The elusiveness of neutrality – why is it so difficult to apply VAT to financial services?

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1. Introduction

The value added tax (VAT) system developed by the European Union in the 1960s[2] is the basic model for consumption tax systems throughout the world today. When it comes to taxing financial services, in almost all cases, the practice is to exempt their supply to resident and zero rate their supply to non-resident customers[3].

Exemption from VAT for financial services has significant drawbacks, not least of which is that it compromises the neutrality of the tax. This in turn can lead to competitive distortion and, in some instances, diversion of tax revenue. Nevertheless, because of the technical difficulty of taxing financial intermediation services, exemption has been widely accepted as inevitable. Financial transactions are basically money against money and hence it is not easy to separate the subject of the transaction and the income it generates.

Although exempting financial services is a pragmatic solution, this approach is widely seen as one of the major outstanding issues in the design of a comprehensive VAT system. A number of attempts have been

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[1] Official at the European Commission. The views expressed in this article are those of the author and should not be interpreted as representing the views or policies of the Commission.

[2] The European Union's VAT system was initially based on Second Council Directive 67/228/EEC of 11 April 1967 on the harmonization of legislation of Member States concerning turnover taxes - Structure and procedures for application of the common system of value added tax, OJ No. 71 of 14 April 1967, English Special Edition OJ 1967 of November 1972, which was replaced in 1978/1979 by Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment, OJ L 145 of 13 June 1977. From 1 January 2007, the EU VAT Directive is Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ L 347 of 11 December 2006.

[3] In New Zealand, financial services supplied to registered businesses are zero rated. Morocco is unique in applying VAT across the board to the services provided by banks. The website of the Moroccan Ministry of Economy and Finance states: "*Le champ d'application est constitué pour les opérations réalisées par les banques, par le montant des intérêts, escomptes, agios et autres produits*" (Resumé du système fiscal marocain, Loi de Finance 2009, http://www.finances.gov.ma/portal/page?_pageid=53,17813873&_dad=portal&_schema=PORTAL). Under EU VAT, financial services supplied to customers outside the European Union are effectively zero rated because, under Art. 169(c), the exemption is accompanied by the right for the service provider to deduct input tax.

made to develop a methodology within the standard VAT model which would overcome the technical difficulties of taxing financial services but they have generally been perceived as suffering from deficiencies which render them problematic. This situation might tend to confirm that the case for exemption of financial services is essentially a negative one, predicated on deficiencies in the alternatives. Concerns about the effect of taxation on final consumers have probably played a role. These points may be historically valid but the reality is that non-recoverable VAT seems to have evolved into a significant revenue source which tax administrations are loath to forego. In the absence of publically available figures, it is difficult to reach conclusions on this phenomenon but it must be accepted as a factor in any discussion on changing the existing system[4].

In any case, given that the banking industry is one of the most intensively scrutinized and regulated areas of economic activity, it is unclear why a VAT problem, whose resolution should be relatively straightforward in comparison with many others, remains such an enigma.

2. Intermediation and fundamental VAT issues

An appealing feature of VAT is that it can be presented as a simple tax. The invoice-credit method creates few problems where the consideration can be identified. Where specific prices in the form of fees or commissions are identifiable, there should be little difficulty in imposing VAT on financial services. The problem however is that most of the commercial activities of financial institutions are intermediation services generating revenue in the form of a margin. Conceptually, the existence of a margin between interest received and interest paid by a bank implies the existence of an intermediation service and this margin is what drives the banking industry.

This margin-based income comes not alone from the acceptance of deposits and the granting of credit but also includes trading in equities, debts and other instruments, as well as foreign-exchange transactions. In reality, all of these activities are combined by financial institutions in a complex structure reflecting a sophisticated mix of traditional and innovative activities, of short and long-term positions, as well as other dynamic variables. In combination with the volumes of the transactions and the volatility of international markets, the financial sector will never be an easy environment in which to apply a classic VAT system.

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[4] Some figures on non-recoverable VAT can be found in the survey undertaken by PricewaterhouseCoopers for the 100 Group entitled "Total tax contribution" which is available at http://www.100groupfd.co.uk/fdgroup/storage/ttc_report.pdf. However, the level of detail is not great.

At its simplest, the international financial system provides the conduits though which the financial assets of savers are directed towards those who seek finance in whatever form[5]. Rather than linking two separate and distinct groups, these savers and users of funds are private individuals, businesses (including other financial institutions) and government bodies, all of whom can be either the source or the user of the funds, at a given time. The commodity involved, money, is almost infinitely fungible. There is not a single model of intermediation but rather a set of complex structures which often compete with each other.

Smith and Walter identify three broad processes of intermediation which link different sectors of the economy:

- fully intermediated financial flows, such as savings or investments, with financial institutions financing themselves by means of funds received from the general public and using these resources to meet the need for funds of private individuals, businesses and government bodies;

- investment banking and securitized intermediation where savings are allocated directly or indirectly via collective investment vehicles and similar arrangements to the purchase of securities in domestic and international financial markets; and

- direct-connect mechanisms between ultimate borrowers and lenders, such as private placements usually involving fiduciaries as intermediaries.

