



CONFIDENTIAL

GST Applicability to the Financial Services Sector in Canada

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1 Executive Summary

The overall objective of this report is to identify possible alternatives to the current application of GST to financial services in Canada. Ideally, the alternatives considered are to be:

- revenue neutral;
- administratively easier and more efficient from a tax collection perspective;
- less distortionary on business incentives / structure;
- supportive of savings and optimal capital flows across the nation; and
- do not discriminate across financial services.

This will be accomplished by considering how other jurisdictions apply VAT¹ to financial services as well as theoretical approaches that have not been implemented to date. In addition, the alternatives will be evaluated regarding the potential impact to Canadian financial service providers.

More than 140 countries around the world have adopted a VAT for a variety of economic, budgetary and developmental reasons. The primary purpose of a VAT is to tax consumption. A VAT is thought to do so in an economically efficient manner and is generally thought to impose less economic costs than taxing income. A VAT can be described as a multi-stage, credit-offset consumption tax. That is to say that while the tax applies at each stage of the production chain, a credit is given for tax paid on inputs to all intermediate stages. The goal of a VAT is to ensure that only the value of final consumption is taxed.²

The general international practice is to include financial services within the VAT regime. The preferred view is that consumer³ expenditure on financial intermediation services is consumption that is properly part of the tax base. However, applying this principle in practice has been contentious and incomplete.

Often, charges for financial services are buried in margins, and fees can also be embedded in the purchase prices of financial products, instead of being explicitly charged. In such cases, it is difficult to identify and value the services on a transaction-by-transaction basis for the purpose of applying the multi-stage, credit-offset VAT. Thus, both margin-based and most explicit fee-based financial services are exempt from taxation in most countries having a VAT.

It is important to emphasize the overall effect is that most VAT systems do not tax the wages and profit of the financial intermediary but rather tax, at the standard VAT rate, the taxable resources consumed by the financial services provider. In effect, financial intermediation is treated as final consumption. As a result the business consumption of financial services is overtaxed by the amount of VAT that is embedded in the supply and cannot be recovered. Further, consumption of financial services by final consumers is under taxed because there is no VAT applied to the value added by

¹ Throughout this report we refer to VAT when discussing the international framework of value added taxes but GST where we discuss the particular VAT regimes that refer to the tax as GST.

² A VAT should not distort the choice between present and future consumption.

³ The term “consumers” is used for any end user that is not eligible for any input tax recovery.

the financial intermediary, which is generally represented by the wages and profit embedded in the supply.

The inefficiencies of the exemption are many and include:

- Under taxation of business-to-consumer (“B2C”) transactions and substitution;
- Over taxation of business to business (“B2B”) transactions, cascade and/or under investment;
- Self-supply bias (or a bias against outsourcing);
- Advantage to offshore suppliers of financial services;
- Advantage to offshore provider to financial intermediaries;
- Compliance and complexity; and
- Definitional and characterization disputes regarding “financial services”.

These inefficiencies are described in more detail in section 4.4.1.2 of the report.

In response, most countries apply an exemption to financial intermediation services, albeit with different scope (i.e., narrow vs. broad). In this regard there are various options and approaches to be considered:

- **Broad Base Exemption – Canada** employs a relatively broad base exemption approach, albeit not as broad as the EU. The Canadian system gives rise to the many problems outlined above. The Canadian system offers some relieving mechanisms to suppliers of financial services, such as a form of VAT grouping under section 150, but has not substantively reviewed or considered the underlying tax policy since the GST was introduced in 1991. It is arguable that many of the outlined problems and complexities are further exacerbated as a result of the introduction of the Harmonized Sales Tax (“HST”). Differing rates in different provincial jurisdictions demands the use of complicated formulas with a resulting increased compliance and administrative burden.⁴ Of note, investment funds suffer a significant GST/HST burden due to the fact that investment plans by and large pay GST/HST on all of their inputs, which can differ from other types of investment products (i.e., GIC’s). Many other VAT jurisdictions have introduced specific measures to ensure that direct investment in securities and investment through undertakings for collective investment is fiscally neutral.
- **Broad Base Exemption – The European Union (“EU”)** has a broad base exemption that seeks to minimize the distortion between types of financial services by applying exempt treatment to an expansive definition of financial services. The objective of this approach is to maximize neutrality across the financial services sector by reducing distortions between the consumption of different financial services. The EU applies this principle even where it may be possible to apply full VAT treatment to a particular financial service. This provides neutrality within the sector but at the expense of efficiency as it spreads the exemption throughout the supply chain.⁵

⁴ An illustrative point would be the investment funds sector where as of July 1, 2010 investment plans, including pension plans, mutual fund trusts, etc., are required to file GST/HST returns and do a formulaic HST calculation.

⁵ Where an exemption spreads throughout the supply chain, more providers of services will face the complexity of allocating between taxable and exempt supplies.

