The EC Tax Journal

OUTSOURCING IN THE FINANCIAL SERVICES SECTOR – THE KEY VAT ISSUES

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Outsourcing is still a growing trend throughout the EU in the financial services and insurance sectors. The advantages seem clear – reductions in head count, freeing up management time to focus on core functions, access to specialist skills, economies of scale, avoiding the need to buy expensive equipment or rely on technology that may become outdated, and so on. This trend has been given renewed impetus with the economic slow down, as firms look to cut costs, increase competitiveness and focus upon core competences. As a result there has been a move towards outsourcing of services that, even a few years ago, would have been considered "core" functions. In the past, most outsourcing tended to be in the areas of data capture, applications and transactions processing, statementing, print and mail and provision of helpline services – the high volume, labour intensive tasks based on role based decisions where it is easiest to bring efficiencies and economies of scale to bear. Typical areas now being considered for outsourcing range from computer support (including e-mail management) and marketing, to more dynamic technical and customer facing operations in the area of customer relationship management.

The main VAT issue concerning a switch from in-house provision to outsourcing is the potential generation of VAT on services previously provided on a vertically integrated basis (and therefore free of VAT). Assuming that the cost of buying external goods and services incurred by the outsourcer is broadly similar to the VAT incurred by the financial institution when carrying on the function in-house, the additional VAT charge will arise mainly on the cost of labour, though there may also be start-up and new technology costs as well to take into account.

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In the early days of outsourcing within the finance sector, the potential VAT implications were not always fully considered, in that the additional burden of VAT that could result from the provision of services by a third party was not properly factored into the cost/benefit analysis. The problem was not helped by the fact that the precise borderline between exemption and taxation for services provided to financial institutions was unclear even to the VAT authorities, and there was little useful case law on the subject. Following litigation both at European Court level (in particular *Sparekassernes Datacenter v Skatteministeriet* [2] ('SDC') and *CSC Financial Services Limited)*[3] and at the level of the higher courts in the UK (in particular *FDR Limited,*[4] BAA *Plc*[5] and *Electronic Data Systems Limited v CCE*[6] ('EDS')) there is now much greater clarity, but there remain some important inconsistencies of treatment in this area across the EU.

Where exemption is definitely not available, there may still be scope for tax mitigation through careful structuring of contracts and planning – for example, through use of partnership structures and, where permitted, group registration. These possibilities are well worth pursuing, taking the appropriate professional advice, but they are essentially beyond the scope of this article. What this article seeks to address is the present borderline of exemption in this area in the light of the recent case law.

The *SDC* case was important because of the nature of the attack on the right to exemption for outsourced financial services mounted by the Danish VAT authority with the support of the Commission and certain key Member States such as Germany. Moreover had the Advocate General's Opinion been upheld by the full court, the appellant would have lost.

SDC operated a data handling centre on behalf of a network of small Danish savings banks, providing its members and other customers with services comprising the execution of transfers, the provision of advice on and trade in securities and the management of deposits, purchase contracts and loans. SDC contended that its services were exempt under Article 13B(d)(3) and (5) Sixth Directive as transactions concerning deposit and current accounts, payments, transfers, debts, cheques and

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2 (Case C-2/95) [1997] STC 932.

3 *CCE v CSC Financial Services Limited (formerly Continuum (Europe) Limited)* (Case C-235/00) [2002] STC 57.

4 *CCE v FDR Ltd* [2000] STC 672.

5 *CCE v BAA plc* [2002] STC 327.

6 *Unreported tribunal case - 19th March 2002.*

other negotiable instruments, and transactions in shares, interests in companies or associations, debentures and other securities.

The ECJ did not find specifically that SDC's services were exempt, but rather, as is usual, gave guidance to the national courts on the basis for deciding whether or not the exemption should apply. It held that exemption was not restricted to transactions affected by a particular type of institution (e.g. with the name of a bank), by a particular type of legal person, or wholly or partly by electronic means or manually. Contrary to the view expressed by the Advocate General, the European Court also found that it was unnecessary for the exempt service to be provided by an institution which had a legal relationship with the final customer nor did the fact that a transaction covered by the provisions was actually effected by a third party, rather than by the customer's bank itself, preclude exemption. Essentially the Court drew a distinction between outsourced services provided as a technical adjunct to an exempt supply, such as mere data-processing, handling and transmission of information, and other purely technical services on the one hand, and operations which were distinct in character, formed a distinct whole and were specific to and essential for the exempt transactions in point 3 and 5 of Article 13B(d). Moreover, where the service involved the transfer of funds, it was paramount that the service actually had the effect of changing the legal and financial relationship between the parties to the transfer.

