THE VAT IN THE BANK SYSTEM

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Abstract

The bank system in the European Union plays an important role as a significant sector of the economy. Implementing in the last century -VAT exemption also for services performed by banks generates extra tax inflows, but decreases international competitiveness of this sector.
However, VAT is a perfect consumption tax, alternatives were created for banks' services taxation. As the paper shows, many of them are used in other then EU countries and provide smaller distortions in taxation.
The aim of this article is to shortly present the dominant model of VAT taxation in the EU with a particular reference to banks' services and describe an alternative method of taxating them. The analysis will also refer to introducing a new Financial Transaction Tax since 2014.

Keywords: VAT, Bank System, Taxation, Financial Transaction Tax

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1 Introduction

Implementation of the new financial tax within the European Union (EU), which has been imposed on the financial transaction (FTT) made by banks as a party or an intermediary for this transaction, compels to consider tax burdens levied on banks. In the EU, exemption from VAT adopted for financial transactions in bank system plays an important role in the calculation of total tax burden in bank sector. Since this model of taxation has been adopted, no important changes has been made. However, many countries around the world implemented VAT as an important turnover tax, yet different models of bank system's taxation have been implemented.

This article presents the model of bank system's taxation in the EU in the perspective of the newly introduced FTT and describes an alternative structure of taxation, which this sector has adopted in other countries. Finally, there is the reflection on changing the current system of taxation.

2 Method of VAT taxation in the EU

The value added tax is one of the turnover and also consumption taxes settled with the net method. It has been adopted in the EU countries and then spread around the world. Nowadays, more than 150 countries have adopted this tax and only a few industrialized countries refused to do so (e.g. United States) [Owens, Charlet, 2011]. The alternative is still the General Consumption Tax calculated with the gross method. The differences between those two calculation methods are presented in Tables 1 and 2.

As tables present, assumptions are as follow: (i) there are five stages of turnover, (ii) the nominal tax rate is always 10% and covers every sale, irrespective of the turnover, (iii) and in the net method the taxpayer has full right to deduct the input tax with the output tax. In the gross method, however, the nominal rate is 10%, average participation of the tax in the final price to consumer amounts to approx. 40%. This is the consequence of the so-called "tax cascade", which compels the calculation of tax burden at every stage from, as well as the value added but also from previously added tax. There are only three methods of preventing this cascade: (i) merge of entrepreneurs from adjoining stages of turnover, (ii) imposing a tax burden only for one stage and (iii) improvement of the net calculation in the form of VAT.

The credit method, on which the EU VAT is calculated, splits the price and tax accounting. Therefore, the tax (output tax) is always calculated on the net value of the price. The input tax, which may be deducted from the output tax, is a kind of a "credit" at the moment of acquiring a good or a service. The buyer pays all the price and after this the input tax may return in form of a deduction from the output tax (indirect method) or from the tax authorities (direct method). Finally, only the difference between the net value of purchase and the net value of sale are taxed (the value added at a given stage). Thus, the total sum of the paid tax at 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 (i) all taxpayers have the possibility to fully deduct the input tax with the output tax and (ii) the whole invoice with the output tax has been paid.

Table 1. The gross calculation of turnover tax

(1) The stage of the turnover	(2) Net price	(3) Value added in the turnover	(4) Gross price (10%)	(7) The tax to pay
l stage Taxpayer A	100	100	110	10
Il stage Taxpayer B	210	100	231	21
lII stage Taxpayer C	331	100	364.1	33.1
lV stage Taxpayer D	414.1	50	455.51	41.41
V stage Taxpayer E	505.51	50	556.06	50.55
TOTAL		**400**		**156.06**

Source: H. Litwińczuk, P. Karwat, Opodatkowanie przedsiębiorców w Polsce, vol. II, p. 22

Table 2. The calculation of turnover tax with the net method

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

Source: H. Litwińczuk, P. Karwat, Opodatkowanie przedsiębiorców w Polsce, vol. II, p. 23

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.

3 Consequences of exemption in the credit-invoice method

If the normal tax rate was to be imposed on banks' services, the final cost would be raised only for the consumers. However, there would be a problem with defining the tax base, as it is hard to determine what the added value in many services is. 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 bank's provision. Apart from this aspect, in order to minimize the consumer cost instead of tax rate, exemption has been implemented. The tax calculation, where one of the intermediate stages is exempted, is shown in Table 3.

At the exemption stage, it is impossible to deduct the input tax as there is no link between the 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 168 of the Directive, 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, they may either cover the input tax with their profit margin or include this value as an element of cost, and finally raise the net value. Table 3 shows the second method, because it is almost impossible in practice to decrease the margin by e.g. 23 % (temporary main VAT tax rate in Poland).

