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Should the EU Adopt the Kiwi Approach for Taxing General Insurance Transactions?

by

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List of Abbreviations

AG	Advocate General of the Court of Justice
EU	European Union, here also used as a reference to the territorial scope of Directive 2006/112/EC
GDP	Gross Domestic Product
GST	Goods and Services Tax
IBFD	International Bureau of Fiscal Documentation
IMF	International Monetary Fund
Kiwi	New Zealand
MS	Member State of the European Union
NZ	New Zealand
Para	Paragraph
UK	United Kingdom
VAT	Value Added Tax

Summary

This thesis primarily concerns the European Union (EU) value added tax (VAT) exemption for insurance transactions. Due to the negative consequences that exemptions have on the proper functioning of the VAT system and those subject to it, this thesis explores the possibility of adopting the Kiwi taxed approach for insurance transactions. In order to do this, the provisions and functioning of both the EU exemption and the Kiwi taxed system are analysed and compared. A discussion of how the Kiwi taxed system could alleviate the problems associated with the exemption is presented, alongside any complications and problems that are currently incorporated in the Kiwi system itself. In addition to the legal issues, practical difficulties that could arise in reality are also presented, as these are very relevant for a discussion on implementing a system change.

A conclusion is reached whereby the Kiwi system is put forward as a preferential model to be used in the EU, as it alleviates many of the core problems associated with the EU exemption. However, it is submitted that the Kiwi system should not be blindly followed and replicated in its entirety, but rather that the EU should take the opportunity to advance a taxed system which learns from and overcomes the problems of the Kiwi system.

1. Introduction

1.1 Background

The European Union (EU) Value Added Tax (VAT) exemption for insurance transactions, laid down in Art 135(1)(a) of the current VAT Directive¹, is well known for being fraught with associated negative consequences. As an exception to the general system of VAT, it easily attracts criticism for not being in line with the true nature of the tax, with little scope for justification for having such exceptional treatment. As it has been noted by the Commission, the decision of the Council in 1977 to exempt financial services and insurance was ‘mainly for pragmatic reasons since the technical difficulties could not be readily overcome’², the principal one being the ‘difficulty of determining the value that is added in an insurance transaction.’³ Such an exemption can only hold its ground if this justification is viable, especially in the light of the ‘legal and economic collateral costs’⁴ that plague the current exemption system.

Elsewhere, such as in New Zealand, Australia, South Africa, Israel and Argentina, insurance transactions are subject to some kind of value added tax, making it easy to contemplate the application of a taxed system in the EU. This thesis will make reference to the highly respected New Zealand (Kiwi) Goods and Services Tax (GST) system which was regarded by the Tax Review 2001 as ‘setting an international benchmark for expenditure taxes’⁵ and as a ‘broad-based, low rate, fair and efficient tax.’⁶ The Kiwi GST therefore makes a perfect point of reference when referring to applying a tax to insurance transactions and will explore whether it is both possible and preferable, from the viewpoint of the character of VAT and associated effects, to apply this system as an alternative to the current exemption.

1.2 Purpose

The aim of this thesis is to reach a conclusion about whether the EU should adopt the Kiwi approach for taxing insurance transactions, from the perspective of the true character of EU VAT and the legal and practical ramifications of doing so. The purpose of reaching such a conclusion is to examine a possible way to alleviate, or indeed minimise, the current problems that arise directly as a result of the current exemption.

¹ Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ L 347/1, 11/12/2006 (Council Directive 2006/112/EC)

² European Commission, Consultation Paper on Modernising Value Added Tax Obligations for Financial Services and Insurances (DG Taxation and Customs Union Brussels, 2006) 2

³ Thomas G. Thornbury, ‘A Better Way To Include General Insurance in VAT Systems’ (1991) International VAT Monitor May (5), 2. See also Report of the Joint Committee on Taxation (U.S.A.), reported in Bureau of National Affairs Daily Executive Report, May 15, 1989, L-14

⁴ Rita de la Feria and Richard Krever ‘Ending VAT Exemptions: Towards a *Post-Modern* VAT’, in Rita de la Feria, *VAT Exemptions: Consequences and Design Alternatives* (EUCOTAX Series on European Taxation, Vol 3, Wolters Kluwer 2013) 25

⁵ New Zealand Treasury, Tax Review 2001: Final Report, i

⁶ Ibid

1.3 Method and material

In order to fulfil the aim of this thesis, the problems associated with exemptions in general, and in relation to the insurance exemption, will be explored. The provisions of the VAT Directive, alongside the jurisprudence of the Court of Justice, will then be used to determine how the EU exemption really functions in practice. The method used for examining whether the adaptation of the Kiwi system would be beneficial will be to apply the Kiwi system to the EU functioning analysis and examine the effects and outcome.

Alongside this, the main indicators for whether the use of the Kiwi system would be beneficial in the EU will be the impact the system is likely to have on the current problems associated with the exemption. In reaching a conclusion, the key negative consequences of the exemption will be assessed in the light of the Kiwi taxed system, to see to what extent they are alleviated, if at all. Similarly, the negative aspects of the Kiwi system will be examined to see how these would affect the application of the system in the EU. These assessments will play a vital role in reaching an overall conclusion regarding the positive applicability of the Kiwi system to the EU. Of course, other factors such as practicability will also be taken into account and must not be overlooked.

1.4 Delimitation

As it is almost universally accepted that it is not preferable to tax life insurance, with the vast majority of countries exempting such insurance and the rest subjecting it to extremely low rates, the discussions in this thesis will be limited to general damage based insurance transactions. This is supported by New Zealand's approach of treating life insurance as an exempt financial service⁷, rendering comparisons between the systems futile in terms of seeking a better alternative approach. In terms of risk materialisation, this thesis will assume that the insured is not required to pay any excess or deductible when making an insurance claim, with the payments analysed being limited to the premium received and the indemnity payment made by the insurance company.

The focus of this thesis will be placed not on the balance sheets of the insurance firms themselves⁸, nor the tax revenues of Member States, but on how the insurance exemption in the EU really functions and the effects of imposing a tax on such transactions. There has been a previous proposal to apply the Kiwi-VAT to insurance services in the EU⁹, which particularly focused on the financial impact of applying the Kiwi system, but which left open many of the necessary legal questions relating to the application. In the light of this, this thesis will largely evaluate the unanswered legal issues that exist in relation to how the systems function in practice, with less focus on

⁷ New Zealand Goods and Services Tax Act 1985, Public Act 1985 No 141, Date of assent and commencement 3 December 1985 (Reprint as at 1 April 2014) (GST Act) s3(1)(h) and (i)

⁸ As this has been adequately covered by Sijbren Cnossen, 'A proposal to apply the Kiwi-VAT to insurance services in the European Union' (2013) Int Tax Public Finance 20, 867

⁹ Sijbren Cnossen, 'A proposal to apply the Kiwi-VAT to insurance services in the European Union' (2013) Int Tax Public Finance 20, 867

the effect on the financial positions of the insurance firms, as this has been adequately covered.

1.5 Outline

The following chapter will discuss the problems associated with exemption systems in general, with a particular focus on those related to non-deductible input VAT incurred by exempt insurance firms. Chapter 3 will move on to discuss how the EU exemption for insurance transactions really functions in practice, and will include several case based examples to demonstrate this. In the light of the negative consequences of exemptions, Chapter 4 examines a contrasting approach for taxing insurance transactions which is currently applied in New Zealand. In an attempt to discover possible solutions for the problems relating to the EU exemption, Chapter 5 will analyse whether it would be possible, and more importantly, if it would be beneficial, to apply the Kiwi system to the EU. Finally, the thesis will reach a conclusion about the overall applicability of the Kiwi system and whether its adoption is recommended.

2. Problems associated with VAT exemptions

The application of an exemption to a particular supply means that output VAT is not chargeable, but consequently, input VAT is also not recoverable. Such a treatment has been rightly described as ‘an aberration in terms of the basic logic of VAT.’¹⁰ The Preambles to the VAT Directives, from the First Council Directive in 1967¹¹, to the current VAT Directive¹², state that the objectives of the internal market presuppose turnover tax legislation which does ‘not distort conditions of competition or hinder the free movement of goods and services’¹³. Furthermore, the Preambles go on to state that a VAT system ‘achieves the highest degree of simplicity and of neutrality when the tax is levied in as general a manner as possible and when its scope covers all stages of production and distribution’.¹⁴ It is submitted that the application of exemptions fly in the face of these objectives.

Exemptions exist as exceptions to the general system of VAT, so much so that they have been described by the Commission as ‘alien to the VAT system’¹⁵. It is not surprising, therefore, that these ‘alien’ exemptions do not live alongside the taxed VAT system harmoniously. Exemptions are well known for causing economic distortions within the VAT system and a critical example of this is the harmful effects of non-deductible input VAT, which exist as a result of this mandatory insurance exemption, and which this chapter will reflect upon. Such a denial of input tax credit has been

¹⁰ Liam Ebrill and others, *The Modern VAT* (IMF 200) 83

¹¹ Council Directive 67/227/EEC of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes, OJ 71, 14/4/1967, p. 1301 (Council Directive 67/227/EEC)

¹² Council Directive 2006/112/EC

¹³ *Ibid*, Preambles, point (4)

¹⁴ *Ibid*, Preambles, point (5)

¹⁵ European Commission, Impact Assessment, Accompanying document: Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax, as regards the treatment of insurance and financial services, COM/2007/747, 28 November 2008, SEC (2007) 1554 (Impact Assessment accompanying COM/2007/747)

branded the ‘original sin’¹⁶ of the common system of VAT. The problems associated with exemptions are not specific to insurance transactions, but are widespread wherever an exemption occurs, due to the nature of the system.

When introduced in the Sixth Council Directive in 1977¹⁷, the current Article 135 exemptions¹⁸ (then Art 13B) were intended merely as a transient solution, however they have now become very much a permanent fixture of the VAT Directive, with little optimism remaining that the current proposals for reform will be effected, nor successful.¹⁹ Given that there have been no changes to the insurance exemption since its introduction, it is often criticised for not being up to date and failing to give guidance on more recent areas of the insurance sector as it has evolved. The result of this, combined with the option for Member States to introduce tax on insurance contracts²⁰, has been that the exemption is not applied uniformly in all Member States and that there is a drastic lack of neutrality in the taxation of the insurance sector.

2.1 Accumulation and under/over taxation depending on the status of the final consumer

Before the modern VAT system was introduced, one of the main criticisms of the previous systems was accumulation, which was one of the key issues the modern system was introduced to tackle. However, the current system of exemptions encompasses the failures of the previous systems in this respect, by allowing the problem of accumulation to continue in the current VAT system. The critical problem with exemptions in relation to accumulation is that they ‘distort economic choices’²¹ in several ways, which directly goes against the objectives discussed previously from the Preambles.

