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Invest Europe position on the European Commission External Study on the Taxation of the Financial Sector

Executive summary

The European Commission's external study on the taxation of the financial sector usefully frames the discussion on how the EU VAT framework for financial services could be improved in a targeted and proportionate way. For Invest Europe, the central objective should be to **preserve the VAT exemption for financial services**, particularly fund management, while reducing legal uncertainty, fragmentation, administrative burdens and hidden VAT. Reform should focus on **Packages 1 to 3** of the study, including clearer definitions, more consistent treatment of comparable services, proportionate simplification of deduction rules, effective cost-sharing arrangements and carefully designed VAT grouping. More fundamental reforms under Packages 4 to 6 should not be pursued unless supported by robust evidence, including an AIF-specific impact assessment, and should in any event be accompanied by appropriate transitional and grandfathering measures.

Introduction

Invest Europe welcomes the publication of the European Commission's external study, Taxation of the financial sector. The study provides an important evidence base for considering the future of the EU tax framework applicable to financial services, particularly the VAT exemption and the interaction between EU VAT rules and national sectoral taxes. Many of the challenges identified in the study, including legal uncertainty, fragmentation and barriers to cross-border investment, are consistent with concerns previously highlighted in Invest Europe's Taxation White Paper: Taxation in Europe. Investors' perspective on getting it right, which called for a more harmonised, neutral and predictable European tax environment that supports long-term investment and the efficient allocation of private capital.

The Commission's study identifies two principal challenges. First, the inability of providers of exempt financial services to deduct input VAT can generate hidden VAT and influence business structures and supply-chain decisions. Second, the overall framework remains uncertain, complex and fragmented, with important differences between Member States in the treatment of fund and asset management, derivatives, custody services, payment value chains and other financial activities. The study also points to divergent rules concerning the option to tax, VAT grouping, cost-sharing arrangements and proportional deduction methods.

These findings are relevant to private equity and venture capital, which form an important part of the European financial services sector. Private equity and venture capital funds connect European businesses seeking financing with institutional and other long-term investors from the EU and beyond. The tax framework applicable to investment funds and their managers should therefore provide regulatory stability and legal certainty and should not make it more costly or complicated to invest in European businesses through collective investment vehicles.

From this perspective, the most proportionate policy options are those that preserve the exemption while reducing legal uncertainty, administrative burdens and hidden VAT. Targeted improvements under Packages 1 to 3 of the study offer a better path than Packages 4 to 6, which envisage more

fundamental changes to the existing exemption and could introduce additional VAT costs for investment funds and their investors.

Preserve the VAT exemption for financial services

Invest Europe strongly supports maintaining the VAT exemption for financial services and, in particular, the exemption for fund management services, as this exemption remains necessary and relevant to the operation of the European investment fund sector.

An important rationale for the fund management exemption is to avoid increasing the VAT cost of investments simply because they are made through a collective investment vehicle rather than through a direct acquisition. Investment through a professionally managed fund should not be placed at a tax disadvantage compared with direct investment in an underlying company.

The application of VAT at the standard rate to all financial services would be undesirable. It would require significant changes to systems, contractual arrangements and operating models, while potentially increasing the cost of financial services for final consumers and for businesses that are unable to deduct the VAT charged to them. The Commission's study recognises that different reform options involve different trade-offs in relation to simplicity, neutrality, public revenues and the distribution of costs between financial institutions, businesses and households.

Removal of the exemption for all financial services, as contemplated under Package 4 and Consideration 3A, would be particularly problematic. Many investors in alternative investment funds are professional investors that may be unable to recover VAT. Consequently, improvements in VAT recovery at fund-manager level would not necessarily compensate for the additional VAT cost borne by funds and their investors. Non-deductible VAT could instead create further costs throughout the AIF value chain, ultimately affecting investor returns and the attractiveness of investment through European funds.

Similarly, a partial removal or narrowing of the exemption under Packages 5 or 6 could increase complexity by creating new boundaries between exempt and taxable services. It could also result in different VAT outcomes depending on how a service is structured, priced or delivered. This would risk replacing existing uncertainty with new classification difficulties.

The case for modernising the VAT framework should not therefore be interpreted as a case for removing the exemption. Targeted reforms within the present framework offer a more proportionate means of addressing legal uncertainty, fragmentation and hidden VAT without introducing the disruption and additional costs associated with a fundamental change of regime.

The study also finds little evidence that the financial sector is a major source of VAT fraud or evasion. Most identified compliance difficulties concern classification and deduction methodologies rather than deliberate fraud. This further supports prioritising clearer definitions and simplified compliance rules over fundamental structural reform.

