Journal of Modern Accounting and Auditing, ISSN 1548-6583
August 2014, Vol. 10, No. 8, 846-852

Value-Added Tax (VAT) on Selected Financial Transactions*

Yvona Legierska
University of Finance and Administration, Prague, Czech Republic

This paper deals with the approach to imposing value-added tax (VAT) on financial transactions. The VAT is a highly harmonized consumption tax within the European Union (EU). VAT operational rules have been set down by the relevant directive of the Council of the EU. Under the directive, it is possible to select either exemption or taxation of financial transactions. Only the first option is permitted in the Czech Republic. Pros and cons of both models are described, in particular, the problems with determining the difference between financial transactions and other similar performance that must always be subject to tax. Potential lower VAT revenue or tax base assessment, as appropriate, seems to be crucial in the case of the taxation of financial transactions.

Keywords: value-added tax (VAT), financial services, financial transactions, reverse charge, option to tax, cost-sharing agreement

Introduction

In addition to taxing income, labor, and property, standard tax systems also comprise consumption taxes. These are indirect taxes, where the tax burden is transferred to consumers, who pay such taxes in the price of goods and services. Particularly, the value-added tax (VAT), paid to financial authorities via registered payers, is one of the universal consumption taxes. Registered payers may reduce their output tax for any executed taxable transactions by the respective input tax (the so-called tax deduction), paid upon the acquisition of goods and services.

VAT has been applied in the Czech Republic since 1993, in reaction to the expected accession to the European Union (EU), since the introduction/enforcement of such tax pursuant to common rules is crucial for the free movement of goods and services within the given territory. A VAT system was first tested in France in 1954, then in Denmark in 1967, gradually expanding to 150 countries worldwide, with the exception of the United States (US).

The tax has been harmonized in the EU member states, as it is the necessary precondition for ensuring the common market operation. In addition to the standard rate, they may also apply one or two reduced rates. However, these simple rules are further complicated by many exceptions that were awarded to some member states in 1992, prior to the adoption of the directive and acts of accession of new member states to the EU.

Full exemptions from tax represent the key exception to the principle of VAT functioning either with or without the right of tax deduction. The exemptions with the right of tax deduction include, for example, exports of goods to third countries. The exemptions without the right of tax deduction include, among others, financial transactions mainly provided by the banking sector.

---

* This paper was prepared as part of the Specific University Research No. 7427.
Yvona Legierska, doctoral student, Department of Finance, University of Finance and Administration. Email: Yvona.Legierska@seznam.cz.

From this perspective, it is an exception that violates the basic principle of VAT functioning. Is the exemption of financial transactions correct in terms of tax theory? Is it possible to tax financial transactions in a member state of the EU, if such country chooses to do so? What are the pros and cons of the approach to taxation of financial transactions? Are there other alternatives to the banking sector taxation? This paper will try to answer these questions as well as a number of others.

VAT in the Community Law

Council Directive 2006/112/EC of 28 November 2006 on the Common System of Value Added Tax (VAT Directive) replaced the former sixth Council Directive (77/388/EEC) of 1977. It has been in force since January 1, 2007, whereas the deadline for its implementation within the national law of individual EU member states expired on January 1, 2008.

Article 137 of the VAT Directive sets down that member states may allow taxable persons[1] a right of option for taxation in respect of financial transactions. The right of option for taxation of financial transactions by entities that are subject to VAT was also embedded in the former sixth Council Directive of 1977, in addition to various exemptions. One of the reasons for the introduction of exemptions for financial transactions is the complicated assessment of value added and consequently the specification of the VAT from the tax base, i.e., from some of the banking services provided.

As of 1993, the Czech Republic has only been applying tax exemptions without the right of tax deduction for financial transactions.[2] Other 20 EU member states regulate this area similarly. The inability to apply tax deduction to inputs by financial institutions, particularly by banks, funds, or securities dealers, thus translates into higher costs, which are then reflected in prices of the provided services. The customers/recipients of such services, entities subject to VAT, cannot apply tax deductions.