Accumulation occurs when exempt firms acquire goods/services from non-exempt wholesalers or when they outsource services. The VAT accumulates, resulting in disparities in the total VAT levied, depending on who the final consumer is. If the final-consumer is a non-taxable person, the result is under-taxation when they acquire goods/services from an exempt supplier, rather than one that is subject to the normal system of VAT. However, if the purchaser of the exempt goods/services is a taxable person with the right to deduct, the impact of the accumulation results in over-taxation of the goods/services from the exempt supplier (such as an insurance firm), making it cheaper for them to acquire goods/services from a supplier that is subject to VAT. It is

¹⁶ Case 498/03 Kingscrest Associates and Montecello, Opinion of AG Colomer, para 14

¹⁷ Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment, OJ L 145, 13/06/1977, p. 1 (Council Directive 77/388/EEC, or Sixth Directive)

¹⁸ Council Directive 2006/112/EC

¹⁹ Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax, as regards the treatment of insurance and financial services COM/2007/747 final (28 November 2007) (COM/2007/747). Supported by: Proposal for a Council Regulation laying down implementing measures for Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, as regards the treatment of insurance and financial services, COM/2007/746 final (28 November 2007) (COM/2007/746)

²⁰ Council Directive 2006/112/EC, Article 401

²¹ Oskar Henkow, *Financial Activities in European VAT* (Kluwer Law International 2008) 4

undoubtedly true that this ‘hidden tax’²² on business clients ‘distorts the principle of fiscal neutrality on which the VAT system is based.’²³

2.2 Damaging international competitiveness of insurance firms

Input VAT doesn’t cause issues for most companies supplying goods or services as they are able to deduct it from their outputs. For insurance firms, however, and indeed any firms supplying goods or services that are exempt, this VAT is irrecoverable as the exempt activities don’t give rise to the right to deduct. There are two possible impacts of this; the non deductible VAT, as a cost to the insurance firms, may go on to form part of the premiums charged, thereby raising the cost of taking out insurance cover. Alternatively, due to the competitive nature of the industry, firms supplying exempt services may have to bear the burden of these costs themselves, so that they can compete internationally. This is in contrast to non-EU based firms who do not have to bear input VAT and therefore don’t have this additional cost component to take into account in pricing considerations for premiums.

This cost component that arises as a result of being subject to input VAT in the EU is also liable to make firms consider relocating outside of the EU, to make use of ‘significant price advantages for financial institutions with headquarters outside of the European Union.’²⁴ Alternatively, exempt suppliers may choose to locate in Member States with the lowest VAT rates, such as Luxembourg. Such relocations based on tax motives caused by exemptions distort competition within the EU and can adversely affect tax revenues of Member States. This is an important consideration as although it is easy to contrast the position of EU and non-EU firms, due to diverging VAT rates within the EU, there are likely to be competition issues between EU firms that are subject to differing VAT rates on their inputs. The impact has been described as potentially bringing significant comparative advantages to financial service providers from MS with lower VAT rates.²⁵

As provided for by Article 169(c) of the VAT Directive, there is an additional scope of right of deduction for exempt insurance transactions where the customer is established outside the Community or where the transaction relates to goods to be exported out of the Community. Because of this provision, the competitive disadvantage is alleviated in terms of supplying to non-EU customers as the right of deduction puts EU firms on the same footing as non-EU firms that aren’t subject to VAT, however, the key problem in relation to EU customers remains, as they can otherwise get insurance cover from non-EU firms without any input VAT included.

²² B Carvalho, M Lamensch and S Thiel, ‘VAT Exemption for Insurance-Related Services of Brokers and Agents: The Case of the “Call Centre”’ (2011) *European Taxation*, Vol 51, No 1, 19

²³ *Ibid*

²⁴ Ivana Drazic Lutlisky, Sanja Broz Tominac, Martina Dragija, ‘Financial Services in the VAT System in the European Union and Croatia’ (2012) *South East European Journal of Economics & Business*, November 2012, 23 at 29

²⁵ *Ibid* at 28. See also PricewaterhouseCoopers, *Study to Increase the Understanding of the Economic Effects of the VAT Exemption for Financial and Insurance Services* (2006)

2.3 Vertical integration of the supply chain and preventing efficient structuring and division of tasks

The problem of accumulation also occurs if exempt insurance or financial firms are required to pay VAT on the services that they outsource to others. Given that this hidden tax can either be passed on to customers due to upward pressure on the costs, or has to be borne by the firm itself, the result is that due to international competition with firms that don't incur non-deductible VAT, firms often have to absorb this cost themselves. The result of this is that the 'exemption creates incentives for the avoidance of tax'²⁶, so in contrast to efficient business structuring, vertical integration of the supply chain will occur, whereby firms will source the goods/services they require internally, often referred to as 'self-supply'. Once again, exemptions are distorting economic choices as the 'non-deductible VAT reduces the economic and financial advantages of outsourcing.'²⁷

Due to the hidden tax incorporated in outsourced goods/services, firms are 'stimulated to choose sub-optimal business models'²⁸, incentivised by the avoidance of tax. The application of an exemption results in a VAT that is not neutral in terms of production, which of course, firms will try to use in a manner that results most favourably for them. The choice to self-supply is therefore biased, particularly in relation to labour intensive services. This results in business models that are inefficient economically. For instance, firms may choose to hire extra staff to carry out particular tasks that could be more efficiently carried out by external suppliers who are more specialised and experienced in the field and who can make use of economies of scale within that field. Furthermore, the exempt industry (such as insurance) is distorted in terms of the competitiveness of various firms. The tax bias in favour of self-supply puts smaller firms at a competitive disadvantage as they do not have the same capabilities for self-supply as larger firms do. Larger firms may therefore unfairly prosper, resulting in market domination of a few relatively larger firms and reduced choice for those seeking exempt services such as insurance.

Although the effect on Member States tax revenues is outside the scope of this thesis, it is interesting to note that they too are affected by the non deductible VAT depending on whether they are net exporters or recipients of exempted services. As Terra has noted, net recipients will suffer a 'drain on their receipts'²⁹, with the unevenness becoming more accentuated as the Pan-European market deepens³⁰.

²⁶ Liam Ebrill and others, *The Modern VAT* (IMF 200) 86

²⁷ Joep Swinkels, 'EU VAT Exemption for Insurance Transactions' (2007) *International VAT Monitor*, July/August 2007, 262

²⁸ Ivana Drazic Lutilsky, Sanja Broz Tominac, Martina Dragija, 'Financial Services in the VAT System in the European Union and Croatia' (2012) *South East European Journal of Economics & Business*. See also Impact Assessment accompanying COM/2007/747

²⁹ Terra and Kajus, *Introduction to European VAT (Recast)* (IBFD, 2013) 704

³⁰ *Ibid*

3. The EU VAT exemption for insurance

3.1 Background and provisions

The VAT exemption for insurance transactions has been in place since 1977, when the Sixth VAT Directive was introduced³¹. The current VAT Directive retains the exemption in its original form under Art 135(1)(a)³², whereby Member States are obliged to exempt ‘insurance and reinsurance transactions, including related services performed by insurance brokers and insurance agents.’ The insurance exemption forms one segment of Article 135, which includes exemptions for ‘other activities’, in contrast to those ‘in the public interest’, which are included in Article 132. Unlike these other exemptions, the Directive doesn’t give any guidance as to the purpose of the Article 135 exemptions, which are otherwise generally financial in nature, although is often put down as being due to the ‘technical complexity inherent in taxing financial services’³³.

In relation to insurance specifically, it was noted earlier that this technical complexity arises out of the need to calculate the value added in each transaction, in order to subject the transaction to VAT. According to De la Feria, it is widely accepted that in relation to insurance, the main service provided to policyholders is ‘financial intermediation through risk pooling...however, the difficulty is to determine the price of this intermediation.’³⁴ Such difficulty arises because the invoice-credit method that is used to apply EU VAT only works well for goods and services ‘that are supplied with explicit prices on which a VAT can be imposed’³⁵, which is lacking in the case of insurance provision.

3.2 Functioning

Given that the wording of the directive gives very little detail regarding the functioning of the exemption or its scope, it is necessary to look to the Court’s jurisprudence to determine the real nature of the exemption and how it functions in reality. It is only by gaining an understanding of how the exemption truly works, that any valid assessment on the potential applicability of another system can be rendered. The following case based examples are used to demonstrate the true functioning of the exemption in practice and the legal problems facing the implementation of a new system.

3.2.1 Coverage

Under Article 135(1)(a), no definition or guidance is given for what constitutes ‘insurance and reinsurance transactions’. However, through its jurisprudence, the Court has interpreted these concepts to provide a more detailed classification. Undoubtedly,

³¹ Council Directive 77/388/EEC

³² Council Directive 2006/112/EC

³³ Impact Assessment accompanying COM/2007/747

³⁴ Rita de la Feria, ‘The EU VAT Treatment of Insurance and Financial Services (Again) Under Review’ EC Tax Review, 2007/2, 74

³⁵ Howell H. Zee, ‘A New Approach to Taxing Financial Intermediation Services Under a Value-Added Tax’ (2004) IMF Working Paper (WP/04/119) 6

the leading case on this matter is *Card Protection Plan (CPP)*³⁶. In this case, in relation to the issue of insurance transactions³⁷, the Court was asked whether a firm, CPP, who supplied a service to customers whose credit cards were lost or stolen, but engaged an insurance broker to arrange the insurance policies, was carrying out an insurance transaction. CPP, taking the view that they were carrying out exempt insurance transactions, had not charged their customers VAT, however, the UK tax authorities contended this outlook.

In relation to the coverage of the insurance exemption, there are several relevant points from the judgement that are worth noting. Firstly, the Court repeats settled case law that exemptions are to be strictly construed³⁸ and ‘constitute independent concepts of Community law’³⁹, which shows that their meaning and scope are defined only by Community law, and not by generally understood notions outside of this field, legal or otherwise. Furthermore, the Court explained that there is no reason for the interpretation of ‘insurance’ in the Sixth Directive to differ from that of the insurance directive. The Court goes on to describe the essentials of an insurance transaction, which were held to be that ‘the insurer undertakes, in return for prior payment of a premium, to provide the insured, in the event of materialisation of the risk covered, with the service agreed when the contract was concluded.’⁴⁰ In the light of these criteria, however, it was held to be down to the national court to determine whether CPP had accepted insurance obligations,⁴¹ although the Member States may not restrict the scope of the exemption to insurers authorised by national law. Although the treatment of intermediaries will be discussed in the next paragraph, it is important at this stage to note that the Court in *CPP* found that it would be contrary to the purpose of the exemption if the term ‘insurance transactions’ referred ‘solely to transactions performed by insurers themselves’⁴²

Another case that illustrates the coverage of the exemption is *Skandia*⁴³. In this case, there was a plan to transfer the administration and operations of a wholly owned insurance subsidiary (‘Livbolaget’) to the parent insurance company (Skandia), with the exception of the insurance liability, which would stay with the subsidiary company (‘Livbolaget’). The legal question referred to the Court of Justice was whether such an assumption of a commitment to run Livbolaget’s business activities could constitute an insurance transaction⁴⁴ within the meaning of the exemption.