The cascade is inherent, although it can be coupled with an option to tax a financial service. An option to tax does not eliminate all embedded tax but offers flexibility. There are issues for margin vs. fee based services and the risk of substitution. There is also uncertainty and complexity under the system as there is constant pressure to expand the scope of exemption. Additionally, cost sharing and VAT grouping can be introduced to address the self-supply bias and minimize both compliance and administration. The broad exemption on a wide array of financial services and services consumed by financial institutions does seek to minimize the amount of input tax (i.e., labour and profit) borne by that sector.

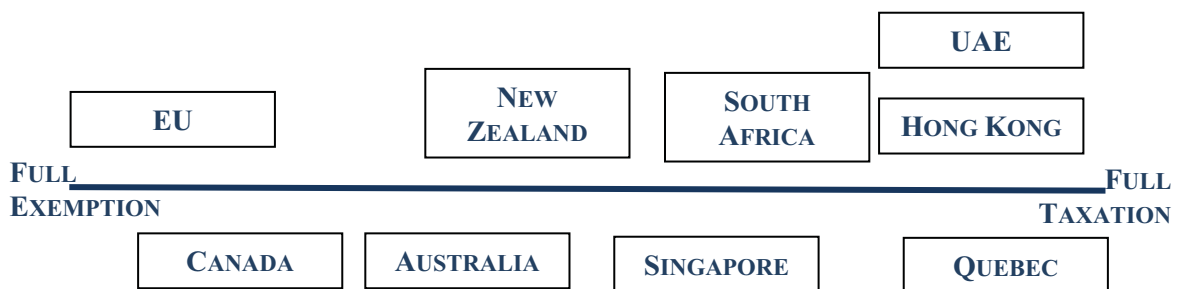
- **Narrow Exemption: RITC – Australia’s GST** has a narrower exemption. For example, the arranging or negotiating of a financial transaction by a facilitator and the supply of non-life insurance is subject to GST. However, many of the items that are contained in the broader exemption in other countries are subject to a special input tax credit regime. As a result, while the supply acquired by the financial services supplier is not exempt, limited input tax credits – 75% – are allowed to the supplier to alleviate the full impact of the GST. These two approaches operate together to tax the resources consumed in financial intermediation. The approach addresses the self-supply bias (i.e., outsourcing vs. in-house services) but does not focus on the cascade per se. Consumers pay more tax overall.
- **Narrow Exemption: Special Deduction Regime – Singapore** has a narrow GST exemption and has introduced a regime whereby financial service providers under the supervision of the Monetary Authority of Singapore are able to claim a fixed percentage of total input tax credits. The percentages are allocated according to the type of financial institutions and reflect an allowance for B2B relief. The percentages range from 43% to 96% and are implemented via regulation. The compliance costs of this approach are low but its application across the broader financial services sector is limited; that is, insurance and funds are excluded. There is a remission order which states that qualifying funds managed by prescribed fund managers will recover a substantial portion⁶ of GST incurred on prescribed expenses (i.e., management, trustee and fund administration fees). To the extent the financial services provider is making B2B supplies the self-supply bias and cascade are somewhat addressed.
- **Broad Base Exemption: B2B Relief via Legislation – In 2005**, the New Zealand government changed the treatment of financial services between GST registered entities from exempt to zero-rated. The zero-rating applies where the supply of financial services is made by a registered person to another registered person who has the predominant activity of making taxable supplies. In essence, the New Zealand B2B zero-rating rules allow an additional input tax deduction to a financial service provider by reference to the taxable status of the recipients of its financial supplies. These rules were implemented to address the fact that tax cascading over taxes financial services in B2B transactions compared to other goods and services and that a core principle of a VAT is that tax should not apply to B2B transactions.
- **Taxation of Insurance – A number countries reviewed for this report tax non-life insurance.** Insurance other than life has been successfully taxed in Australia, Singapore, South Africa and New Zealand. Life insurance is not taxed due to the savings element but, arguably, the risk component of group life policies could be subjected to VAT, but this has not yet been

⁶ The rate in 2009 was 93%.

addressed. To ensure that only the margin between premiums and payout is subject the GST, a special input tax deduction for payments made under a contract of insurance is available.