The margin achieved is a global composite measure of the intermediation services rendered by the institution and is not easily measured for individual transactions for VAT purposes. A unique and identifiable margin relating to an individual transaction between a single borrower and a single lender might be hypothetically conceivable but, in practice, is not a workable concept. Lending activities contain a risk-pooling process which functions as an insurance against loan defaults so that individual depositors do not bear the risk that their funds are contingent on the performance of individual loans but, rather, have the safety that their funds are covered by the financial institution's whole portfolio of loans. In consequence, there is no precise way of allocating margin on a transaction-by-transaction basis in respect of deposit and lending services provided by banks. The lack of any observable or measurable linkage at detailed level is a characteristic that runs through virtually all the intermediation activities of financial institutions.

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[5] Roy C. Smith and Ingo Walter, *Global Banking* (2003), pp. 356 et seq. This description of the intermediation function of financial institutions also draws from a presentation made by Professor Walter at a seminar held jointly by the European Commission and the Netherlands Tax and Customs Administration at Rotterdam in March 2007 under the Fiscalis programme.

Apart from reducing the risks involved in savings and borrowing, financial intermediation operates also over time. The inflows and outflows of money represent a complex mixture of short-term and long-term positions. Sources of funds range from very long (capital raised from shareholder) to demand deposits, whilst lending operations are equally variable in duration.

In recent years, technological and regulatory changes, particularly those associated with the Internet and the European Union's FSAP[6] have enhanced the efficiency of financial intermediation. Internet banking and related applications have cut information and transaction costs for institutions as well as for retail and wholesale users of the system. These developments continue to evolve, sometimes with radical consequences for business models. Within the European Union, most national banking systems are now an integral part of a pan-European market, reflecting a profound process of change. These changes also cause the mix of activities and relationship to become more complex, which does not make it any easier to measure them. They also call into question the long-term sustainability of the VAT exemption within the European Union, particularly because of the way it allocates the revenue from non-recoverable VAT between Member States without much regard for where the financial institution's services are actually consumed.

Because of the difficulty in measuring complex intermediation services at detailed level, a workable method of taxing them has eluded tax authorities. What is missing is an acceptably simple mechanism to overcome the problem of taxing the services when they are supplied without explicit charges, on a transaction-by-transaction basis, as required in the classic invoice-credit VAT system. To that end, 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.

The invoice-credit method works by charging tax at each level in a chain of transactions, which is then invoiced to the individual purchasers. The VAT shown as paid on the invoice then provides the basis for business customers whose transactions are subject to VAT to recover the tax on their business purchases. In respect of financial services other than those having a clearly identifiable fee, the only directly observable values in the framework of the transactions are transfers of funds (which should not be taxed) and the gross interest (which, for reasons outlined below, is not a suitable basis for taxation). There is thus often no base to apply the tax in a way that is comparable to non-financial transactions. The operational requirements for the invoice-credit system are not readily satisfied.

[6] The Financial Services Action Plan (FSAP) is a cornerstone of the European Union’s scheme to create a single pan-European market for financial services. See http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm.

3. Why is there a problem?

The difficulty of taxing financial services is not in measuring the value added created or consideration received by the service provider. This information is already generated as a result of the service provider's accounting and reporting obligations. Quantifying the consideration on a transaction-by-transaction basis is however not so straightforward but is necessary for the purposes of drawing up an invoice recording the services supplied and giving the recipients of the services the right to deduct the corresponding tax as input tax.

Any attempt to tax financial intermediation must take account of the transaction as both an output for the service provider and as an input for the recipient. Even if a technical solution is found for taxing transactions between VAT registered businesses, questions would remain about deposits made by private individuals, who are not registered for VAT, as well as movements of funds that are outside the scope of VAT.

The financial institution's margin relates to services rendered to both depositors and borrowers, including compensation for risk of loss. The exact mix of the services will vary and the individual components are unlikely to be directly observable. The periodic margin is the resultant of a complex mixture of capital and interest flows against an equally complex portfolio of deposits and other investments from savers.

The process is further complicated by sensitivities on disclosure of margins which puts commercial confidentiality at risk. VAT does not usually require information about the margin achieved on individual transactions to be divulged[7]. Basing VAT rules on such an obligation would be a radical and unique departure from the principle of neutrality, in that the tax rules *per se* would interfere in the market in a distortive manner. It would be almost impossible to justify such an interference.

Within the European Union, one consequence of attempting to isolate the margin on financial services would be to highlight that the consistency of the currently applied rules for allocating inputs, which are not directly attributable to particular services, to taxed and exempt transactions is badly compromised. Such an allocation is a complicating but unavoidable aspect of partial exemptions. Rather than reducing the perceived uncertainty here, EU tax administrations seem to have opted collectively for a degree of slackness in using different approaches for allocating inputs between taxed and exempt financial services[8]. Although there may some advantages (even

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[7] This margin at individual transaction level should not be confused with the overall margins achieved by a company over time. Where a company is obliged to publish its accounts (because it is publicly listed or for other reasons), its overall periodic margin is usually transparent.

[8] Arthur Kerrigan, "The impact of VAT on financial services and insurances – the law of unintended consequences?", *Frontiers in Finance and Economics*, Vol. 4 (2007), No. 2.

competitive opportunities) for financial institutions in such a diversity, the result is far from satisfactory from the perspectives of the European Union as an internal market and VAT as a harmonized tax. The neutrality and revenue impacts are sufficiently serious that policymakers might consider more specifically targeted responses to address these shortcomings[9].

