

International Practices of Financial VAT

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The question of what constitutes the most appropriate VAT treatment for financial services has not yet been answered. In this article, the authors identify and evaluate the theoretical alternatives and current international practices in this area, and provide, in their view, the most promising method to tax financial services.

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1. Introduction

This article discusses different methods for levying financial services under VAT (hereinafter, financial VAT), or under alternative taxes. It is structured into five sections. Section 2. explains the main methods used worldwide for levying financial VAT or alternative taxes and Section 3. discusses the international practices in this area. A brief assessment of these practices is then provided in section 4., together with a proposal for an alternative method based on current best practices. Section 5. offers a summary of the conclusions.

2. Methods of taxation

Many methods how to tax financial services have been proposed in the literature, in order to replace the exemption from VAT currently in force in most countries. Some of those approaches have even been tested in a few countries. Nonetheless, there is no single method that is widely recommended by academics. In this section, the authors introduce the main methods developed and/or discussed by legal and economic scholars for taxing financial services, distinguishing between methods that tax financial services under VAT and those that tax them under other taxes.

2.1. Financial VAT methods

2.1.1. VAT exemption

The exemption of financial services from VAT is characterized by a supply with no VAT for the customers and the irrecoverability of input VAT for the suppliers. An advantage of this approach is the avoidance of the problem of measuring the value added, which is complex to observe for margin-based financial services (without an explicit price) on a transaction-by-transaction basis. The allocation of these charges among the consumers is also difficult (in contrast, fee-based financial services are easier to tax due to their explicit prices, i.e. explicit fees and commissions). However, on the downside, the exemption method implies several distortions. First, the exemption results in irrecoverable VAT

for businesses, resulting in a cascading effect. As financial entities cannot deduct all their input VAT for non-financial operations, they might try to add this amount to their prices, with a direct impact on customers. Although the "incidence of VAT" is still an unresolved issue,¹ this may result in overtaxation of businesses, but undertaxation of households. In addition, exemption incentivizes vertical integration (i.e. businesses integrating some or all of the steps of the production chain) to avoid irrecoverable input VAT. Second, distinguishing between exempt and non-exempt transactions represents a compliance cost and makes taxation more complex.² Third, exemption has implications for tax revenue and income distribution and has legal consequences.³ There are some interpretative troubles in determining the scope of the exemption and the exempt products and services, and there are also some difficulties in calculating the recoverable input VAT. Finally, tax avoidance and planning strategies are induced by the exemption.

2.1.2. Zero-rating

This method consists in applying a zero VAT rate to financial services but at the same time allowing full input VAT recovery. Thanks to this method, simplicity is achieved and vertical integration incentive and overtaxation of businesses are eliminated. A disadvantage of this method, however, is the low VAT collection, and the persistence of undertaxation of the consumers. If the zero rating only applies to business-to-business (B2B) transactions, for financial companies with non-business

¹ The incidence of VAT refers to the identification of who ultimately bears the economic burden of the tax: the producer or the consumer. VAT incidence does not depend on who the legal taxpayer is, but on the price elasticity of demand and supply and therefore on the ability of firms to pass through the VAT to consumers.

² T. Edgar, *Exempt Treatment of Financial Intermediation Services Under a Value-Added Tax: An Assessment of Alternatives*, 49 Canadian Tax Journal/Revue Fiscale Canadienne 5, p. 1134 (2001); R.S. Avi-Yonah, *Designing a Federal VAT: Summary and Recommendations* (University of Michigan Law School, Olin Working Paper 09-013, pp. 7-8, 2009).

³ R. De la Feria & M. Walpole, *Options for Taxing Financial Supplies in Value Added Tax: EU VAT and Australian GST Models Compared*, 58 International and Comparative Law Quarterly 4, pp. 897-932 (2009); J. López-Laborda & G. Peña, *A new method for applying VAT to financial services*, National Tax Journal (forthcoming).

customers, the method does not eliminate the need to allocate input VAT between taxable and exempt transactions, because business-to-consumer transactions (B2C) are still exempt.⁴

2.1.3. Exemption with input credits

This method is also known as *partial input recovery*. It is an intermediate method between exemption and zero rating that allows crediting a percentage of the input VAT. By applying this percentage, the pro rata problem disappears, because the quantity is fixed. A version of this method applies a percentage that reflects the cost of outsourced activities over the total value added, so that the cascading effect and the integration incentive can be totally or partially eliminated. Another version applies the percentage of the financial services provided to VAT-registered and overseas customers over the total of services. In this way, the need to differentiate among customers can be avoided. Nonetheless, the problem of undertaxation of consumers remains because the VAT rate is still equal to zero.⁵

2.1.4. Taxation of explicit fees and commissions

Under this method, all fee-based financial services are subject to VAT, but the financial margin is still exempt from VAT. The main advantage is that fee-based services are easy to tax. In spite of that, full elimination of undertaxation of consumers is not achieved.

