

Chapter 2

Taxing Loan Intermediary Services: Theory and Design Considerations

Robert F. van Brederode and Richard Krever

Abstract The most prevalent treatment of loan intermediary services in global VAT treatment is the characterisation of the services as exempt or input taxed supplies. It is almost universally recognized that this treatment is suboptimal in terms of VAT theory and outcomes, leading to compounding overtaxation of registered enterprises using the services and undertaxation of final consumers. Developing workable alternatives is a challenge, however. While some jurisdictions have adopted partial solutions for particular types of taxpayers or transactions—zero-rating some supplies, taxing others using additive methods to determine the base, recharacterizing finance leases as taxable supplies—no jurisdiction has successfully tackled the full problem. This chapter reviews the merits and drawbacks to the various alternatives that have been tried and proposed.

2.1 Introduction¹

Under a consumption tax, services, including financial intermediary services, should only be taxed insofar as their use constitutes private consumption. To develop a theoretical model for determining what types of financial intermediary services should be subject to or exempt from the consumption tax, it is imperative

¹Further discussion on the issues in this chapter, sometimes reflected in the current materials, is found in Robert F. van Brederode, *Systems of General Sales Taxation: Theory, Policy, and Practice* (Kluwer Law International, Alphen aan den Rijn, 2009), Sect. 8.2.6 and Harry Grubert and Richard Krever, VAT and Financial Services: Competing Perspectives on What Should Be Taxed (2012) 65 (2) *Tax Law Review* 199 (reproduced in: Rita de la Feria (ed.), *VAT Exemptions: Consequences and Design Alternatives* (Kluwer Law International, Alphen aan den Rijn, 2013) 311).

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to gain first an understanding of what constitutes consumption. In Chap. 1² we distinguished between two main philosophical approaches to the concept of consumption. The first defines consumption from the perspective of an individual making an expenditure, and is generally broader in its approach. The second view, referred to as the Hobbesian view, prefers a utilitarian or societal approach based on the total consumption in a country. The divergence between the two views is the result of their different perspectives on how to determine what constitutes consumption. Importantly, under both views of consumption, neither payments nor repayments of loan principal nor gross interest payments would be subject to consumption tax. There is no consumption element in the payment of loan principal amounts or pure interest. As is often the case, however, tax practice may sometimes veer significantly from theory and, while no tax policy theory supports the imposition of a consumption tax on payments of loan principal or gross interest, the consumption tax laws of two jurisdictions covered in this volume do exactly that.

2.2 Characterizing Loan Principal, Interest and Loan Intermediary Services for VAT Purposes

2.2.1 Loan Principal

In ordinary commercial transactions, a payment from one unrelated party to another is an indicator of consumption. Most often, the person making the payment acquires something of value—tangible goods, intangible benefits, or services—from the person receiving the funds. In contrast, there is no consumption element to the advancing of loan funds. The net economic position of the lender and borrower are unchanged before and after the loan is made. Once funds are advanced, the lender has substituted a right to repayment for cash of equal value and the borrower has acquired cash that is offset by an equal value debt or obligation to repay. From a personal consumption perspective, neither the borrower nor lender have parted with economic capacity—neither has given anything away, precluding alternative use of funds for other types of consumption. It is, therefore, not surprising that no jurisdiction imposes VAT or similar consumption taxes on payments or repayments of loan principal.

2.2.2 Interest

The consensus view on the VAT treatment of loan principal payments and repayments does not hold for interest. Two jurisdictions explicitly impose

²See Robert F. van Brederode and Richard Krever, *Theories of Consumption and the Consequences of Partial Taxation of Financial Services*, this volume.

consumption taxes on gross interest payments, and most others could be regarded as doing so to a small extent implicitly by virtue of their characterization of loans as exempt or input taxed supplies. The characterization of loans as exempt or input taxed supplies leaves financial institutions with no option but to pass on to customers the input tax they incur on ancillary acquisitions used in the loan business.

Jurisdictions that levy consumption tax on interest payments are clearly outliers. The prevailing general view is that VAT should not be levied on pure interest charges. The case for not taxing interest charges may be counterintuitive for some, however, because interest paid for the use of money from a bank seems to resemble rental charges for the use of any other asset lent to a customer by a provider of rental goods. If lease payments for the use of a rental car are subject to VAT, why should payments for the 'use' of money not be treated similarly? The difference is that the use of a rental car constitutes tangible consumption while the receipt of loan funds in itself involves no consumption. The money can be used for consumption, i.e., the purchase of goods or services, or for investment, but mere receipt of loan funds does not give rise to consumption in terms of either the personal or social definitions of that concept. Money is the means of acquiring goods or services but shifting cash from one person to another involves no acquisition from the social pool and no transfer of economic capacity from one person to another.

What loans do transfer is the time of consumption. By shifting money to a borrower, the lender defers consumption until the time of repayment, when funds are once again available for consumption. And by taking on a debt obligation, the borrower is able to bring forward the time of consumption, with reduced consumption at a future period when income must be applied to repayment of the loan.