Following the judgment in *SDC*, SDC and the Danish VAT authority reached an out-of-court settlement, which recognised that the great bulk of SDC's payment card and cheque-clearing functions involving settlement and the provision of management of deposits and loans as well as the trading and securities fell within the exemptions.

This result occurred while a parallel case was under way in the UK,[7] which ultimately went from a nine-day hearing in the VAT Tribunal in 1999 to the Court of Appeal in 2001, with a clear victory to the appellant in both cases, and further appeal to the House of Lords being refused.

FDR supplied payment card management and processing services to a number of banks and other financial institutions. The services supplied included the issue of payment cards, maintenance of cardholder and merchant accounts, authorisation services, processing of merchant vouchers, production of statements, remittance processing and, at each stage of the process, the settlement of liabilities between the parties to the transactions (i.e. the card issuer, card acquirer, the merchant outlets and the payment systems). Although Customs accepted that settlement services were included in FDR's overall supply, and that that supply was single rather than

7 *CCE v FDR Ltd.*

multiple, in their view the extent of the administrative and management services provided predominated and made the overall supply taxable.

Customs also changed the domestic UK legislation in 1999 by means of the Value Added Tax (Finance) Order 1999 just before the receipt of the Tribunal judgment in *FDR* in a way that was clearly designed to strengthen their case for taxation, at least in future cases. In particular the reference in the wide ranging exemption in the UK provisions (Group 5, Schedule 9, VATA 1994) to 'the making of arrangements' was removed, and certain services such as credit-rating, authorisations, and account management were specifically deemed to be part of the taxable 'management of credit' by a person other than the credit grantor.

In the event, in the Court of Appeal, Laws LJ made his findings almost exclusively on the basis of the provisions of the Sixth Directive, and the controversial changes in the UK legislation have proved to be of little relevance in other litigation (for example, *EDS* and *BAA Plc*). The Court of Appeal held that the services in question did qualify for exemption on the basis, firstly, that under the principles set out in the *Card Protection Plan* case[8] they did form a single composite supply, and, secondly, that supply was exempt because crucially FDR, in the course of providing its services, made a series of payment transfers in settlement between the parties at various stages of the process. It was not necessary for FDR to execute these payment transfers itself (this was done by automated banking systems, BACS or CHAPS) – what mattered was that it gave the binding instructions for the transfers to be made. Nor did it matter that in certain cases the settlement was effected by netting off. In all cases FDR effected a change in the legal and financial position of the parties concerned, and this was sufficient to bring it within the exemption. *CSC Financial Services Limited (formerly (Continuum) Europe Limited)*[9] showed where the borderline between exemption and taxation for outsourced services now lies. CSC supplied various services to a PEP manager, which included dealing with telephone enquiries, and the issue and processing of application forms and payments. It was not involved (at least to any substantial extent) in the issue of actual securities to the customer. CSC argued that the services represented either the making of arrangements for an exempt transaction (Item 7, Group 5, Schedule 9 VATA 1994) or the introduction of prospective investors (Note 5, Group 5, Schedule 9) and that it was in any event within the exemption in Article 13B(d)(5) of the Sixth Directive. CSC had been successful in the VAT Tribunal, where the Chairman had used the principles laid down in the *SDC* case to distinguish between services which were no more than a mere technical or physical supply (such as data handling or provision of information) and those which were a specific and essential

8 *Card Protection Plan Ltd v CCE* (Case C-349/96) [1999] STC 270.

9 (Case C-235/00) [2002] STC 57.

part of the main exempt supply, which he said applied in the case of CSC.

The ECJ took a different view, arguing that to qualify for exemption in Article 13B(d) the services must fulfil functions which are specific and essential to the transaction, and in themselves alter the legal or financial positions of the parties to the securities transactions. As CSC was not involved in the issue of securities, this was not the case – it was merely acting as the front office for the issuer of the securities, nor was it engaged in negotiation in the sense of acting as an intermediary between a buyer and seller of financial services – it was rather the front office of the principal to the transaction, and did not provide a distinct act of mediation.