In rejecting Skandia’s arguments, the Court noted that although insurance companies may be required to limit their objects to insurance business or operations, this does not mean that all of their transactions constitute insurance transactions for tax purposes, as

³⁶ Case 349/96 CPP

³⁷ This case is also a key case for single/composite supplies

³⁸ Case 349/96 CPP, para 22. See also Case 348/87 *Stichting Uitvoering Financiële Acties v Staatssecretaris van Financiën*. This principle has subsequently been consistently affirmed by the Court: See Case 346/95 *Blasi v Finanzamt München I* para 18

³⁹ C-349/96, *Card Protection Plan* judgment para 15. See also Case 453/93 *Bulthuis-Griffioen v Inspecteur der Omzetbelasting* para 21 and 22

⁴⁰ Case 349/96 CPP, para 17

⁴¹ *Ibid*, para 19

⁴² *Ibid*, para 23

⁴³ Case 240/99 *Skandia*

⁴⁴ It was commonly agreed that it did not constitute reinsurance, Case 240/99 *Skandia*, para 20

referred to in the exemption.⁴⁵ Furthermore, a distinction was made between the insurance exemption and other financial exemptions⁴⁶, which formed the basis of the *SDC*⁴⁷ case. In contrast to these other exemptions, which were said to ‘refer in a general way to transactions ‘concerning’ or involving’⁴⁸ certain financial transactions, the insurance exemption covers ‘insurance transactions in the strict sense.’⁴⁹

Quoting the essentials from *CPP*⁵⁰, the Court in *Skandia* then focused on the legal relationship between the insurer and the insured which had been created in this case⁵¹. The Court goes on to state that according to *CPP*, it appears that ‘an insurance transaction necessarily implies the existence of a contractual relationship between the provider of the insurance service’ and the insured.⁵² The assumption of the commitment was not sufficient to constitute an insurance transaction, given that it did not include the assumption of liability in respect of the insurance business⁵³. The *Skandia* case therefore shows that in terms of the coverage of the exemption, the transfer of insurance liability and the existence of a contractual relationship are necessary conditions for an insurance transaction. This was also an issue in the *Swiss Re* case⁵⁴ which concerned the transfer of a portfolio of contracts. Here, the timing of the existence of the legal relationship was also considered an important factor, with the transaction falling between two contractual relationships.

A final case, which is also relevant in relation to the next subsection, is that of *BGŻ Leasing*⁵⁵. This case involved BGŻ leasing items, with the condition that the items were insured. BGŻ could provide its clients with insurance, which it would then subscribe from an insurance company and re-invoice the costs to the lessee. It was contended whether this re-invoicing of the insurance cost was covered by the exemption, due to the argument that the supply of insurance was ancillary to the leasing service. The jurisprudence surrounding single/composite supplies is outside the scope of this thesis⁵⁶, however, the Court noted that despite the fact that there is ‘necessarily a connection between the leased item and the relevant insurance’⁵⁷, the insurance transactions can’t be subject to VAT solely on the basis that the relating item is subject to VAT. Furthermore, the insurance was held to constitute an end in itself, rather than a means to best enjoy the leasing service⁵⁸, which is critical for a finding of the presence of separate supplies. In addition, the requirement for insurance cover can’t invalidate this

⁴⁵ Case 240/99 *Skandia* para 34

⁴⁶ Case 349/96 *CPP* para 36, Art 13B(d)(3) and (5) in Council Directive 77/388/EEC, corresponding largely to Art 135(1)(d) and (e) in Council Directive 2006/112/EC

⁴⁷ Case 2/95 *SDC*

⁴⁸ Case 349/96 *CPP* para 36

⁴⁹ *Ibid*

⁵⁰ Case 240/99 *Skandia* para 37

⁵¹ *Ibid*, para 39

⁵² *Ibid*, para 41

⁵³ Case 349/96 *CPP* para 40

⁵⁴ Case 242/08 *Swiss Re Germany Holding*

⁵⁵ Case 224/11 *BGŻ Leasing*

⁵⁶ But can be found in the following cases: Case 392/11 *Field Fisher Waterhouse*, para 14, Case 425/06 *Part Service*, para 51, Case 276/09 *Everything Everywhere*, para 23, Case 41/04 *Levob Verzekeringen and OV Bank*, para 22, and Case 111/05 *Aktiebolaget NN*, para 23, Case 349/96 *CPP*, para 30, Case 242/08 *Swiss Re Germany Holding*, para 51

⁵⁷ Case 224/11 *BGŻ Leasing* para 36

⁵⁸ *Ibid*, para 42

finding, particularly given the option for sourcing the insurance independently⁵⁹. In the light of these findings, the Court went on to hold the term ‘insurance transactions’ could cover this situation in which the lessor takes out insurance, at the request of its clients, with a third party insurer and then re-invoices this exact amount.

3.2.2 Treatment of intermediaries

The treatment of intermediaries plays a fundamental role in shaping the functioning of the insurance exemption and its coverage. The exemption in Article 135(1)(a) includes ‘related services performed by insurance brokers and insurance agents’, which, alongside the need for a contractual link between the insurer and the insured, has been the subject of much case law in the Court of Justice.

Once again, *CPP* is a good starting point for evaluation. Alongside the Court ruling that the term ‘insurance transactions’ was broad enough to cover ‘provision of insurance cover by a taxable person who is not himself an insurer’⁶⁰, the opinion of AG Fennelly is particularly useful regarding the interpretation of the exemption in relation to intermediaries. As a starting point, the AG rightly interprets that ‘related services’ are only exempt if provided by insurance agents or brokers and that the term ‘related services’ includes any services related to the provision of insurance.⁶¹ The crucial issue in relation to intermediaries is therefore who qualifies as an agent or broker. To determine this, the AG looked to the relevant contemporaneous Community insurance legislation⁶², and noted that the wording of the Sixth Directive shows a purposeful use of the separate terms ‘insurance agents’ and ‘insurance brokers’, ‘rather than to use a more general term such as insurance ‘intermediaries’’.⁶³ Such an interpretation narrows the potential scope of the exemption, a limitation which the AG felt would otherwise deprive the exemption of any meaning if ‘any intermediary whatever which is incidentally involved in arranging insurance *ipso facto* came within the definition.’⁶⁴

The question remains, however, what the critical elements of an agent or broker are, in contrast to those of a more general intermediary nature. Here, the AG noted that the use of the more restricted terms refers to ‘persons whose names professional activity comprises the bringing together of insurance undertakings and persons seeking insurance’.⁶⁵ Although the AG was not explicit about whether only authorised agents/brokers are covered by the exemption, Jespersen has interpreted his use of the term ‘professional’ to most likely imply that ‘non-authorised agents or brokers are not likely to meet the necessary criteria to be covered by the exemption.’⁶⁶

⁵⁹ Ibid, para 43

⁶⁰ Case 349/96 CPP para 22

⁶¹ Case 349/96 CPP, Opinion of AG Fennelly, para 31

⁶² Council Directive 77/92/EEC of 13 December 1976 on measures to facilitate the effective exercise of freedom of establishment and freedom to provide services in respect of the activities of insurance agents and brokers (ex ISIC Group 630) and, in particular, transitional measures in respect of those activities, OJ L 26, 31/01/1977, p. 14 (Council Directive 77/92/EEC)

⁶³ Case 349/96 CPP, Opinion of AG Fennelly, para 32

⁶⁴ Ibid

⁶⁵ Ibid

⁶⁶ Claus Bohn Jespersen, *Intermediation of Insurance and Financial Services in European VAT* (EUCOTAX Series on European Taxation Vol 30, Wolters Kluwer 2011) 194

As with ‘insurance transactions’, legal relationships play a significant role in defining the scope of insurance agents and brokers. Although not a question referred to the Court, AG Saggio in *Skandia* quickly ruled out the possibility of Skandia being regarded as a broker or agent, on the sole ground that ‘it has no legal relationship with the insured’⁶⁷. Later, in *Taksatorringen*⁶⁸, which concerned the possible exemption of damage assessment services, both AG Mischo and the Court were of the opinion that the provisions apply only to ‘professionals who have a relationship with both the insurance company and persons seeking insurance’.⁶⁹ The Court ruled out the possibility of Taksatorringen fulfilling the conditions of the contemporaneous Community legislation on insurance⁷⁰ as this included the power to render the insurer liable in case of loss, which wasn’t possible given Taksatorringen only had a contractual relationship with the insurer, and not the insured.

Building upon this, AG Maduro in *Arthur Andersen*⁷¹ believed that the ‘decisive aspect’⁷² in the relationship between the agent and policy holder ‘necessarily implies the existence of an agent’s own declarations’⁷³ towards the policyholder, with the agent ‘acting on behalf of and possibly in the name of the insurer.’⁷⁴ This position of acting ‘in the name and on behalf of, or solely on behalf of’⁷⁵ the insurer was interpreted by AG Maduro to conclude that ‘the power to render the insurer liable cannot be the decisive criterion’⁷⁶ as when acting solely on behalf (and not in the name) of the insurer, the agent does not have this power to render the insurer liable.⁷⁷ Other conditions were deemed necessary to be fulfilled.⁷⁸ Given that exemptions are to be interpreted strictly, the AG was against a possible extension of the concept of insurance agent,⁷⁹ as expressed earlier in *Taksattoringen*, so concluded that an agent’s activity should be viewed ‘as a supply of services on a professional basis, which begins and ends in itself and which thus has an independent substance distinct from the business of the insurer.’⁸⁰ The AG’s opinion was then followed by the Court.

The following case of *Beheer*⁸¹ introduces some unclarity into the line of jurisprudence of the Court of Justice up until this point. In this case, although the activities carried out by Beheer were ‘unquestionably the characteristic activities of an insurance broker or agent’⁸², Beheer was only in ‘an indirect relationship with one of the parties to an insurance contract.’⁸³ In spite of this, the Court re-evaluated and qualified its judgement in the previous cases of *Taksatorringen* and *Arthur Andersen*, to conclude that it had not

⁶⁷ Case 240/99 *Skandia*, Opinion of AG Saggio, para 19

⁶⁸ Case 8/01 *Taksatorringen*

⁶⁹ Case 8/01 *Taksatorringen*, Opinion of AG Mischo, para 86

⁷⁰ Council Directive 77/92/EEC, Art. 2(1)(a) or 2(1)(b)

⁷¹ Case 472/03 *Arthur Andersen*

⁷² *Ibid*, Opinion of AG Maduro, para 28

⁷³ *Ibid*

⁷⁴ *Ibid*

⁷⁵ Council Directive 77/92/EEC, Article 2(1)(b). See also Case 8/01 *Taksatorringen*

⁷⁶ Case 472/03 *Arthur Andersen*, Opinion of AG Maduro, para 31

⁷⁷ *Ibid*

⁷⁸ *Ibid*

⁷⁹ *Ibid*, para 40 and 41

⁸⁰ *Ibid*, para 33

⁸¹ Case 124/07 *Beheer*

⁸² *Ibid*, para 18

⁸³ *Ibid*, para 16

limited ‘the nature of that relationship to a specific form.’⁸⁴ This allowed the Court to find that the indirect relationship with the insurers was sufficient to include Beheer’s activities under the exemption.

