

Krzysztof Biernacki

Wrocław University of Economics

EXEMPTION OF FINANCIAL SERVICES IN VALUE ADDED TAX

Summary: Financial services are hard to tax by VAT because of the precise evaluation of the value added for tax-based purposes. The invoice-credit method with exemption dominates in the European Union. However, it results in too negative consequences, such as an additional tax burden for financial institutions. In order to cope with these problems, alternative methods of taxation of financial services were proposed. This article presents the invoice-credit method of the taxation of financial services in Poland and also provides comments in terms of the other method of taxation, such as services. The conclusions regard the possibility of applying other forms of taxation for financial services in Poland.

Keywords: financial services, taxation, VAT exemption.

1. Introduction

The capital market significantly influences the economic growth of every country. This sector of national economy operates on the basis of liquid assets, which are very useful for taxation. Thus, the tax system charges are an important part of the value added in financial transactions as a central budget income.

The taxation of the financial services may be imposed directly, as it is in the case of direct taxes (e.g. Corporate Income Tax of Banks, Insurance Companies etc.), as well as indirectly. The second form of taxation may be exemplified by the exemption of Value Added Tax.

Value Added Tax (VAT) covers all B2B and B2C transactions. However, the main problem with the taxation of financial services is the lack of the possibility of the precise determination of the tax base. Due to the main features of VAT, the value added shall be taxed. If the goods are sold, the invoice-credit method allows determining the value added, whereas in terms of financial services both the taxation as well as the exemption lead to economic distortions in achieving equilibrium between the seller (e.g. Bank) and the buyer (e.g. the Investor). That is the reason why it is necessary to perceive the financial sector as different from the other parts of the national economy and introduce other methods of the taxation of financial services.

This article provides the basis for considering the reasons for the distortion in the taxation of financial services. The example is based on the domestic and EU-regulations. The focus is brought to other methods of the taxation of financial services in the world. Finally, these other methods are analyzed from the point of view of the domestic capital market.

Considering temporary observations, it is possible to formulate a hypothesis that the present form of the taxation of financial services in terms of VAT is an excessive burden for the capital market. Introducing new methods of tax calculation could minimize this problem. This hypothesis shall be facilitated by the theory of Lipsey's refined falsification.

2. Financial services – an overview

Financial services shall be treated as a specified form of performing business. While other services generate a cash flow as a result of such a service, the financial services focus on the money transfer. It means that the aspect of financial services embraces the cash flows. However, the regulations do not introduce a precise definition, but they are rather described in general terms [van Brederode 2009].

The subject of financial services is a huge interest of the tax system. As those transactions cover liquid assets, it is easy to treat a part of them as a tax burden. That is the reason why many countries particularly tax the financial services.

Table 1. The main categories of financial services

1.		Deposits, borrowing, and lending
	a.	Banking operations
	b.	Credit card operations
2.		Purchase, sale, and issuance of financial securities
	a.	Bond, shares, options, guarantees, and foreign currencies
	b.	Gold and precious metals
3.		Insurance
	a.	Life
	b.	Property and Casualty
4.		Brokerage and other agent services
	a.	Buying and selling of financial securities
	b.	Underwriting and other transactions where agents act as principals
5.		Advisory, management and data processing
	a.	Asset management and investment advice
	b.	Administrative and information services, incidental or supplementary to financial services
	c.	Others

Source: [Poddar 2003].

If we focus on the type of services provided, all services may be divided into five categories [Poddar 2003], as it is shown in Table 1.

The presented categorization shall change if the criteria are shifted. The other may be: the type of provider, economic function, the role played by the service provider (as a principal or as agent), and, finally, the nature of consideration. At the tax level, the aforementioned categorization is dominant; however, it is also necessary to take into account the provided criteria. For example, if the loan is granted by the bank, this shall be the financial service, but the same loan from a private person may not be treated similarly. It is more visible in the group of “incidental or supplementary” services. While they are performed by financial institutions, it is easier to categorize them as financial services [Sobańska, Sieradzan 2001].