The optimal response is, of course, fundamental reform of the VAT system resulting in comprehensive taxation of financial intermediation services. However, for the reasons mentioned in section 5, there are at present significant obstacles to the adoption of such a fundamental measure. It is not only within the European Union that the focus is generally towards more short-term solutions. The balance between assuaging the immediate problem and fixing it structurally has always tended to favour the former. Resolution of tax problems is not an exception in that respect.

Exemptions however will always be dogged by two obvious operational problems. The first is to establish a clear boundary between exempt and taxed services and to maintain this distinction consistently. The second is to ensure that, where institutions supply a mixture of exempt and taxed services, input tax is correctly allocated. Dealing with these issues is burdensome for both tax administrations and businesses. If a suitable methodology could be devised for applying VAT, these (and other) problems would simply disappear, which has to be a goal worth pursuing.

4. Methods for calculating VAT

Unsurprisingly, considerable work has been done over the years with the aspects mentioned above in mind. The following short summaries of some of the main proposed methodologies for taxing financial services is no more than an overview[10].

4.1. Subtraction method

Under a subtraction-type of VAT, the tax base for each VAT reporting period is determined by subtracting from total financial revenues for that period (fees and commissions as well as margin income), the total financial expenses incurred by the institution. The institution's VAT liability is then computed by multiplying the tax base by the VAT rate. This method would require common rules on the calculation of the

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[9] Recital 39 of the preamble to the VAT Directive states that "*The rules governing deductions should be harmonised to the extent that they affect the actual amounts collected. The deductible proportion should be calculated in a similar manner in all the Member States*". In practice, Recital 39 seems to be regarded as a dead letter.

[10] The literature on the TCA method in particular sets out in considerable detail how it might be applied to a wide and complex range of financial services.

margin, which could be based on reported results in statutory accounts subject to appropriate adjustments. If the consideration for financial services is included in the VAT base, financial institutions would be entitled to full input tax deduction.

A fundamental flaw is that the tax base cannot readily be calculated on a transaction-by-transaction basis. As a result, the financial institution's business customers can only deduct input VAT on a formulary basis.

The attraction of the subtraction method is simplicity. No adjustment is required when the tax is introduced or when the tax rate changes. The margin can be calculated for any given period and is subject to the tax rate applicable for that period.

Allocation of the margin to services supplied to depositors and borrowers and its identification at the level of an individual transaction however remains problematic. Neither is there, in the event of partial exemption, any precise way of identifying the burden of input tax on "exported" services. Input VAT can only be apportioned to individual transactions in a global manner.[11]

4.2. Cash-flow methods

Basic cash-flow method

The cash-flow VAT models are intended to measure the margin from financial intermediation services in a manner which allocates the margin to the recipients of the services on a transactional basis consistent with the invoice-credit system.

In its most basic form, the cash-low model is based on measuring the total cash inflows and outflows (capital and revenue) associated with financial transactions. The inflows are treated as consideration for taxed sales on which VAT is charged and outflows are treated as consideration for taxed purchases on which the institution can recover the tax. The implicit fee (the margin) can be identified in terms of the net cash inflows or outflows associated with a financial transaction. That model also allocates the margin to services supplied to borrowers and lenders on a transactional basis (at least over time) and can sustain a invoice-credit mechanism enabling business customers to recover input VAT.

There are at least three identifiable drawbacks which detract from the attractiveness of this method. The most serious of these are the cash-flow-funding consequences which would be resisted by business customers whose transactions are subject to VAT on an accrual basis.

[11] For these reasons, the subtraction method was never seen as viable. A variant of the method was proposed in Canada prior to the introduction of a federal GST. It was never implemented, presumably because of the inherent difficulties in identifying the tax charged for each individual transaction. Canada continues to exempt the supply of intermediated financial services.

In addition, the business customers would need to undertake accounting and record-keeping operations to calculate their deductible input tax relating to received financial services, and this would be seen as disproportionately onerous, especially for SMEs.

The model assumes a constant rate of tax, ignoring changes in VAT rates. In the 1980's and early 1990's, when the investigatory work on this model was done, it was not possible to foresee the development of a reasonably consolidated pan-European market for financial services, in which VAT rates differ between Member States. Complex intermediated transactions spread across several Member States (such as syndicated loans) would not readily be accommodated. Furthermore, some complex adjustments would also be required at the time of introduction of the tax regime in the financial sector.

Tax Calculation Account method

The Tax Calculation Account (TCA) method was developed by Satya Poddar to take account of at least some of the drawbacks of the basic cash-flow system[12]. It deals with the cash-flow concerns, as well as most of the transitional problems in rate changes and the initial shift to taxation.

A TCA is seen as a tax suspension account where the VAT charges on inputs and outputs under the basic cash-flow method are suspended and treated as merely bookkeeping entries. It requires no payment of the tax on capital flows, therefore creating no new funding requirements. For both financial institutions and customers, the tax on inflows or outflows is passed through the TCA. The balance at the end of a reporting period is adjusted for an interest deferral charge and the amount payable or receivable can be computed. Transactions between financial institutions would be zero rated.

Truncated cash-flow model

The truncated cash-flow tax model takes the TCA model a step further and relieves the administrative burden on taxable persons who are not financial institutions. The full compliance burden falls on the financial institution. The tax on the margin on financial intermediation would be reflected in a periodic invoice to customers, forming the basis for input tax recovery. In the view of its proponents, the result is a methodology that overcomes obstacles to identifying, measuring and taxing the intermediation margins of financial institutions, albeit at the cost of some complexity.