2.1.5. Option to tax

The option-to-tax method allows financial entities to opt to tax financial services under VAT. If an entity decides not to levy VAT, the exemption is applied. If it opts to tax, then financial services are subject to VAT using the VAT method chosen by the

⁴ P.R. Merrill, *VAT Treatment of the Financial Sector*, Tax Analysts, p. 171 (2011); H.H. Zee, *VAT Treatment of Financial Services: A Primer on Conceptual Issues and Country Practices*, 34 Intertax 10, pp. 458-474 (2006).

⁵ Zee, *supra* n. 4, at 463; P-P. Gendron, *VAT Treatment of Financial Services: Assessment and Policy Proposal for Developing Countries*, 62 Bull. Intl. Taxn. 11, pp. 494-507 (2008), Journals IBFD; Merrill, *supra* n. 4, at 171.

country where the financial services provider is established. In this way, each financial entity chooses the most profitable option depending on the volume of input VAT that the company incurs. This method is designed for financial entities which provide services to businesses and apply for a large amount of deductible input VAT.⁶

2.1.6. Taxing gross interest

Under this method, VAT is imposed on the gross lending interest. Borrower businesses can deduct input VAT but financial entities and lender businesses cannot. This system also has problems and disadvantages: a cascading effect remains on the pass-through of irrecoverable input VAT to prices by financial institutions and lender businesses.⁷

2.1.7. Separate tax rates

Under this system, developed by Bakker and Chronican,⁸ it is the proportion of the interest that reflects the service charge on each type of transaction over the total amount of the transaction that is being levied with VAT. It allows taxation of margin-based services but only with rough accuracy. A major disadvantage of this method is that obtaining the data and the proportion of value added for each type of transaction could become complex and costly to calculate.⁹ Bird and Gendron¹⁰ developed a *hybrid system*, which taxes fee and margin-based services by applying both separate tax rates and taxing explicit fees and commissions.

2.1.8. Cash flow

⁶ T. Pons, *Option for Taxation of Financial Services in France*, 17 Intl. Vat Monitor 3, p. 182 (2006), Journals IBFD; Gendron, *supra* n. 4, at 499.

⁷ P. Mullins, *Options in tax policy and administration for the financial services sector*, p. 13 (International Monetary Fund 2006).

⁸ Victoria University of Wellington Institute for Policy Studies, *Financial Services and the GST: A Discussion Paper*, at 54 (Victoria University Press 1985).

⁹ R.M. Bird & P-P. Gendron, *VAT Revisited, A New Look at the Value Added Tax in Developing and Transitional Countries*, p. 79 (International Tax Program, University of Toronto 2005).

¹⁰ *Id.* at p. 78.

Under this method, developed by Hoffman et al.,¹¹ all cash inflows are considered as taxable supplies (on which VAT must be remitted to the tax authorities) and all cash outflows are taxed purchases (on which VAT is refunded by the tax authorities).¹² In other words, the cash flows of financial transactions are considered in the same way as non-financial purchases and sales. The main goal of this method is to be conceptually accurate and to achieve complete taxation of the financial value added on a transaction-by-transaction basis, fully compatible with the credit-invoice method applied to general VAT. In spite of that, a variant of this method, the cash flow with tax calculation accounts (TCA), was pilot tested in the European Union,¹³ and considered not feasible in practice due to its complexity.¹⁴

2.1.9. Modified reverse charge

This method, proposed by Zee,¹⁵ applies a reverse charge whereby a taxable person (the financial institution) collects VAT on inputs (reverse charge) and outputs. The gross interest is taxed by establishing a "franking" mechanism that works on a transaction-by-transaction basis. The available credits are obtained after each deposit and loan in a franking account. The main advantage of this method is full taxation with few distortions.¹⁶ However, this method has the same downside as the cash flow method: complexity. It is indeed considered a variant of the former.¹⁷ The basic version of this method is only applied

¹¹ L.A. Hoffman, S.N. Poddar & John Whalley, *Taxation of banking services under a consumption type, destination basis VAT*, National Tax Journal, pp. 547-554 (1987).

¹² S. Poddar & M. English, *Taxation of financial services under a value-added tax: Applying the cash-flow approach*, National Tax Journal, pp. 89-111 (1997).

¹³ A. Schenk, V. Thuronyi & Wei Cui, *Value added tax*, p. 380 (Cambridge University Press 2015).

¹⁴ European Commission, *Value Added Tax: A Study of Methods of Taxing Financial and Insurance Services*, pp. 114-115 (European Commission 1997); Gendron, *supra* n. 6, at p. 500.

¹⁵ H.H. Zee, *A New Approach to Taxing Financial Intermediation Services Under a Value-Added Tax* (IMF Working Paper 04/119, 1 July 2004).

¹⁶ Bird & Gendron, *supra* n. 8, at 72.