This division is important from the point of view of the tax law. Very often the special taxation is imposed due to the provider, not the matter of the transaction. It may cause much trouble due to the specific treatment of financial services in domestic and UE-tax law.

3. Taxation of financial services – domestic regulations

To the extent specified by the tax law, domestic regulation are based on the EU directives. *Polish Act on goods and service tax*¹ implements the VAT methods of financial service taxation, which are defined in the Directive No. 2006/112/EC². It means that the Polish regulations duplicate the UE law and cannot be changed solely.

The domestic system of VAT clearance is based on the invoice-credit method. The taxable event is confirmed by the invoice issued by the taxpayer. Moreover, if there was no transaction and the invoice was issued, the tax shown in the invoice must be paid. This invoice-based method imposes the obligation to pay the tax, irrespective of the payment of the invoice by the purchaser of goods or services. This method generates additional risk for the seller, which is associated with the unpaid receivables. The credit element of the method refers to the clearance of the tax and is presented in Table 2.

The tax rate amount is hypothetically 10% and covers every sale, irrespective of the turnover. The credit method bases on the input tax, which may be deducted with the output tax. It is also defined as the crediting of the paid tax (input tax) with the output tax. Finally, only the difference between net value of purchase and net value of sale is taxed (the value added in a given stage). Thus, the total sum of the paid tax in every stage is proportional to the total value added. It must be underlined that the credit method is effective only if two presumptions are fulfilled:

¹ *Goods and Services Tax Act* of 11 March 2004, Journal of Laws No. 54 item 535, as amended, hereinafter *the VAT Act*.

² Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, Journal of EU L 347/1.

- all taxpayers have the possibility to fully deduct the input tax with the output tax;
- the whole invoices with the output tax has been paid.

Table 2. The main method of applied VAT in selling goods and services

(1)	(2)	(3)	(4)	(5)	(6)	(7)
The stage of the turnover	Net price	Value added in the turnover	Gross price (10%)	Input tax	Output tax	The tax to pay
I stage Taxpayer A	100	100	110	–	10	10
II stage Taxpayer B	200	100	220	10	20	10
III stage Taxpayer C	300	100	330	20	30	10
IV stage Taxpayer D	350	50	385	30	35	5
V stage Taxpayer E	400	50	440	35	40	5
TOTAL		400				40

Source: [Litwińczuk, Karwat 2006].

Passing one of them over allows transforming the method of calculation from net tax into gross tax, where the so-called “phenomenon of tax cascade” effectively increases the final burden.

VAT may be perceived as a form of sales tax. It causes the increase of the final value of sold goods and services. In the B2B relations, if the first presumption is fulfilled, it does not generate an extra burden. There is only a necessity to cover the gross price by the purchaser and until he or she is not able to issue his or her own invoice with output tax, the input tax is credited. But in B2C relation, the VAT tax rate generates an extra cost.

If the normal tax rate were to be imposed on financial services, the final cost would be raised only for consumers. However, there shall be a problem with defining the tax base, as it is hard to determine what the added value in many financial services was. As an example, the intermediations in the form of *swap* or *futures* transactions may be presented, where the extra gain is not equal to the agent’s provision. Apart from this aspect, in order to minimize the consumer cost instead of tax rate, an exemption has been implemented. The tax calculation where one of the intermediate stage is exempted is shown in Table 3.

Table 3. The consequence of the exemption in invoice-credit method of VAT

(1)	(2)	(3)	(4)	(5)	(6)	(7)
The stage of the turnover	Net price	Value added in the turnover	Gross price (10%)	Input tax	Output tax	The tax to pay
I stage Taxpayer A	100	100	110	–	10	10
II stage Taxpayer B	Exemption 210	100		–	–	–
III stage Taxpayer C	310	100	341	–	31	31
IV stage Taxpayer D	360	50	396	31	36	5
V stage Taxpayer E	410	50	451	36	41	5
TOTAL		400				51

Source: [Litwińczuk, Karwat 2006].