- **Zero-Rating:** The Province of Quebec zero-rates most financial services with the result that financial service providers receive a refund of the tax paid on inputs and a compensatory tax is applied to make up for the revenue shortfall. Hong Kong looked at applying a full zero-rate to the financial services sector before stepping back from the implementation of a VAT. The Gulf States are considering this approach. Zero-rating financial services could improve international competitiveness and offers efficiencies from a compliance and administrative point of view. A broad zero-rate would have a cost in terms of government revenues unless it is combined with an alternate revenue raising measure (i.e., a compensatory tax).
- **Other Regimes –** There are other examples of different approaches to dealing with financial services under a VAT. South Africa applies VAT to almost all explicit fees and non-life insurance. As a result more VAT revenue is collected and more input deduction is recovered by suppliers.
- **Theoretical models –** There have also been VAT models designed but not yet introduced in any jurisdiction. In the late 1980's Canada considered a Margin Tax to be applied on a financial institution's tax base that included explicit fees charged for financial services, as well as financial margins. The European Commission investigated a Comprehensive Cash Flow which was designed specifically to overcome the problem of identifying the margin bundled into the interest rate on financial services. The model was developed by Satya Poddar with the objective of replicating how full VAT taxation would apply to financial services through the use of a cash flow accounting model. Finally, Tim Edgar has proposed a hybrid model that seeks to fully tax financial intermediation applicable to consumers only by charging VAT on explicit fees and use a cash flow methodology where a margin is charged. However, all of the above have complexities and neutral application across the financial sector would be a challenge.

The following diagram depicts where the various VAT countries fall on the exemption/taxation continuum:⁷



From an overall trend perspective partial reforms of an exemption model have tended to be preferred as a means to address the issues of applying a VAT to the financial services sector. The

⁷ This diagram is also available in Appendix G.

focus appears to be on mechanisms to address the application of VAT to financial services providers rather than addressing the stated goal of taxing final consumption.

The options discussed in this report can have differing application to the various sectors of the financial services marketplace. In this regard, in many instances the implications of an option may treat some sectors more advantageously than others.

It is also important to recognize that many of the options for reform come with a revenue cost to governments that may require additional revenue raising measures. This additional cost could be borne by the sector or consumers. Options include another form of tax (i.e., the compensatory tax in Quebec) or simply by narrowing the exemption and subjecting consumers to VAT on many financial services that currently are VAT exempt.

Finally, it must be acknowledged that there is very little empirical data on the overall impact of the Canadian GST regime to the financial service sector in the wider Canadian economy and this will undoubtedly pose a challenge for any discussion of GST policy.

2 Introduction

This report has been prepared at the request of Canadian Bankers Association, Canada Life and Health Insurance Association, Credit Union Central of Canada, Insurance Bureau of Canada, Investment Industry Association of Canada, and The Investment Funds Industry of Canada (collectively referred to as the “Associations”). The Associations jointly sponsored a tax study that considers the GST Applicability to the Financial Services Sector in Canada.

The overall objectives of this study are:

- Identify possible alternatives to the current application of the GST to the financial services sector.
- Provide insight into how other jurisdictions have applied a value added tax to their financial services sector, highlighting relevant best practices.
- Present a series of areas for consideration, as well as estimates of the financial costs and any industry specific implications of each.

Specifically, the scope of this report addresses the following:

- Assess the existing system and identify areas where the current approach may not be optimal and where the current approach is working well;
- Review practices of other countries that have a VAT regime and areas pertaining to the VAT that are now under review; and
- Recommend areas that the Associations can explore to improve the system, highlighting different impacts by industry of options examined.

Given the Canadian experience with GST within the financial services sector over the last 20 years it is reasonable to conclude that an overall review and evaluation of the system is warranted. With 20 years of experience with broad based exemption in Canada, as well as extensive experience in numerous other countries with value added tax systems, the lessons learned should springboard discussion, ideas, and options for the future of the applicability of GST to the financial services sector in Canada.

In Chapter 1, under Sales Tax Reform in the 1987 White Paper, the principles of a good sales tax were outlined by the Department of Finance as follows:

A reformed sales tax system – a system that will better serve all Canadians – should be based on three fundamental principles.

- It should support the **growth** and **efficiency** of the economy.
- It should be **fair**, both to individuals and families and its application to sectors and firms across the economy.
- It should **minimize compliance costs** for business and **administrative costs** for the government. [Emphasis not KPMG]

Arguably these criteria have stood the test of time. Generally speaking, the exempt treatment of financial services does not meet these criteria. Where the ultimate goal is to support economic growth and efficiency, fairness, the minimization of compliance and administrative costs to both business and government, no tax system should be beyond reproach and no option should be left unexplored. This is the focus of this report.

The balance of this report is broken out into seven sections followed various appendices. These sections are as follows:

- Principles and Objective of a VAT;
- VAT in the Financial Services Sector – The Problem;
- The Canadian Experience;
- Reactions to Exemption / Solutions;
- Incidence of VAT in the Financial Services Sector;
- Model Costing; and
- Conclusions.

The Reactions to Exemption / Solutions includes the broad base exemption model in the EU, the narrow exemption with RITC in place in Australia, the special deduction regime in Singapore, the B2B relief offered in New Zealand, as well as various partial and full taxation models.

3 Principles and Objective of a VAT

The purpose of this section is to consider the principles and objective of VAT to assist in understanding how financial services should be treated. In the course of doing so, the rationale behind a VAT and its impact on the economy will be considered.

Please see Appendix E for a list and definition of VAT principles and guidelines.