The basis for not taxing pure interest can best be illustrated with an example of a consumer expecting income of \$110 in the following year and having the choice of borrowing in 'Year 1' to consume now or waiting until 'Year 2' to consume when the income is available. If the pure interest rate (the government's borrowing rate) is 10% and the consumer can borrow directly from the lender without incurring any expense for the services of a financial intermediary, a loan of \$100 would be repaid with interest for a total cost of \$110 the following year. A consumer thus has a choice of borrowing to buy \$100 of goods and services today using borrowed funds or \$110 of supplies next year using the consumer's own funds.

It might be thought that the \$10 interest payable for use of the borrowed funds is the price the consumer has been willing to pay to shift the time of consumption. In this sense, the interest payment is the cost of choosing when to consume, which looks like a form of consumption akin to consuming goods or services. If, however, the effect of the time value of money is considered, the case for taxing pure interest falls away. If interest were subject to consumption tax at 20%, the consumer who borrows would be charged a 20% consumption tax on the initial \$100 used to buy goods and services and then a further consumption tax on the \$10 interest charge the following year when the loan is repaid. The tax paid would be \$20 in Year 1 and \$2 in Year 2, or \$22 in total. In contrast, if consumption is deferred until the following year when \$110 of goods and services are purchased, the consumer will pay \$22 tax in Year 2. It can be seen that the consumer would end up paying \$22 in

either case but most of it is paid a year earlier in the borrowing case. From the government's perspective, much of the tax from the borrower has been collected far earlier than the tax paid by the person who defers consumption. Once the time value of money is considered (the benefit to the government of collecting \$20 tax a year earlier), it can be seen that the government ends up with more tax from the person who borrowed to accelerate consumption.

If interest is not subject to consumption tax, the consumer who borrows to fund accelerated consumption faces a \$20 tax burden in Year 1 while the one who defers will bear a \$22 burden in Year 2. In present value terms, the tax liability from accelerated and deferred consumption is the same. Unlike the case where the interest is taxed, if the interest is not taxed, the tax system would have no effect on consumption decisions. The government, too, is indifferent between present or future consumption.

Thus, once the time value of money is taken into account, it can be seen that the person who shifts consumption forward and consumes less but pays tax on the consumption sooner ultimately enjoys the same economic benefit as the person who consumes more later but must postpone consumption by one year in order to do this. Put another way, in a consumption tax world, a consumer who accelerates consumption or defers consumption will have less to consume after tax than that person would in a no-tax world, but the relative value of current to deferred consumption is identical if no tax is levied on the interest paid by the borrower until the lender uses it to consume.³

2.2.3 *Loan Intermediary Services*

Embedded in the interest paid to depositors and that charged to borrowers is an implicit fee levied by the intermediary service provider that distributes the savings of lenders to borrowers seeking loan funds. This implicit fee is borne by both parties by way of the spread charged by the financial institution between the interest charged to the borrower and paid to the depositor.

Under the social pool view of consumption, the intermediary cost would be dissected from the other costs borne by the borrower to shift the time of consumption and treated as the price of acquiring a separate taxable service.⁴ While the individual might regard the higher interest charge incorporating an intermediary fee as the cost of shifting consumption forward, unlike interest, this fee is used to acquire actual services.⁵ If the consumer-borrower were not acquiring these services, the capital and labour used to provide the services would be used to provide taxable goods or services to other persons. In other words, the acquisition uses real

³Edgar (2001, p. 1137).

⁴Carroll and Viard (2010, p. 1125).

⁵Carroll and Viard (2010, p. 1125).

resources from the pool of economic resources and thus would amount to consumption under the social pool perspective.

In contrast to payments for pure interest borne by private consumers, which shifts the time of consumption but utilizes no real resources, payments for financial intermediary services are used to acquire real labour and capital inputs. Had the consumer chosen to defer consumption and spend the funds on other services, the alternative acquisitions would be subject to tax. For tax revenues from accelerated or deferred consumption to be equal, therefore, the acquisition of financial intermediary services by the person who accelerates consumption must be taxed in the same manner as the acquisition of non-financial services by the person who defers consumption. Only in this way will the total tax paid by the person who accelerates consumption equal the tax paid by the person who defers consumption and the decision to accelerate or defer be equal in present value terms.

An argument has been made that the cost of loan intermediary services should be considered an ancillary charge for the provision of credit similar to interest and be excluded from consumption tax in the same way as interest.⁶ Under this view, the intermediary costs incurred to accelerate consumption are simply another expense incurred to facilitate an individual borrower's time preference. This approach assumes that the present value of future consumption varies from borrower to borrower (largely dependent on their personal risk profiles, their need to access intermediary services, and the relative cost of arranging the loan given its size) and that any intermediary fees incorporated into the interest charged are simply further costs of bringing forward consumption that should be treated similarly to the pure interest rate.⁷ The assumption under this view is that there is no utility to the borrower from these charges; rather, they are a means to an end, which is acceleration of actual consumption. Whatever components are included in the borrower's cost of shifting consumption, the present value of VAT on accelerated consumption and the larger amount of VAT on deferred consumption will always be equal in economic terms to the borrower.