Modernise and harmonise the definitions of exempt services

Although the exemption should be maintained, the definitions of exempt financial services should be clarified, modernised and applied more consistently across the European Union. Many of the relevant

concepts in the VAT Directive were developed for a substantially different financial market and do not always provide sufficient clarity for current products, services and delivery models.

The Commission's study identifies uncertainty and divergence in areas including fund and asset management, derivatives, custody, payment value chains and crypto-asset services. It considers the modernisation of definitions as one of the policy approaches that could improve legal certainty and reduce administrative complexity while keeping the exemption in place.

Consideration 1A, concerning the modernisation of fund-management definitions, is therefore particularly relevant for our sector. Consolidating the applicable Court of Justice of the European Union case law could provide greater clarity on the meaning of "special investment funds" and the application of the exemption to UCITS, non-UCITS funds that are comparable to UCITS, AIFs and pension funds.

However, such clarification must preserve rather than narrow the treatment currently applied to AIFs, including private equity and venture capital funds. The application of a strict UCITS-equivalence test could reduce the scope of the exemption in Member States that currently apply a broad or quasi-general exemption to AIF management. Modernisation should not result in previously exempt private equity and venture capital fund-management services becoming taxable.

Any common EU definition of a UCITS-equivalent fund should therefore be supported by clear and objective indicators. These could include the characteristics of the fund, its regulatory framework, its investment and risk-spreading features, and its primary target investors. Non-binding guidance or a targeted secondary legal act could reduce differences between national case-by-case assessments without narrowing the broader treatment currently available to AIFs.

Modernisation should take account of three significant developments:

- First, the financial sector has become increasingly digitalised, with the emergence of electronically delivered financial services and technology-enabled investment and fund-management processes. The VAT treatment of a service should remain neutral regardless of the technology or delivery channel used.
- Second, financial products have become more sophisticated. The concepts contained in the VAT Directive do not always accommodate products such as derivatives or services comprising several closely connected financial and technological elements. Updated definitions should provide clarity while remaining sufficiently flexible to accommodate future innovation.
- Third, financial institutions and investment managers increasingly rely on outsourcing, global centres of expertise and shared-service centres. The Commission's study finds that the current framework can make outsourced and centralised inputs more expensive than in-house production, influencing supply-chain arrangements even where those arrangements would otherwise be economically efficient. It also notes that these distortions are becoming more important as financial institutions increasingly rely on specialist and digitally delivered services.

The definition of "management of investment funds" should remain broad enough to cover the core activities required for the operation of private equity and venture capital funds. These include investment management as well as relevant administrative support, valuation and reporting functions. Clearer guidance is also needed on the distinction between exempt fund-management

activities and potentially taxable administration or custody services, particularly where several functions form part of an integrated service.

The VAT treatment of custody and fund-administration services should also be harmonised. Divergent national approaches, under which similar activities may be taxable in one Member State but treated as ancillary to exempt fund management in another, create uncertainty and may influence where services are located. Harmonisation should remove these cross-border distortions without narrowing the fund-management exemption.

Ensure that VAT treatment follows the nature of the service

VAT treatment should be determined by the objective nature of the service supplied and not by the identity, status or location of the supplier. Comparable services should receive comparable VAT treatment, irrespective of the operating model through which they are delivered.

In practice, this principle is not always applied consistently. Differing classifications of comparable services can create an uneven playing field between providers, particularly where fund managers outsource activities to specialised service providers or operate across several Member States.

A uniform approach is important for ensuring equal treatment of similar services. At the same time, harmonisation should not mean treating genuinely different financial products or activities in the same way. Financial services that differ in their nature, economic function and effects should continue to be assessed according to their own characteristics. The objective should be equal treatment of comparable services, not the indiscriminate application of identical rules to different products. This distinction is central to Invest Europe's established position.

The current VAT exemption also does not appear to play a determining role in whether services are supplied by EU or non-EU providers. Decisions concerning the location of suppliers are influenced by a broader range of commercial considerations, including expertise, availability, operational efficiency and the structure of global service-delivery models. Changes to the exemption should not be presented as an effective solution to location or sourcing decisions without clear evidence that VAT treatment is a determining factor.

Nevertheless, differences in the application of the exemption within the EU can create barriers for European fund managers seeking to develop efficient and scalable cross-border operating models. The inconsistent treatment of outsourced fund-management services can generate additional operating costs and affect the international competitiveness of EU fund managers.

Changes to the exemption could also influence fund domiciliation and the location of associated services. The study recognises, in the context of custody services, that differences in VAT treatment may encourage activities to move towards jurisdictions offering more favourable treatment. The same concern should be examined specifically for investment funds. A narrowing of the AIF exemption in a major European fund jurisdiction could lead to the establishment of funds and related activities outside Europe.