4.3. Modified reverse charge

Another methodology to overcome the operational problems in applying VAT is the modified-reverse-charge method developed by Howell Zee of

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[12] The TCA method and its development is well documented elsewhere. See, for instance, Satya N. Poddar and Morley English, (1997) *"Taxation of Financial Services under a Value-Added Tax: Applying the Cash-Flow Approach"*, National Tax Journal, Vol. L (1997), No. 1.

the IMF[13]. Applied correctly, it would ensure that, for any reporting period, the net tax revenue to be remitted to the authorities by a financial institution corresponds to the VAT on its provision of intermediation services with the burden of the tax being borne by the recipient.

It allocates input VAT to borrowings through a unique franking mechanism on a transaction-by-transaction basis. The result would be a system fully compatible with the invoice-credit mechanism with VAT being assessed and charged at the point of each interest payment.

Financial institutions must account for VAT under the reverse charge mechanism on their inputs (such as deposits) and deduct it from the tax due on their outputs. Loans to non-resident borrowers would be zero rated. The absence of a link between any specific deposit and any specific loan is overcome by a pooling system with regularly updated running balances. The margin for any particular intermediation service is an average of all current deposit and lending transactions in the pool.

Only the borrower is taxed as a recipient of a financial intermediation service, ignoring the receipt of any service by the depositor. Although not a purist approach, there are probably sufficient pragmatic arguments to sustain it. The modified-reverse-charge method could deal with the limitations of the exemption in a seemingly simple and straightforward manner. For intermediation services other than deposit-taking and lending, a similar approach is advocated. This would include the more fraught areas of foreign-exchange, investment and trading activities.

In practice, however, such a model would be a great deal more complex than presented. The myriad pools of financial assets that underlie the range of intermediation services provided by a financial institution are not discrete and self-contained but are fungible and intermingled. It is beyond the scope of this article to consider how this would function in practice.

It is also not clear how the model would work when financial intermediation services are supplied by non-mainstream institutions or even in a dis-intermediated fashion.

4.4. A workable method?

What these different approaches have in common is that, to some extent at least, they attempt to allocate the margin from financial intermediation so as to allow the invoice-credit VAT mechanism to function.

The criticisms that have been raised are that they either do not achieve this objective to a sufficient degree or impose excessive

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[13] Howell H. Zee *"A New Approach to Taxing Financial Intermediation Services under a Value Added Tax"*, National Tax Journal, Vol. LVII, No. 1, March 2005.

burdens or fail to take account of the complexity of the financial intermediation. Most attention in the past has been paid to the TCA model but financial institutions and tax administrations remain concerned about the costs of implementing such a system[14]. As is sometimes the case, issues that are perceived as either technically complex or politically sensitive stall on the question of whether there is a really pressing problem to be addressed.

Both the TCA and the modified-reverse-charge methods provide a mechanism which allocates the total margin to individual transactions. Achieving complete accuracy of the real margin at the level of individual transactions is certainly a chimera but both of these methods give a reasonably acceptable proxy. Perhaps this result is in itself a realistic objective for any method.

These two methods are certainly open to criticism on the basis of complexity. A simpler approach is conceivable but has yet to be set out. Ideally, any such an alternative should make as much use as possible of established accounting rules to minimize compliance costs.

5. Measuring financial activities for VAT

VAT is not based on the service provider's periodic accounts (as are income taxes) but rather on individual transactions. Neutrality requires that, for any given area of business, its application be broadly consistent with the way in which the tax is applied in other business sectors. The tax should not create undue compliance burdens and, in particular, should not have an adverse effect on the competitive position of businesses.

Notwithstanding some difficulties, it is possible to identify the value added of a financial institution from its statutory accounts, taking into account the rules under which they have been prepared and subject to a number of caveats on how the information is presented. It is similarly possible to identify the overall margin achieved by institutions from financial intermediation. Some detailed adjustments are needed but they depend on routinely available accounting data. The difficulty of applying the outcome to individual transactions will however still remain.

The consolidated financial statements of most financial institutions are generally prepared in accordance with the International Financial Reporting Standards ("IFRS"), as issued by the International Accounting Standards Board ("IASB") and now mandatory in the European Union[15]. Banks (if they are public companies) are required to conform

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[14] Pasquale Pistone and Carlo Romano, *"Report on 57th Sydney IFA Congress Proceeding"*, Rivista di Diretto Tributario, Fasc. 11 - 2003.
[15] **Regulation (EC) No. 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards**, OJ L 243 of 11 September 2002. There are however a number of carve-outs in areas such as hedge accounting. Moreover, as these principle-based accounting rules

to a single set of international financial reporting standards (EU-IFRS) for their consolidated financial statements. Thus, there is an expectation of consistency in the way data is presented.

In order to compute value added in a manner consistent with VAT rules, it would be necessary to reconcile total turnover for VAT purposes with accounting data used for computing other taxes. The financial statements drawn up for other taxes are based on estimates and assumptions for certain categories of assets and liabilities, and impute income (or losses). For VAT, these estimates and assumptions require adjustment.

Institutions also face other accounting and reporting obligations, for example, under general regulatory requirements, but they are of little identifiable benefit in computing the taxable base for VAT at the level of individual transactions.