On further reflection, one of the key architects of this argument retreated from and subsequently abandoned the view.⁸ The change of heart followed a recognition that the original analysis, based on the personal view which treated intermediary charges as part of the cost of shifting the time of consumption (and hence yielding no separate utility to the borrower), did not consider the impact of the revenue constraints that the government might face if intermediary services are not subject to tax. The present value of accelerated consumption (using borrowed funds) or deferred consumption should be exactly the same for a consumer, which means the value of tax paid on accelerated consumption should equal the value of tax paid on deferred consumption. As was shown earlier, that outcome can only be achieved if the cost of intermediary services is subject to tax.

⁶Grubert and Mackie (2000, pp. 23–25).

⁷Chia and Whalley (1999, pp. 704–705).

⁸Grubert and Krever (2012).

2.3 Alternative Methods of Taxing Financial Services

2.3.1 *Treating Financial Services as Exempt Supplies*

The cost of intermediary loan services can be contrasted with some other types of services provided by the same financial institution that provides loan services. Often these separate services are rendered for explicit fees. Examples include the rental of safety deposit boxes, the issuance of cheques, and access to remote payment and withdrawal systems such as online transfers or ATMs. However, explicit fees do not always represent the actual value added of the service. For example, banks may offer low- or no-cost chequing services to customers who maintain minimum balances in their chequing accounts that pay lower interest rates, imposing an implicit fee for the service.

Where implicit fees are charged, in other words when the value added is expressed in a margin, this value added cannot be identified on a transaction basis and, therefore, cannot be directly taxed under the credit-invoice method VAT. The apparent incompatibility of the credit-invoice VAT and the supply of loan intermediary services paid by way of implicit charges embedded in interest rate spreads has led most VAT jurisdictions to simply designate the services as exempt supplies. To mitigate actual and potential adverse effects of treating intermediary loan supplies as exempt supplies, some jurisdictions have attempted to quarantine the impact by carefully limiting the exempt designation to intermediary services paid implicitly through the interest rate spread and imposing VAT on supplies that attract explicit charges. South Africa is often seen as a leader in this approach. Many jurisdictions, however, also designate a range of other services such as cheques, money transfers, and ATM access provided by financial institutions providing loan intermediary services as exempt supplies. This approach concedes the ease with which suppliers can shift explicit fees into implicit fees through a larger interest rate spread, as in the example above of no-cost chequing services for accounts entitled to lower interest rates on balances.

The EU, which defines exempt financial supplies remarkably broadly to include a very wide range of ancillary supplies in addition to intermediary loan services, provides Member States with an option to subject financial supplies other than intermediary loan services to VAT.⁹ It was anticipated that under the option method, financial institutions would choose to tax their services rendered to business customers who will be entitled to a tax refund and retain exempt treatment for services rendered to private consumers. Only seven of the 28 Member States have acted on the option to date, however, and the application is far from uniform, leading to further distortions to neutrality across the EU.

⁹EU legislation, i.e., Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ L 347, 11 December 2006 [VAT Directive], Art. 137(1)(a), allows Member States to introduce the option in their national VAT legislation.

The designation of a supply as an ‘exempt’ supply, as input taxed supplies are labelled in most jurisdictions, does not mean it is free of tax. The supplier of an exempt supply is denied credit for VAT on related inputs and must, therefore, bear the tax imposed on acquisitions.¹⁰ The tax paid by a supplier of loan intermediary services on acquisitions then becomes another business cost that will be reflected in the price of its supplies. Although there is input tax embedded in the price of the later supply, the further value added by the financial supplier remains untaxed. The result, when compared to a benchmark VAT, is undertaxation of final consumers using the intermediary services and overtaxation of enterprises that would ordinarily be able to recover fully all tax on acquisitions by means of input tax credits.

On average, 24.7% of the GDP in developed countries originates from the financial sector.¹¹ This under- and overtaxation of such an important part of the economy leads to a range of distortions, some of which can have serious economic implications. The undertaxation of consumers creates a bias in favour of consumption of loan intermediary services, with broader implications from possibly distorted consumption timing decisions and overreliance on debt financing. At the same time, the overtaxation of supplies to businesses distorts initial reliance on debt while the VAT on acquisitions that becomes embedded in the cost of financial services creates ongoing distortions as it cascades through the supply chain, unrecoverable by all enterprises along the chain. The value of intermediate inputs, on which tax would cascade, has been estimated at 20–30% of the value of intermediation services.¹² In other words, financial institutions spend one-fifth to one-third of the value added they generate on purchases from other businesses. The VAT on all these acquisitions becomes part of their cost, cascading through the supply chain of their customers, their customers’ customers, and so on.