Only six EU member states, Belgium, France, Lithuania, Germany, Austria, and Estonia, allowed the right of option to exemption or taxation of financial transactions for taxable persons in their respective national laws pursuant to the VAT Directive. In addition, each country does so in a different form.

The differences in application are mainly given by the following:

(1) Scope of taxation (although most of these states apply VAT to financial transactions, each state does so in a different scope, for example, in Lithuania, Germany, and Estonia, VAT is also imposed on currency transactions, also within investment funds in Estonia);

(2) Customer status (e.g., in Germany and Lithuania, customers must be subject to VAT). For the vast majority of cases, the tax base is the gross amount of fees paid by a customer (Šindelář & Šindelář, 2010). Moreover, Belgium and France, for example, modified this area by defining the scope of taxable transactions, using percentages or otherwise, which may be executed with VAT in addition to taxable transactions exempt from VAT (Pátek, 2008).

The reasons for such regulations were mainly motivated by concerns that the application of VAT deductions by institutions providing financial transactions will result in lower VAT payments to public budgets.

---

[1] According to Article 9 of the Council Directive 2006/112/EC of 28 November 2006 on the Common System of Value Added Tax (Council of the EU, 2006), "taxable person" shall mean any person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity. "Economic activity" shall mean any activity of producers, traders, or persons supplying services, including mining and agricultural activities and activities of the professions.

[2] Provisions of Section 51(1)(d) of Act No. 235/2004 Coll. (VAT Act) (Czech Republic, 2004).

In 2007, the European Commission (EC) prepared a proposal for an amendment to the VAT Directive in the area of financial services. The proposal imposed an obligation on the EU member states to provide financial institutions with the right to choose either VAT taxation or exemption mode without the right of deduction in respect of their services (option to tax). The existing VAT Directive only provides the EU member states with the opportunity, not an obligation to introduce such option for VAT payers within respective national laws. Moreover, the proposed amendment to the VAT Directive also addressed the so-called cross-border cost-sharing agreement, which is related to an agreement to share tax by individual EU member states in case of the cross-border provision of financial transactions.

The objective of the proposed change was to increase the legal certainty in the area that has not been amended since 1977 and to update existing rules in the light of the financial environment globalization (Balážová & Diviš, 2008). In September 2008, the proposal was discussed by the European Parliament. The expected effective date of the VAT Directive amendment as of January 1, 2009 or January 1, 2012 was not met due to the heterogeneous approach of the EU member states to the given issues. Further discussions regarding the option to tax and cost-sharing agreements were then abandoned. The attention is only given to continuous specification of definitions of financial transactions. This is absolutely crucial for the application of either taxation or exemption. Often, this also leads to court disputes, since the specification of taxation and exemption of some similar services has not been unified in the EU.

However, the approach to taxation of financial transactions does not only relate to the EU. There are different types of regulation used throughout the world. For example, Singapore, Australia, New Zealand, South Africa, and India apply exemptions to the so-called margin trades. Unapplied deductions are reduced in the form of exemptions in Singapore, Australia, New Zealand, India, and Canada, or in the form of compensatory taxes in Israel and Quebec. Full taxation of financial transactions is not used in practice in any country that has introduced VAT (Šindelář & Šindelář, 2010).

Application of VAT to Financial Transactions in the Czech Republic

According to the VAT Act currently in force, the provision of services for consideration by taxable persons as part of their economic activities is also subject to tax, in addition to the delivery of goods and transfer of real estates. According to the provisions of Section 14(1) of the VAT Act, the provision of service is defined as an activity that is not the delivery of goods or the transfer of real estates.

In general, provided services are taxed by VAT with the right of deduction. These services also include financial services. Some of these services, as specified in Section 54(1) of the VAT Act and referred to as financial activities/transactions, are exempt from tax without the right of deduction of tax on inputs. Furthermore, Sections 54(2) and 54(3) also specify the terms and conditions for tax exemptions of certain services associated with financial transactions. Any tax that is not deducted on inputs is then included in costs of the given service provider.