Preserve the fund-management exemption and ensure a level playing field

The VAT exemption for fund management is of particular importance to private equity and venture capital. Its application should be clear, broad and harmonised across the EU, while preserving the existing treatment of AIF management.

Equal investment-management services should receive equal VAT treatment. Member States should not apply materially different VAT outcomes to comparable services or investment products. At the same time, the framework should recognise relevant differences between financial services and avoid a one-size-fits-all approach that does not reflect their individual characteristics.

Greater convergence would reduce uncertainty for fund managers and the funds they manage, support cross-border activity and strengthen the ability of European fund managers to achieve economies of scale. It would also help ensure that investment through a fund is not made less attractive by additional VAT costs when compared with direct investment.

Package 1, involving incremental improvements, and Package 2, involving stricter harmonisation, are the packages most closely aligned with these objectives. Both would retain the exemption while seeking to modernise definitions and simplify the rules on proportional deduction, VAT grouping and the option to tax. Package 2 could contribute to a more level playing field by extending VAT grouping to Member States where it is not currently available, provided that the specific features of investment funds and their managers are properly reflected.

Before proposing any change to the definition or treatment of AIF management, the Commission should undertake an AIF-specific impact assessment. The study acknowledges limitations in the available data, including the absence of comprehensive information distinguishing between national classifications of AIFs and the structures that would be affected by a narrowing of the exemption.

Such an assessment should examine not only VAT revenue, legal certainty and market functioning but also the potential effects on capital raising, investor participation, fund domiciliation and the attractiveness of EU-based private equity and venture capital vehicles. Investor deterrence should be treated as a distinct evaluation criterion in any future Commission impact assessment.

Improve proportional deduction rules without creating new costs

The Commission's study identifies proportional deduction as the most burdensome aspect of the current VAT framework and considers several options for simplifying and harmonising the relevant rules. These include clearer default methodologies and different forms of fixed-rate deduction.

Simplification could reduce administrative costs, particularly where it allows direct attribution for inputs connected to taxed transactions and provides a clear pro-rata method for mixed inputs. However, unless deduction levels are increased materially, such changes would not fully address hidden VAT or the resulting distortions.

Fixed-rate deduction arrangements should therefore remain proportionate and should not indirectly affect the application of the fund-management exemption. The design should also avoid creating incentives to restructure activities solely to secure a more favourable deduction outcome.

Any option to tax should remain voluntary and should be available on a transaction-by-transaction basis. Fund managers should be able to assess the appropriate treatment by reference to the

particular fund, service, investor base and commercial circumstances. An entity-wide or mandatory option could cause one decision to increase VAT costs in relation to other funds or investors for whom taxable treatment would be inappropriate. A transaction-by-transaction option would enable a management company to select the most commercially appropriate treatment for the circumstances and investor terms of a particular fund.

Facilitate cross-border operations through VAT grouping and cost-sharing arrangements

If the VAT exemption for financial services is maintained without a broader update, the introduction or re-establishment of effective cost-sharing arrangements for the financial sector would be highly desirable.

Cost-sharing arrangements could help address hidden VAT costs associated with the sharing of resources, functions and expertise. They would be particularly relevant to contemporary operating structures involving specialist teams, shared-service models and cross-border centres of expertise.

For these arrangements to be effective, they should be capable of operating across borders. Their design should not require participating businesses to establish a separate entity solely for VAT purposes, nor should participation automatically require the submission of a consolidated VAT return by all entities involved.

The Commission's study recognises that broader use of cost-sharing arrangements could reduce hidden VAT on intra-group and cross-border supplies while retaining the exemption. It considers this option alongside reform of VAT grouping and wider availability of the option to tax.

Considerations 2A(ii) and 2A(iii), concerning the cross-border extension of VAT grouping and the reintroduction of cost-sharing arrangements, are particularly relevant to multinational platforms. These measures could enable groups to centralise functions such as IT, legal, compliance, accounting and administrative support without creating irrecoverable VAT solely because the functions are shared across borders.

This would reduce a structural disadvantage currently faced by multinational groups compared with businesses that can organise the same activities within a domestic VAT group. It would also support the objectives of the Savings and Investment Union by removing a tax barrier to cross-border operating models and the free movement of capital.

Cross-border VAT grouping should nevertheless be developed cautiously. Differences between national VAT systems and deduction methodologies could create incentives to locate functions in jurisdictions offering more favourable treatment. Its introduction would therefore require clear allocation rules, enhanced reporting arrangements, effective safeguards, and close cooperation between national tax authorities.

The potential fiscal effects may also generate resistance from Member States. This feasibility concern should not prevent further work on cross-border VAT grouping, but it underlines the importance of a coordinated EU approach and a realistic implementation plan. Cost-sharing arrangements may offer a more targeted route to reducing hidden VAT in the near term.

