

# Financial Services & VAT

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## Financial services: the VAT exemption

**The EU VAT system is exempting “financial and insurance services” (since it was harmonised by the 6th VAT Directive and nowadays under the Council Directive 2006/112/EC on the common system of value added tax- ‘the VAT Directive’);**

**This means that banking services as well as insurance and other financial services, as listed in the Directive, are exempt from tax with no right of input tax deduction for services supplied to residents and zero rated (exempt with a right of deduction) for supplies made to non-residents customers.**

**This is also the case under virtually most if not all other value added tax systems around the world !**

## Why to exempt financial services ?

The primary reason for the exemption is purely technical, it results from the conceptual and practical difficulty in measuring the value of consideration for the financial services rendered by banks.

The consideration for financial services could be of two forms:

- 1. Explicit Fee Transactions:** An explicit fee may be charged by the institution for its services (e.g., credit card processing fee, fee for grant of a loan, asset management fee). In the case of an explicit fee, the financial service is charged for in the same manner as any other services.  
**Conclusion: the explicit fee is the consideration for the service => There is no reason not to tax explicit fee transactions !**
- 2. Margin Transactions:** Alternatively, the financial institution may earn an implicit margin or spread between the buying and the selling prices of the financial instrument or the difference between the lending rate of interest on a loan and the borrowing rate of interest on deposits.  
**Conclusion: as long as we don't know how to calculate and allocate that margin, it was considered easier to exempt those services.**

## **Margin transactions: their consideration is a spread !**

**This is especially true for the traditional financial intermediation services of deposits and loans: the consideration for these services is the spread between the interest charged on loans (for ex 8%) and the interest paid on deposits (for ex 3%).**

**The EU VAT system is a credit-invoice system where the tax must be applied transaction by transaction; the VAT invoiced giving a right to deduction.**

**When the margin is a global composite measure of intermediation services rendered by a bank to both depositors and borrowers, it cannot be readily measured for individual transactions for applying a VAT . What is missing is clear rules for calculating the margins of each category of the exempt financial services are needed and these in turn would need to be applied consistently by financial institutions.**

**Similar issues arise in the taxation of insurance and other types of financial intermediation services, e.g., currency exchange, and trading in securities.**

## Problems with the Exemption System

**Under the exemption system for VAT, no tax is applied to goods and services exempted from tax, but, at the same time, no input credit is allowed for the tax paid on inputs acquired for use in providing those exempt supplies.**

**This blockage of input taxes (notably for B2B transactions) gives rise to cascading of tax, competitive distortions and economic non-neutralities.**

**In addition, it creates a bias in favour of self-supply of inputs which, in turn, leads to an inefficient utilization of economic resources and raises the cost of procurement.**

**It also results in a tax penalty on outsourcing of banking functions and consolidation of processing of transactions under cost-sharing arrangements among affiliated groups of financial intermediaries (except to the extent those outsourced or consolidated services themselves enjoy exemption).**

## Other problems with the exemption

- **Problems with the definition of exempt services: definition of a financial service is imperative for the application of the exemption, difficult to place the borderline between taxed and exempt services, difficulties with mixed services etc. Cannot rely on the difference between explicit fee transaction and margin transaction !**
- **Distortions of competition between domestic services (exempt with no right of deduction) and international services exported from a VAT country (with a right of deduction) or from a non-VAT country (USA) with no tax ! Nowadays with internet or telebanking it does matter!**
- **Allocation of input tax : as most financial institutions have both taxable and exempt activities they must determine the proportion of deductible input tax. Where the method used is based on a prorata of taxable to total revenues, significant differences may arise in the definitions.**

## Exploring solutions: the experience of other jurisdictions

**To address these economic distortions and complexities, several countries outside the European Union have adopted special measures to reduce the magnitude of blocked input VAT:**

- various models are narrowing the exemption mainly by taxing some or all explicit fees and confining the exemption to margin transactions -- in Singapore, Australia, New Zealand, South Africa and India,
- at the same time different methods are used for effectively zero rating B2B supplies to free up input tax on financial services supplied to VAT registered businesses – in Singapore, New Zealand, Québec (Quebec zero rates all financial services under its provincial goods and services tax, but applies a compensatory tax for recovery of the revenue loss from zero rating) and Australia, under its ‘Reduced Input Tax Credit’ system, allows a credit equal to 75% of the tax paid on specified inputs used in providing exempt financial services.

## Exploring solutions: Full Taxation

Full taxation of financial services is the best scenario but it supposes to have resolved the problem of identification of the taxable base for the levy of VAT.

One method (the only?) identified in the literature (Satya Poddar) for applying VAT to financial services is the so-called “**cash flow method**”:

- Fully compatible with the credit-invoice system of VAT for non-financial goods and services;
- Applicable transaction by transaction;
- It does result in the appropriate taxation of financial services;
- Simplified version has been elaborated and a pilot testing has been made in a sample of financial institutions for the Commission;
- A detailed report has been made for the EBF by S. Poddar

## Exploring solutions: the recent EU proposal

The Proposal of the Commission (COM(2007) 747 final amending Directive 2006/112/EC on the common system of value added tax, as regards the treatment of insurance and financial services) is also designed to address these problems, but in a different manner:

- By providing greater clarity on the definition of exempt financial services;
- By allowing supplies under cost-sharing arrangements among affiliated entities to be made without tax;
- By allowing option financial institutions to opt for an application of VAT to financial services and thereby increasing their entitlement for input tax deduction and allowing their fully taxable business customers themselves to recover input tax.

But the proposal does not explain how financial institutions opting for taxation would apply VAT to their services (cash flow ??).