3.2.3 Consequences of the location of insurance companies and customers

As was briefly discussed earlier, the location of both insurance companies and their customers have important VAT consequences. For insurance companies, being located in a third country brings the advantage of not being subject to EU VAT on inputs. Due to differing rates within the Community itself, there can also be VAT consequences attached to the choice of MS to establish in. For example, if an insurance firm was to establish itself in Luxembourg, it would be subject to a lower VAT rate on its inputs than if it were to be established in a MS with a higher VAT rate, such as Sweden⁸⁵.

The extent of the negative consequences related to non-deductible input VAT is also affected by the firm’s client profile. The location of the customers is hugely significant for VAT purposes given Article 169(c) of the Directive, under which there is an additional scope of the right of deduction when the goods/services are used for certain exempt transactions, including insurance. This additional right of deduction exists ‘where the customer is established outside the Community or where those transactions relate directly to goods to be exported out of the Community.’ Consequently, if an EU based insurance firm supplies its services predominantly to customers outside of the Community, it will be able to deduct a greater proportion of its input VAT in comparison to a similar firm which predominantly supplies to customers located within the EU. This additional scope for deduction is crucial for securing the international competitiveness of EU firms as otherwise they will be at a disadvantage compared to firms established outside of the EU, who don’t incur hidden VAT costs.

This Article (169(c)) formed the basis of the *Commission v UK*⁸⁶ case, which has important consequences relating to the location of taxable persons. The case concerned the UK treatment of denying the recovery of input VAT in respect of transactions referred to in Art 169(c), when carried out by taxable persons not established in the EU. The Commission applied to the Court for a declaration that this treatment amounted to a failure by the UK to comply with its obligations under Art 169 to 171 of the current VAT Directive and Art 2(1) of the Thirteenth VAT Directive.⁸⁷ The case hinged on finding the correct interpretation of the provisions, in particular, whether the clear and precise wording should be followed, or going against this and following the overall logic of the VAT system. The Court, agreeing with the AG, found in favour of legal certainty by holding that the relevant provisions discussed did not confer the right to recover input tax in the MS in respect of goods and services used for the purposes of transactions falling under Art 169(c), where the trader is established outside the EU.

⁸⁴ Ibid, para 24

⁸⁵ Luxembourg’s standard rate is 15%, compared to Sweden’s standard rate of 25%, IBFD (correct as of 15/05/2014)

⁸⁶ Case 582/08 *Commission v United Kingdom*

⁸⁷ Thirteenth VAT Directive 86/560/EEC of 17 November 1986 on the harmonisation of the laws of the Member States relating to turnover taxes – Arrangements for the refund of value added tax to taxable persons not established in Community territory, OJ L 326, 21/11/1986, p. 40 (Thirteenth VAT Directive 86/560/EEC)

The result of this case is that there is clearly no obligation, and indeed no legal basis, for providing a refund to traders in this situation who are established outside of the EU. Such a judgement, while undoubtedly reaching the right conclusion in terms of the correct interpretation of the Directives in the light of legal certainty, creates problems for the functioning of the VAT system. The AG notes that commentators have suggested that the ‘possibility to deduct or refund was granted in order to ensure the competitive neutrality of EU financial and insurance service providers on international financial markets by introducing a possibility to alleviate tax cascading’⁸⁸. This possible underlying reason of ensuring international competitiveness of the EU financial sector doesn’t go against the findings of the Court, however there are likely to be other consequences of the judgment. For example, as taxable persons not established in the EU are not entitled to a refund of input VAT on these respective goods and services, they are likely to be dissuaded from sourcing such goods/services from suppliers in the EU and instead source them from outside the EU so that EU VAT will not apply to these inputs.

This result only applies to a certain extent however, as the application of this interpretation of the provisions is not consistent throughout the MS. This practical problem was invoked by the Commission, given that the majority of MS ‘currently allow refunds to persons not established in the EU and carrying out the transactions contained in Article 169(c) of the VAT Directive’⁸⁹, which is in breach of the VAT Directives. The scope of entitlement to refunds is far from consistently applied throughout the EU, which undermines the functioning of the VAT system and adds to the negative results of the exemption.

3.2.4 Risk materialisation

The final section in this chapter deals with what happens when an insured risk materialises and the VAT implications of indemnity payments. As a starting point, the indemnity payments to the insured are classified not as consideration for supply, which is the basis of VAT, but rather as compensation for loss sustained. For this reason, the indemnity payments do not include VAT. This is true whether the indemnity payment is made to a VAT registered business or to a private individual.

In relation to settlements in kind, as insurers are exempt, they are unable to recover any VAT incurred when replacing goods or carrying out repairs for the insured. If, on the other hand, the insured is directly supplied with the goods/repair service, rather than the supply being made to the insurer, the deductibility of the VAT included on these supplies is determined by the VAT status of the insured party. A tax registered business will therefore be able to deduct the VAT included in the supply, provided the supply relates to insured property which is for business use. In this case, where the insured can make a deduction for the VAT, the insurer will normally make an indemnity payment to the insured to cover only the net amount. Insurers will then be better off if making settlements in kind to VAT registered parties who are directly supplied with the goods/repair service, rather than non-registered parties, as there is a possibility to cover only the net amount, whereas there is no possibility for the insurer to deduct the input

⁸⁸ Case 582/08 *Commission v United Kingdom*, Opinion of AG Jääskinen, para 32. See Oskar also Henkow, *Financial Activities in European VAT* (Kluwer Law International 2008) 286.

⁸⁹ *Ibid*, para 66

VAT included in replacement goods/services to be supplied to a non-registered party. In this situation, where the insurer covers only the net amount to VAT registered parties who in effect have the benefit of input VAT recovery on the acquisition, there is neutrality between VAT registered and non-registered parties.

In relation to cash indemnity payments, however, there is a lack of neutrality between VAT registered and non-registered insured parties. As cash payments to both are exclusive of VAT, when the parties go on to purchase the replacement goods/repair service themselves, the non-registered party is worse off, as the payment they receive is exclusive of VAT, but the replacement they have to purchase (assuming it is taxable) will be inclusive of VAT, which they can't deduct. VAT registered businesses, however, also receive the cash payment exclusive of VAT, but when purchasing the replacement, they will be able to deduct the VAT included. For a VAT registered business, therefore, the two outcomes of a payment in kind or in cash are equally as beneficial, but for a non-registered party, receiving a cash payment is less beneficial compared to receiving a payment in kind.

4. The Kiwi system of taxing insurance

4.1 Background and provisions

In New Zealand, Goods and Services Tax (GST) is imposed on supplies of goods and services⁹⁰. The statutory provisions of the tax are enshrined in the NZ Goods and Services Tax Act 1985 (GST Act), where a tax rate of 15% is imposed on supplies of goods and services⁹¹. In contrast to the EU exemption for insurance transactions, New Zealand subjects insurance transactions to its GST. It does so by 'ignoring the theoretical nicety of attempting to determine the true value added by the insurer's intermediation activities'⁹² and instead is based upon the business cash flow of the insurance firm. The system has been described as shifting the determination of the taxable value added from an individual policy basis to the level of the insurance company.⁹³

4.2 Mechanism

The basics of the tax are that the insurer charges GST on premiums received and claims input tax credits for both insurance payments and the firm's costs attributable to taxable insurance. The treatment by the insurance firm therefore does not distinguish between GST registered and non GST registered customers. The insured party, if GST registered, can claim input tax credits on the premiums paid⁹⁴ and on payments it receives.⁹⁵ If not

⁹⁰ GST Act, s8

⁹¹ GST Act, s8(1)

⁹² Thomas G. Thornbury, 'A Better Way To Include General Insurance in VAT Systems' (1991) *International VAT Monitor* May (5), 2 at 3

⁹³ Sijbren Cnossen, 'A proposal to apply the Kiwi-VAT to insurance services in the European Union' (2013) *Int Tax Public Finance* 20, 867 at 868

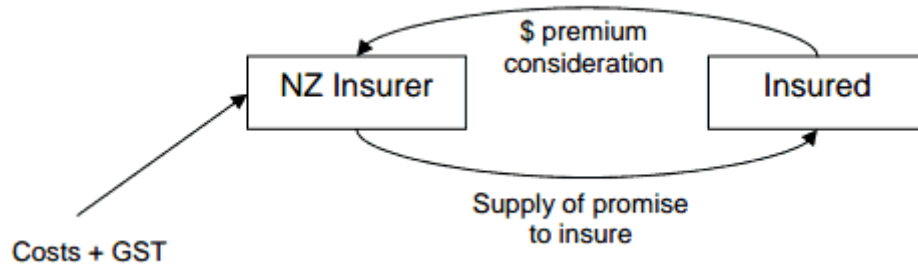
⁹⁴ GST Act, s20(3)(d)

⁹⁵ New Zealand Inland Revenue Department (December 2000) *Tax Information Bulletin*: Vol 12, No 12, 17

GST registered, the insured must pay GST on the premium and receives indemnity payments which are grossed up to include GST.

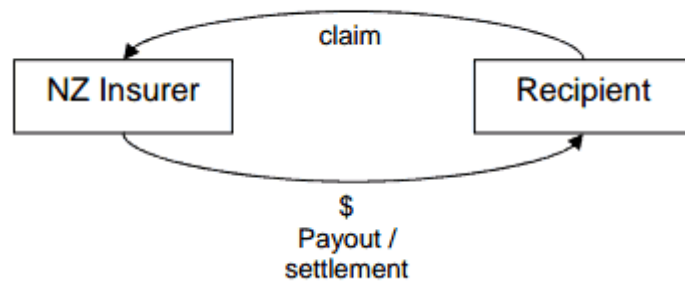
The two diagrams below illustrate the mechanics of a premium being paid and a claim being made under the policy.

Premiums paid under policy – general position



The first diagram (above) represents the situation of a premium being paid under a general insurance policy. In supplying the promise of insurance, the NZ insurer incurs costs with input GST, which it is then able to deduct as it supplies a taxed service. The premiums received, as consideration, also include GST, which the insurer accounts for. This is true regardless of the taxable status of the insured party, as the premium always includes GST whether the insured is GST registered or not. The insured, if GST registered, is able to deduct this GST paid on the premium as input tax⁹⁶, with a non-GST registered insured party not having this ability.