3.1 Why a VAT on Consumption

The OECD has described the adoption of VAT as, "...the most important development in taxation over the last half-century."⁸

The more than 140 countries that have adopted a VAT have done so for a variety of economic, budgetary and developmental reasons. These reasons include:

- by only taxing the 'value added' and providing a credit for taxes paid at intermediate stages of production, it avoids the cascading effect of turnover taxes and intermediate sales taxes;
- a VAT provides a stable, growing source of revenue for governments;
- in developed economies, a VAT has allowed a shift in the composition of tax revenues, reducing reliance on income taxes in favor of consumption taxes;
- by taxing consumption and not savings or investment, a VAT does not distort decisions between saving and consuming;
- in integrated trade regions such as the EU⁹, adoption of uniform VAT regimes eliminated potential trade distortions from embedded non-creditable domestic taxes; and
- through its credit-offset mechanism and the adoption of a "destination principle" of taxation, exports are free of tax at the point of production and imports are taxed in the same way as domestic production. In this way, VAT assists locally produced goods and services to compete in international markets.

Professor Schenk has described the rationale for a VAT this way:

The Value Added Tax is intended to tax personal consumption expenditure comprehensively, neutrally, and efficiently.¹⁰

⁸ OECD, *International VAT/GST Guidelines* (February 2006) at 1.

⁹ The form of the value added tax that operates in Europe is determined by the European Union – Council Directive 2006/112/EC – 28 November 2006 ("the Revised 6th Directive"). Originally, the EU members were required to conform with the "Sixth Council Directive of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes—common system of value added tax: uniform basis of assessment (77/388/EEC)" - referred to as "the 6th Directive". These Directives set the rules which each of the member states of the European Community must enact in their domestic VAT law.

¹⁰ Schenk, A. & Oldman, O., *Value Added Tax – A Comparative Approach* (Cambridge University Press, 2007) (Schenk, 2007).

Understanding each of the components of this statement of intent is essential to the design of a VAT. Without each of the components being reflected in the design of a VAT, the advantages of a VAT as a consumption tax will not be achieved.

3.2 Taxing Personal Consumption Expenditure

While there is much focus on the concept of taxing value added under a VAT, this is not the primary purpose of a VAT. Its primary purpose is to tax consumption.¹¹ Specifically, the tax base is domestic final personal consumption expenditure which does not include:

- savings or investment;
- consumption of resources for the purpose of business or government activity;
- consumption of goods and services outside of the jurisdiction; and
- business consumption of goods and services.

The primary purpose for the taxation of consumption expenditure is one of economic efficiency. In this sense, economic efficiency is maximizing production of goods and services with minimal economic costs to the economy.

With few exceptions, the imposition of taxation reduces economic efficiency by causing individuals and businesses to make different decisions to what they would make in the absence of taxation. By altering behavior, the imposition of taxation raises the risk that resources in an economy will be allocated, not according to their most valued use, but by their relative tax burdens.

Income taxes impose economic costs by altering the decisions of businesses and consumers to work and save. Conversely, consumption taxes, which may affect decisions as to which goods and services to consume, have a less direct impact on working and saving.

As noted above, a shift in the composition of taxation revenue from income tax to consumption taxes is sometimes cited as a reason for the introduction of a VAT; that is, the introduction of a VAT may result in taxes on income being lower than what they would have been in the absence of a VAT. The lower the tax rates on income, the lower the efficiency costs on the economy.

The intention of a VAT is therefore to tax only those goods and services that enter into the final consumption decisions of consumers. In the area of financial services, for example, there are alternative views as to whether financial services are in fact consumption. One view holds that a financial service changes the timing of final consumption decisions, but does not represent final consumption itself.

¹¹ Ebrill, L *et al.*, *The Modern VAT* (Washington: IMF, 2001) (Ebrill, 2001).

3.2.1 Comprehensively, Neutrally, and Efficiently

While a consumption tax may not have the same direct economic costs on working and saving as an income tax, a poorly designed consumption tax can also impose efficiency costs on the economy. Conversely, a well designed VAT tax will minimize these efficiency costs.

The efficiency costs of a VAT will be minimized when the VAT minimizes the incentives for consumers to change their consumption decisions on the basis of the VAT. This will occur when the VAT is:

- comprehensive – it is applied to the broadest range of goods and services possible;
- neutral – goods and services are taxed on the same basis; and
- efficient – the tax is designed to minimize changes in consumption decisions.

The extent to which these objectives are achieved varies from country to country. Some countries apply VAT to a very wide consumption base (e.g., New Zealand). However, most countries choose to exclude some items from the scope of their VAT for policy and practical reasons.¹² Unless there are sound policy reasons to exclude them, goods and services that are part of final consumption should be part of the VAT base.