Exemption is also likely to lead to inefficiencies in the financial sector, particularly artificial vertical integration (in-sourcing) as financial providers bring in-house a wide range of ancillary services to avoid the VAT they would face if they used external, and possibly more efficient, specialized external service providers.

Although it is not possible to identify the value added of intermediary loan services on a transaction basis, determining the value added on an aggregate level is possible. Figure 2.1 demonstrates the key elements of the identification of the value added on an aggregate level of simplified intermediary loan services by a bank.

The bank provides intermediation services by pooling funds from depositors and making those funds available to borrowers. The transfers of funds in the form of deposits by savers and subsequent loans to borrowers, however, do not constitute any value added, nor do the payments of interest by the borrowers to the bank and by the bank to the deposit holders. Because the bank needs to pay for labour and

¹⁰This effect is sometimes described as the VAT paradox: those who are exempt are actually taxed; and those who are taxed are actually exempt, see Terra (1989, p. 43). Terra borrowed the paradox from Reugebrink (1985, p. 58).

¹¹Schenk and Zee (2004).

¹²Garber and Raboy (1989, p. 172).

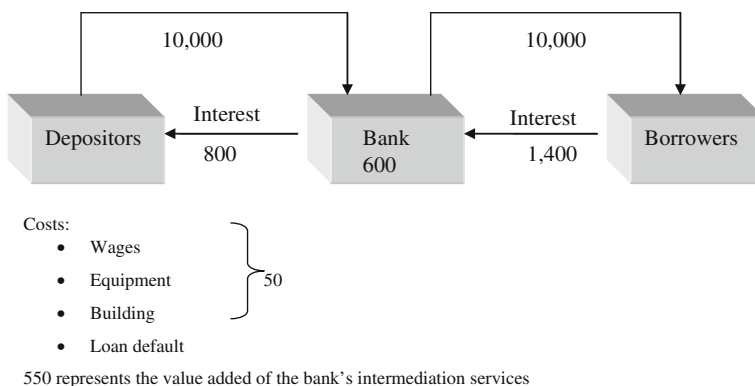


Fig. 2.1 Value added of bank intermediary loan services

capital inputs, and incurs other costs including loan defaults, the value added, which should be subject to VAT, can be calculated as interest received (1400) minus interest paid (800) and costs (50) = 550.

A number of responses to address these problems have been proposed or adopted by selected jurisdictions. These are discussed below.

2.3.2 *Recharacterizing Loans as Ordinary Business Supplies*

One of the most common means used to avoid the overtaxation of business customers inherent in the designation of loan services as exempt supplies is the recharacterization of loans as ordinary taxable business supplies. Under this approach, the financial institution will treat the supply as a fully taxed supply and provide the 'borrower' with a tax invoice, allowing registered customers to recover fully the VAT imposed on the supply.

The most common example of the recharacterization of a loan as an ordinary taxable supply is the recasting of loans to business customers as finance leases.¹³ The success of this technique relies entirely on tolerance by revenue authorities sympathetic to the goal of removing taxation on business-to-business loans and consequently applying VAT on the basis of the form of the transaction rather than its economic substance.

¹³Finance leases are to be contrasted with operating leases, which are simple rental services involving no transfer of ownership to the lessee and no element of financial supply with an accompanying financial intermediary charge. Operating leases, devoid of loan elements and implicit financial intermediary charges, are fully taxed under the VAT as the entire rental cost borne by the lessee is for consumption of the service provided.

Accounting principles look beyond the notional title of the financing arrangements as ‘leases’ and treat them as blended payment loans for financial accounting purposes.¹⁴ While this approach may be taken for income tax purposes in some jurisdictions,¹⁵ the notional form of the transaction as a ‘lease’ is often respected for VAT purposes, and the so-called ‘lease’ payments are subject to tax as if they were ordinary operating lease payments. This is beneficial to registered customers, because they can offset the VAT paid on the full lease payment as an input-VAT credit. Had the transaction been structured as an explicit loan, it would be an exempt supply and the intermediary financial service of the lender would be subject to input taxation in most jurisdictions. Treating a finance lease as if it were an operating lease is thus a simple ‘backdoor’ way for VAT jurisdictions to remove all VAT from the financial service provided to business customers under current rules.

As noted in Chap. 1,¹⁶ a benchmark VAT, whether it is based on the personal view of consumption or the social view, would subject the intermediary fee component to tax but not the interest component. A final consumer who uses a finance lease in contrast to an ordinary loan will be overtaxed where finance leases are treated as operating leases for VAT purposes. This could explain in part why finance leases are used primarily for business borrowing.

While it is possible to recast loans used to acquire tangible assets as finance leases, this technique is not an option for the vast majority of business loans. It is, therefore, a very limited solution to the problem of overtaxation of business financing where financial services are treated as exempt supplies.