At the same time, the term “financial services” is not equivalent to the term “financial transactions”. Financial and banking services that are subject to VAT include, for example, factoring, debt recovery, financial consultancy services, provision of banking information, or the lease of safety deposit boxes.

Such complicated concept of the “lines” among similar financial services, where such services are subject to tax in one case and exempt from tax in another case,[3] may lead to frequent errors. Consequently, the VAT Act had to be modified.

Pros and Cons Relating to the Approach to Taxation of Financial Transactions

According to an analysis of Professor Lockwood (2011), who studied the above mentioned issue, the total amount of VAT that cannot be claimed by the EU banking sector is approximately EUR 33 billion (i.e., CZK 825 billion) per year. Therefore, the principle of VAT functioning is partly distorted. Professor Vostatek (2012) claimed that VAT exemptions with regard to financial transactions are absolutely wrong in terms of tax theory. The fact that VAT is not neutral represents a barrier to the overall effectiveness of the financial sector (Zee, 2004).

The key question for many governments of the EU member states is whether the taxation of financial transactions would result in higher VAT revenue compared to VAT exemptions (see Tables 1 and 2). According to an analysis of Professor Lockwood (2011), it is unlikely that VAT charged to persons, who are not subject to tax, by entities providing financial transactions would significantly exceed amounts claimed in the form of tax deductions on inputs by such entities subject to VAT. Some calculations in the report suggest that if the exemption for bank fees or commissions on various transactions is cancelled, it could result in the reduction of tax revenue by up to EUR 7 billion per year in the EU.

Table 1

Exemption of Financial Transactions From VAT

Pros	Cons
Elimination of problems in assessing value added and consequently in determining the VAT for some financial services	The “non-deductible” VAT on inputs is transferred into the costs of financial institutions, thereby reducing their economic effectiveness
Lower prices of financial transactions provided to final consumers who are not subject to tax	The tax mode puts a significant administrative burden on financial institutions, as they must only specify the proportional part of the right of deduction using a reduction coefficient or they apply the so-called matching method for inputs and outputs, as appropriate
	It does not lead to preferential tax treatment of financial institutions
	Violation of the basic principle of VAT functioning, i.e., to tax final consumption
	Violation of the VAT neutrality principle

Note. Source: Own elaborations.

[3] The provisions of Section 54(1) of the VAT Act (Act No. 235/2004 Coll., Czech Republic, 2004) specify the following activities as exempt from tax: (1) transfer of securities, shares in business corporations, and cooperative memberships; (2) acceptance of deposits from the public; (3) granting loans and cash loans; (4) the payment and clearing; (5) issuing payment instruments, especially credit cards or traveler’s checks; (6) the provision and receipt of cash and assumption of financial guarantee obligations; (7) opening, advising, and confirming letters of credit pursuant to special legal regulations; (8) collection pursuant to special legal regulations; (9) exchange activity; (10) operations related to money; (11) the supply of gold to the Czech National Bank and accepting deposits from banks, including foreign banks, or from the state by the Czech National Bank; (12) operating a regulated market in investment instruments; (13) the acceptance or transmission of orders in relation to investment instruments on behalf of the customer; (14) execution of orders concerning investment instruments on behalf of another party; (15) trading on own account for another party; (16) management of client’s assets under contract with a customer, if such assets comprise investment instrument, with the exception of administration or custody of investment instruments; (17) underwriting or placement of investment instruments; (18) keeping records of investment instruments; (19) settlement of investment instruments; (20) foreign exchange trading for one’s own account or on behalf of a customer; (21) assignment of receivables ceded by another entity, for consideration, the exemption does not apply to services relating to debt collection and factoring; (22) management or administration of investment funds or mutual funds pursuant to special legal regulations; (23) collection of radio and television fees; (24) payment of pension benefits or collecting recurring payments of the population; and (25) negotiation or mediation of activities specified in sub-Sections (1), (2), (3), (4), (5), (6), (7), (8), (9), (10), (12), (13), (14), (15), (16), (17), (18), (19), (20), and (21).