Claim under policy – general position



This second diagram (above) represents the situation of a claim being made under a policy when the insured risk materialises. Note that the ‘Insured’ party in the previous diagram has been replaced by the ‘Recipient’ of the indemnity payout, as for GST purposes, the liability to account for GST lies with the recipient, regardless of whether they are a party to the insurance contract. If a successful claim is made under the insurance contract, the insurer makes a payout which includes GST, regardless of the GST status of the recipient. The insurer is then able to claim a deduction for this GST that is included in the payout⁹⁷. Only if the recipient is GST registered, and the payout

⁹⁶ GST Act, s20(3)(d)
⁹⁷ Ibid

amount relates to their taxable business, must they account for the GST on the amount received.⁹⁸

Numerical example – supply of general insurance

The example will use a hypothetical insurance company which sells taxable insurance policies for a total of \$1,150,000 in June 2014.

\$700,000 of those policies was sold to taxpayers who are general GST taxpayers.

\$450,000 of those policies (the remainder) was sold to private individuals.

During June 2014, the insurer pays out total cash settlements of \$1,000,000.

\$600,000 of those settlements was paid to general GST taxpayers.

\$400,000 of those settlements (the remainder) was paid to private individuals.

The GST rate used in this example is 15%, as this is the current applicable rate for general insurance in NZ⁹⁹.

On payment of the premium

Insurer's GST is = $1,150,000 \times 0.15/1.15$	\$150,000
Insured's input GST credit is = $700,000 \times 0.15/1.15$	\$91,304

On cash settlement of the claims

Insured's GST is = $600,000 \times 0.15/1.15$	\$78,261
Insurer's deemed input GST credit = $1,000,000 \times 0.15/1.15$	\$130,435

GST Liability	\$26,087
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Result

Only the margin of \$200,000 attributable to sales to private individuals is subject to GST of \$26,087 (being $200,000 \times 0.15/1.15$)

As can be seen from this numerical example, the value added, and therefore the VAT/GST liability is 'not calculated on a policy-by-policy basis, but rather, is pooled amongst all of the premiums invoiced and claims paid during each tax period'¹⁰⁰, which in this example is the duration of June 2014. It is purely the cash flow of premiums received and settlements paid that determines the VAT liability, the insurer 'does not take into account reserves or other accruals in that calculation.'¹⁰¹

⁹⁸ GST Act, 5(13)

⁹⁹ GST Act, s8(1)

¹⁰⁰ KPMG, Proposed Introduction of VAT for the Insurance Sector in China, August 2013, 19

¹⁰¹ Ibid

5. Application of the Kiwi system to EU VAT

5.1 Could the Kiwi system be applied?

5.1.1 Differences that could affect replication

It is widely accepted that applying the current exemption to insurance transactions is not an ideal treatment, and indeed the Commission has outlined proposals for reform which would broaden the tax base.¹⁰² Cnossen, amongst others, has proposed to integrate property and casualty insurance services fully within the VAT base¹⁰³, ‘basically by adopting the approach found in countries with modern VAT systems, such as New Zealand.’¹⁰⁴ In theory, and when focusing purely on the financial aspects, proposals along these lines can’t be criticised, especially given the negative consequences of the exemption which were discussed earlier.

However, it is submitted that vital aspects have been overlooked, which make such proposals seem slightly unrealistic in practice. Focus has been placed on the functioning of the tax system itself and the economic and financial aspects; however there are critical differences between New Zealand and the EU, which have the power to dramatically affect the potential replication of the system. These differences include those that are economic, social, political and legal in nature, and cannot be overlooked.

New Zealand is a country with a current population estimated at 4.5m people¹⁰⁵, with the EU having a population estimated at 507m people¹⁰⁶. In terms of GDP, which is perhaps a more useful comparison tool, the GDP of New Zealand in 2012 was an estimated \$171.3 billion¹⁰⁷, compared to \$16.66 trillion in the EU.¹⁰⁸ In this case, the EU has a GDP nearly 100 times greater than that of New Zealand. As GDP represents the ‘monetary value of all the finished goods and services produced’¹⁰⁹, it also serves as a reasonable indicator of the scope of economic transactions subject to the tax system in place. Comparing the specific total gross premium figures for insurance shows the sheer magnitude of the insurance industry in the EU compared to NZ. In 2008, the gross premiums in NZ totalled \$3,144 million, whereas in 15 EU countries, the figure stood at \$624,742 million.¹¹⁰ Such an exceptionally greater value (and volume) of insurance

¹⁰² Sijbren Cnossen, ‘A proposal to apply the Kiwi-VAT to insurance services in the European Union’ (2013) Int Tax Public Finance 20, 867. See COM/2007/747 and COM/2007/746

¹⁰³ Ibid at 868

¹⁰⁴ Ibid

¹⁰⁵ Figure taken from Statistics New Zealand, available online at http://www.stats.govt.nz/tools_and_services/population_clock.aspx (accessed 09/05/2014) and rounded to two significant figures.

¹⁰⁶ Figure taken from Europa (data sourced from Eurostat) available online at http://europa.eu/about-eu/facts-figures/living/index_en.htm (accessed 09/05/2014) and rounded to three significant figures.

¹⁰⁷ Figure in USD. Figure taken from the World Bank. Available online at <http://data.worldbank.org/country/new-zealand> accessed 09/05/2014

¹⁰⁸ Figure in USD. Figure taken from the World Bank. Available online at <http://data.worldbank.org/country/EUU> accessed 09/05/2014

¹⁰⁹ Investopedia, available online at <http://www.investopedia.com/terms/g/gdp.asp> (accessed 09/05/2014)

¹¹⁰ OECD.StatExtracts, Insurance Indicators, available online at <http://stats.oecd.org/Index.aspx?QueryId=25437> (accessed 30/05/2014) Figure in USD and includes only non-life policies, including both insurance and reinsurance. 15 EU countries included are: Belgium,

transactions makes the effective and efficient application of the NZ system questionable in practice on such an enormous economic scale, given that it has never been tested on such an extensive basis.

Despite these tremendous economic differences, potentially the greatest difficulties facing the adoption of the NZ system are the legal differences between the two systems. GST only needs to be applicable to one legal system, that of New Zealand, whereas EU VAT needs to be applicable throughout the 28 sovereign MS, all of which have different legal systems. Given that these 28 sovereign Member States have varying VAT rates, it is unlikely that the adoption of a taxed system would function as efficiently and as smoothly as the NZ system which is limited to one legal system. As Englisch has noted, ‘the fact that VAT is harmonized at EU level but mostly implemented through national VAT Acts constitutes a particular challenge with regard to its uniform and principle-based interpretation.’¹¹¹

An additional problem related to multiple Member States are place of supply issues. In New Zealand this doesn’t cause many problems as the GST only applies to one State, which has a uniform tax rate throughout, so the place of supply is only relevant in relation to supplies involving other countries. In the EU however, the place of supply is of great importance given the varying rates within the EU, which create a situation whereby, in addition to the place of supply issues concerning third countries, there are also such issues related to transactions carried out within the EU but involving more than one MS. Despite these differences, however, the fundamentals of value added tax systems contain many similarities, which make comparisons between systems easier than for other types of taxes. The structure and reasoning behind a VAT lends itself to discussions of technical ways to solve problems.

5.1.2 Feasibility of removing the exemption

Aside from the legal ramifications and challenges, the political context is worthy of consideration, given the practical issues it presents in reality. Implementing a change in the VAT Directive, such as removing the exemption for insurance transactions and subjecting them to a NZ style value added tax, would require the unanimous consent of all Member States¹¹². Agreeing on changes such as this is likely to be an extremely long and challenging process, particularly because the MS will be effected in different ways depending on many factors such as whether they are net importers/exporters of insurance services and their VAT rates.

Despite this, indications from the 1973 Hutchings Report, from before the introduction of the exemption, concluded that the most serious objection to imposing VAT on insurance was ‘the absence of a readily identifiable mechanism’¹¹³ for doing so. A recent Commission Consultation Paper notes that there was a ‘widespread perception at

France, Italy, Luxembourg, Netherlands, Germany, Denmark, Ireland, United Kingdom, Greece, Spain, Portugal, Austria, Sweden, Finland.

¹¹¹ Joachim Englisch, ‘The EU Perspective on VAT Exemptions’ in Rita de la Feria, *VAT Exemptions: Consequences and Design Alternatives* (EUCOTAX Series on European Taxation, Vol 3, Wolters Kluwer 2013) 39

¹¹² See Article 113 of the Treaty on the Functioning of the European Union

¹¹³ European Commission, Consultation Paper on Modernising Value Added Tax Obligations for Financial Services and Insurances (DG Taxation and Customs Union Brussels, 2006) 2

the time that a technical solution allowing the introduction of full taxation on insurance and financial services, which was seen as the best option to rectify the breach in neutrality, would duly be identified.’¹¹⁴ This could show that, if accepted as such a mechanism for doing so, the Member States may agree to the implementation of the New Zealand system. However, it must be taken into account that at that stage of the EU’s development, only six Member States existed and were consulted in the Report. Given the rapid expansion of the EU and the evolution of the insurance industry which has grown in complexity, reaching agreement on the introduction of the system, and indeed the specific workings of the system, is undoubtedly going to be a more formidable task than at the time of the exemption’s introduction.

More light can be shed on the feasibility of removing the exemption from the Commission’s proposal for a Directive¹¹⁵ to modernise and simplify the VAT rules for insurance. The proposal aims at setting clear, modern definitions of exempt services and introducing the ability to opt for taxation. The proposal has been described as the ‘result of a political agenda set out in 2000 aimed at changing the legislation regarding the VAT treatment of insurance and financial services.’¹¹⁶ The consultation process began in 2004¹¹⁷, however the progress has been slow and arduous with each Presidency releasing compromise texts of the proposals¹¹⁸, which ‘show the difficulties in agreeing on an amendment of the current legislation.’¹¹⁹ Furthermore, most scepticism from national delegates has surrounded the proposed mandatory option to tax at the choice of financial institutions¹²⁰. Given the limited progress of these proposals on the same area, it is likely that a proposal to introduce the NZ system would be faced with as much, if not more, difficulty given how significant the change would be.

5.1.3 Transitional issues

Assuming the feasibility of removing the exemption and applying the Kiwi system, consideration must also be given to transitional issues that would undoubtedly occur given the extensiveness of the changes, and which arise as a result of all tax reforms. Although a thorough examination of these issues is outside the scope of this thesis, it is interesting to briefly note a few, given that any resultant benefits in relation to this must also be able to justify such a profound system change.¹²¹ These transitional issues may be amplified exponentially in relation to the number of MS applying the changes. Even

¹¹⁴ European Commission, Consultation Paper on Modernising Value Added Tax Obligations for Financial Services and Insurances (DG Taxation and Customs Union Brussels, 2006) 2

¹¹⁵ COM/2007/747, supported by COM/2007/746

¹¹⁶ Claus Bohn Jespersen, *Intermediation of Insurance and Financial Services in European VAT* (EUCOTAX Series on European Taxation Vol 30, Wolters Kluwer 2011) at 388. Communication from the Commission to the Council and the European Parliament – A strategy to improve the operation of the VAT system within the context of the internal market, COM/2000/348 final (COM/2000/348)

¹¹⁷ COM/2007/747, 5

¹¹⁸ For greater detail see Claus Bohn Jespersen, *Intermediation of Insurance and Financial Services in European VAT* (EUCOTAX Series on European Taxation Vol 30, Wolters Kluwer 2011) 387

¹¹⁹ *Ibid*

¹²⁰ See Document 15793/08 FISC 156, 14 November 2008 from Presidency of the Council of the European Union to the Working Party on Tax Questions – Indirect Taxation (VAT), at 3-6; and Document 11013/08 FISC 80, 23 June 2008

¹²¹ European Commission, Consultation Paper on Modernising Value Added Tax Obligations for Financial Services and Insurances (DG Taxation and Customs Union Brussels, 2006) p2 and 3, regarding the Commissions 1990’s proposals.

when changes are limited to one State (such as a change relating only to the NZ system), transitional issues can be challenging and costly, however, when applied throughout an area such as the EU, these issues are likely to be vast as they apply on a much greater scale.

