive effects, given that the (hidden) VAT burden under the exemption regime is by far lower than in the situation where the services would be taxed. We thus highly suggest that this Commission evaluate any proposed measure also carefully taking into account the impact at the level of the end-consumer.

In addition to the above, AIPB wishes to highlight that the difficulty to tax financial services[2] (in particular those for which the service provider derives its revenue from a margin) is just one of the main reason for the introduction of the VAT exemption regime, but, leaving aside this pragmatic one (whose importance has diminished today), there are also other reasons for the exemption.

First of all, it is the view of many commentators that to tax the use of capital may be damaging to the economy, since taxation of deposits and (at least indirectly) savings rather than consumption would reduce the funds available for investments[3]. In this respect, the CJEU explicitly mentions the need to avoid an increase in cost of consumer credits[4], as well as the purpose to facilitate investment in securities for retail investors[5], among the reasons for the exemption.

Moreover, it has to be recalled that several other taxes affect the financial and insurance sectors, which largely escapes VAT (*e.g.* taxes on insurance premium, payroll taxes and also financial transaction taxes in some member States). Avoiding double taxation at the level of the final consumer[6] is thus another reason for very carefully considering any option of abandoning and/or limiting the scope of the VAT exemption.

We therefore strongly encourage the European Commission to take the above considerations into account when assessing possible revision of the VAT treatment of financial and insurance services and, in particular, we recommend exploring the following alternatives (in order of preference):

1. Subject financial and insurance services to a zero-rate[7] allowing for VAT deduction of the input VAT. Under this model, financial and/or insurance service providers are allowed to deduct (refund) input VAT paid on purchases of goods and services related to the production of VAT exempt services. Although costly in terms of loss of VAT revenues, this solution would guarantee both vertical VAT neutrality (by avoiding VAT becoming a cost in B2B contexts and by removing the embedded VAT effects towards end-consumers, as well) and horizontal VAT neutrality (by allowing businesses to operate on an internationally level

from the hidden VAT which is partially passed though on financial services, which cannot be deducted against their output VAT.

[2] See CJEU judgments of 12 June 2014, case C-461/12, *Granton Advertising BV*, para. 30; of 10 March 2011, case C-540/09, *SEB*, para. 21, and of 19 April 2007, case C-455/05, *Velvet & Steel*, para. 24.

[3] OECD Report of 22 October 1998 on the Indirect Tax treatment of Financial Services and Instruments, p. 1, referring to H. GRUBERT AND J. MACKIE, *An unnecessary complication: must financial services be taxed under a consumption tax?*, 1996.

[4] See CJEU judgments of 2 October 2009, case C-242/08, *Swiss Re*, para. 49; of 19 April 2007, case C-455/05, *Velvet & Steel*, para. 24 and of 14 May 2008, Joined Cases C-231/07 and C-232/07, *Tiercé Ladbroke and Derby*, para. 24.

[5] See, in relation to the VAT exemption regarding the management of investment funds, *inter alia*, CJEU Judgments of 9 December 2015, case C-595/13, *Fiscale Eenheid*, para. 34; of 28 June 2007, case C-363/05, *JP Morgan*, para. 45; of 7 March 2013, case C-424/11, *Wheels*, para. 19; of 13 March 2014, case C-464/12, *ATP PensionService A/S*, para. 43 and 62.

[6] See, in respect with insurance transactions, *inter alia*, CJEU judgments of 17 January 2013, case C-224/11, *BGŻ Leasing*, para. 67 and of 25 February 1999, case C-349/96, *CPP*, para. 23.

[7] If not possible, reduced rates should then be considered.

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playing field where VAT does not influence decision-making; in particular, the financial and insurance service providers bias towards in-sourcing would be completely removed).

In order to mitigate the negative budgetary result for Member States deriving from a broad application of the measure, it could be considered to introduce the zero-rating on specific financial and/or insurance services only (*e.g.* to the services perceived as more deserving because of economic or social considerations, such as the management of investment funds or pension funds, as well as the granting of credit) so that financial services providers would not have to charge VAT on these supplies but could also recover any associated input VAT. Nevertheless, this alternative solution would not eliminate embedded VAT but would reduce it only to the extent that the zero-rating provisions are introduced.

2. Introducing an option to tax financial and insurance services at the discretion of the service provider itself.

   The VAT Directive already allows Member States to implement an option to tax financial services. However, the provision is not mandatory and so the VAT Directive would need to be amended to ensure that all Member States allow taxpayers the right of option. This would help achieving consistency and neutrality across the EU. Moreover, it is worth noting that the option does not currently extends to insurance services, and the VAT Directive would thus have to be amended in order to include them.

   This solution would give financial and insurance service providers the option to tax their services, enabling the recovery of input VAT (as it could be attributed to an onward taxable supply) and thus helping to cope with the problems associated with cascading effect.

   One of the essential aspects of this solution concerns its actual implementation and the concrete modalities for exercising the option to tax, since this latter may be limited to B2B transactions but it could also be either granted on a rigid basis (e.g. B2B supplies only, on an "all-in or all out" basis) or on a more flexible basis (under a case-by-case basis or "transactional" approach). While enabling financial and insurance service providers to selectively charge VAT and avoid price increases for final consumers, taxation on a case-by-case basis would normally cause a loss of revenue for Member States: in order to safeguard their competitiveness, financial and insurance institutions would indeed continue to exempt services supplied to final consumers and would opt for taxation in respect of services supplied to their non-financial business customers only.
3. Introduce a cross-border VAT Grouping Regime, making it mandatory for all Member States to allow cross-border VAT Grouping. This solution would allow financial services operators to reduce the VAT costs associated with cross-border operations and provide for an equal VAT treatment between institutions structured on a head-office/branch basis and those structured on a parent/subsidiary basis.
4. Introduce a new cross-border "cost-sharing agreements", enabling businesses in the banking and insurance sectors to pool investments and re-distributing the associated costs under exemption from VAT. This solution would also be applicable to cross-border arrangements and, reasonably, to groups whose members partly make taxable supplies.
5. Extending the scope of the exemptions. The current VAT system causes distortion in the context of outsourcing and shared services by effectively forcing financial and insurance organizations to limit outsourced activities to those that are VAT exempt. The existing exemptions could thus be extended to apply to transactions further down the supply chain so

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that currently taxable supplies become VAT exempt. Such a solution may limit banks and financial institutions bias against outsourcing of services as well as hidden VAT and cascading effects.

We sincerely look forward to discussing our contribution as this initiative moves forward.
In case of any questions, please do not hesitate to contact us to discuss any of the points raised above.

AIPB - Associazione Italiana Private Banking

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