The benefits of a comprehensive base will not be realized unless the VAT is applied equally across all goods and services. Neutrality of tax treatment requires:

- the same concept or value of consumption is applied equally across all goods and services;
- goods and services to be taxed at a single uniform rate, or with a minimal number of rates¹³; and
- all goods and services only bear the effect of the VAT once – at the point of final consumption.

It is this last point that embodies the concept of “value added” in the VAT.

A traditional VAT is described as a multi-stage, credit-offset consumption tax. While the tax applies at each stage of the production chain, a credit is given for tax paid on inputs to all intermediate stages, to ensure that only the value of final consumption is taxed.

A VAT should only apply to the price of final consumption, which is the equivalent of the sum total of the components of value added at each stage of production and distribution.

As will be explored in this report, achieving these objectives is not always straightforward. In the area of financial services there remain many unresolved issues to achieve comprehensive, neutral and efficient tax treatment. As a consequence, careful consideration must be given to designing the treatment of financial services if the objective of the VAT is to be achieved.

¹² Examples of items that are exempted for practical reasons are residential rents and financial services. In many countries basic food is zero-rated to address perceived regressivity of a flat rate uniform VAT on consumption expenditure.

¹³ It is arguable that goods and services that are price inelastic can be taxed at higher rates than those where price elasticity is high. In these cases it is contended that the price distortion created by the higher VAT will not distort the choice of what to consume.

3.2.2 Calculating the Value Added

Central to a broad based consumption tax being neutral in its effects on consumer behavior is that it should apply to a broad measure of consumer expenditure. When the goods and services are purchased by a consumer, it is the price paid by the consumer that is the consumption tax base for the VAT.

The value added can be measured in two ways, either an additive or subtractive approach:

- Under the additive method, the direct components of value that are added in the production process are summed to provide the tax base. These components of value added are:

$$\text{value added} = \text{wages} + \text{profits}$$

Tax may be applied to either the individual components of the value added or the combined total.

- Under the subtractive method, value added is calculated as the difference between outputs and inputs:

$$\text{value added} = \text{outputs} - \text{non-wage inputs}$$

A multi-stage, credit-offset VAT follows the subtractive method. The tax paid is calculated as the tax paid on outputs less the tax paid on inputs:

$$\text{VAT} = (\text{tax on outputs}) - (\text{tax on inputs})$$

Even though the subtractive method only represents an approximation of the value added, it remains the most common method for calculating the VAT tax base. This is because the subtractive method, in combination with a credit-offset system¹⁴:

- allows the tax liability to be attached to each transaction, “making it legally and technically ... superior”;
- creates an audit trail; and
- is better suited to multiple (including zero) rates.

Significantly, for present purposes, the above formulation excludes savings and investment. Savings (and return on savings) are taxed as consumption when used to purchase goods and services.

While the subtractive method works well for most industry sectors it does not work well for financial services. This is because, for some financial services, the subtraction of non-wage inputs from outputs (depending on how it is defined) will not give a true measure of value added.

¹⁴ Tait, A., *Value Added Tax, International Practice and Problems* (IMF, 1998) at 4.

4 VAT in the FS Sector – The Problem

The first section explored the principles and objective of a VAT and highlighted the importance of VAT applying comprehensively and efficiently. This next section will consider the particular problem of levying VAT to the financial services sector and include a discussion on the particular problems and resultant implications.

4.1 Defining Consumption of Financial Services– Financial Intermediation

As stated previously, the purpose of a VAT is to only tax consumption expenditure. While international practice is to include the consumption of financial services in the VAT base, there are different views among tax academics as to whether financial services – in principle – should be subject to a broad-based consumption tax.¹⁵

Consumers have the choice of either spending their income in the present – on which they will pay VAT – or deferring consumption to a future period, through the process of saving. If consumption is deferred and saving takes place, VAT should be paid at the point of consumption in the future.

Consistent with the general principles of consumption taxation, a VAT should not distort the decisions of consumers as to whether they consume in the present or save and undertake consumption in the future. At its basic level this means that the return on savings¹⁶ – the actual compensation to lenders or investors for deferring consumption – should not be subject to VAT.

However, as the process of saving requires a financial intermediary to connect diverse and unrelated financial institutions or investors and customers seeking finance, there remains some debate as to whether financial intermediation services (i.e., the services required to facilitate saving) should be an activity subject to VAT. In other words, if an objective of a VAT is not to distort the act of saving for future consumption, it is argued that the services which facilitate saving should also be excluded from the VAT.

The preferred view is that the value of financial intermediation services is consumption expenditure that is properly part of the consumption tax base.