There exists a ‘stubborn fact that legal transitions produce winners and losers’¹²², the extent of this being determined both by the changes themselves and the economic choices made in reliance of the previous exemption system. For example, some insurance firms may have chosen less economically efficient structuring methods, such as vertical integration, in order to be tax efficient when subject to the exemption. When a tax is imposed, these firms will lose the tax advantages they were benefitting from and be left with an economically inefficient business structure. Perhaps the most crucial transitional issue is the date that VAT would become applicable to insurance transactions. Given the method for calculating the value added in NZ, using both the premium received and the indemnity payment made, it would be logical that if VAT were to apply, it would be imposed on both of these payments. For example, if an insurance premium was paid before the imposition of VAT, but the indemnity payment was made afterwards, the insurer should not be able to deduct VAT for the indemnity payment made, assuming that no VAT was received on the insurance premium. For this reason, VAT should only apply to new policies agreed after the date of imposition, as this way both relevant payments are subject to the same tax treatment, whether exempt or taxed.

Just touching on a few of the other issues can give a good indication of the intensity and scope of the problems. For example, the timing of MS transposing the changes to the Directive is critical to ensure a harmonious application of the taxed system and reducing tax planning opportunities. The accounting practices will also have to be completely recast to fit the new system which lies outside of the standard invoice-credit basis. The revenue authorities of Member States will need to issue new guidelines, update their practices and IT systems and retrain staff. There is a possibility that current insurance policies, especially those with an extended duration, may need to be updated and re-negotiated in the light of the taxed system, depending on the way in which the new tax is imposed. Finally, but by no means an exhaustion of the issues, businesses are likely to incur increased administrative costs in order to comply with the new system.

5.2 Functioning

5.2.1 Coverage

Despite being rather basic and somewhat circular in nature, the GST Act, unlike the VAT Directive, provides a definition of insurance. S2(1) states that ‘insurance means insurance or guarantee against loss, damage, injury, or risk of any kind whatever, whether pursuant to any contract or any enactment; and includes reinsurance; and contract of insurance includes a policy of insurance, an insurance cover, and a renewal of a contract of insurance’.¹²³ As an exception to the general principle that

¹²² Michael Doran, ‘Legislative Compromise and Tax Transition Policy’ (2007) University of Chicago Law Review, Vol. 74, 545

¹²³ GST Act, s 2(1)

turnover tax is levied on all goods or services supplied for consideration by a taxable person, the insurance exemption, like other exemptions, must be interpreted strictly and indeed the Court of Justice has done so.¹²⁴ The Kiwi definition of insurance, however, does not relate to an exemption, so strict interpretation is neither necessary, nor appropriate.

It is likely, therefore, that the New Zealand concept of (taxed) insurance is wider than the EU concept of exempt insurance transactions. If the EU were to adopt the Kiwi approach, the coverage of the terms used is likely to increase as the logic behind a strict interpretation will be removed with the exemption. An important distinction then arises between, on the one hand, transactions which currently fall under the exemption, and which would then be subject to the Kiwi style taxed system when adopted, and on the other hand, those transactions which do not currently fall within the strict scope of the exemption, so presumably would not be subject to the Kiwi style taxed system when adopted. The outcome could be that, insurance transactions which currently fall within the exemption will be subject to the Kiwi style of tax and other transactions, which may be also be related to insurance but haven't fallen within the strict interpretation, are subject to the existing EU VAT. This could result in two types of VAT systems, one on a cash-flow basis (Kiwi) and one on an invoice-credit basis (EU) being applied to questionably similar insurance related transactions, given that the basis for the strict interpretation which acts as the determining factor between exempt and non-exempt transactions has been lost.

Alternatively, the starting point could be that a wider scope is used to define insurance transactions (which would then need to be determined), so that the Kiwi style VAT applies to all insurance related transactions and not just those that previously fell under the strict exemption. However, there are also several issues with this approach, especially as it is likely to subject transactions which are currently taxed under EU VAT to Kiwi style VAT instead, rather than just subjecting currently exempt transactions to VAT. The critical issue here is in determining the correct scope of the application of the NZ style VAT and ensuring a clear division between transactions which are subject to this, and those that are subject to the EU VAT. If this is not done successfully, the result could be that the two styles of VAT system overlap, or leave gaps, in their coverage. Where there is any uncertainty in the application of either system, especially in terms of coverage, disparities are likely to arise between the treatment given in each MS, which undermines the success of the VAT and creates problems for revenue authorities, the courts (both national courts and the Court of Justice), insurers and the insured parties.

Ultimately, the critical problem attached to the EU exemption is a definitional one. Due to the presence of the exemption, it is crucial that there is a strict borderline division between what is taxed and what is classified as exempt. As is the case whenever there is the presence of a special rule, in this case the exemption, the distinction between the classification of transactions is fundamental given the differing tax treatments available. If we were to remove this special rule and introduce a system whereby insurance is subject to tax just like other supplies of services, the definitional problem that plagues

¹²⁴ C-349/96, Card Protection Plan judgment para 22. See also Case 348/87 *Stichting Uitvoering Financiële Acties v Staatssecretaris van Financiën*. This principle has subsequently been consistently affirmed by the Court: See Case 346/95 *Blasi v Finanzamt München I* para 18

the EU system could be resolved as it would no longer be necessary to define such strict borderlines between categories of transactions.

5.2.2 Treatment of intermediaries

The NZ GST Act contains provisions relating to agents, under which ‘where an agent makes a supply of goods and services for and on behalf of any other person who is the principal of that agent, that supply shall be deemed to be made by that principal and not by that agent’.¹²⁵ The condition for being considered an agent is that they must have the power to ‘issue a tax invoice or a credit note or a debit note in relation to that supply as if that agent had made a taxable supply’, provided the principle does not do so in addition to the agent.¹²⁶ As discussed earlier, the EU jurisprudence uses the terms ‘in the name and on behalf of, or *solely* on behalf of’¹²⁷ to describe the relationship between the actions of an agent and an insurer, which directly relate to the NZ provision whereby agents make supplies ‘for and on behalf’¹²⁸ of the principal.

Although the wording to define an agent’s activities seems similar in the EU and NZ, given that the terms used in the Directive, ‘related services performed by insurance brokers and insurance agents’¹²⁹, are defined in terms of the exemption which must be strictly interpreted, the Court of Justice has stopped attempts to extend the application of the concept of an agent.¹³⁰ Furthermore, as concepts of the VAT Directive, the terms ‘insurance brokers’ and ‘insurance agents’ have an independent Community definition.¹³¹ Such a definition has been the subject of much case law in the Court of Justice, however in New Zealand the intermediary service has uncontroversially been considered to simply follow the tax treatment of the underlying supply, so is far less reliant on a strict definitional basis of the person themselves.

If the Kiwi system were to be applied, a decision over which concept of intermediary, whether the strictly disputed EU concept or the wider, less disputed Kiwi concept, is to apply in the new system. In its jurisprudence, when determining the scope of the terms ‘insurance agents’ and ‘insurance brokers’, the Court of Justice looked to the contemporaneous insurance Directive¹³² relating to insurance agents and brokers, in order to define the scope of the concepts. For this reason, if the Kiwi system were to be applied, attention would have to be given to determining the scope of the concepts and how they fit in line with other non-VAT related EU legislation.

Like the coverage of the exemption however, the use of a taxed system could largely limit the definitional problems that arise in relation to the borderline distinction that is required by the strictly interpreted EU concept of agents and brokers, as the activities of

¹²⁵ GST Act, s60(1)

¹²⁶ Ibid

¹²⁷ Council Directive 77/92/EEC, Article 2(1)(b). See also Case 8/01 Taksatorringen

¹²⁸ GST Act, s60(1)

¹²⁹ Council Directive 2006/112/EC, Art 135(1)(a)

¹³⁰ Case 472/03 Arthur Andersen

¹³¹ Claus Bohn Jespersen, *Intermediation of Insurance and Financial Services in European VAT* (EUCOTAX Series on European Taxation Vol 30, Wolters Kluwer 2011) 93. See also Paul Farmer and Richard Lyal, *EC Tax Law* (Clarendon Press 1995) 90. See also Anthony Arnall, *The European Union and its Court of Justice* (Oxford EC Law Library, 2nd edn, 2006)

¹³² Council Directive 77/92/EEC

both those falling inside and outside of the category would be subject to tax. Furthermore, in relation to both the coverage and individual terms such as ‘agents’ and ‘brokers’, the definitional problem in the EU exists due to the context in which the system operates. This is because in the EU, the exemption provisions need to be applied universally, so parallels between civil laws and EU laws can’t be formulated, with the concepts requiring their own EU VAT definition. With the Kiwi system, however, there is no need to have a separate definition, and common law concepts can be used to shape and define the provisions.

5.2.3 Consequences of the location of insurance companies and customers

Location is of great importance when determining GST liability. One of the main features that distinguishes GST from earlier VATs, especially the harmonised EU VAT, is that the ‘jurisdiction to tax is based on the residence of the supplier, not the location of the supply.’¹³³ In theory, therefore, ‘a supplier resident in New Zealand is subject to GST on its worldwide supplies.’¹³⁴ Section 8 of the GST Act, however, is said to ‘narrow the scope of the tax considerably’¹³⁵, and deals with the imposition of tax, whereby GST will only be charged on the supply in New Zealand of goods and services¹³⁶, which is deemed to take place ‘if the supplier is resident in New Zealand, and shall be deemed to be supplied outside New Zealand if the supplier is a non-resident.’¹³⁷

In relation to the right to deduct, location plays a significant role, as can be evaluated from s20 of the GST Act, under which a registered person (such as an insurer) can make a deduction from their output tax in only in specific circumstances. This ability is restricted for several certain types of transaction, with location of some description being a determining factor. The right of deduction is refused for a registered person in situations including where the payment relates to goods situated outside of NZ (e.g. the insured goods are located outside of NZ), or services physically performed outside NZ and also in situations where the payment is made to a person who is not registered and is a non-resident¹³⁸.