At the exemption stage, it is impossible to deduct the input tax because there is no link between taxed sale and the acquisition of goods and services. If the sale is partially exempted, the taxpayer has the right to deduct part of the input tax [Henkov 2008]. Referring to Article 86 of *the VAT Act*, the taxpayer may deduct the input tax only in the situation when the purchased goods and serviced are used for taxable sale. Because the taxpayer B has an exemption sale, he or she may either cover the input tax with his or her profit margin or include this value as an element of cost and finally raise the net value. Table 2 shows the second method because it is almost impossible in practice to decrease the margin by for example 23 % (temporary main VAT tax rate in Poland).

In fact, the taxpayer B sells the goods and services in the same net and gross value. In this case, the exemption could lead to a more competitive relation than it is in the case of the sale with the normal tax rate. But the price of taxpayer B includes the previous, non-deductible input tax and the next taxpayer cannot deduct any input tax. He or she adds the normal tax rate to the net value and in this structure the tax cascade is visible. In the end, the total 51 [u] of tax has been paid in all stages, where the sum of value added was only 400 [u]. As Table 1 shows, the tax shall only amount to 40 [u].

The bank sector, in the first six months of 2008, could not deduct approx. 1.1 billion PLN³. In the same period, the gross profit of the bank system amounted to

³ The main data from bank sector in the first six month of 2008 are taken from KNF database: www.knf.gov.pl_20.04.2011y. This value was calculated as a difference between the whole cost of performing business and personal costs. The 22% tax rate was applied.

9.7 billion PLN. It means that the possibility of fully deducted input tax by the banks could raise the gross profit by about 11.3%. From the fiscal point of view, it could only generate extra 0.2 billion of CIT. Thus, at this stage it is better to retain the exemption, than allow for a full deduction.

However, this extra burden is perceived as a significant impediment in the development of the capital sector and thus another method of taxation for such services was proposed.

4. Alternative methods of taxation

The invoice-credit method with the exemption of financial services described earlier dominates in the EU-countries. It is not only associated with the EU legislation, but previously many countries used this method of clearance as a basis. Although there are a few differences, especially in the group of performing secondary (additional) financial services [Cnossen 1999], in fact the exemption is the most important one.

This method has many modifications, which allow minimizing the economic distortions. The most common are [Poddar 2003]:

- the option system,
- the taxation of explicit fees and commissions,
- the taxation of agency services only,
- New Zealand system,
- exemption with input credits,
- Australian system.

The option system provides a possibility for the providers of financial services to choose the full taxation. This solution is convenient to those institutions which deal with other taxable persons. As it was mentioned earlier, VAT in this case does not generate extra costs if the purchaser is able to deduct the input tax. Three EU-states introduced a similar solution: Germany, France, and Belgium [Cnossen 1999].

The taxation of explicit fees and commissions focuses on those transaction for which the remuneration is paid in the form of fees or commissions to the provider. Such transactions are taxed with normal tax rates, where the other services are exempted. For the financial institution (provider), this method allows deducting at least a part of the input tax which is associated with the taxed sale.

The taxation of agency services is only a variant of the previous method that was adopted in Singapore. The services provided by agents are taxed with normal rate. For example, this method covers all the services performed by insurance agents or brokerage. All other financial services are exempted.

The New Zealand system taxes only selected financial services. The exemption method is valid, but does not refer to, for example, selling life insurances. This system differentiates the taxation of insurance services. In terms of other financial services, this system is similar to the EU invoice-credit method.

The exemption with input credits is a method in which the taxable person who performs the financial services has a limited ability to deduct the input tax, as it is in the case of taxation at normal tax rate or zero tax rate. In practice, this method is divided into a “special method” and a “fixed input tax recovery method”. Both of them are associated with assigning the amount of input tax for the deduction. In the first method, the provider sells certain services with exemption, but in terms of tax clearance this sale is perceived as a zero-rated sale. The second method sets out a limited value of input credit, which can be deducted by the financial institution during a particular year or another period. In both methods, the main problem is the determination of the scope of deduction.

The Australian system is a mixed one in which the broad tax base also embraces financial services. They are exempted with some exclusions and certain financial institutions perform the recovery in the forms of input credits. This system also has the inland definition of financial service – the fact which is reflected in the scope of taxation.