5.1. Taxing deposits and loans

If the value of the institution's intermediation services on interest-generating activities can be measured by the difference between its loans and deposit interest, it might then seem logical to regard loans as outputs and deposits as inputs, on both of which VAT could certainly be imposed. The VAT on the loan and deposit interest could then be output and input tax, respectively, for VAT purposes. This would however lead to an imbalance in the manner in which interest generating activities are taxed compared with other intermediated services where the charge is less transparent (e.g., transactions relating to collateralisation of loans).

Taxing loans is clearly technically feasible on a transaction-by-transaction basis with VAT being added on each occasion on which interest is charged and paid, making it compatible with the requirements of the invoice-credit VAT system. Taxation would be attractive where the recipient of the service recovers at least a significant part of the VAT[16].

In the case of deposits, the situation is more complex. Deposits from private individuals are essentially supplies made by non-taxable

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generally apply only to the consolidated accounts of publically traded companies and, although some Member States require them for non-publically traded companies, they are not universal. Member States can exercise an option to extend the application of IFRS on a compulsory or voluntary basis, and IFRS is not universal across the European Union. This diversity is widely perceived by businesses as an obstacle to the integration of financial markets, and the European Banking Federation advocates that both listed and non-listed companies be allowed to use IFRS for compiling their statutory accounts (See *Overcoming the crisis and moving beyond,* published by the European Banking Federation, Brussels 2009).

[16] It seems indeed to be the practice that such a relatively crude method is acceptable when computing a taxable base for the lending of money under the limited circumstances that taxation is possible under an option to tax (e.g. in Germany) but this can only be seen as a local aberration.

persons, which are not subject to VAT. It would be unreasonable to expect non-taxable persons to register and account for VAT on the "supplies", even where the deposited sums are significant. Other depositors - businesses or other financial institutions - are likely to find taxation attractive, merely because it improves their overall tax recovery. Where the depositor is a taxable person who charges VAT on interest received and issues an appropriate invoice to the financial institution, the procedures for accounting for this VAT for both parties are as straightforward as they would be in any other business relationship.

There are however two negative consequences rendering this approach undesirable. Both consequences flow from the fundamental misconception which leads to the use of gross interest as the tax base for output VAT, rather than attempting the more correct, but more difficult, approach of taxing the value of the intermediation service.

Ignoring the real nature of the service being provided, that of intermediation, and applying the tax to the gross interest charged (the gross margin) would have striking consequences. It would create a disproportionate increase in the financial institution's recovery rate by virtue of taxing one kind of financial intermediation service - lending - in a manner different to other intermediated services with the sole identifiable effect of increasing recovery. Conversely, it will significantly increase the cost of borrowing where the borrower is not entitled to deduction. Not only is the transaction overtaxed but the recovery rate of the service provider is also distorted.

5.2. Taxing foreign-exchange transactions

The VAT Directive contains no special rules on the taxable base for financial services. Member States who currently tax some of these services (by allowing financial institutions to opt for taxation) can plough their own furrow without being overly concerned about consistency. In the absence of any guidance at Community level on what constitutes the taxable base in these circumstances, they will continue to act independently.

The one notable, if limited, exception is the taxable base for foreign-exchange transactions, in respect of which the Court of Justice of the European Union (ECJ) has intervened to create some clarity. It stated that "in foreign-exchange transactions in which no fees or commissions are calculated with regard to specific transactions, the taxable amount is the overall result of the transactions of the supplier of the service over a given period"[17] - in other words, the periodic margin achieved.

The margin derived from foreign-exchange transactions is not difficult to measure. An institution dealing in foreign exchange will profit over time from the spread between the prices at which it buys and

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[17] ECJ judgment of 14 July 1998 in *Commissioners of Customs and Excise v. The First National Bank of Chicago,* Case C-172/96, [1998] ECR I-4387.

sells currency. For its intermediation role, it receives a consideration which is reflected in the value of this spread. The currencies receives by the institution are clearly not remuneration. The ECJ recognized that, for the purposes of the turnover-based method of deduction of input VAT, the financial institution's turnover is what it could keep for itself, calculated as the net result of all transactions over a period of time.

What the ECJ did not indicate is how the value the services must be established on a transaction-by-transaction basis (it was not asked because the services were exempt from VAT). Given however the clarity about what constitutes the taxable base, this is simply a technical difficulty which remains to be overcome.

5.3. Other complex margin activities

Financial institutions maintain inventories of equity and debt which are purchased and sold in the ordinary course of their intermediation business. The resulting income is reflected in the published accounts but requires adjustment in order to determine the value added for VAT.

Certain elements, such as unrealized inventory gains or losses reflecting changes in market value of the securities (fair value) which are booked under normal accounting rules, must be disregarded for VAT.

Apart from these adjustments, the ECJ's logic in *The First National Bank of Chicago* can be readily extended to such more complex margin services (such as derivatives, including interest rate swaps). In most cases, all that is missing is a mechanism or proxy to allocate the outcome to individual transactions.

Realistically however, this is not the end of the difficulties. Financial institutions generate income from complex transactions, such as the issue of shares (IPOs), in the form of mixtures of margin and fees. Some of those transactions may be carried out in the absence of a clear counterparty and the tax system would have to deal with this situation. More generally, practical difficulties in identifying the counterparty for individual transactions may leave little alternative than to treat these as bearer transactions. Not the least consequence of such a constraint could be difficulties in identifying transactions with customers in third countries, which should be zero rated.