¹⁷ Gendron, *supra* n. 5, at 500.

to lending services, but an advanced variant also levies deposits; in both cases, businesses and households are levied by the tax.

2.1.10. Subtraction method

The tax base is calculated as the difference between revenues and deductible purchases, considering both financial and non-financial transactions. This method allows taxing the full financial value added. However, it is accounts based. Therefore, it is incompatible with the credit-invoice method and does not allow full input VAT recovery.

2.1.11. Method of net operating income

Developed by Bakker and Chronican,¹⁸ this method is calculated with the net operating income as taxable base, i.e. the sum of the net interests plus the explicit fees and commissions obtained by the provider of financial services. It is similar to the subtraction method, with which it shares the same advantages and disadvantages.

2.1.12. Addition method

This is an accounts-based method that considers the sum of wages, cost of capital and profits as the value added. The addition method is simple and taxes all financial value added, but it is incompatible with the credit-invoice method, performed on a transaction-by-transaction basis. Therefore, businesses cannot deduct input VAT and the cascading problem or the vertical integration incentives are not eliminated.¹⁹

2.1.13. *Full invoicing*

Under this method, proposed by Bakker and Chronican,²⁰ the taxable base for VAT is the full amount of the transaction, which includes either the nominal amount of the transaction (e.g. deposits and withdrawals) or its actual value added (fees and commissions).²¹ This method allows businesses to achieve input VAT recovery.

¹⁸ *Supra* n. 8, at 54.

¹⁹ Bird & Gendron, *supra* n. 9, at 71.

²⁰ *Supra* n. 8, at 53.

²¹ Gendron, *supra* n. 5, at 500.

However, it collects more than the desirable tax revenue because the total amount of the financial transaction is taxed, which is more than taxing just the value added of the financial service. Furthermore, the excessive tax liability of taxing capital could cause liquidity problems.²²

2.2. Other taxes

2.2.1. Separate taxes

This method consists in creating a new tax on financial services different from VAT. It allows for the application of any other method of taxing financial services in that tax. Financial entities become separated: those related to tax on non-financial services and those on financial services. This separation opens new possibilities for calculating and administering taxes in a different way. Nonetheless, it does not settle the issue of full input VAT recovery by financial entities.²³

2.2.2. Financial activities tax

Developed by the IMF,²⁴ the financial activities tax (FAT) is a separate tax that consists of three alternative versions of the same tax designed to address different financial distortions. FAT1 eliminates the exemption of the financial sector under VAT. FAT2 imposes tax on all rents generated in the financial sector. FAT3 aims to discourage risk-taking by taxing only rents in excess of remaining high rates of return. FAT1 would be a neutral and indirect tax that applies the addition method, while FAT2 and FAT3 could be considered as direct Pigovian taxes.²⁵

²² Bird & Gendron, *supra* n. 8, at 72.

²³ Mirrlees et al., *Tax by Design*, Mirrlees Review, p. 202 (Institute of Fiscal Studies, Oxford University Press 2011).

²⁴ G20, *A Fair and Substantial Contribution by the Financial Sector*, (Final Report for the G20 2010).

²⁵ Pigovian taxes are levies on negative externalities, i.e. taxes on the effects that can damage other agents without responsibility of these effects, such as the damage or crisis produced on the society by the bankruptcy of a big bank. This damage is considered a market distortion.

3. International Practices of Financial Services VAT

Table 1 shows the different methods considered in the international practice and clarifies when and where financial services are levied by VAT or other taxes.

3.1. Financial VAT practices

3.1.1. New Zealand

A full exemption is applied in B2C transactions while zero rating has applied to B2B transactions since 2005,²⁶ allowing input VAT credits.²⁷ New Zealand also levies VAT on non-life insurance and the reverse charge mechanism applies when financial services are imported.²⁸

3.1.2. Australia, Singapore and Malaysia

These countries apply the exemption with input credit method, but with different percentages of input VAT credit for each country. Australia has applied this method since 2000,²⁹ Singapore since 1994³⁰ and Malaysia since April 2015.³¹

In Australia, the percentage of input recovery is 75%, the estimated share to avoid integration incentives.³²

Singapore uses industrial statistics to establish the average percentage of creditable inputs (known as "fixed rate of creditable inputs") for each of the five kinds of financial

²⁶ M. Pallot, *GST and Financial Services-Rating Zero-rating*, in *GST in Retrospect and Prospect*, p. 163 (R. Krever & D. White, eds. (Thomson Brookers 2007); Merrill, *supra* n. 3, at 170.

²⁷ A. Schenk, *Taxation of financial services (including insurance) under a US value-added tax*, 63 *Tax Law Review*, pp. 424-425 (2009).

²⁸ P-P. Gendron, *Canada's GST and Financial Services-Where Are We Now and Where Could We Be?*, 64 *Canadian Tax Journal/Revue Fiscale Canadienne* 2, p. 410 (2016).