Table 2

VAT From Financial Transactions

Pros	Cons
Persons subject to VAT could apply the right of VAT deduction to received financial services	Higher costs of the public sector, because organizational units and other institutions are usually not subject to VAT, i.e., they cannot apply VAT deduction to such received services
VAT revenue would only increase by VAT relating to value added paid by final consumers who are not subject to VAT	It does not have to lead to a significant increase in VAT revenue, mainly due to the caution of EU member states in applying the right of option to taxation or exemption of financial transactions

Note. Source: Own elaborations.

Reverse Charge

The administrative burden of the standard taxation mode for financial transactions (instead of the existing exemptions) could be partially resolved by introducing an analogy to the reverse charge mode. In the Czech Republic, it has been applied in accordance with the VAT Directive since 2011 for the delivery of gold, scrap iron, and wastes, including the processing thereof, transfer of greenhouse gas emissions permits; as of 2012, it has also been applied to construction works. The given taxable persons who apply this mode do not pay VAT on outputs in providing the aforementioned transactions, because the obligation to declare and pay the tax is imposed on a party, to which the given taxable transactions were provided in the Czech Republic. The recipient of such services may apply a tax deduction in the same taxable period. Therefore, the tax revenue is neutral. Such mode could only be implemented in the Czech VAT Act in case it is specified in the VAT Directive and in case it is possible to impose VAT on financial transactions in the Czech Republic.

Another Approach to Taxing Services Provided by Banks

In many EU member states, the problematic application of VAT, particularly to financial transactions, is currently replaced by an income tax. For example, in Denmark, the financial services sector pays a tax of 9.13% on the volume of wages, whereas the tax rate has been increased to 10.5% as of 2013 (Hovorka, 2011).

As Europe was affected by the financial crisis in 2009, originating from some US banks, the EC started to consider the idea of introducing a tax on financial transactions in October 2010. The prevailing opinion at the time was that the financial sector should more fairly contribute to the payment of costs necessary for overcoming the crisis, as it had only been subject to low taxation due to the VAT exemption. Moreover, the financial sector received significant financial aid from many countries' governments during the crisis.

The Proposal for a Council Directive of 28 September 2011 on a Common System of Financial Transaction Tax and Amending Directive 2008/7/EC (Council of the EU, 2011) only applies to transactions relating to financial instruments. The main goal is to ensure that financial institutions fairly contribute to covering the costs of the crisis and to prevent the fragmentation of the common financial transactions market. Fourteen EU member states agree with the introduction of the tax. The previous Czech government rejected the tax, stating that banks in the Czech Republic did not contribute to the crisis. However, we should not block the introduction of the financial transaction tax, which is currently sought by the EC and the European Parliament as the EU's own tax revenue; the tax is expected to restrain speculative financial transactions.

Conclusions

Financial transactions represent an exception to the VAT application, which violates the taxation neutrality principle in the case of their exemption. The reason for this is, in particular, the complicated assessment of the tax base for some financial transactions. However, the non-payment of VAT on some financial services is absolutely wrong in terms of theory.

Therefore, the VAT Directive makes it possible for taxable persons to choose, whether they would tax or exempt such services. However, the EU member states have not been required to provide such option to taxable persons within their respective national laws. The Czech Republic is one of those states. Only six member states of the EU have provided taxable persons with the opportunity to apply VAT to financial transactions instead of exemptions, however, with various restrictions due to a potential negative impact on tax revenue.

In practice, there are many uncertainties in determining what is/is not a financial transaction. Following prior unsuccessful attempts at amending the VAT Directive of 2006 with a view to imposing an obligation on the EU member states consisting in the implementation of the option to exempt or tax financial transactions by taxable persons, at their own discretion, the attention has been paid to improving the definitions of such transactions.