5.4. Value added as identified in statutory accounts

The complex nature of the relationship between a financial institution and its clients makes it difficult to disentangle the margins associated with different intermediation services, and cross-subsidization cannot be excluded. Transparency is also a problem where the price for administrative services is bundled with the apparent margin. The implicit pricing of these other services must similarly be observed and imputed to customers if VAT is to be charged.

It is however established audit practice to reconcile the turnover disclosed in the income statement (used for direct tax purposes) with the taxable consideration declared for VAT for the same period. Making such cross-checks would usually be regarded as best practice, if not essential. Were the decision made to tax financial services, such reconciliation should play a key role.

On the question therefore as to whether the total taxable base for VAT purposes can be derived from the sources used in the statutory income statement of a financial institution, the answer, despite complications, has to be yes. It is a matter of setting the adjustments needed to get from one set of figures to the other. Common standards across the Union would be a first element in ensuring consistency. What is then required are the elements needed to compute the taxable margin for VAT purposes and these should also be laid down at Union level to discourage the development of local interpretations[18].

This approach requires a methodology which allocates the taxable margin at the level of individual transactions so that for B2B transactions, an invoice can be generated and VAT is correctly applied to the charge for financial services.

6. Problems with partial solutions

A tentative step towards increasing neutrality could be to extend the existing option to tax financial services, which has been a feature of the VAT Directive since 1977[19]. Here, it could be posited that the option simply reflects the uncertainty of the Union legislator about the long-term sustainability of the exemption. In any event, the provision is somewhat half-hearted in that it leaves the issue at the discretion of Member States. The take-up of the option has been limited and there is no pretence of uniform application. The result is almost certainly distortive and difficult to reconcile with a Union-wide level playing field for financial services (the technical and regulatory obstacles to a single market for financial services having fallen to an extent that was not envisaged in 1977). The distortive consequences of limited and selective access to the option are exacerbated by the rules on deduction (notably Art. 169(a) of the VAT Directive)[20], which open the door to what is in effect zero rating

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[18] This could draw on the work of the Joint Expert Group on Reconciliation which is sponsored by the European Central Bank and the Committee of European Banking Supervisors to develop and promote convergence in reporting processes for statistical and prudential/financial reporting for the European Union's financial services industries.

[19] See Art. 13(C)(b) of the former Sixth Directive and Art. 137(1)(a) of the current VAT Directive.

[20] The relevant parts of the provision read as follows:
"[...] the taxable person shall be entitled to deduct the VAT [...] in so far as the goods and services are used for the purposes of:
(a) transactions [...] carried out outside the Member State in which that tax is due or paid, in respect of which VAT would be deductible if they had been carried out within that Member State."

financial services supplied to customers established in another Member State by service providers established in Member State where the option is available[21].

There is however a strong argument that, if taxation is justified, it should be equally accessible to financial institutions wherever they are located and subject to the same technical conditions and obligations (particularly concerning a consistent approach to the taxable base). This has motivated the European Commission to propose changes in the rules under which access to the option to tax is available [22].

An option to tax suffers from two obvious problems. Firstly, as with the more general application of VAT to financial services, it evokes difficult conceptual and technical complexities (whether based on cash-flow or some other methodology) in trying to quantify the implicit price charged for the relevant financial intermediation service. These complexities could entail compliance and administrative burdens similar to those associated with the TCA method which bedevilled earlier attempts for reform by the Commission.

Secondly, even partial elimination of input taxation revenue would have uncertain costs for governments and it is not certain that these would be recovered by taxing financial services supplied to final consumers, even if considered desirable.

An option to tax addresses the tax bias to vertical integration merely by refining that system. If new sources of distortion are to be avoided, it would however require considerable preparatory work on a consistent taxable base and implementing rules which would not create new distortions. If this is possible and if Union policymakers wish to respond to the full range of distortions, there is no obvious reason to choose a wider option to tax over a more comprehensive response. If the general application of VAT is considered possible, there is no obvious intellectual reason to stop there other perhaps than to ease the process of transition or to allow for restricted field testing of a new scheme. Experience to date with the exemption seems to have been mixed and has probably contributed to uncertain and uneven taxation of

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[21] In a submission to the Commission, the European Banking Federation suggested quite reasonably that any wider access to the option to tax financial services should be linked to the withdrawal of Art. 169(a), at least in as far as it covers financial services.

[22] *Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax, as regards the treatment of insurance and financial services,* COM (2007) 747, which was accompanied by a *Proposal for a Council Regulation laying down implementing measures for Directive 2006/112/EC on the common system of value added tax, as regards the treatment of insurance and financial services,* COM (2007) 746. However, in the accompanying Impact Assessment, the Commission states (on page 37) that "Any use of the option to tax will need a clear and consistent approach to the definition of the taxable base which is consistent across the market and which ensures neutrality in tax treatment".

some financial services[23]. Furthermore, it does nothing about the complexity and associated compliance and administrative burdens attributable to the need to allocate tax payable on inputs between exempt and taxed financial services.

In the meantime, a less sweeping policy response might be considered, i.e. adjustment of the boundary between taxed and exempt services. This adjustment could be achieved by simply refining the definition of the exempt services but a more logical distinction might be based on pricing. Taxing more of the fee-based services would lead to higher recovery rates. It would also lead to higher prices for customers who do not have a full right of recovery, including other financial institutions. Whether the increase in recovery rates would compensate for higher prices is unclear.