²⁹ De la Feria & Walpole, *supra* n. 2, at 898.

³⁰ G. Jenkins & R. Khadka, *Tax reform in Singapore*, Development Discussion Paper 644, pp. 11-12, 18-21 (Harvard Institute for International Development, Harvard University 1998).

³¹ International Monetary Fund, *Malaysia: Selected Issues Paper* (IMF Country Report 15/59 2015) at 15.

³² Zee, *supra* n. 3, at 463.

entities regulated by law. The fixed recovery ranges from 72% to 96% for banks and is 53% for finance companies. The percentage is calculated to avoid the need to find out the customer status by financial companies.³³

Malaysia has followed the same regime as Singapore for specific banking entities, establishing a recovery rate of 70% for commercial banks and 75% for investment and development banks. Furthermore, all three countries also levy VAT on explicit fees and commissions.³⁴

3.1.3. South Africa, Andorra and Ghana

South Africa established the exemption of financial services from VAT in 1991, following the model of New Zealand.³⁵ However, since 1996, this country taxes with VAT all explicit fees and commissions applied to consumers. Furthermore, South Africa taxes with VAT short-term (casualty and property) insurance.

Andorra has had VAT since January 2013, taxing some fee-based financial services with a 9.5% VAT rate. From June 2002 to 2012, Andorra taxed financial services with a separate tax, consisting of a sales equalization tax on the input VAT. The VAT rate was 12% for banking services and 4% for insurance services. The tax payable was an estimation based on economic and financial figures.³⁶

Ghana has applied VAT on fee commissions or similar charges of financial services since January 2015.³⁷

3.1.4. European Union (EU)

³³ Merrill, *supra* n. 4, at 171; Jenkins & Khadka, *supra* n. 30, at 20.

³⁴ Gendron, *supra* n. 4, at 501; M. Evans, *GST equivalent taxation of financial services* (Supplementary financial tax), Prepared for the South Australian Department of Premier and Cabinet (2015), at 3, available at <http://taxsifu.com.au/?p=742> (accessed 20 July 2016).

³⁵ Merrill, *supra* n. 4, at 168.

³⁶ ABA, *Andorra and its Financial System* (2010), at 22-23, available at <http://www.andorranbanking.ad/wp-content/uploads/2017/08/financial-system-2015.pdf>.

³⁷ PWC, *VAT on Financial Services, On point, Tax services*, p. 1 (March 2015), <http://www.pwc.co.za/en/assets/pdf/on-point-vat-on-financial-services-3rd-edition.pdf>.

Article 137(1) (a) of the VAT Directive currently in force³⁸ allows EU Member States to introduce an option to tax financial services.³⁹ In the European Union, the exemption is generally applied, but since 1978 several countries, such as Austria, Belgium, Estonia, France, Germany and Lithuania, have successively introduced the option-to-tax system.⁴⁰ This method is usually applied taxing gross interest and explicit fees and commissions. Belgium, France and Lithuania tax only fee-based services and the other three Member States tax fee and margin-based services.⁴¹ Nonetheless, each Member State applies a specific method of taxation compatible with the option to tax.⁴² For example, in Germany, the option to tax is solely applied to B2B transactions, while in Belgium the option to tax is applied to B2B and B2C transactions.⁴³ In France, if a financial institution opts to tax, VAT is applied to fee-based financial services and the entity can deduct input VAT. If the entity does not opt to tax, the service is exempt and the entity is not allowed to deduct input VAT and another tax different from VAT is applied to fee and margin-based services by the addition method.⁴⁴

3.1.5. Argentina

Argentina has applied a variant of the method of taxing gross interest since 1992.⁴⁵ Under this method, VAT is applied to the gross amount of interest payments realized by financial entities,

³⁸ Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ L347 (2006), 1-118.

³⁹ This provision was found in article 13C(b) under the 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 EC145 (1977), 1-45. For a detailed explanation of national practice in the O2T, see Appendix B of R. De la Feria & B. Lockwood, *Opting for Opting-In? An Evaluation of the European Commission's Proposals for Reforming VAT on Financial Services*, 31 Fiscal Studies 2 (2010).

⁴⁰ Ernst and Young, Design and Impact of the "Option to Tax" System for application of VAT to financial services, p. 4 (Report prepared for the European Banking Federation, 28 Oct. 28, 2009).

⁴¹ F. Annacondia, *EU VAT Compass 2017/2018* (IBDF 2017).

⁴² Ernst and Young 2009, *supra* n. 40, at 4.

⁴³ F. Borselli, *A sensible reform of the EU VAT regime for financial services*, 20 Intl. VAT Monitor 5, p. 377 (2009).

⁴⁴ Pons 2006, *supra* n. 5, at 182-185.