2.3.3 Limited Input Tax Credits for Financial Loan Service Suppliers

It was noted earlier that the treatment of financial supplies generally, and intermediary loan services specifically, as exempt supplies encourages suppliers to bring support services in-house so that no VAT is incurred on the acquisition of these services. This vertical integration may lead to significant inefficiencies as enterprises specializing in financial services find themselves operating a range of other services. It will also inhibit competition by providing the largest financial institutions with a significant advantage over small local providers unable to establish costly in-house operations for systems such as data processing.

To level the playing field between the largest institutions and smaller institutions, Australia adopted a system of providing institutions making exempt financial supplies with limited input tax credits (generally 75% of the total VAT incurred,

¹⁴Fletcher et al. (2005).

¹⁵Fletcher et al. (2005, p. 21).

¹⁶Van Brederode and Krever, Theories of Consumption and the Consequences of Partial Taxation of Financial Services, this volume.

with a 55% recovery provided for a small group of inputs) for VAT incurred on a list of designated supplies often used by financial institutions. A variation of Australia's 'reduced input tax credit', as the system is called, has been proposed for Europe by PricewaterhouseCoopers in a 2006 report to the European Commission.¹⁷ The 'Uniform Limited Input Tax Credit', as its authors labelled it, canvassed the options of a reduced input tax credit for all purchases related to making exempt financial supplies and for selected inputs only. The limited input tax credit can be targeted to achieve the primary aim of avoiding distortions that encourage vertical integration and that prejudice smaller suppliers unable to bring some services in-house by modifying the recovery rate for different types of services depending on the relative labour component of each service.

An across-the-board limited input tax credit reduces the overtaxation of registered business customers (by way of input tax expenses embedded in the cost implicitly charged by the institutions) but also enhances the undertaxation of final consumer customers. Reduction of one distortion is thus offset by an increase of another.

An alternative limited input tax credit model is one that pro-rates inputs on the basis of output services provided by the institution, allowing credits for input taxes to the extent output services are provided to registered business customers. If the supplier passed on the benefits of input tax recovery to business customers and not final consumers, the designation of output supplies as exempt supplies combined with the effective recovery of input tax related to the exempt supplies achieves the equivalent of a zero-rated supply. This model has been adopted in Singapore,¹⁸ where financial institutions have directed the benefit of input tax recovery to registered business customers, in effect eliminating tax on those supplies. The system continues to undertax final consumers in the same way as in countries that treat loan intermediary supplies as exempt supplies across the board.

2.3.4 Zero-Rating

Zero-rating (also referred to as 'exempt with credit' or GST-free in some jurisdictions) has the result that financial services will be totally relieved from tax. No VAT will be due on the supply of these services, whereas full input tax credits will be granted to financial institutions regarding their purchases. Cascading, therefore, will be completely eliminated under the application of the zero rate provided no compensating taxes are levied. Most other problems and complexities associated with the exemption of financial services, related to input tax allocation, mixed use and change of use, will automatically be eliminated as well. However, definition complexities may remain when determining which services are subject to the zero rate, particularly given the rapid pace of product innovation in this industry.

¹⁷PricewaterhouseCoopers (2006, p. 35).

¹⁸See Merrill (2011, p. 171).

While full zero-rating would solve the problem of overtaxing business customers, it would, of course, lead to greater undertaxation of final consumers. Not surprisingly, in New Zealand, the only jurisdiction to have adopted zero-rated treatment for intermediary loan supplies,¹⁹ the treatment is reserved for services to registered businesses and only those business customers for which taxable supplies constitute at least 75% of total supplies made. As noted earlier, the Singapore system allowing input tax credits that can be matched to exempt supplies to business customers achieves the functional equivalent of the New Zealand explicit zero-rating system.

One consequence of the New Zealand system is that the suppliers, financial institutions in this case, need to ascertain the VAT status of their customers. This requirement undermines one of the fundamental strengths of a VAT relative to the alternative consumption tax, a retail sales tax (RST), namely that in a pure VAT the supplier is relieved of any responsibility for checking the status of the customer.

Zero-rating financial services to business does not address the problem of undertaxation of services to final consumers (or in the case of Australia, with reduced input tax credits across the board for financial institutions, even greater undertaxation of services to final consumers). It can, however, solve the overtaxation of business-to-business transactions compared to the alternative of treating loan intermediary supplies as exempt supplies. An obvious question is why the system is only used in two jurisdictions (explicitly in New Zealand and, via a different mechanism, implicitly in Singapore). The answer may be the negative budgetary consequences in terms of revenue if the current overtaxation of supplies to business were remedied without a corresponding correction to the undertaxation of final consumer borrowers.

2.3.5 *Addition Method*

The only system currently in use to tax fully loan intermediary services is the 'addition method' which calculates the value of services as the total of the costs incurred to provide the services and the profits realized on the services. Costs are measured as the sum of wages, rent, and interest, so the total value of services is the sum of wages, rent, interest and profits.