When taxation of more fee-based financial services has been suggested in the past, the main concern was that it would merely skew the pricing structure in a direction which would extract the maximum benefit for the institution, rather than increase neutrality. This is not an unreasonable concern, given that banks have considerable flexibility in setting their charges. Where the buyer of financial services is accustomed to paying a mixture of fees and margins (hidden or otherwise), there will be significant room for arbitraging, particularly if a mutually advantageous outcome is on offer.

These concerns may however be overstated, as evidenced from countries which have adopted VAT more recently than the European Union (Australia or Singapore for instance) and where services supplied for explicit fees are generally excluded from exemption. There is some indication that arbitraging between fees and margins declines under pressures from statutory disclosure requirements and competitive forces, which discourage bundling of margin and fee-services.

There will always however be shortcomings in any scheme to limit exemption, which stops short of full taxation. The difficulties associated with bearing non-recoverable tax on outsourced services will persist, as will the inconsistencies between Member States.

More fundamentally however, as a possible response to the perceived problem of vertical integration and lack of neutrality, the greatest weakness of either the option to tax or restricted exemption is that neither is primarily a response to these problems, but rather a partial alternative to replacement of an exemption system. The solutions respond only partially, at best, to the distortions and loss of neutrality attributable to exemption.

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[23] This seems to be the case for the provision of payment services where the evolution towards cross-border supply can only increase distortion under the present regime.

7. Reasons for change

With limited exceptions, governments have been reluctant to move away from the exemption for financial services. It is difficult however to identify specific policy considerations here apart from inertia. Input taxation of financial institutions is certainly an ever-growing source of tax revenue but it is impossible to identify from publically available figures how much it contributes to total VAT revenues. This makes it extremely difficult to compare the utility of alternatives for taxation, let alone start a serious debate around them.

Notwithstanding the evident drawbacks, financial institutions have on the whole been muted in their criticism of the existing regime. The criticism that has been voiced in the past has been made in the absence of any hard figures on the actual impact of the taxes which they bear. Consequently, little political motivation has been generated for taking up the issue. Levels of non-recoverable VAT and recovery rates are seldom if ever disclosed - rather they are treated by companies as sensitive commercial information to be closely guarded. There is also a perception that the senior management of financial institutions have more pressing issues when it comes to negotiating with governments on regulatory or other fiscal impositions.

It is not however the intention here to rehearse the arguments on the merits of taxation over exemption, which are in any event widely available elsewhere. Instead, it might be more useful to consider what is necessary to truly open up the debate, i.e., elements which might alter perspectives and develop some leverage on the merits or otherwise of a change of the VAT regime applicable to financial services.

The most important of these elements might be the deficiencies in the availability and quality of data. The hidden nature of the tax flows, whether in the form of non-recoverable VAT paid by businesses or the tax foregone though exempting supplies to final consumers is a barrier to reasoned debate.

One way to remedy this lack of data would be for the institutions concerned to modify the way in which they report their activities and to account for VAT with the same level of transparency as for other taxes. The existing accounting method dates from the time of introduction of VAT and reflects the perception that VAT would not generate any costs for businesses. Non-recoverable VAT in the exempt sectors was seen as a minor burden (outsourcing was not a big factor then) and any cost did not justify a specific treatment beyond simply treating it as an expense.

Change might be prompted through increasing awareness of the impact of VAT. The shift from dependence on income taxes (particularly corporate income taxes) towards consumption taxes is an established trend which is unlikely to be reversed. If financial institutions are now going through a period of reduced or no profit, there will be a change in the balance between the real impact of income taxes and non-recoverable VAT with the latter exceeding the former. External factors, such as a change in the federal tax system in the United States involving a broad-based multi-stage consumption tax there, might be sufficient to open the case for new disclosure rules[24].

For the time being however, there is a widespread perception that consistent accounting for VAT, let alone disclosure, is a low priority, confirming that any pressure for increased disclosure will have to come from outside[25].

A more pressing reason to open a serious debate may lie in the impact of the exemption on the distribution of tax revenues. The EU VAT system covers 27 Member States, generating revenue which, to the maximum extent possible, should accrue where consumption takes place. Where changes in technology or deregulation in certain industries put this important practical objective at risk, the legislation can be changed[26].

For a cross-border service which is exempt, this matching of consumption and tax revenue cannot be assured, notwithstanding that the amounts at stake are probably significant. The tax accrues, in the form of non-recoverable input VAT, to the Member State where the service provider is established rather than that where the recipient of the service is located.

As financial institutions embrace European consolidation, this effect will become more pronounced. With regulatory barriers falling, there may be little reason to locate many activities in close proximity to customers and no reason at all to replicate them in each Member State.

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[24] In fact, this debate is already underway. In February 2009, the American Tax Policy Institute held a conference in Washington DC on the topic "Structuring a Federal VAT: Design & Coordination Issues". Details of the papers discussed can be found at http://www.americantaxpolicyinstitute.org/research.html.