Prior to proceeding with an examination of the VAT treatment of financial intermediation services it is important to note that there is a distinction:

between the acquisition and holding of financial instruments and the intermediation or market making function on the other hand. It is this intermediation service, along with the associated charge, that is the proper target of any definition of financial services. The acquisition and holding of financial

¹⁵ Burns, L., *Consumption Taxation of Supplies of Financial Services in the Asia Pacific Region*, Asia Tax Forum, August 2008 at 20 (Burns 2008); Edgar, T., *The Search for Alternatives to Exempt Treatment*, GST in Retrospect and Prospect, 2007 at 136-141 (Edgar 2007); New Zealand Internal Revenue Department (New Zealand IRD) *GST & financial services, A government discussion document*, Policy Advice Division of the Inland Revenue Department of New Zealand, October 2002 at 15 (New Zealand IRD, 2002).

¹⁶ For example, interest on loans or an increase in the value of investments or pensions.

instruments in all other circumstances is a function of the savings decision and should be characterized as a non-taxable transaction under VAT.¹⁷

While the principle of only taxing financial intermediation is generally accepted, applying this principle in practice has been contentious and incomplete. The reasons for this being so are outlined below.

4.2 What are Financial Intermediation Services?

Financial intermediation services include the following:

- deposit-taking intermediation;
- risk-taking intermediation; and
- brokerage services.¹⁸

It is important to note that non-core services are often included within the description of incidental financial services, such as:

- administrative and cash management services; and
- agency and advisory services.¹⁹

Services that are generally classified as incidental to financial intermediation include “the operation and maintenance of accounts, data processing, clearing and settlement services, general accounting and record-keeping services, custodial services and trustee administration.”

Professor Edgar²⁰ comments that the function of intermediation is to facilitate:

- inter-temporal shifting of consumption through deposit-taking intermediation;
- transactions in commodities, currencies; and/or debt and equity securities through brokerage; and
- shifts in consumption from good to bad states through risk-taking intermediation (the insurance function).

An examination of the legislative schemes in the EU, Canada and New Zealand shows that the definition of exempt financial services, broadly, includes the type of categories of intermediation referred to above, incidental financial intermediation services and arranging, granting and dealing in:

- insurance and reinsurance transactions, including underwriting of securities;
- credit facilities;

¹⁷ Edgar, 2007, fn 44.

¹⁸ Annex A.

¹⁹ Edgar, 2007 at 152.

²⁰ Edgar, 2007 at 133.

- credit guarantees or any other security for money;
- deposit and current accounts, payments, transfers, debts, cheques and other negotiable instruments;
- exchange of currency, bank notes and coins used as legal tender;
- interests in companies or associations, debentures and other securities;
- superannuation and pension schemes and the management of special investment funds; and
- derivatives.²¹

Please see Appendix D for a breakdown by jurisdiction of the GST/VAT application to financial services.

4.3 Taxing Financial Intermediation – The Problems

The correct application of VAT to financial intermediation is summarized in the following observation by Professor Edgar²²:

When interest is not taxed under a VAT, the tax does not distort the savings residual.

The principle of taxing financial intermediation services – and not interest – has proved easier said than done. The application of this principle would be relatively simple if the interest rate charged by a borrower reflected only the actual compensation required by the lender for deferring consumption decisions. In practice, this is not the case.

The interest rate charged on borrowings is not a ‘pure’ interest rate in most cases. Typically, the interest rate charged on money borrowed by financial institutions comprises two components:

- the pure or real interest rate required to compensate consumers for inter-temporal consumption; and
- a margin²³ to cover the costs of financial intermediation – connecting borrowers and lenders.

The first component should be excluded from the VAT base. The second component should be fully taxable under a VAT.²⁴ The bundling of both these components into a single interest rate has meant that in no country with a VAT are financial services subject to full taxation (as is the case with most other goods and services).

²¹ In some cases, derivative transactions perform a ‘risk-taking’ intermediation role and should be treated in the same manner as the underlying risk. This illustrates the difficulty in distinguishing between exempt and taxable services where transactions involve taking up rights in relation to underlying commodities.

²² Edgar, 2007 at 140.

²³ The margin includes a premium for risks incurred by the intermediary (i.e., credit risk, market risk, interest rate risk, etc.).

²⁴ The non-wage component of these costs is taxed under an exemption.

This is not because of an inability to identify the margin attributable to financial intermediation for a particular financial service provider. This can be calculated in an aggregate for a financial institution using a cash flow base. The difficulty arises in attributing the aggregate margin to individual financial services provided to customers.

This rationale is summarized by Professor Joosung Jun in the following terms²⁵:

Often, charges for financial services are buried in margins, such as the differences between interest on loans and deposits or between the rates for buying and selling of foreign currencies. Fees can also be included in the purchase prices of financial products, instead of being explicitly charged as fees. In such cases, it is difficult to identify and value the services on a transaction-by-transaction basis for the purpose of applying the credit-offset VAT.²⁶

For such administrative reasons, financial services provided for margin-based and other implicit charges are mostly treated as exempt supplies under the VAT. Furthermore, even most explicit fee-based financial services are exempt from taxation in most countries having a VAT. This is because financial institutions may otherwise have incentive to substitute margin-based charges for explicit fees.²⁷ As a result, most financial services are exempt from the VAT, regardless of whether they are rendered for explicit or implicit fees.²⁸

Without being able to identify the individual margin charged to each customer, it is not possible to apply a VAT to financial services in its pure form.