Israel is the only state that applies the addition method VAT to financial services, based on the computation of wages and profits. Interestingly, it is administered by the Income Tax Authority, and not by the VAT Administration. The system has four drawbacks in terms of benchmark VAT principles. From a general design perspective, the accounts-based tax as applying to the financial sector seems inconsistent with the transaction-based VAT applied using the invoice-credit method to other (non-financial) sectors. More significantly, because the addition method measures the

¹⁹See Marie Pallot and Thomas Allen, *Loan Intermediary Services: New Zealand*, this volume.

value of the supplies at an aggregate institutional level, there is no possibility of segregating the overall tax basis on a transaction basis and providing tax invoices to business customers, leaving them unable to deduct input VAT. This, in turn, means the tax becomes a compounding business input. Finally, the addition method is origin-based as it determines value added on an aggregate level without regard to the destination of the services, making it impossible to exclude exported services.

The drawbacks to an additive-based VAT on intermediary loan services may be exaggerated. An important tax review in Australia suggested it would not be difficult to combine an additive-type VAT on these services with an effective zero-rating for supplies to registered businesses and exported supplies, measuring these using global methodology based on revenue from these two sources relative to total revenue.²⁰

2.3.6 Subtraction Method

Under the subtraction method VAT, the tax base is computed by determining the value of total sales and then subtracting the value of total purchases and expenses.

The application of the subtraction method VAT to financial services gives rise to a number of issues similar to those described in Sect. 2.3.5 above in respect of the additive method: its inconsistency with an invoice-based system, the difficulty in providing credits to business customers, and the difficulty of removing tax from exported supplies. A subtractive-based method proposed to be adopted in the Philippines was ultimately never implemented for these reasons, particularly the perceived difficulty in allocating the tax to business customers via tax invoices.²¹ The solutions suggested for an additive-type tax on financial services might work equally well for a subtractive-based tax. Once again, because there exists no precise method of allocating the financial margin to individual transactions, tax credits will need to be determined on the basis of an approximation formula. This raises the risk of tax cascading where these formulas provide relevant outcomes which are too low and no doubt complicates the application of the VAT, although compliance and administrative costs may well be less than those encountered in the current system of exemption.

2.3.7 Cash Flow Method

The cash flow method takes the financial inflows and outflows respectively to determine the tax base and the tax credit volume.²² This could be implemented relatively simply at an institutional level or in a more refined model through a tax

²⁰Australia's Future Tax System Review Panel (2009, Pt. 2, Vol. 2, pp. 309–310).

²¹Burns (2008, p. 356, n. 25).

²²Hoffman et al. (1987). Earlier, Meade (1978) discussed this approach in the context of a replacement of the corporate income tax.

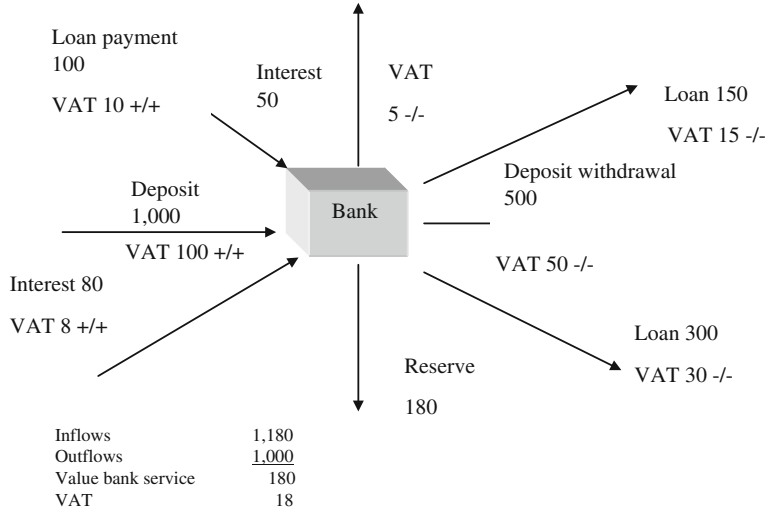


Fig. 2.2 Cash flow method

calculation account method that uses a ‘pure’ interest rate—the rate payable by the government on its bond borrowings—rather than the actual rates paid to depositors or charged to borrowers.²³ Under the simplest version, all cash inflows (e.g., deposits, interest received, loan repayments) are considered to be taxable sales and, therefore, tax must be remitted on these inflows. Tax outflows (e.g., expenses, deposit repayments and interest paid) are treated as business expenses, allowing for tax credits. The cash flow method is demonstrated for a bank in Fig. 2.2.

Loan repayments, deposits and interest received account for a total income of 1180 (inflows), whereas loans, interest paid and deposit withdrawals amount to 1000 of business expenses (outflows). Financial reservations made by the bank will be ignored for VAT purposes because they constitute neither an inflow nor an outflow of funds. The VAT payable can be calculated as VAT due on the inflows (118) minus VAT on outflows (100) = 18, which is exactly 10% (the statutory rate in our example) of the total value (1180 – 1000) = 180 of the bank’s services.