Provide regulatory stability and protect existing investments

The Commission should attach significant importance to regulatory stability. The benefits of any change must clearly outweigh its implementation costs, operational disruption and effects on existing investments.

The Commission's study finds that modernising definitions and simplifying proportional deduction rules could improve legal certainty and reduce administrative complexity, although such measures would not remove all the underlying distortions. This supports a targeted approach under which specific shortcomings are addressed without replacing the entire framework.

Private equity and venture capital funds make long-term commitments on the basis of the regulatory regimes applying at the time of investment. Their structures, contractual arrangements and investment decisions cannot be adjusted immediately following a change in VAT treatment. Any future reform must therefore respect investors' legitimate expectations and carefully consider its effect on existing structures.

Private equity and venture capital funds are commonly established as long-dated, closed-ended vehicles. A change in VAT treatment during the life of a fund could affect its documentation, limited partnership agreement economics, cost-allocation arrangements and existing investor commitments.

Accordingly, any structural or definitional change should be accompanied by appropriate transitional and grandfathering provisions for existing funds. These arrangements should provide sufficient time for fund managers, investors and service providers to adapt without retrospectively changing the economic assumptions on which long-term commitments were made.

The study's discussion of path dependency is particularly relevant in this context. Market participants have developed operating models, contractual structures and compliance systems around the existing framework. Although the status quo is imperfect, replacing it with a new system whose effects are uncertain could create greater disruption than targeted improvements to established rules.

Clear and transparent rules should be accompanied by consistent implementation across Member States. Divergent national interpretations create compliance costs, complicate cross-border activity and risk influencing investment and operating decisions for reasons unrelated to their economic merits.

The Commission should also assess VAT reform together with the wider landscape of national sectoral taxes. The VAT exemption does not operate in isolation, and changes to one element of the framework may interact with insurance premium taxes, financial transaction taxes, financial institution levies, payroll taxes and other national measures considered in the study.

The available evidence also supports a proportionate approach. Stakeholder feedback documented in the study indicates stronger support for targeted improvements, including clearer definitions and effective cost-sharing arrangements, than for wholesale removal of the exemption. Concerns about implementation costs, administrative complexity, consumer prices and competitiveness reinforce the case for concentrating near-term Commission action on Packages 1 to 3.

Conclusions and recommendations

The Commission's external study offers a valuable basis for addressing uncertainty, complexity and fragmentation in the taxation of financial services. For private equity and venture capital, reform should support long-term investment, cross-border activity and a competitive European fund-management industry.

Invest Europe therefore calls for:

- the preservation and strengthening of the VAT exemption for financial services, particularly the exemption for fund management;
- priority consideration of the targeted measures contained in Packages 1 to 3, rather than the more fundamental reforms contemplated under Packages 4 to 6;
- the rejection of a general application of the standard VAT rate to all financial services;
- the modernisation and harmonisation of the definitions of exempt services, taking account of digitalisation, new financial products, outsourcing and shared-service models;
- explicit confirmation that modernisation of the "special investment fund" definition will preserve, rather than narrow, the existing exemption for AIF management;
- explicit confirmation that modernisation of the "special investment fund" definition will preserve, rather than narrow, the existing exemption for AIF management and other existing exemptions;
- VAT treatment to be determined by the nature of the service rather than by the identity or location of the supplier;
- equal VAT treatment of comparable investment-management services and investment products;
- a clear, broad and consistently applied fund-management exemption across all Member States;
- an AIF-specific quantitative impact assessment before any legislative proposal, including an assessment of effects on capital raising, investor participation, fund domiciliation and the international competitiveness of EU funds;
- harmonisation of the VAT treatment of custody and fund-administration services without narrowing the fund-management exemption;
- effective cross-border cost-sharing arrangements that do not require a separate legal entity or a consolidated VAT return;
- further development of cross-border VAT grouping, subject to appropriate safeguards, administrative coordination and a realistic assessment of implementation and fiscal implications;
- retention of a voluntary option to tax that can be exercised on a transaction-by-transaction basis;
- appropriate protection of legitimate expectations and existing long-term investment structures;
- transitional and grandfathering provisions for existing funds if any structural or definitional change is pursued;
- recognition of the study's finding that VAT fraud and evasion are not major concerns in the sector and that most compliance difficulties arise from classification and deduction rules;

- the inclusion of investor deterrence and effects on private capital mobilisation as specific criteria in any future impact assessment; and
- a holistic assessment of the interaction between the VAT framework and national sectoral taxes.

The objective should be a stable, clear and future-proof VAT framework that reduces unnecessary complexity without increasing the cost of investing through European private equity and venture capital funds. Reform should strengthen the competitiveness of the European investment ecosystem and ensure that VAT rules support, rather than hinder, the mobilisation of private capital for European businesses.

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