

European Court adds VAT to outsourcing costs

Trevor Fannin looks at the impact of HMRC's proposal to add VAT to outsourcing costs

A European Court of Justice Ruling ('ECJ') issued earlier this year effectively added VAT to a wider range of outsourcing activity than hitherto anticipated.

Not only is this a setback to all the recent work to reduce costs by use of outsourcing, this ruling also potentially impacts on mathematical reserves, realistic basis liabilities and hence on the capital adequacy of life companies, including ICA assessments.

What is VAT?

Value Added Tax ('VAT') is levied on most business transactions and on many goods and some services. It does not apply to services such as insurance, some types of education, training and loans, as these are deemed to be 'exempt'.

Typically a company charges VAT at a standard rate of 17.5% on the sale value of its output and this is paid to HMRC (the new name for the combination of Customs and Excise and the Inland Revenue). It also pays VAT on many of the goods, materials and services it buys (input VAT) but this is usually recoverable from HMRC.

For exempt services such as insurance and life assurance, there is no requirement to charge VAT on the value of its output (i.e. the premiums) but conversely, the company may not be able to recover any VAT paid on office equipment, materials and services it buys. Hence premiums are affected by VAT costs, but often only to the extent that VAT is paid on office equipment, materials, etc..

However if a company buys in services such as management or actuarial consultancy, the fees for those services include VAT (which the life company cannot recover) unless the service is also exempt, or is deemed to be supplied from outside the UK.

Background to current treatment

Until now it has been possible under UK law for insurance related services such as policy administration and claims handling to be treated as provision by an insurance broker or insurance agent of any of the 'services of an insurance intermediary' and so qualify as an exempt service.

On 3 March 2005 the ECJ ruled on a case concerning the VAT liability of certain 'back office' services provided by Andersen Consulting Management Consultants ('ACMC') to a Dutch life insurance company. The question put to the ECJ was whether such back office activities carried out for an insurance company were exempt from VAT under the 'EC Sixth Directive' as 'related services performed by insurance brokers and insurance agents'. The ECJ found that ACMC were neither insurance brokers nor insurance agents for the purposes of the VAT exemption and their services therefore fell to be liable to VAT at the standard rate.

The implications of the judgment are that the UK VAT exemption for insurance-related services under UK Law (VAT Act 1994) is currently drawn too widely. It needs to be amended to bring it into line with the judgment.

Proposed amendments to UK law

The intention (consultation closed on 30 September 2005) is that the UK law itself will be made more concise and effectively replicate the wording of the EC Sixth Directive which indicates that a service will only fall within the VAT insurance exemption when it is both 'insurance-related and performed by an insurance agent or broker'. This change is expected to come into effect during the first quarter of 2006.

Impact on policyholders, shareholders and service providers

Insurers that outsource affected services will face an increase in their irrecoverable VAT. For existing agreements at least, it is likely that most increases will be met by the insurers and much of this will probably flow through to policyholders. The cost to policyholders may arise met through:

- increased expense charges on asset shares for with-profits business reducing policy benefits on existing business;
- increased expense charges on unit linked policies where discretion is allowed, again reducing policy benefits on existing business.
- an increase in premiums on new savings and protection business.

Guaranteed policy benefits will be unaffected but the costs of guarantees will increase, affecting other policy holders or shareholders depending on who finances the guarantees.

Fees charged by service providers will need to increase by up to 17.5% (although input VAT will be recoverable providing some offset) but this will reduce the attractiveness of the new outsourcing arrangements.

Impact on capital for insurance companies

Insurers will need to re-budget for these costs in all future years. In the UK, actuaries should consider the need to strengthen expense assumptions to allow for additional VAT costs in reserving calculations and other calculations requiring future expense assumptions where administration is outsourced to a third party.

The impact on regulatory, realistic and ICA calculations will depend largely on how the increased costs are expected to be met. If they are to be met by lower bonuses or higher charges made to policyholders then the impact may be smaller. However if it is to be met by shareholders then the impact may be quite significant.

For closed life companies this judgment is particularly unpleasant news because outsourcing is routinely a feature of the runoff plan. Where companies closed for reasons of low capital resources, the capital cost of the increased reserves could be significant, further restricting its flexibility and so further impacting on policyholder benefits and potentially on their security. In a world of treating customers fairly, particularly as promoted by the FSA, this government imposed inequity between internal administration and 'non- optional' outsourcing typical of closed funds, seems particularly unfair.

Conclusion

It appears to be bad news for policyholders, with the increase in costs expected to hit their benefits, security, or both; with much of the impact being felt by closed funds.

Further details including proposed rules and guidance can be found on the HMRC website, www.HMRC.gov.uk

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