

Specified supplies of financial services: possible restrictions on input VAT recovery

Restrictions seem likely to be introduced on the scope of input VAT recovery for supplies of insurance and financial services (including intermediary services) to third country customers.

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Update

In response to representations received by HMRC, [it has been announced](#) that the measure has been more tightly targeted on avoidance situations and now will apply only to insurance intermediary services and only when the primary supply of insurance is made to UK customers. The revised legislation will be laid in December and implemented from 01 March 2019.

Under the current VAT rules, a business providing certain specified supplies of services (such as insurance and financial services) to a person outside the UK will be entitled to input VAT recovery on the costs associated with those supplies. These “specified supplies” attract beneficial input VAT treatment pursuant to the VAT (Input Tax) (Specified Supplies) Order 1999 (the Specified Services Order).

However, there are two proposals that may restrict the scope of these rules and, accordingly, increase the VAT costs for associated transactions:

- Firstly, in response to the FTT decision in [Hastings Insurance](#), HMRC has put forward draft legislation to restrict the application of the specified supplies rules in cases involving insurance or other financial service intermediation, and
- Secondly, the Government’s paper on the future of the VAT system under a “no deal Brexit” suggests that the scope of the specified supply rules may be generally restricted post-Brexit.

Intermediary services

Under paragraph 3(c) of the Specified Services Order, supplies of insurance intermediation or intermediary services in relation to other exempt financial transactions may benefit from input VAT recovery when supplied to a non-EU recipient. In [Hastings Insurance](#), an insurance broker provided services to a connected Gibraltar insurance company, which in turn provided insurance products to UK recipients. The FTT held that the Gibraltar insurance company did not have a UK

fixed establishment in these circumstances and that, therefore, the supplies by the UK broker to the non-EU insurer benefited from the VAT recovery rules in the Specified Services Order. This was despite the fact that the supplies of insurance made by the Gibraltar insurer were made to UK recipients.

HMRC has decided to take action against this “offshore loop” structure and has released [draft legislation](#) to amend the Specified Services Order. The draft legislation will limit the scope of VAT recovery to circumstances where “the final consumer is not in the UK, as was intended”. The changes will apply whether or not there is any avoidance motive.

When the change becomes effective, any supplies by insurance or financial service intermediaries to non-EU customers will only benefit from VAT recovery provided that the ultimate supplies of insurance or financial services by those non-EU customers are made to persons belonging outside the EU. This will, in principle, require insurance brokers and agents, loan or share brokers, fund distributors and other financial service intermediaries to ensure that they can establish the location of the recipients of the financial services that they are arranging.

This may be very challenging, especially in relation to fund distribution, which will often involve a large network of sub-distributors. At the very least, the changes may require significant changes in systems to capture the necessary data to comply with the rules and even then the detailed information required may not, in practice, be available.

There are also technical questions over the scope of the application of the restriction where the underlying supply, such as an issue of new shares, debt or units in a fund, do not give rise to a supply to the ultimate customer.

Post-Brexit changes?

The UK Government recently published a number of technical papers concerning the implications of a no-deal exit from the EU on 29 March 2019. One of these papers, "[VAT for businesses if there's no Brexit deal](#)", covers the VAT implications of cross-border trade in goods and services post a no deal Brexit.

The paper notes that the main consequence of Brexit is that the EU would essentially become a “third country” and the rules for the place of supply of services will generally apply as if supplies of services to an EU customer were to a third country customer. In principle, therefore, the scope of VAT recovery under the Specified Services Order would be greatly expanded, covering exempt supplies of insurance and other financial services to EU customers as well as existing third country customers.

However, the paper notes that, as regards supplies of insurance and financial services to EU customers, “input VAT deduction rules for financial services supplied to the EU may be changed”. Under the current rules, input VAT on supplies of such services to EU customers is not deductible, whereas input VAT on such services supplied into non-EU customers is deductible. Whilst it would be sensible to treat supplies to EU customers in the same way as supplies to non-EU customers post-Brexit, the Government may well have concerns over the cost to the Exchequer of such a change. Accordingly, it seems likely that this potential change would be made whether the UK leaves the EU with or without any deal in place.

Comment

Financial services and insurance businesses potentially affected by these changes should monitor developments closely. These changes have the potential to increase costs associated with affected supplies of insurance and financial services (including intermediary services) and businesses should be prepared to consider the impact of these additional costs and take appropriate action.

In relation to the changes to the intermediary services, whilst there is a need for HMRC to address the specific avoidance scheme concerned, question marks remain over the way in which HMRC has chosen to do so. The proposed change has the potential to create significant additional compliance costs, particularly in relation to fund distribution, creates uncertainty and may be detrimental to the competitiveness of UK investment managers compared to competitors in other Member States at a time when that competitiveness should be at the forefront of the Government's thinking.

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