⁴⁵ H.H. Zee, *Taxing the financial sector: concepts, issues, and practice*, pp. 68-69 (International Monetary Fund 2004).

with a full credit of the input VAT of registered businesses.⁴⁶ However, there is a wide range of specific exemptions which require allocating the input VAT between exempt and taxed inflows of cash. Argentina taxes financial services at a reduced VAT rate.

3.1.6. Mexico

Mexico has applied the method of net operating income for a small range of transactions since 1992.⁴⁷ VAT was implemented in Mexico in 1980, initially exempting margin-based financial services, but taxing the fee-based ones at the standard VAT rate. A major change occurred in 1992, when the granting of personal consumer loans started to be taxed, but the exemption to business loans and mortgages was maintained. At the beginning of 1996, the taxable base was modified, which became the real interest rate. Mexico had trouble applying the tax due to the difficulties in defining the transactions.⁴⁸

3.1.7. Michigan

In Michigan (United States), the single business tax (SBT) levied the value added of financial services using the addition method from 1976 to 2007.⁴⁹ The tax base was the net income of the business, adding the wages, salary costs, depreciations and profits. The Michigan business tax (MBT) became effective in January 2008 and replaced the SBT.⁵⁰ Financial institutions were subject to the financial institutions tax, levying their net capital.⁵¹ Insurance companies are subject to an insurance company premiums tax.

3.2. Other taxes

⁴⁶ Edgar, *supra* n. 1, at 1199.

⁴⁷ R. Schatan, *VAT on Banking Services: Mexico's Experience*, 14 Intl. VAT Monitor 4, 287 (2003), Journals IBFD, also available at <http://www.empcom.gov.in/WriteReadData/UserFiles/file/2003-17.pdf>.

³⁹ Id., at 289.

⁴⁹ M.E. Bean, *Background and History: Michigan's Single Business Tax*, pp. 5-8 (House Fiscal Agency 2003), <http://www.house.mi.gov/hfa/Archives/PDF/singlebusinessstax.pdf>.

⁵⁰ See http://www.michigan.gov/taxes/0,4676,7-238-43519_43533---,00.html.

⁵¹ See http://www.michigan.gov/taxes/0,4676,7-238-43519_46621-173089---,00.html.

3.2.1. Slovenia

Financial services are exempt from VAT. Slovenia has imposed a separate tax on fee-based services, the financial services tax, since March 2013.⁵²

3.2.2. China, India, Philippines, Taiwan, Thailand and Korea

Several countries levy financial institutions using a separate tax that is a proxy of VAT: the Philippines since 1946 (replaced by VAT only from January to December 2003),⁵³ Korea since 1982,⁵⁴ Taiwan since April 1986,⁵⁵ Thailand since 1992⁵⁶ and China and India since 1994.⁵⁷ The reason to apply a proxy tax is that an implicit financial margin cannot be easily separated from the pure interest component on a transaction-by-transaction basis. Therefore, the above-mentioned countries rather apply the tax on the gross interest on an aggregate periodic basis (a kind of account-based method). Taxing the value added in this way, these countries aim to separate the implicit fee from the pure interest. Nonetheless,

⁵² PKF, *Worldwide Tax Guide*, p. 458 (2014), <http://www.pkf.com/media/4335950/worldwide%20tax%20guide%202014%20v3.pdf>; also see http://www.fu.gov.si/en/taxes_and_other_duties/areas_of_work/financial_services_tax/.

⁵³ ZGLO, *Technical Report Policy Review of Financial Sector*, p. 39, prepared for the Taxation Capital Market Development Council Republic of the Philippines (30 June 2006), http://pdf.usaid.gov/pdf_docs/Pnadh620.pdf.

⁵⁴ MSF, *Korean Taxation*, p. 16 (Korean Ministry of Strategy and Finance 2012), <https://www.nts.go.kr/eng/data/KOREANTAXATION2012.pdf>.

⁵⁵ ROC, *Guide to ROC Taxes 2016*, p. 82 (Taiwan Ministry of Finance 2016), http://www.mof.gov.tw/File/Attach/64613/File_8005.pdf.

⁵⁶ BOI, *A Business Guide to Thailand 2016*, p. 28 (Thailand Board of Investment 2016), http://www.boi.go.th/upload/content/BOI-BusinessGuide2016-20160318_87145.pdf.

⁵⁷ Y. Xu & R. Krever, *Applying VAT to financial services in China: Opportunities for China and lessons for the world?* 45 *Australian Tax Review* [P] 1, pp. 38-44 (2016); Deloitte, *Service Tax in India. A Handbook*, pp. 52-65 (2013), http://www.cefi.in/wp-content/uploads/2014/09/Deloitte_Service-Tax-in-India.pdf.

sometimes these taxes levy the pure interest, not only the margin.⁵⁸ These countries also tax explicit fees and commissions.⁵⁹

3.2.3. Quebec

Until 2013, financial services were zero rated under the Quebec sales tax (QST) system in Quebec (Canada). Since then, financial services have become exempt as under the goods and services tax/harmonized sales tax (GST/HST) system applied in most of the Canadian provinces.⁶⁰ Quebec also taxes financial institutions with a compensatory tax separate from VAT, the *taxe compensatoire des institutions financiers*, which is an account-based tax that applies to the sum of salaries and wages and the capital, or the premium, in the case of insurance.⁶¹ Financial institutions have not had to pay this tax on capital since 2013.