[25] Some sporadic attempts have been made at purely Member State level to quantify the amounts involved in non-recoverable VAT or the cost of exemption more generally. Bernd Genser and Peter Winkler in "*Measuring the Fiscal Revenue Loss of VAT Exemption in Commercial Banking*", Finanzarchiv NF Bd. 54 (1997) conclude that the net revenue loss to the German exchequer from exempting bank services for 1994 was DM 10 billion (just over EUR 5 billion). In the United Kingdom, a recent unpublished study by the Hundred Group (an ad-hoc group who act as a mouthpiece on financial issues for FTSE-100 companies) attempts to quantify the total tax contribution, including non-recoverable VAT, from the financial services industry.
In his article "A European VAT on financial services?", Economic Policy, Vol. 17 (2002), No. 35, p. 498-534, Harry Huizinga suggested that introducing VAT on financial services in the then 15 Member States of the European Union would cause tax revenues to increase by EUR 12 billion in a full year.

[26] The recent changes in place of taxation for intangible B2C services which can be delivered from remote locations (such as e-services or telecommunications services) are aimed at ensuring this outcome (Council Directive 2008/8/EC of 12 February 2008 amending Directive 2006/112/EC as regards the place of supply of services).

Under the current exemption system, this has consequences for national exchequers.

There are limits to the extent that Member States will be happy to accept such revenue transfers as a worthwhile trade-off for a more efficient market. It is however more likely that the diverted revenue has not yet reached a level of consequence.

Were the diversion of VAT revenues to become critical, one obvious way to rectify the problem would be a move towards taxation of the services. Taxation is however not the only solution and perhaps when the time comes, other measures might be contemplated[27]. It is however likely that, at some point, the European Union will have to address the erosion of revenue faced by those Member States who are net "importers" of financial services.

8. Conclusions

This short article can provide little more than an overview of a VAT issue which, over the years, has been the subject of considerable analysis and commentary. It must also be said that none of those activities have brought us any nearer a definitive solution. Therefore, putting some perspective on the issues that need resolution and the realistic options for change may be as close to a conclusion as is possible in this ongoing debate.

If the objective is merely to relieve the burden of non-recoverable VAT from banks and outsourcers, is it worthwhile to expend so much energy in working out a taxable base if the final outcome for B2B is to generate VAT which will largely be recoverable by the recipient? Even if the end result is simply to tax final consumption of financial services on the basis of the consideration which the institution receives, then why bother with excessive complications? If the desired outcome is full taxation and full recovery, the mechanism for achieving this does not have to be over-sophisticated but it should be consistent, both between individual financial institutions and across EU Member States.

It is certainly technically possible to devise a methodology which taxes margin-based financial services in an equitable manner. It is probably also possible to ensure that this can be done in a manner which strikes a balance between simplicity and excessive attention to detail.

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[27] In Canada, where there is a clear pattern of some provinces being net recipients of exempt financial services which are supplied from elsewhere, the uneven accrual of non-recoverable tax is the subject of a compensatory mechanism. See Bird, Richard M. and Gendron, Pierre-Pascal, Sales Taxation in Canada: The GST-HST-QST-RST 'System' (May 29, 2009). Revision of paper present at American Tax Policy Institute Conference on Structuring a Federal VAT: Design and Coordination Issues, Washington, D.C., February 18-19, 2009. Available at SSRN: http://ssrn.com/abstract=1413333

What is missing are the essential elements of a serious economic debate on the benefits of change or the cost of inertia. The financial institutions themselves must bear a large part of the responsibility for the current situation but they are not alone in playing their cards close to their chests.

Lack of data makes it difficult to reach any conclusions on the impact of introducing taxation. One effect would be to transfer the burden that is currently borne by financial institutions (albeit in turn reflected in the cost of the services they supply) to final consumers. This is what a consumption tax, like VAT, generally does and should come as no surprise. Determining the effect of taxation on prices and on the performance of businesses, and whether the tax generated on supplies to consumers is sufficient to offset the input tax which will become recoverable (assuming that supplies of B2B services generate no real tax) is an exercise that can only be concluded on the basis of hard data.

Further analysis is needed to address concerns that change might have negative implications for overall VAT receipts or might have undesirable social or redistributive effects. In the absence of more detailed information, it is unreasonable to expect that the governments of the Member States will be prepared to make choices about sensitive and wide-ranging issues.

The changes in accounting rules brought about by Regulation 1606/2002[28] were enacted by the Council in the clear expectation that they would have an impact on the way in which profits are computed for corporate income tax purposes and, in consequence, for the way in which these taxes are assessed and collected. Given this degree of acceptance by the tax administrations of the EU Member States, their reticence on common accounting rules for VAT seems difficult to explain.

It is also difficult to understand why financial institutions regard the cost of input VAT as more sensitive than the cost of other taxes. Logic would seem to indicate that the total tax burden on a financial institution is a crucial figure, albeit one which receives little attention. Taken in isolation, complaints about excessive VAT costs sound just a little hollow if the picture in incomplete.

It is however beyond doubt that, at the level of individual financial institutions, both the overall taxable base for VAT (and hence VAT on outputs), as well as the value of non-recoverable VAT can be computed. If there is a willingness to disclose this information, it would provide the elements for the next steps in this debate.

Taking a full picture perspective might then allow us to contemplate the words of John Kenneth Galbraith when he said (admittedly in other

[28] See note 15.

circumstances) "The solution is not difficult; it has the advantage of inevitability"[29].

[29] As quoted by Theodore Dalrymple in *The Galbraith Revival,* City Journal, Winter 2010 Vol. 20, no. 1.