The importance of the *EDS* case was that essentially it applied SDC principles to transactions falling within Article 13B(d)(1) of the Sixth Directive, that is in the area of loan administration. Lloyds Bank (now Lloyds TSB Bank) had taken a policy decision in early 1997 to outsource its arrangements for granting personal loans to EDS. As noted above, Article 13B(d)(1) of the Sixth Directive excludes services comprising the management of credit where these are supplied other than by the person granting it, though exemption does apply to granting and negotiation of credit.

EDS argued that its services were exempt on the basis that they were either predominantly the granting or negotiation of credit within Article 13B(d)(1), with any management of credit being ancillary, or they were transactions falling within Article 13B(d)(3) because they concerned deposit and current accounts, payments, transfers and debts. The Tribunal concluded that EDS was providing a service of granting credit under Article 13B(d)(1) (notwithstanding that the funds were provided by Lloyds) and that, if wrong about that, EDS was providing a service of negotiating credit under the same Article. Finally, if that was wrong, EDS was in any case engaged in transactions, including negotiation, concerning deposit and current accounts, payments and transfers and debts under Article 13B(d)(3). Customs are appealing the decision directly to the Court of Appeal.

Customs are also taking the *BAA Plc* case on appeal from the High Court. This case is mentioned for the sake of completeness, though it is not really an outsourcing case. BAA marketed a co-branded credit card to members of its Executive Travel Club. It received commission from the issuing bank, and the question was whether its role in the proceedings amounted to an exempt intermediary supply. The Tribunal held that it was making an exempt supply, and that intermediary services did not have to be in relation to a specific contract. The High Court agreed, and the case is also being appealed to the Court of Appeal, though given the similarity of the facts to the *Civil Service Motoring Association Limited* case[10] already decided by

[10] *CCE v Civil Service Motoring Association* [1998] STC 111.

the Court of Appeal, the prospects of success do not seem high.

Turning to the position across the EU, there is still considerable uncertainty on the precise scope of exemption in a number of key Member States, arising principally from different views of the implications of the *SDC* case. Because Denmark settled with SDC after agreeing that its main service provision was within the exemption, it might be thought that all the other Member States VAT authorities would accept that the outcome of in the *SDC* case was reasonably clear. But in practice this is not necessarily the case.

Questions arise particularly over the nature and quality of settlement services, with the German VAT authority in particular insisting that a data centre must actually execute the payment transfers, rather than simply issue binding instructions for those transfers to take place. Within the modern banking system it is not necessarily possible for an outsourced entity to actually execute payment transfers – an agency of the clearing banks such as the UK BACS system must be used. In the case of Germany therefore, it seems likely that further litigation will be necessary before the SDC principle is fully accepted.

In other Member States such as the Netherlands, France and Sweden the position seems to be reasonably clear (i.e. the SDC principle is accepted) though there is little guidance from the authorities on this subject anywhere in the EU (apart from the UK and Denmark) and little relevant case law. Given that each outsourcing contract is slightly different, every case put to the relevant local authorities has to be considered carefully on its merits and against the SDC criteria. There can be particular difficulties of the kind encountered in the UK in the EDS case over loan management services falling within Article 13B(d)(1), i.e. to what extent are they really the management of credit rather than its granting and negotiation, and how should a composite supply be treated with all three elements present.

As a result of this uncertainty, even armed with the *SDC* case and providing services broadly similar to SDC and FDR, an outsourcer must proceed with extreme care in Member States, such as Germany, Italy and Spain where clear guidance on the scope of the exemption is not available from the authorities, and where taxable rulings in this general area have generally been given in the past. For its part the Commission seems strangely reluctant at present to deal with the confusion and uncertainty which still prevails, notwithstanding the relative clarity of the *SDC Decision*. One might expect for example the matter to be referred to the VAT Committee so that the Member States can consider the matter collectively and with the Commission's help, issue clear guidelines on the precise scope for exemption. This has not happened, partly no doubt because the process of litigation through the national courts and the ECJ may still not be over. As a result great care and

circumspection is needed in setting up outsourcing arrangements in the different Member States.