In case it is possible to tax financial transactions instead of their exemptions, it is not certain whether the implications for public finance, particularly for the revenue side, would be outright positive. However, it is safe to state that the potential taxation of financial transactions would have a negative impact on the public budget expenditure, because the costs of the public sector would increase by the VAT on received financial services. The situation would be similar for final consumers—individuals.

Potential introduction of VAT in the area of financial transactions in the Czech Republic pursuant to the applicable VAT Directive represents a comprehensive topic, with many consequences. However, the consensus of politicians and experts, not only in terms of the taxation introduction, but also in terms of a specific legislative/technical solution, continues to be the key precondition.

Due to inconsistent effects of the taxation of financial transactions on VAT revenue, instead of the existing VAT exemption, the EC has focused on the application of a financial transaction tax, as this solution is easier to apply in practice. The aforementioned approach is to increase the participation of the banking sector in resolving the consequences of the recent financial crisis. The directive will come into effect as of 2014, whereas the tax will be collected in 10 EU member states.

The Czech Republic, like the 16 other EU member states, will not join this form of taxation. Since commercial banks operating in the Czech Republic generate very high profits, which are transferred abroad after only imposing a 19% corporate income tax, quicker consolidation of public finance would benefit from an introduction of either higher income tax or an introduction of a financial transaction tax. Moreover, it is also possible to combine both approaches to taxing the services of the banking sector.

References

Balážová, A., & Diviš, M. (2008). Nová příležitost (New opportunity). *Evropská unie: Euro, 1*, p. 64.

Council of the EU. (2006). *Council directive 2006/112/EC of 28 November 2006 on the common system of value added tax*. Retrieved from http://www.eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006

Council of the EU. (2011). *Proposal for a council directive of 28 September 2011 on a common system of financial transaction tax and amending directive 2008/7/EC.* Retrieved from http://europa.eu/legislation_summaries/internal_market/single_market_services/financial_services_general_framework/mi0087_cs.htm

Czech Republic. (2004). *Act No. 235/2004 coll., on value added tax, as amended*. Retrieved from http://www.zakonycr.cz/seznamy/235-2004-sb-zakon-o-dani-z-pridane-hodnoty.html

Hovorka, J. (2011). *Zisky bank jsou extrémně vysoké; bankovní služby by neměly být bez DPH (Banks' profits are extremely high; banking services should not be exempt from VAT*). Retrieved from http://www.mesec.cz/clanky/zisky-bank-jsou-extremne-vysoke-bankovni-bez-dph/

Lockwood, B. (2011). *How the EU VAT exemptions impact the banking sector. Study to assess whether banks enjoy a tax advantage as a result of the EU VAT exemption system* (p. 117). PricewaterhouseCoopers (PwC). Retrieved from http://www.pwc.com/en_GX/gx/financial-services/pdf/2011-10-18_VAT_Study_final_report.pdf

Pátek, V. (2008). *DPH u finančních a pojišťovacích služeb nejen pro banky a pojišťovny* (*VAT on financial and insurance services not only for banks and insurance companies)* (p. 110). Právo ES v praxi (Community law in practice). Prague: C. H. Beck.

Šindelář, J., & Šindelář, J. (2010). Daň z přidané hodnoty a finanční služby (Value added tax and financial services). In *Evropské finanční systémy 2010* (*European financial systems 2010)* (pp. 71-75). Brno: Masarykova univerzita (Masaryk University).

Vostatek, J. (2012). Insufficient taxes and high subsidies in financial services. In *Teoretické a praktické aspekty veřejných financí (Theoretical and practical aspects of public finance)* (p. 39). Prague: Oeconomica.

Zee, H. (2004). A new approach to taxing financial intermediation services under a value-added tax. International Monetary Fund, IMF Working Paper, WP/04/119. Retrieved from http://www.imf.org/external/pubs/ft/wp/2004/wp04119.pdf