3.2.4. Italy

In Italy, a regional tax on productive activities (*imposta regionale sulle attività produttive*, IRAP) was introduced in 1998 and it currently applies to the financial sector,⁶² with a taxable base similar to the subtraction method. It is an income-type value added tax separate from VAT and it taxes financial and non-financial entities.

3.2.5. Israel, Iceland, Denmark, and Norway

The addition method was adopted in Israel for levying financial services under VAT in July 1976, and was separated from VAT in

⁵⁸ L. Burns, *The Taxation of Financial Services under a VAT in Developing Countries*, p. 13 (paper presented at the 4th annual Asian Tax Forum, Hanoi, Vietnam, 19-20 April 2007).

⁵⁹ Asiatax 2016, <http://asiatax.com/consumption-taxation-of-supplies-of-financial-services-in-the-asia-pacific-region/>.

⁶⁰ Finances Quebec, *Changes to Québec's tax system pursuant to the undertakings to harmonize it with the federal tax system applicable in 2013*, Information Bulletin 4, p. 1 (2012), http://www.finances.gouv.qc.ca/documents/bulletins/en/bulen_2012-4-a-b.pdf; J-H. Chabot & M.A. McMahon, *The Evolution of Indirect Taxes*, 61 Canadian Tax Journal/Revue Fiscale Canadienne, p. 26 (2013).

⁶¹ M. Keen, R. Krelove & J. Norregard, *The Financial Activities Tax*, in: *Financial Sector Taxation: The IMF's Report to the G-20 and Background Material*, ch. 7, p. 123 (S. Claessens, M. Keen & C. Pazarbasioglu, eds. International Monetary Fund 2010).

⁶² L. Gambacorta et al., *The effects of tax on bank liability structure*, pp. 2-3 (BIS Working Papers 2017).

1981.⁶³ Israel taxes the sum of profits and wages and salaries of insurance and financial entities by a tax administered out from the VAT system. Israel is one of the few countries where insurances other than life insurance are levied with this tax.

Iceland has been using the FAT to tax financial services since 2013.⁶⁴ As indicated in section 2, it is a separate tax, different from VAT, and it taxes financial services using the addition method, but also corrects externalities as a financial transaction tax.

In Denmark, a separate tax, applying the addition method, was introduced in 1988, in the same way as in France.⁶⁵ Norway has applied a separate tax on financial services since 2017, and it is similar to the Danish one. Taxation of financial entities consists of two elements: first, a financial tax that levies salary costs at a 5% tax rate, and second, the financial sector is levied at a 25% tax rate on the corporate tax, while the rest of the economy is levied at 24%. Nonetheless, there are some exemptions and deductions.⁶⁶

Table 1 shows the various methods of taxing financial services and the countries in which they are applied.

⁶³ M. Gillis, *The VAT and financial services*, Development Research Department discussion paper DRD220, pp. 6-7 (World Bank 1987), <http://documents.worldbank.org/curated/en/1987/02/887934/vat-financial-services>; Centre for Co-operation with Non-members, *Value-Added Taxes in Central and Eastern European Countries: A Comparative Survey and Evaluation*, p. 72 (Publications de l'OCDE 1998); A. Zur, *The Value-Added Tax (V.A.T.) in Israel. A Proposal for Reform*, p. 1 (Koret Milket Institute 2004).

⁶⁴ M. Keen, R. Krelove & J. Norregaard, *Policy Forum: The Financial Activities Tax*, Canadian Tax Journal, p. 392 (2016).

⁶⁵ Keen et al. 2010, *supra* n. 64, at 123; also, see [http://www.econ.ku.dk/pbs/Dokumentfiler/Comments%20\(English\)/Brussels%20Tax%20Forum%202011%20Danish%20FAT%20including%20notes.pdf](http://www.econ.ku.dk/pbs/Dokumentfiler/Comments%20(English)/Brussels%20Tax%20Forum%202011%20Danish%20FAT%20including%20notes.pdf), p. 6.

⁶⁶ See <http://www.ey.com/gl/en/services/tax/international-tax/alert--norwegian-government-issues-2017-fiscal-budget>.