Given the number of Member States in the EU, extra considerations would have to be made in order to apply the Kiwi style VAT to insurance transactions. In relation to place of supply issues, the Kiwi system is only concerned with activities either located inside New Zealand or outside of New Zealand, whereas the EU system needs to deal with a multitude of issues concerning activities taking place within the EU, but concerning multiple MS. This is particularly so given the existence of differing VAT rates and revenue authorities.

¹³³ Alan Schenk and Oliver Oldman, *Value Added Tax: A Comparative Approach* (Cambridge University Press 2007) 69

¹³⁴ *Ibid* at 70

¹³⁵ *Ibid*

¹³⁶ GST Act, s8(1)

¹³⁷ GST Act, s 8(2)

¹³⁸ GST Act, s20(3)(d)(ii) and (iv)

5.2.4 Risk materialisation

There are important GST consequences when a risk materialises and an indemnity payment is made to the insured. If the insured is a GST registered person, the New Zealand system considers such a payment to be ‘consideration received for a supply of services performed by the registered person’,¹³⁹ regardless of whether the person is a party to the contract, so long as the payment relates to ‘a loss incurred in the course or furtherance of the registered person’s taxable activity’.¹⁴⁰ As this is treated as a supply of services which are taxable in New Zealand, the payment is made to insured with GST included. The insured recipient of the payment then has to account for this GST, provided that the payment received relates to their taxable business. However, this GST component is creditable for the registered recipient, who can then report it as output tax. According to the GST Act, ‘the insurer can deduct from their amount of output tax attributable to the taxable period ‘an amount equal to the tax fraction of any payment made during the taxable period by that registered person to another person pursuant to any contract of insurance’¹⁴¹, provided certain conditions are met.

When combined, the input credit to the insurer and the output tax reportable by the registered insured, ‘the government does not receive any net GST revenue on a claim paid to GST-registered businesses that is attributable to the insured’s taxable activity.’¹⁴² Neutrality is also achieved in the amount of VAT credit between situations where ‘the insurance company pays the repair company for a \$1,000 repair (on which \$100 of VAT is due) or the insurance company pays the policyholder \$1,100.’¹⁴³ In terms of the indemnity payment, the insurer does not have to distinguish between GST liable and GST exempt persons, meaning that when the insured is unregistered, the payment is also grossed up to include VAT, so that the insured is able to ‘pay the GST-inclusive cost to replace the lost property or repair the damaged property.’¹⁴⁴

Given the timing of transactions and lengthy periods needed to settle insurance claims, the New Zealand system has been criticised on the basis that the ‘Inland Revenue will have in its possession for extensive periods of time, sometimes years, an over-collection of the value added.’¹⁴⁵ Furthermore, due to not distinguishing between GST liable and non-liable persons at the point of making the indemnity payment, there is added complication in the system whereby the GST liable person will have to pay the VAT they receive in the indemnity payment from the insurer to the Inland Revenue. Although not creating any legal issues in itself, this process makes the system more administratively complex. The Australian system is simpler in this regard, as it permits insurers to make such a distinction, resulting in GST liable persons receiving the indemnity payment without VAT included with the insurer correspondingly losing the

¹³⁹ GST Act, s5(13)

¹⁴⁰ GST Act, s5(13)

¹⁴¹ GST Act s 20(3)(d)

¹⁴² Alan Schenk and Oliver Oldman, *Value Added Tax: A Comparative Approach* (Cambridge University Press 2007) 349

¹⁴³ Example uses former VAT rate of 10%. Peter Merrill, ‘VAT Treatment of the Financial Sector’, (2011) *The VAT Reader* (Tax Analysts) 163, 178

¹⁴⁴ Alan Schenk and Oliver Oldman, *Value Added Tax: A Comparative Approach* (Cambridge University Press 2007) 349

¹⁴⁵ Thomas G. Thornbury, ‘A Better Way To Include General Insurance in VAT Systems’ (1991) *International VAT Monitor* May (5), 2 at 3

ability to grant itself a credit.¹⁴⁶ The experience in New Zealand is that, due to the system not distinguishing between GST registered and non-registered insured parties when making payouts, ‘there are relatively high levels of non-compliance’¹⁴⁷. There are several explanations for this, which surround such a GST inclusive payment to GST registered parties being unusual in a value added tax system. The insured may be unaware of the liability to account for this GST component of the payout due to unfamiliarity with such a transaction, the lack of an invoice being issued which usually acts as a ‘trigger’ event, and misunderstandings relating to the nature of the payment as many will not consider they have supplied any good/service, which is normally the basis to account for VAT.¹⁴⁸ Such compliance issues need to be taken account when proposing to implement a new system.

Furthermore, as explained in Chapter 4.2, the contractual relationship relating to the indemnity payment doesn’t bear the same importance as in the EU system. In NZ, it is not the status of the insured that is relevant for indemnity payout purposes, but rather whoever is the recipient of the payout. The recipient may therefore not be a party to the insurance contract, so may be more likely not to fulfil the compliance requirements of accounting for the GST received, as the ‘obligation will be less obvious’.¹⁴⁹ The Australian system manages to reduce this problem as the compliance obligations are placed on the insurers, who are likely to be better able to fulfil the obligations, rather than a broad range of GST registered insured parties.¹⁵⁰

In comparison to the EU system, greater neutrality is achieved between recipients of indemnity payments in relation to their GST status. In terms of a cash payment, as both GST registered and non-registered parties receive an indemnity payment including GST, the parties are in the same position with regards to then purchasing replacement goods for example, as the GST registered party has to account for the GST received. This is in contrast to the EU system, whereby both parties receive the cash payment exclusive of VAT, but a VAT-registered party can go on to deduct the VAT included in the replacement, whereas the non-registered party receives a VAT exclusive payment, with which they have to purchase VAT inclusive replacements (assuming the replacement goods/repair services are taxed). Although creating greater compliance burdens for VAT registered insured parties, the NZ system manages to solve the neutrality problem inherent in EU cash indemnity payments.

In relation to payments in kind, there is also neutrality between GST registered and non-registered insured parties. This is because the insurer can deduct the input GST included in the purchase of the goods (regardless of the tax status of the recipient), so then no output GST is accountable when the goods are supplied to the insured. For example, if both a GST registered and non-registered party settle an insurance claim in relation to a car, the insurer will purchase the car, claim an input GST deduction for it, and then supply it to the insured without any GST component included, so there is neutrality in relation to the replacement goods each party receives.

¹⁴⁶ Sijbren Cnossen, ‘A proposal to apply the Kiwi-VAT to insurance services in the European Union’ (2013) *Int Tax Public Finance* 20, 867 at 879

¹⁴⁷ KPMG, Proposed Introduction of VAT for the Insurance Sector in China, August 2013, 22

¹⁴⁸ *Ibid* at 23

¹⁴⁹ *Ibid*

¹⁵⁰ *Ibid* at 22

5.3 Would the application of the Kiwi system solve the problems associated with the EU exemption?

Alongside exemptions being contrary to the general characteristics and purpose of a VAT, it is the negative consequences that result from the exemption that are responsible for increasing calls for change. Any system that is brought in to replace the exemption system for insurance would therefore need to address these negative consequences and hopefully substantially reduce them, if not alleviate them altogether.

Of course, this would need to be done while simultaneously not introducing any significant new problems into the system. A direct adoption would need to ensure that it does not exacerbate other existing imperfections that exist in the EU VAT system in general, such as various disparate rates. In this example, the creation of new problems doesn't result from faults in the NZ system in itself, but rather from the differences between the systems which make application challenging. Of course, this could be reduced if the adoption of the Kiwi system were to be supported by a corresponding increase in VAT consistency throughout the MS. While such an outcome may be favourable to the working of the VAT system, it is a change that is likely to prove harder to implement in terms of MS agreement.

5.3.1 Accumulation and under/over taxation depending on the status of the final consumer

The problem of accumulation, which results in the over-taxation of insurance services supplied to businesses and an under-taxation of those supplied to final consumers, arises out of the inability to deduct input VAT costs from output VAT charged, precisely because there is no output VAT charged on exempt insurance services, meaning this input VAT cascades. Under the New Zealand system, which taxes the gross premiums, insurance providers can claim input credits for both VAT on 'purchases attributable to taxable insurance and the "grossed-up" portion of claims paid.'¹⁵¹ Because of this ability to claim input credits, the problem of accumulation that is inherent in the current EU exemption is resolved.

The existing issue of under-taxation of final consumers may be reversed, however, as the problem of determining the value-added rears its head again. The Kiwi system tries to get around this problem by shifting the determination of the taxable value added from an individual policy basis to the level of the insurance company¹⁵², however it seems in this instance, the Kiwi system doesn't quite manage to escape the problem. This is because under the Kiwi system, those final consumers that cannot claim credit for the input tax paid on premiums bear GST on the gross premium 'and not just on the value of the intermediation services rendered by the insurer'¹⁵³, which is the real value added in the transaction. Schenk believes this can be justified by considering the difference between the gross premium and the value of the intermediation as 'consumption similar

¹⁵¹ Alan Schenk and Oliver Oldman, *Value Added Tax: A Comparative Approach* (Cambridge University Press 2007) 349

¹⁵² Sijbren Cnossen, 'A proposal to apply the Kiwi-VAT to insurance services in the European Union' (2013) *Int Tax Public Finance* 20, 867 at 868

¹⁵³ Alan Schenk and Oliver Oldman, *Value Added Tax: A Comparative Approach* (Cambridge University Press 2007) 349

to a warranty agreement'¹⁵⁴, however such a treatment is questionable. Despite this issue, the Kiwi system has, for the most part, avoided the problem of accumulation which plagues the EU insurance exemption, which is very persuasive in terms of choosing to implement the Kiwi system.

5.3.2 Damaging international competitiveness of insurance firms

EU insurance firms who source their input supplies from within the EU are currently at a competitive disadvantage when supplying to EU customers, who could otherwise use an insurance provider located in a third country, who is not subject to this input VAT. The main issue is that this input VAT, which can't be deducted, forms a cost component for EU insurance firms. Applying the Kiwi style VAT would give insurance providers a credit for input purchases and claims paid, which could reduce this cost component.

However, although the problem of input VAT affecting international competitiveness could be solved by allowing deductions, the removal of the exemption would result in EU insurance firms being forced to charge VAT on the premiums. Although indemnity payouts would then also include VAT, the cost of insurance premiums would be increased by the amount of VAT. EU businesses could then deduct this amount, making the supply comparative to sourcing insurance cover from a third country insurer. EU consumers, however, would have to bear the VAT cost on the gross premium, making supplies from EU insurers relatively more expensive than those from third country insurers who are not subject to EU VAT and would therefore not have to charge it on their insurance premiums, depending on the place of supply rules used to determine where the transaction is taxed. In this instance, the application of the Kiwi system would improve the competitiveness of EU insurance firms whose client base predominantly consists of businesses as the insurance firm can deduct input VAT (so it doesn't become a cost component) and output VAT can be deducted by the insured, however the effect on those firms who make supplies to consumers will not be as favourable. Although the insurer can still deduct the input VAT, they will have to charge output VAT on the supply made which the consumer will have to bear.