Again, it is necessary to state that it is the value of financial intermediation that is the focus of VAT and not the activity of savings or investment. The cash flow transaction of borrowing, lending, savings and investment are non-taxable transactions – they are not financial intermediation services. It is the activity of the intermediary that brings disparate investors and borrowers together that adds value by way of intermediation and the margin or implicit fee is the focus of a consumption tax.

4.4 Taxing Financial Intermediation

The difficulty in applying full taxable VAT treatment to financial services raises significant challenges to the underlying rationale for a VAT outlined above – the taxation of personal consumption comprehensively, neutrally and efficiently. Despite the ongoing debate as to the role of financial services in final consumption, the default position has been to include financial services only partially in the VAT base.

²⁵ The Value-Added Tax and Financial Services in Developing Countries, Indirect Taxation of Financial Sector Supplies in the Asia Pacific Region, Asia Tax Forum, August 2008 (Jun 2008).

²⁶ Even if the margins can be measured, they need to be apportioned between the related services (i.e., between depositors and borrowers).

²⁷ How strong this incentive could be is an empirical question and likely to be affected by the market conditions and institutional arrangements in any specific setting.

²⁸ Exports of financial services are typically zero-rated.

4.4.1 The International Model – Exemption

The initial response of countries to the difficulties posed by financial services has been to apply exempt VAT treatment to a very wide definition of financial services.

If services are exempt, the vendor does not apply VAT to the goods or services supplied and no input tax credits can be claimed in respect of these supplies. As VAT is not applied to supplies made to final consumers, the value added (wages plus profits) of the financial services provider is not taxed.

It is important to emphasize that in the terms of the ‘additive approach’ to the calculation of value added, the exemption approach:

- does not tax the wages and profit of the financial intermediary; but
- taxes, at the VAT standard rate, the taxable resources consumed by the intermediary in making supplies of financial services.

An exempt treatment for financial services has the effect of including, in the tax base, the taxable supplies of goods and services that are consumed in providing financial services. The adoption of an exemption means that all goods and services consumed in providing financial services are taxed, whether or not the financial services are consumed within the production and distribution process. In effect, financial intermediation is treated as final consumption.

It must be appreciated from the above that, if it is accepted that the value of financial intermediation should be subject to tax, the exemption:

- over taxes the business consumption of financial services; and
- under taxes the consumption of financial services by consumers.

In its recent report to the Australian Government on *Australia’s Future Tax System*²⁹, the Australian Treasury estimated that the current GST regime in Australia is likely to overtax business by \$760 million in 2010-2011 while the failure to tax consumer expenditure results in a \$3.9 billion shortfall. There is no published empirical evidence for Canada on this matter. However, for purposes of comparison it is important to note:

- the Australian standard rate is 10%;
- the Australian regime provides much more input tax relief than the Canadian one; and
- Australian consumers pay more GST on financial services due to a narrower exemption (i.e., arranging for services and general insurance).

See Appendix Q for more data.

²⁹ Australian Government, 2010, *Australia’s Future Tax System* at http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm

4.4.1.1 Scope of Exemption

Recognizing that exemption creates distortionary taxation in both production and consumption, policy makers must decide how to minimize the distortion created between exempt financial services and other fully taxable goods and services. Policy makers will have the choice of:

- applying a very wide VAT exemption to financial services. This will ensure neutrality between financial service providers but create:
 - greater embedded tax for business consumption of financial services, and
 - non-neutrality between exempt financial services and other taxable goods and services; or
- apply the VAT exemption to those financial services where it is not possible to separately tax the financial intermediation service. This will ensure greater neutrality between suppliers of financial services and other taxable goods and services, but create:
 - non-neutrality between financial services providers.

Neither of these approaches is ideal and result in non-neutrality and inefficiency.

While it has not been possible to fully tax many financial services, improvements in technology and increased competition in the financial services sector means that financial institutions will likely seek to apply explicit fees to some financial services products. Where these fees are separately identified, full VAT treatment could be applied. South Africa, for example, has adopted an approach that distinguishes between margin-based and explicit fees. It achieves this by defining ‘financial services’ in such a way that it excludes any services for which an explicit fee is charged.³⁰

For those countries that apply exempt VAT treatment to financial services, the general approach has been to apply the exemption very broadly, including to financial services that have explicit fees and could be taxed directly.

The Australian Treasury noted in its 1999 Consultation document on the GST treatment of financial services in Australia³¹:

International practice is to also input tax³² many explicit fees or commissions related to the provision of financial services (even where these fees and commissions can be readily valued). These fees and commissions are often input taxed to avoid biases that would be caused by different tax treatments applying to similar services that happen to be charged for differently.