The cash flow method seems to be fully compatible with the credit-invoice method VAT. Tax cascading in relation to financial services will be eliminated under the cash flow method because registered businesses are eligible for tax credits regarding their outflows to financial institutions. No complicated formula of estimating the input-VAT credit for taxable customers is required as under the subtraction method VAT. The cash flow method is destination-based; no tax will be due regarding financial services rendered to foreign customers.

²³Poddar and English (1997). The system was endorsed by the recent Mirrlees Review in the UK; see Mirrlees et al. (2011, Chap. 8).

Problems may arise with introduction of the cash flow method and when tax rates change. Moreover, on its introduction, transitional rules will be needed to bring outstanding deposits and loans within the new system. Otherwise, a depositor would receive a tax credit on principal and interest when the funds are withdrawn despite never having paid tax on the cash inflows.

Business borrowers will be required to pay VAT on their outstanding debts and business lenders will receive a credit on their outstanding deposits. If the tax rate changes, adjustments need to be made. To operate accurately, the credit for a cash outflow should be at the same rate as that used for tax collection on the original cash inflow. In the case of a tax increase, borrowers will be required to pay an additional tax on their outstanding debts, including accrued interest, and lenders will receive an additional credit on outstanding deposits, also including accrued interest. In the rare case of a tax decrease, business lenders will be required to make restitution of an equivalent portion of their previously received credit, and business borrowers will receive an equivalent refund of tax paid. These adjustments would complicate the system and increase compliance and administrative costs.

This method also triggers a timing problem. When taking out a loan, a business would be required to pay tax that it would recover at a later time when the loan is repaid. As a result, the borrowing requirements would increase for the duration of the loan to finance the tax element associated with the loan. To mitigate this disadvantage the concept of 'Tax Collection Accounts' (TCAs) has been suggested, which are managed by the financial institutions. Essentially, the institution keeps a separate account for VAT purposes tracking tax due, regarding monetary inflows, and tax credits, regarding monetary outflows. In essence, a TCA is a tax suspension account that allows for a deferral of tax due on inflows and of tax credit payments by the government due on outflows. The tax payable and/or creditable is debited or credited, respectively, to the TCA and carried forward to the time when the capital transaction is reversed at which time the balance will be settled. The account would bear interest at the government borrowing rate. The TCA in the accounts of an individual business is the mirror image of the one held by the financial institution in relation to the same transaction. The TCA mechanism solves the cash flow issue through deferral of payments and compensates for losses or benefits resulting from the deferral period by indexing the outstanding balances by an interest rate. Transition issues can also be resolved through the TCA by initial debiting or crediting of outstanding balances at the time of introduction of the new system, and by adjusting outstanding balances in case of rate changes.

A particular point of interest is the case of cross-border financial transactions, for example, when businesses borrow and/or lend in different jurisdictions. In principle, a business will be drawn into the VAT system of every country where it is engaged in financial services. When borrowing, it would be required to pay VAT on its outstanding debt to the state in which the bank has residence; making deposits would give rise to a tax credit. This problem is avoided by simply zero-rating exchanges with non-residents. In other words, inflows from, and outflows to, non-residents are neither taxable nor creditable. Under the destination principle this makes perfect sense. It also enables financial institutions to operate in foreign

markets on a level playing field. For example, a bank would provide a loan to a foreign resident at a tax-exclusive interest rate.

Under the cash flow method, non-financial businesses would be required to conduct complicated calculations in order to exercise their right to input tax credits. Especially for smaller and medium-sized companies, this would constitute a significant additional administrative burden.

Conceptually, the cash flow method has been reviewed favourably in relation to the taxation of margin services because it fully removes cascading on financial services rendered to business customers and avoids complications in cross-border situations. It is however also perceived as very complex and as giving rise to significant compliance and administrative costs. For that reason, financial institutions have shown no enthusiasm for the system and, although it has been under consideration in the EU, it has not been adopted in any jurisdiction.

2.3.8 Modified Reverse Charge

All aspects of loans apart from the services of a financial intermediary are normally disregarded for VAT purposes—deposits, loans and interest are amounts that change the time of consumption but the payments do not in themselves involve any consumption. It is, however, possible to devise a VAT system that treats interest paid by and to an intermediary as if it were consideration for a supply and end up with a net tax accruing to the government equal to the tax that should be imposed on intermediary services only. The primary advantage of such a system, if it could be made workable, is that it could operate on a transaction-by-transaction basis, so as to be a system fully compatible with the invoice and credit system used for all other transactions in the VAT system.

A model along these lines faces an initial problem, however. Most depositors receiving interest payments are not registered for VAT purposes and could not, therefore, remit VAT on the interest they receive or issue tax invoices to the financial institution paying interest to them. A possible solution to this problem is a modified reverse charge system postulated by former International Monetary Fund economist Howell Zee.²⁴ Zee's proposed reverse charge system would shift the collection of the VAT on deposit interest from depositors to banks. In effect, a bank would account on its VAT return for the tax paid on its deposits and claim the same as a credit against its output tax due on loan interest collected from its borrowers, leaving the government with a net amount equal to the tax on the value of the bank's intermediary services. At the same time, it could issue VAT invoices to borrowers that are registered enterprises using borrowed funds in the course of their businesses so they could recover the VAT included in the interest they paid.

