association of the
luxembourg fund industry

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Object: **European Commission roadmap on the review of VAT rules for financial and insurance services**

Dear Mr. Pillet,

ALFI welcomes the publication of the roadmap regarding the review of VAT rules for financial and insurance services and is pleased to hereby provide you with its views in this respect.

As a preliminary remark, ALFI would like to underline that it would also welcome the publication of the study conducted by a consortium of consultants on behalf of the Commission to better inform the stakeholders and the public in case of public consultation.

A. Context, Evaluation, Problem definition and Subsidiarity Check - Problems the initiative aims to tackle

Lack of tax neutrality

ALFI agrees with the statement made that the exemption may lead to a lack of tax neutrality which is key for any tax. The roadmap refers to Fintech companies that are more affected by the non-deduction of VAT than other more traditional financial services due to the required high level of IT investments.

This statement should however be balanced by two elements. On one hand, the question of the non-deduction of VAT in case of huge investments exists also for any activity, including for more “traditional” activities when for example a “traditional” asset manager or a bank has to renew its IT systems or to implement new regulations and reporting. On the other hand, the fact that, in case the VAT exemption would be cancelled, the application of VAT would result in an increase of the price of services for all persons or entities that would not be allowed to recover VAT, such as individuals, public bodies, NGOs, businesses benefitting from the small businesses scheme, activities in the public interest (hospitals, schools, etc.). By essence, the VAT due on the turnover of an entity is higher than the VAT recoverable on inputs (except possibly when the turnover benefits from a reduced VAT rate). Indeed, the price of a service is determined based on all the costs of the supplier, whether subject to VAT or not, including salaries (which fall outside the scope of VAT), on the expected profit and other taxes, such as corporate tax.

In addition, due to the internalisation of the business and the use of internet, the risk of delocalisation of activities should not be underestimated. In this respect, the roadmap refers *to “[…] produces competitive disadvantage compared to business supplying similar non-exempt services […]”.* ALFI is of the view that these situations might exist where two Member States would apply different interpretations to the same situation but should not exist within one Member State because the VAT analysis should be based on the nature of the services and not on the status of the provider or the way the services are provided. Despite these clear principles, variations in the interpretation may exist between Member States according to the "may" provisions foreseen by Council Directive 2006/112/EC of 28 November 2006, but also due to the different legal systems. In addition, as mentioned above, the competitive disadvantage between exempt and taxable services would vary on the basis of the fact that customers could or could not recover VAT.

As to non EU businesses as referred to *(“or to businesses operating outside the scope of VAT in third countries”*), ALFI agrees that this is an important element to be taken into account but is of the opinion that the comparison with non EU businesses is complex and should take into account the fact that VAT exempt financial services performed by EU services providers open them the right to deduct VAT when rendered to non-EU clients (or are related to goods exported outside the EU). They may still open the right to recover VAT on costs in those non EU countries. In this context, for EU service providers that perform services for EU or non EU clients, the VAT consequences in these different scenarios would be different. The same comment could be made about non-EU services providers. It would be worth clarifying and nuancing this statement to avoid giving the impression that the current exemptions are in any case detrimental for the EU services providers in an international environment.

B. Objectives and Policy options

ALFI agrees with the comments regarding the cost sharing agreements foreseen by article 132.1.f) of the EU VAT Directive 2006/112 and supports the idea that this instrument should be made again available to the financial services industry on a cross-border basis.
In addition, the VAT group foreseen by article 11 of the EU VAT Directive 2006/112 is an important tool for the financial services industry. The current VAT review should include an evaluation of the VAT Group with the view of introducing it throughout EU Member States on a harmonised basis with clear application rules and the possibility to implement it on a cross-border basis.
In this respect, it is worth mentioning that the VAT group and the costs sharing association are not perfect substitutes to each other. They have their own specific features, advantage and disadvantages and it is thus important to have both of them available to meet as much as possible the needs of the businesses which want to mutualize resources without additional VAT costs. This is the reason why the financial services industry considers the VAT group only or the cost sharing association only as an insufficient solution.

C. Preliminary Assessment of Expected Impacts

Likely social impacts

In the section "Likely social impacts", the document mentions without many details that these impacts would be positive. ALFI would welcome more granular information and assessment in this respect.
As mentioned above, cancelling the exemption would lead to an increase of prices for financial services and that would create an additional tax burden on those who could not recover VAT, as it is in particular the case for individuals. Also favouring the deduction of VAT on IT investments may have some further negative impacts on employment.
ALFI believes that in case the review of the current VAT rules is limited to clarification of exemptions, reintroduction of IGP, etc., the social impact would probably be very limited. In case the reform is more extensive, i.e. taxation of (some) financial services, social impacts will probably be more significant. Indeed, as illustrated by the presentation of the draft consultant's study during the GFV call of 25 May 2020, the taxation of financial services at the standard VAT rate would affect negatively and substantially the demand of financial services. This would also, most likely, affect in the same manner the employment in the financial services sector. ALFI believes this should be reflected in the communication about the review.

ALFI would also like to draw the attention to the social impact a taxation on investment management services would have. The current VAT exemption has substantial positive social impacts:

- It incentives savings by "retail" investors. Indeed, most investors in retail and institutional funds are either private persons or institutional investors in the pension sector (insurance companies, pension funds, CTAs etc.) that are generally not able to recover input VAT due to the fact that they do not provide taxable services or that they provide VAT exempt financial or insurance services. Applying VAT on management services for investment funds would increase the tax burden for retail investors and in particular (retirement) savers. Private investors being the ultimate investors would be penalized. This would stand true whether they would invest directly in an investment fund or indirectly via a pension fund or an insurance product investing in turn in investment funds.