Table 1: Methods of taxing financial services and countries where applied

Section	(Section) Method	Countries where applied
2.1. Financial VAT	(2.1.2.) Zero rating	New Zealand (since 2005; only B2B), Quebec (until 2013)
	(2.1.3.) Exemption with input credits	Australia (since 2000), Singapore (since 1994), Malaysia (since 2015)
	(2.1.4.) Taxing explicit fees and commissions	Australia, Singapore, South Africa (since 1996), Malaysia, China (since May 2016), Philippines (2003), Belgium (1971-1977), Andorra (since 2013), Ghana (since 2015), Mexico (since 1980)
	(2.1.5.) Option to tax	Option to tax only fees: Belgium (since 1978), Lithuania (since May 2004), France (since 1979)
		Option to tax fees and margin: Austria (since 1997 with retroactive effect), Estonia (since 2002), Germany (since 1968)
	(2.1.6.) Taxation of gross interest	Argentina (since 1992). Proxy taxes on VAT: China (since May 2016), Philippines (2003)
	(2.1.7.) Separate tax rates	
	(2.1.8.) Cash flow method	
	(2.1.9.) Modified reverse charge	
	(2.1.10.) Subtraction method	Proposed in Japan to be established in 1950, but rejected; also proposed in Canada in 1987, and in the Philippines proposed in 2000, but abandoned before implementing
	(2.1.11.) Net operating income	Mexico (since 1992)
	(2.1.12.) Addition method	Michigan (from 1976 to 2007), Israel (1976-1980)
	(2.1.13.) Full invoicing	
2.2. Other taxes	(2.2.1.) Separate taxes	Compensatory taxes (addition method): Quebec, Israel (since 1981), France (since 1968), Denmark (since 1988), Norway (since 2017). FAT (addition method): Iceland. IRAP (subtraction method): Italy (since 1998). Sales equalization tax: Andorra (from June 2002 to 2013). Financial services tax (taxing explicit fees and commissions): Slovenia (since March 2013). Proxy taxes (taxation of gross interest method and explicit fees and commissions): China (from 1994 up to May 2016), India (since 1994, proposed under GST in 2016, but postponed until 2017), Philippines (since 1946, except for the year 2003 when it was taxed under VAT), Taiwan (since April 1986), Thailand (since 1992), Korea (since 1982).
	(2.2.2.) Financial activities tax	Iceland (since 2012)

Source: J. López-Laborda & G. Peña, *Does financial VAT affect the size of the financial sector?* 11 Economics: The Open-Access, Open-Assessment E-Journal 7, pp. 1-28 (2017), available at <http://dx.doi.org/10.5018/economics-ejournal.ja.2017-7>.

4. Assessment

The main features of the international practice for taxing financial services are summarized in Table 2, which indicates the advantages and disadvantages of each applied method. A general and simple assessment of the international experience with taxes on financial services is shown.

Table 2: Main features of the international practices for taxing financial services

Country/ Jurisdiction	Applied method	Features						
		1: Elimination of business distortions ¹	2: Elimination of consumer distortions ²	3: Elimination of compliance costs ³	4: Credit of input VAT ⁴	5: Desirable VAT collection ⁵	6: Transaction basis ⁶	7: Administrative issues ⁷
New Zealand	Zero rating B2B ⁸	Yes	No	No	Partial	Low	Yes	Simple
Quebec	Zero rating ⁹	Cascading eliminated, incentive for outsourcing to avoid the compensatory tax	No	Yes	Full	Low	Yes	Simple
Australia	Exemption with input credits, taxing explicit fees and commissions ¹⁰	Yes	Distortion reduced by taxing fees and commissions	No, the need to find out the customer's status remains	Partial	Higher than zero rating	Yes	Simple
Singapore and Malaysia	Exemption with input credits, taxing explicit fees and commissions ¹¹	Distortions reduced, outsourcing incentives remains	Reduced by taxing fees and commissions	Yes	Partial	Higher than zero rating	Yes	Simple
South Africa, Andorra and Ghana	Taxation of explicit fees and commissions ¹²	Reduced	Reduced	No	Full	Higher than zero rating	Yes	Simple
Slovenia	Taxation of explicit fees and commissions, ¹³ separate taxes	Remain due to the non-creditable input VAT	Reduced	No	No	Higher than zero rating	Yes	Simple
EU	Option to tax ¹⁴	Yes	Depends on the applied method	Depends on the applied method	Financial entities decide full credit or not	Depends on the applied method	Yes	Depends on the applied method
Argentina	Taxing the gross interest ¹⁵	Yes	Eliminated for borrowers, but not for depositors	No	Full	High, but taxing capital gains	Yes	Simple
China, Philippines, Taiwan, Thailand, Korea and India	Taxing the gross interest (proxy tax), taxing explicit fees and commissions ¹⁶	Remain due to the non-deductable input VAT	Eliminated for borrowers, but not for depositors	No	No	High, but taxing capital gains	No: account based	Simple, but with difficulties in calculating the correct value added
Canada and Japan (proposed), Italy	Subtraction ¹⁷	No	No, consumers are not directly taxed	Yes	No	High	No: account based	Simple, but difficult to define financial entities
Mexico	Net operating income, taxing explicit fees and commissions ¹⁸	No	No, consumers are not directly taxed, but reduced by taxing fees and commissions	Yes	No	High	No: account based	Complexity due to a prorated
Israel, Michigan, Iceland, Denmark and Norway	Addition ¹⁹	No	No, consumers are not directly taxed	Yes	No	High	No: account based	Difficult to calculate the VAT in exported financial services