²⁴Zee (2005).

Table 2.1 Reverse charge on financial intermediary services to final consumer

Depositor	Bank	Borrower	Output Tax	Input Tax Credit
1,000 →	1,000 →	1,000		
50 ←	Interest		10	10
	100 ←	Interest	20	0/20
Total tax			20/0	

Assumptions Principle amount 1000, Deposit interest rate: 5%, Loan interest rate: 10%, VAT rate: 20%

The reverse charge method would work well with a destination-type VAT. Foreign deposits would be taxed under the reverse charge, as is the case with domestic deposits. Loans to non-residents would simply be zero-rated as exported services.

The application of the reverse charge to financial intermediary services is demonstrated in Table 2.1. The tax on deposits is accounted for by the bank under the reverse charge regardless of whether the depositor is a taxable business or a private consumer. The status of the depositor, therefore, is irrelevant in terms of tax burden because the bank will receive a tax credit for the same amount as the tax due on the deposit interest. However, the status of the borrower is relevant for determining whether the tax administration would effectively collect any tax. If the borrower is a taxable business, it will receive a credit for the tax paid on the loan interest equal to the tax paid and remitted to the taxing authorities by the bank. Only when the borrower is a final consumer, would tax accrue to the treasury.

A problem with applying a simple reverse charge method to financial intermediary services is that in effect the outcome is a tax on gross interest where it should be a tax on net interest. The total tax amount due by the borrower in the example in Table 2.1 is 20, which is equal to the statutory rate of 20% applied to the loan. The value of the intermediary service, however, is the margin between interest amounts paid and received and the tax burden should, therefore, be 10. This is immaterial for a borrower that is a taxable business because it will be able to recover the tax, but it is an issue, of course, when the borrower is a private consumer. Extending an invoice-credit VAT to deposit and loan interest will lead to the overtaxation of final consumers as bank borrowers.

To overcome this problem a mechanism is needed by which the reverse charge on depositors can be used to reduce the VAT that is actually paid by borrowers. This is accomplished in Zee's model with a modified form of the reverse charge that

uses ‘franking accounts’ to allocate an appropriate portion of the intermediary fee to depositors and lenders based on the relative value of their investment or borrowing, as the case may be. Once the fee is allocated in this manner, notional input credits provided to borrowers reduce their VAT so it is the correct amount for the value of the intermediary service they use. The system corrects the overtaxation of borrowers that would result from the use of a simplified reverse charge regime, but does so at the cost of some complexity and administrative burden. It remains to be seen how this might compare to the burdens resulting from the current system of exemption for these services. Also, even if registered depositors were able to receive tax invoices and recover VAT on services associated with their savings, unregistered depositors continue to bear tax on services that relate to savings, not consumption, unless exercising the choice to defer consumption is itself seen as a type of consumption.

2.4 Summary, Conclusions, and Policy Objectives

The most widely used system of applying VAT to loan intermediary services—treating the services as exempt or input taxed supplies—leads to results that are clearly inappropriate from a policy perspective. Unable to recover input tax credits, registered enterprises borrowing for business or investment purposes are overtaxed. Private consumers are undertaxed. Registered depositors are also overtaxed. Unregistered depositors may be under- or overtaxed, depending on whether the cost of using external services to shift the time of consumption is seen as a personal consumption choice.

Because loan intermediary fees are recovered by the service provider through a margin on all interest paid and received, it is difficult to allocate the fee to individual users of the service. Imposing tax on the overall value of the service determined using a subtractive method or additive method is not difficult but allocating the cost to individual users is more problematic. Without the allocation, undertaxation of final consumers is removed but overtaxation of business users is increased. Partial input tax credits across the board exacerbates the problem. Zero-rating services to registered businesses either explicitly, as in the New Zealand example, or implicitly by allowing the intermediary service provider to access input tax credits and attribute them to services provided to business customers, as in the Singapore example, solves the problem of overtaxing these customers. However, unless it is combined with additive or subtractive method taxation or a cash-flow model, undertaxation of final consumers remains.

As the chapters that follow show, examples of all the various parts of a theoretically ideal system that imposes VAT on loan intermediary services while relieving business customers of the tax have been adopted and successfully applied across the range of jurisdictions considered in this volume. However, no single jurisdiction has brought together all the parts that are needed to achieve the model VAT outcome. The principle impediment may not be technical. Rather, it may be a

simple practical budget constraint—the cost of relieving business from VAT on intermediary services is unlikely to be offset by additional VAT imposed on final consumers, and in a period of revenue shortfalls costly reforms are unlikely to attract the support of government.

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