- The long standing VAT exemption on management services related to collective investments vehicles or schemes has created a clear and stable tax environment. Removing the exemption for management services of EU funds would be a disruption for investors that, as mentioned, would ultimately bear the VAT incurred by investment funds.

- The management of collective investment vehicles implies the use of specialized service providers. Applying VAT to the remuneration paid on these specialized services will be detrimental to investors because this may further increase price pressure and lead to less specialist input being sought. For this reason, the EU VAT Directive, as well other non-EU VAT systems, foresees a VAT exemption for management services of collective investments.

It is worth reminding that the Court of Justice of the European Union (CJEU) has ruled that the aim of the VAT exemption for management services is to facilitate the collective investment[1]: "*In that regard it should be observed that the purpose of the exemption of transactions connected with the management of special investment funds is, particularly, to facilitate investment in securities by means of investment undertakings by excluding the cost of VAT and, in that way, ensuring that the common system of VAT is neutral as regards the choice between direct investment in securities and investment through collective investment undertakings*".

[1] Staatssecretaris van Financiën v Fiscale Eenheid X NV cs, C-595/13, 9 December 2015, point 34

The purpose of the exemption outlined above becomes even more critical when one considers the current pension savings gap in Europe. The savings gap is defined as *"…how much more people retiring between 2017 and 2057 need to save each year to achieve an adequate standard of living in retirement."* A recent study estimates the current savings gap to be in the region of ***€2 trillion***[2]. It is clear therefore that the need to encourage investment through the removal of the VAT burden remains a priority.

ALFI would like to emphasize that taxing investment management services would also be in contradiction with the different national tax measures favouring long term investments (e.g. income tax deductions when participating to collective investment schemes, exemptions or at least reduced tax rates or deferral of taxation of the income and capital gains raised by individuals from these long term investments). It would also be counterproductive of the efforts of the European institutions and of the objectives of the recently released new Capital Markets Union action plan that favour long term investments via e.g. the European Long Term Investment Fund (ELTIF) or the Pan European Personal Pension Product (PEPP) as well as the recommendations made by the European Commission to member States to create a favourable tax environment that incentives the development of those initiatives[3][4].

Likely economic impacts

ALFI agrees with the roadmap considering the likely economic impacts as "Most likely positive" and that *"The measures envisaged will assist in strengthening the Internal Market and enhancing competitiveness, among other elements – through removing fiscal barriers to outsourcing. Tax compliance should be made easier."*

It is however unclear which measures are envisaged and their likely economic impacts. Thus, this part of the document should be nuanced and further detailed.
Here again, regarding the measures envisaged, it should be distinguished between a "limited reform" where the principle of the VAT exemption would be maintained with some improvements and a "systemic reform" where financial services would become taxable.
A "limited reform" that would consist in clarifying, modernizing and harmonizing the VAT exemptions and making available cost sharing agreements and VAT group on a cross-border basis may have these positive impacts. In particular, cost sharing associations and VAT group would help solving the question of VAT in case of insourcing but not in case of outsourcing.

It would also be extremely important to clarify the following sentence "*A systemic change in the VAT rules for the sector may also have a positive impact on VAT revenues*". It is ALFI's understanding that "systemic change" would refer to opting for the cancellation of the current exemption regime and a taxation of financial services. It should be emphasized that a "systemic reform" where financial services would become taxable could trigger a massive drop in the demand as mentioned above and as evidenced by the consultants' study. This would thus have negative economic impacts and ALFI thus strongly suggests to provide additional details and clarifications on the possible economic consequences depending on whether financial services would remain exempt or would become taxable.

ALFI further believes that taxing fund management services would lead to less capital being available for long term investments of businesses and public bodies. Not only because the taxation of fund management services would reduce the amounts available for investments but also because investors may switch to investments, such as cash savings, that do not require as much specialized services and would thus be less expensive.

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[2] "*Mind the Gap - Quantifying the pension savings gap in Europe*" – Aviva, September 2016

[3] Commission Recommendation of 29.6.2017 on the tax treatment of personal pension products, including the pan-European Personal Pension Product (https://ec.europa.eu/info/sites/info/files/170629-personal-pensions-recommendation_en.pdf)

[4] Final Report of the High Level Forum on the Capital Markets Union set up by the European Commission (https://ec.europa.eu/info/sites/info/files/business_economy_euro/growth_and_investment/documents/200610-cmu-high-level-forum-final-report_en.pdf)

The taxation of management services of EU investment funds would also affect the level of savings and investments due to the decrease of net returns for investors and this would also have a negative impact on the amount funds could invest in the real economy.

In the end, taxation may then favor non-EU service providers and potentially entail delocalization of activities to non-EU jurisdictions.

D. Summary

ALFI welcomes the publication of the roadmap and encourages the European Commission to clarify the various points in order to better inform the stakeholders and the public. It would also be useful to publish the study conducted by the consortium of consultants for the Commission.

We are grateful in advance for your attention and remain at your disposal for any additional information you may wish to receive. Please do not hesitate to contact ALFI.

Sincerely yours,

ALFI