Client Alert

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Outsourced Insurance Intermediary Services Forthcoming changes to the UK VAT Exemption

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The European Court of Justice ("ECJ") has given its judgment in Staatssecretaris van Financien v Arthur Andersen & Co Accountants cs, a case which concerned the provision of outsourced insurance intermediary services. The case may have serious cost repercussions for the insurance sector in terms of the ability of insurers to achieve cost effective outsourcing arrangements with their third party suppliers. In some cases, the addition of VAT to previously "exempt" service charges could result in customers failing to achieve forecast cost savings through outsourcing. In any event, the insurance sector's appetite for outsourcing certain back office functions, and the supplier communities' ability to deliver cost effective services which meet insurers' needs, now faces a significant challenge.

Background

In the UK, VAT is charged on any supply of goods and services where a taxable supply is made in the UK by a taxable person (one who has registered, or is liable to register, for VAT) in the course of business carried on by that person. Goods and services are rated for UK VAT purposes into three categories, two of which are taxable (the standard category set at 17.5% and the zero rated category set at 0%); and the third of which is exempt. Until now, certain types of insurance intermediary services, including insurance contract administration and claims handling services (which are often outsourced), have been afforded exemption from VAT in accordance with European law. Article 13B(a) of the Sixth VAT Directive[1] states that:

> *"Without prejudice to other Community provisions, member states shall exempt…(a) insurance and reinsurance transactions, including related services performed by insurance brokers and insurance agents."*

In the UK, this VAT exemption, which was implemented in the VAT Act 1994[2], has been used to considerable effect to minimise input tax on the supply of services such as broking and claims handling. This in turn has allowed the supplier community to offer competitive pricing to its customers, sealing some significant business process outsourcing contracts with UK insurers.

[1] 77/388/EEC.

[2] See group 2 of Schedule 9.

Client Alert

The Case

Andersen Consulting Management Consultants ("Andersen") (now called Accenture) provided various back-office functions under an outsourcing agreement with Universal Life ("Universal"), a Dutch life insurer. These functions included accepting insurance applications; issuing, amending and managing policies, contracts and premiums; claims handling; setting and paying out commission to insurance agents; organising and managing information technology resources; and supplying information to Universal, insurance agents and insured parties and the tax authorities.

These insurance services could potentially be exempt under Article 6B(a) of the Sixth VAT Directive[3] either as "insurance transactions" or "related services". The first category was inapplicable, as the insurance transactions were made between Universal and the insured party (with Andersen simply facilitating on behalf of Universal). Instead, Andersen treated their activities as exempt from VAT under the second category - the services supplied related to an insurance transaction and were performed by an insurance broker or agent. Consequently, Andersen did not add VAT to the charges payable to Universal. The Dutch tax authorities took the view that VAT should be added onto the charges. The matter was eventually referred from the Dutch courts to the ECJ.

The ECJ noted that the Sixth Directive did not define insurance "brokers" and "agents. It ruled that, being exceptions to the general principle that VAT was to be charged on all supplies, these terms were to be construed strictly. It was held that the services provided to Universal were not those of an "insurance agent". Andersen's charges were therefore were not exempt from VAT.

This was because *"although [the services contributed] to the essence of the activities of an insurance agent, the services rendered … do not constitute services that typify an insurance agent … [and should be regarded] as a form of co-operation consisting in assisting the insurer, for payment, in the performance of its activities which would normally be carried out by it, but without having a contractual relationship with the insured party."*

The decision turned on the definition of "insurance agent". The ECJ said that it was an essential part of the work of an insurance agent to find clients and introduce them to the insurer; moreover, the ECJ did not agree that the existence of the power to bind the insurer (which power Andersen possessed under its agreement with Universal) was the determining criteria of an insurance agent; a conclusion supported by HM Revenue & Customs[4]. Also, many of the services which Andersen did provide were found by the court not to be part of an insurance agent's activities.

Accordingly, the court ruled that Andersen's back-office services did not qualify as services relating to insurance transactions carried out by an insurance broker or insurance agent within the meaning of Article 13B(a) of the Sixth VAT Directive. This means that suppliers of outsourced back-office functions which do not involve a clear sales element, including collecting premiums, claims handling and management and administration, will be obliged to charge VAT on these services; such VAT is unlikely to be fully recoverable by the insurers. Whether services relating to in-bound call centres

[3] Op cit.

[4] HM Revenue & Customs Business Brief 11/05: "the power to bind the insurer is not in itself enough to gain exemption."

Client Alert

will also become taxable is as yet unclear. The charge will not only affect suppliers based in the EU, but may also impact those based outside, as certain services are deemed to be received at the recipient's location. In such circumstances, EU-based insurers could be required to pay VAT even where no VAT was charged or chargeable by its supplier.

Conclusion

The ECJ has made it clear that, in order to determine whether an outsourcing supplier is acting as an insurance agent, one must look to all the activities it carries out. Andersen's services to Universal began with its handling of applications received from other insurance agents, whereas what was required (to be an insurance agent) was for Andersen to find the initial prospect and introduce it to the insurer. Mere capacity to bind the insurer was not, on its own, sufficient. It is reasonable to assume that where this criteria is met, the outsourcer may still be able to avail itself of the exemption.

HM Revenue & Customs reviewed the case (Business Brief 11/05) and announced plans to consult with industry prior to making any changes to UK VAT law, with a view to publishing the consultation document in July 2005. No change to the law or policy relating to the VAT exemption for insurance related services will be implemented in the UK in the meantime, but affected parties are entitled to rely directly on the decision until such time as the law is amended. HM Revenue & Customs has said that, in its view, the judgment "*does not preclude exemption where the provider does not itself have direct contact with the customer, provided that it sub-contracts the introductory service to a sub-agent, and there is a direct contractual link between the principal agent and the agent providing the introductory service*."

We recommend that insurers take urgent steps to review any affected outsourcing contracts, engage fully in the consultation process with HM Revenue & Customs and commence discussions with their suppliers to develop plans to deal with any adverse fiscal impact which might result from the expected change to UK VAT law.

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