1. Elimination of business distortions: overtaxation, tax cascading, integration incentives and others.
2. Elimination of consumer under taxation.
3. Elimination of the difference between taxable and exempt services and of the need to find out the customer status.
4. Crediting of input VAT.
5. Positive and efficient VAT collection.
6. Transaction-by-transaction basis.
7. Simplicity, feasibility.
8. Merrill, *supra* n. 4, at 170-171; Evans, *supra* n. 33, at 3-4.
9. Poddar, Satya, *Consumption taxes: the role of the Value Added Tax,* in Honohan, P. ed. (2003): Taxation of financial intermediation. Theory and practice for emerging economies (Washington: The World Bank). at 8.
10. Merrill (2011), *supra* n. 4, at 171; Zee, *supra*-note 4, at 463; Gendron, *supra*-note 4, at 501.
11. Merrill (2011), *supra*-note 4, at 171; Zee, *supra*-note 4, at 463-465; Gendron, *supra*-note 4, at 501.
12. Merrill (2011), *supra*-note 4, at 168-169, Gendron (2016), *supra*-note 28, at 410-415.
13. *Id.*
14. De la Feria and Lockwood, *supra*-note 29, at 171-202.
15. Edgar, *supra*-note 2, at 1199.
16. Burns, *supra*-note 61, at 13.
17. Schenk, *supra*-note 27, at 423-424.
18. Schatan, *supra*-note 13, at 287-294.
19. Schenk, *supra*-note 27, at 420.

Source: authors' elaboration.

As Table 2 shows, there is currently no practice that satisfies all the main desirable features of a financial VAT: every system harbours some disadvantage. However, countries/jurisdictions with account-based methods (e.g. China, Philippines, Taiwan, Thailand, Korea, India, Mexico, Israel, Michigan (US) and Iceland) have few advantages, while other countries/jurisdictions with methods working on a transaction-by-transaction basis (like Argentina,

South Africa, Andorra, Ghana, Australia, Singapore and Malaysia) have the most positive features.

Against this background, the authors have proposed a “mobile-ratio method” that, in their view, has all desirable features.⁶⁷ The proposed method taxes the financial margin of each company using a mobile-ratio approach. The taxable base is constructed by applying the same ratio to each interest transaction carried out by the company in a given period: e.g. each loan or deposit interest. The ratio consists of the margin generated by financial services provided by the company (i.e. the difference between interest receipts and interest payments) during the period closest to the current one for which the information is available (for example, the previous quarter), divided by the total value of the company’s interests (i.e. interest receipts and interest payments) in that same period. The VAT rate is then applied to such taxable base.

Under this method, the VAT rate is also directly applied to net explicit fees and commissions. Thus, all the financial value added provided by a company is subject to VAT. Furthermore, the mobile-ratio method is applied to financial services provided by financial and non-financial entities in order to achieve neutrality.

In the authors’ view, this approach achieves all the desirable features identified in Table 2:

- thanks to the full input VAT recovery, it completely eliminates business overtaxation, tax cascading and integration incentives (features 1 and 4);
- applying VAT to B2B and B2C financial services at a rate higher than zero allows the tax collection to be increased and eliminates the undertaxation of consumers (features 2 and 5);

⁶⁷ López & Peña, *supra* n. 3.

- taxing B2B and B2C services also allows the differences between taxable and exempt services to be eliminated (feature 3);
- because it is a simple transaction-by-transaction-based method it distributes the value added among transactions (features 6 and 7); and
- unlike financial transaction taxes such as FAT, the mobile-ratio method applies VAT (rather than a different tax) to financial services, achieving a low distortion of the economy. Moreover, because this method would also be applied to financial services between non-financial entities, without financial intermediation, it would not provoke disintermediation (and therefore, a reduction in the taxable base).

5. Concluding Remarks

This article provided a summary overview of the main methods that have been proposed in the economic and legal literature for taxing financial services under VAT or under alternative taxes. Subsequently, an overview of the international practice in the field has been presented. The main contribution of this article is to recompile how, when and where the main methods of financial services VAT have been applied around the world.

Among the methods applied in international practice, the exemption with input credits, the taxation of explicit fees and commissions, and the taxation of gross interest are the ones with the best properties. However, there are some other methods, not yet applied, that fulfil all the desirable properties assessed in this article: the cash flow with TCA, the modified reverse charge, the hybrid, and the mobile-ratio methods. In the authors' view, this latter method is, moreover, simpler than previous ones, which makes it the most promising method to tax financial services.