The methods presented earlier constitute a variety of the invoice-credit method. Their main purpose is to minimize the negative consequences of an exemption. Moreover, there are four generally different methods of the taxation of financial services. They are as follows:

- basic cash flow tax,
- Tax Calculations Account (TCA) system,
- TCA system with zero-rating of business transaction,
- addition method.

The cash flow system reflects the necessity of looking for a new solution in the taxation of financial services. It must be underlined that the payment within the consideration in performing financial services includes at least four payments: principal, time value of money, intermediation services, and premium for the risk [Poddar 2003, p. 362]. Financial services, as services operating in the money flows, can be perceived for tax purposes as a set of cash flows between the financial institution and the customer. In the case of basic cash flow tax, the tax base is calculated on terms of transaction-by-transaction and customer-by-customer flows. In the invoice-credit method, there is no possibility to allocate the value added in each transaction.

In fact, the basic cash flow method can precisely allocate the tax base between the parties of the transaction, but a few problems are associated with this system:

- If the entire cash flow is taxed, the party of the transaction taking the money may be compelled to raise the fund in order to cover the tax; it may lead to the increase of the final cost of financing.
- Changing the tax rate may negatively influence the final taxation; the cash flows (especially the back-flows, e.g. when borrowers pay installments) as a base for taxation may vary in time.

- The detailed registration of all the transactions for tax purposes may be burdensome for both financial institutions and tax authorities.

In order to meet the needs, the TCA methods were proposed [Friedrich-Vache 2005]. The Tax Calculation Account (TCA) is created for a transaction and the payment of the tax is suspended until the transaction is closed. This account is provided by the financial institution and includes all the payments and cash flows associated with a certain transaction. The suspensions of tax clearance allow for the precise determination of the tax base for a transaction, regardless of any tax rate changes. This system embraces the principal and marginal payments for the financial institution. When the consideration is in the form of a fee or commission, it is taxed directly.

TCA with zero-rating is an alternative which implements a zero tax rate in the transaction with business companies (other VAT registrants). In this method, the relation with the final customer (consumers) or VAT non-registrants, generates the tax burden. This method allows for the introduction of the main idea of VAT, where the last link in the chain bears the tax burden. This method is optionally introduced in practice.

The addition method changes the calculation of the tax base. In comparison with the invoice-credit method with exemption, where the non-labour inputs are taxed, this method also includes the labour fund of the financial institution and the profits from selling the services as the elements of the tax base. This concept was applied in France, Israel, and Quebec; however, it is not free from flaws, for example partial cascade effect.

5. Conclusions

The alternative methods presented in this paper are focused on minimizing the negative effect of the applied invoice-credit method with exemption. It is necessary to underline that Poland is obligated to respect the UE-common law, including tax directives. It means that any fundamental changes in the methodology of VAT clearance in financial services require the unanimous decision of all the countries of the European Union.

Nevertheless, there is a possibility to introduce partial changes or optional taxation as it was presented within the group of the modified exemption method. These methods do not change the core form of calculation, but allow implementing particular solutions. It is important to bring this problem up in order to make the financial sector efficient and free from the tax burden.

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ZWOLNIENIE USŁUG FINANSOWYCH W PODATKU VAT

Streszczenie: Zwolnienie usług finansowych w podatku od towarów i usług (VAT) niesie ze sobą negatywne konsekwencje związane z dodatkowym obciążeniem instytucji finansowych oraz możliwością zaistnienia kaskady podatkowej. W oczywisty sposób znajduje to odzwierciedlenie w kosztach świadczonych usług. W związku z tym na świecie rozwinięto szereg alternatywnych metod opodatkowania świadczenia takich usług. Przedmiotowe opracowanie analizuje metodę stosowaną w Polsce z uwzględnieniem przepisów Unii Europejskiej w tym zakresie oraz prezentuje alternatywne rozwiązania występujące w innych krajach. W konkluzji odnosi się do możliwości modyfikacji obowiązującego systemu w kierunku rozwiązań minimalizujących dodatkowe koszty opodatkowania.