An interesting point to note is the overall effect on the cost of EU insurance cover for both businesses and consumers. Although there are many practical considerations which will affect the end premium price, in theory, upon application of the Kiwi system, businesses are likely to experience a reduction in the cost of insurance as the insurance firm can now recover its input VAT costs and the business can deduct the output VAT charged on the premium. For consumers, the overall effect on the price of insurance premiums is likely to increase, the extent to which will depend on the relationship between the amounts of input VAT the insurance firm can now deduct compared to the total output VAT charged.

5.3.3 Vertical integration of the supply chain and preventing efficient structuring and division of tasks

¹⁵⁴ Alan Schenk, 'Taxation of Financial Services Under a Value Added Tax: A Critique of the Treatment Abroad and the Proposals in the United States' (1994) 9 Tax Notes Intl., 834

The logic behind firms self-supplying, which results in vertical integration of the supply chain, rests in the intention of reducing the amount of non-deductible input VAT incurred on input supplies, and thus making the firm more competitive/profitable. Because the problem of non-deductible input VAT is resolved by the Kiwi system, the benefit of self-supplying has also been removed. As the insurer is entitled to recover VAT charged by its suppliers, decisions on whether to self-supply or source from third party suppliers no longer revolve around the VAT implications of doing so. Efficiency may therefore be increased as firms may opt to outsource required services to experienced specialist suppliers.

At present, there are great VAT implications for services deemed to be carried out by insurance agents or brokers, given that they fall under the exemption. Because of this, the matter is heavily litigated. In cases such as *Arthur Andersen*¹⁵⁵, which concerned the outsourced back office activities of the insurer, the finding that the activities didn't fall within the scope of the exemption created an extra VAT burden and with a strict interpretation of the terms agents and brokers, firms are less likely to outsource these services. As explained previously, the imposition of the Kiwi system would remove the VAT disadvantages of outsourcing and as a tax would be imposed on the activities of insurance intermediaries, the area is likely to be less heavily disputed as there would be less at stake financially.

Previous market distortions whereby larger insurance firms were at a competitive advantage due to their greater ability to self-supply will be corrected under the taxed Kiwi system, as all firms will be able to deduct the input VAT costs.

6. Conclusion

The exemption system used in the EU has been subject to much criticism, some of which is aimed specifically at the financial services exemptions (which includes the insurance exemption) as given that the exemption doesn't raise particular equity concerns, 'exempting such a large sector of an economy for practical reasons seems decidedly unconvincing as a policy choice and unsatisfactory as an administrative solution.'¹⁵⁶ In addition to this, the EU's decision to simply VAT-exempt the financial sector has been described as 'fateful'¹⁵⁷ as most other countries simply followed suit when introducing their own VATs, which proliferated the negative consequences onto a worldwide stage. New Zealand has, however, been branded the 'innovator'¹⁵⁸ by taxing non-life insurance under its GST, a decision that has been followed by other countries with more youthful VAT systems. This is in spite of many, including AG Jacobs, believing that insurance is 'structurally unsuited'¹⁵⁹ to subjection to turnover taxes.

The approach taken by New Zealand has defied these opinions to some extent and achieved a system whereby insurance transactions are brought within the scope of GST.

¹⁵⁵ Case 472/03 *Arthur Andersen*

¹⁵⁶ Howell H. Zee, 'A New Approach to Taxing Financial Intermediation Services Under a Value-Added Tax' (2004) IMF Working Paper (WP/04/119) 7

¹⁵⁷ *Ibid*

¹⁵⁸ Alan Schenk, 'Taxation of Financial Services (Including Insurance) Under a United States Value Added Tax' (2010) *Tax Law Review*, Vol. 63, No. 2

¹⁵⁹ Case 38/93 *Glawe v Finanzamt Hamburg-Barmbek-Uhlenhorst*, Opinion of AG Jacobs, para 9

As has been explained, this has been accomplished by way of a different mechanism for determining the value added. Insurance transactions may very well be ‘structurally unsuited’,¹⁶⁰ to the invoice-credit based VAT which applies on an individual transaction basis, however, New Zealand has managed to find a suitability to turnover taxes in its application of the business cash flow of an insurance company, which raises the determination of value added from the level of individual transactions to the insurance company itself.

As it has been submitted that the harmful effects that arise as a result of the exemption are not in compliance with the character and nature of VAT, every effort should be made to reduce their application to improve the functioning of the VAT system and reduce market distortions that failures in the VAT system contribute to. The imperative question remains, therefore, as to whether the Kiwi system provides the solution to the problems that plague the EU system. It has been suggested by Cnossen that full taxation of this type on insurance transactions is ‘quite feasible, simpler and more efficient than the current system.’¹⁶¹ However, Chapter 5.1 of this thesis shows that this evaluation may overlook critical aspects relating to the application of the Kiwi system to the EU, especially in relation to its feasibility and simplicity. Thus far, those that have followed New Zealand’s example and learnt from ‘the EU VAT’s shortcomings’¹⁶² have been sovereign States acting individually and independently¹⁶³, which is perhaps the greatest contrast to the potential application in the EU. Furthermore, the Kiwi style VAT has been introduced in countries with relatively less established VAT systems or at the point of enactment of a VAT regime, making transitional issues less troublesome and leaving a clear path for setting out the legal and practical ramifications of the taxed system. Although the application of the Kiwi system (and corresponding removal of the EU exemption) may prove feasible, there is likely to be a long and uphill struggle before the EU could reap the benefits of a taxed system, which must not be overlooked or underestimated.

Although Cnossen proposes a direct transplantation of the New Zealand system to the EU¹⁶⁴, De la Feria and Krever explain that for a transfer to succeed, it is necessary to look not only to the advantages of the modern VAT (such as the Kiwi GST), but also to its limitations.¹⁶⁵ Aside from comparative and practical difficulties, the Kiwi system in itself contains shortcomings that need to be considered. By shifting the method of assessment to the level of the insurers, rather than the transactions, the overall result is correct in terms of the insurer’s cash flow, ‘but does not yield, however, the correct result at the level of the policyholders, if they are viewed individually and not as a group.’¹⁶⁶ The problem of consumers who can’t claim input credit for premiums paid

¹⁶⁰ Case 38/93 Glawe v Finanzamt Hamburg-Barmbek-Uhlenhorst, Opinion of AG Jacobs, para 9

¹⁶¹ Sijbren Cnossen, ‘A proposal to apply the Kiwi-VAT to insurance services in the European Union’ (2013) *Int Tax Public Finance* 20, 867 at 869

¹⁶² *Ibid* at 868

¹⁶³ For example South Africa, Australia and Singapore

¹⁶⁴ Sijbren Cnossen, ‘A proposal to apply the Kiwi-VAT to insurance services in the European Union’ (2013) *Int Tax Public Finance* 20, 867

¹⁶⁵ Rita de la Feria and Richard Krever, ‘Ending VAT Exemptions: Towards a *Post-Modern VAT*’, in Rita de la Feria, *VAT Exemptions: Consequences and Design Alternatives* (EUCOTAX Series on European Taxation, Vol 3, Wolters Kluwer 2013) 3 at 34

¹⁶⁶ Tim Edgar, ‘The Search for Alternatives to the Exempt Treatment of Financial Services Under a Value Added Tax’ in Richard Krever and David White (eds), *GST in Retrospect and Prospect* (Thomson Brookers 2007) 50

arises again as under this system, if they do not receive an indemnity payment (risk doesn't materialise) they remain taxed on the gross amount of the premium, but they do not 'receive payouts that reverse the flow of premium payments'.¹⁶⁷ This is in addition to the issue discussed previously whereby those who can't claim input credit for the premiums end up bearing GST on the gross amount, rather than the value of the intermediation services rendered. A further problem that arises out of taxing insurance transactions is that, when other financial services remain exempt, new market distortions are likely to be created as insurance becomes comparatively over-taxed for consumers who can't deduct input VAT and under-taxed for businesses, which is a reverse of the outcome under an exemption system.

Furthermore, as was discussed in Chapter 5.2.4, regarding risk materialisation, the method used by NZ also creates compliance problems when cash payments are made to GST registered businesses. The requirement for GST registered businesses to account for GST on indemnity payments is administratively complex and unfamiliar to many insured parties, which is one of the reasons why, when introducing a VAT, Australia, after considering the NZ system, chose to apply a slightly different method, which instead places the compliance burden on the insurers.

Accuracy has been sacrificed by the very nature of the Kiwi taxed system which has shifted the tax basis away from individual payments to an overall business cash flow, however, in simple terms of subjecting insurance to VAT, the New Zealand system has been successful. Although, like with all tax systems, some issues exist with the Kiwi system, when reaching a conclusion about the substitution of one system for another, these issues must be weighed against each other. Given the fundamental flaws with the exemption system and the market distortions it causes which have been evaluated, it is unsurprising that the Kiwi system looks more favourable. As it has been shown, it addresses the core failures of the exemption system, most notably, the existence of non-deductible input VAT, definitional problems relating to the coverage of the exemption and intermediaries and lack of neutrality between different insured parties in relation to indemnity payments. For this reason, from a theoretical point of view, it would be advantageous for the EU to apply the Kiwi VAT system, as Cnossen proposes.¹⁶⁸

In the light of the EU not being able to resolve the problems of the exemption and the proposals for reform¹⁶⁹, although having the potential to reduce the problems of the exemption to some extent, so far being unsuccessful in reaching agreement or implementation, it seems compelling to turn to other systems for inspiration and in this instance, New Zealand seems to provide a workable system. Given the potential for a fundamental change in the taxation of insurance in the EU, it is submitted that the Kiwi system should not be blindly followed, but that the EU should make every attempt to introduce the most practically and legally appropriate system available. In order to do so, the EU should learn from the weaknesses of the Kiwi system and find ways of resolving them, if possible. It has already been realised that 'modern VATs are not a

¹⁶⁷ Ibid

¹⁶⁸ Sijbren Cnossen, 'A proposal to apply the Kiwi-VAT to insurance services in the European Union' (2013) *Int Tax Public Finance* 20, 867

¹⁶⁹ COM/2007/747, supported by COM/2007/746

complete panacea'¹⁷⁰, so this could be the EU's opportunity to not only benefit from the advantages of the Kiwi system, but also from the negative aspects, in order to evolve a post-modern VAT in this area, which leads the way globally for the correct tax treatment of insurance transactions.

¹⁷⁰ Rita de la Feria and Richard Krever, 'Ending VAT Exemptions: Towards a *Post-Modern VAT*', in Rita de la Feria, *VAT Exemptions: Consequences and Design Alternatives* (EUCOTAX Series on European Taxation, Vol 3, Wolters Kluwer 2013) 3 at 34

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