Table 3. The consequence of 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**
l stage Taxpayer A	100	100	110	–	10	10
Il stage Taxpayer B	**Exemption** 210	100		–	–	–
lII stage Taxpayer C	310	100	341	–	31	31
lV stage Taxpayer D	360	50	396	31	36	5
V stage Taxpayer E	410	50	451	36	41	5
TOTAL		**400**				**51**

Source: H. Litwińczuk, P. Karwat, Opodatkowanie przedsiębiorców w Polsce, vol. II, p. 24

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 sale with 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. They add 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 is paid at all stages, where the sum of value added was only 400 [u]. As Table 2 shows, the tax shall only amount to 40 [u].

The bank sector in Poland during 2008 could not deduct approx. 2.2 billion PLN.[1] In the same period, the gross profit of the bank system amounted to 9.7 billion PLN. It means that the possibility of a fully deducted by the banks input tax 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. In EU similar researches were provided and the net loss was estimated as a 0.15% of GDP, which for all EU countries in 2000 translated into approx. 20 billion EUR (Huizinga, 2002).

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

4 Alternative methods of bank system's taxation

The invoice-credit method with exemption of bank's services described earlier dominates in the EU-countries. It is not only associated with the EU legislation, but in the past many countries used this method of calculation 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 had many modifications, which allow minimizing the economic distortions. The most common are [Poddar 2003]:

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

(I) *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].

In 2011, there was a report prepared and published by PwC and prof. Lockwood [Report, 2011], in which this option was proposed for a broader use in other EU countries. Also, the method of proportionally deducting the input VAT was proposed (at the level of 21%). In conclusion, it was assumed there that the changes in the bank's taxation may cause a diminishment of the tax return for the budget. Finally, other UE countries, e.g. Poland, because of the economic slowdown, refuse up to now to implement any changes.

(II) *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. This calculation is important for those banks, which deal with advising or asset management (investment banks). In this model, transactions are taxed with normal tax rates, where the other services are exempted. For the bank, which

[1] The main dates of bank sector in 2008, 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.

plays the role of a provider for the transaction, this method allows deducting at least a part of the input tax, which is associated with the taxed sale.

The most problematic in this method is the proper tax base calculation. The transaction-by-transaction procedure must be adopted and the revenue and costs of every transaction shall be calculated. Thus, in practice, high compliance costs are generated. This model was adopted in Italy in 1997 and it is referred to as an income form of VAT [Schenk, Oldman, 2007].

(III) *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 the normal rate. For example, this method covers all the services performed by insurance agents or brokerage. All other financial services are exempted.

(IV) The *New Zealand system* taxes only selected financial services. The exemption method is valid, but does not refer to e.g. selling of life insurances. This system differentiates the taxation of financial services and for the group of them bank's may adopt a zero rating tax [Lang, Metz, Kristoffersson, 2009]. In terms of other financial services, this system is similar to the EU invoice-credit method.

(V) *Exemption with input credits* is a method where 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 the normal tax rate or the 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.

(VI) 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 forms of input credits. This system also has an inland definition of financial service, a fact which is reflected in the scope of taxation.

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

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

(1) The cash flow system reflects the necessity of looking for a new solution in 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 flow 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 single 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.
- Detailed registration of all transactions for tax purposes may be burdensome for both financial institutions and the tax authorities.

(2) 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 payments and cash flows associated with a certain transaction. The suspensions of tax clearance allow for a precise determination of the tax base for the transaction, regardless of any tax rate changes. This system embraces the principal and marginal payments for the financial institution. When the consideration is in a form of a fee or commission, it is taxed directly.

(3) *TCA with zero-rating* is an alternative, which implements a zero tax rate in a 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.

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

5 VAT exemption and new Tax proposals in the EU

The described above VAT credit method with exemption imposes significant tax burden for the banks system. The proposed option of taxation with rates for the B2B transaction has not been commonly adopted. Nevertheless, the new Financial Transaction Tax (Directive 2008/7/EC, the Council Directive on a common system of Financial Transaction Tax) has been adopted and will be valid since 2014 in most of the EU countries.

This tax generates an extra charge and increases the global tax amount paid by the banks from the EU countries. Except the option method, no other alternatives have been introduced within the VAT system in the EU. FTT seems to be complementary to VAT and charges directly the profit of selling shares, bonds and derivatives by banks.

Many negative consequences were listed due to implementing FTT [van der Paardt, 2012], including shifting the transaction centers outside the EU. It is worth to say, that for those investment banks, which operate in London or Frankfurt, it is temporarily quite easy to change the office. It may result in a decrease in the financial sector in the EU.

6 Conclusions

During the last century, VAT has been invented and since then it has spread around the globe. However, the dominant credit-invoice method is suitable for goods trading; financial services are harder to tax. Thus, many countries modified this method or implemented a new one, aiming at decreasing the tax burden for those, who perform business. It must be remembered, that VAT shall be charged only to consumers, not the goods or service providers.

In the EU countries, although many analyses have been prepared, VAT exemption still prevails. It is worth to say, that alternative method of bank's system taxation works in practice and this experiences may be used in the EU. So far there were no analyses made in this direction.

Recently implemented FTT only raises the global tax burden. The lack of reform in the taxation of the bank sector (or broader: financial transactions) may lead to a decrease in this part of economy and deepen the slowdown.

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