In a similar vein, the Treasury stated that, as well as extending the range of financial services subject to exemption, a number of countries have also extended exempt treatment to businesses that are not primary financial service providers, but are associated with the supply of financial services:

³⁰ See section 2(1), *Value-Added Tax Act, 1991* (Act 89 of 1991), ‘Provided that the activities contemplated in paragraphs (a), (b), (c), (d) and (f) shall not be deemed to be financial services to the extent that the consideration payable in respect thereof is any fee, commission, merchant’s discount or similar charge, excluding any discounting cost.’

³¹ Consultation Document 1999 at 1.

³² The term “input taxed” generally means that the transaction is exempt from VAT and thus the purchaser bears the cost of the tax on that input.

...many overseas jurisdictions have input taxed a range of fee or commission based financial services that could feasibly be taxable. This is particularly the case where the services are not directly financial supplies but involve ‘arranging’ financial supplies. Often this has been done partly in an attempt to address the self-supply bias that arises when an input taxed financial service provider uses inputs that would normally be taxable. In other words, many overseas jurisdictions have attempted to ameliorate the problems of input taxation by extending the scope of input taxation ‘upstream’ to another layer of suppliers.

While a wide exemption achieves greater neutrality across the financial services sector it does so at the cost of denying input tax credits on financial services that would otherwise be fully taxable and eligible for input tax credits. There is no empirical evidence to indicate which of these approaches is more costly to the economy. However, it will certainly be the case that a broad financial services exemption will not come without a cost to economic efficiency. Finally, the broad exemption ensures neutrality of treatment for consumer expenditures for financial services and thus minimizes competitive non-neutrality between suppliers of financial services.

4.4.1.2 Inefficiencies of Exemption

As indicated above, value added tax regimes worldwide have adopted the “exemption” approach to financial services. This approach is a requirement of the EU and, while the more recent GST regimes in Australia, New Zealand, South Africa, Canada and Singapore vary in the breadth of the exemption and entitlements to input tax relief from the EU standard, the exemption approach to financial services is generally consistent.

There is little if any empirical evidence of the distortions to behavior listed below resulting from exemption. There are a number of approaches discussed later in this report that are designed to address the distortions (in all cases partially).³³ The absence of empirical evidence of the distortionary effects of exemption makes the assessment of the partial reform alternatives to exemption doubly difficult.

The non-neutrality and inefficiencies caused by the exempt model are well documented³⁴ and are outlined below.

Under taxation and substitution

The under taxation that an exemption gives to goods and services falling within the defined exemption creates a bias in favor of expenditure on and production of exempt goods and services. The exemption encourages the substitution of the exempt financial services compared to taxable goods and services.

³³ Edgar, 2007 refers to these approaches, such as full zero-rate (discussed in Hong Kong’s proposal for GST), fixed recovery rates (Singapore), RITC (Australia) and B2B zero-rate (New Zealand), as ‘partial reform alternatives to exemption’.

³⁴ Burns, 2008; New Zealand IRD 2002; Edgar 2007.

Over taxation, cascade and/or under investment

Over taxation arises through the taxation without credit of inputs to financial service providers. To the extent that the taxation of inputs is passed through to suppliers of taxable goods and services and to the prices paid by consumers (i.e., the cascade, as depicted in Appendix F³⁵) there may be a misallocation of resources and an under consumption of over taxed goods and services at the consumer level. To the extent that the taxation of inputs of financial service providers cannot be passed on through higher prices or pushed back onto suppliers in the form of lower prices, the tax could result in lower rates of returns of financial suppliers and under investment in the financial sector.

Self-supply

The bias to self-supply, or vertical integration, is a result of the tax cost differential between outsourcing and self-supply. This substitution effect in production and distribution may cause efficiency costs to the extent that outsourcing would otherwise be preferred. This bias creates non-neutrality between financial service providers who have capacity to internalize the services and those that do not (i.e., smaller institutions, investment plans, etc.).

Advantage to offshore financial service suppliers

The competitive advantage arising to non-resident suppliers of financial services who do not suffer tax costs on their own business inputs. This advantage to offshore suppliers is evident for both domestic business and consumers of financial services. This distortion may lead domestic suppliers to move the supply of financial services offshore.

Advantage to offshore service suppliers to financial intermediaries

The advantage to domestic financial service providers to access otherwise taxable goods and services in VAT free form from offshore suppliers. Many jurisdictions seek to counter this bias by a “self assessment”³⁶ or imported services regime to neutralize the substitution effect.

Compliance and complexity

The complexity and compliance costs associated with apportionment of acquisitions between exempt and non-exempt activities (including exports). A financial service provider is likely to have a mix of both exempt financial services as well as fully taxable services, such as the provision of financial advice. As input tax credits will be denied for the exempt services, but allowed for the fully taxable services, financial service providers will be required to allocate their business inputs between the exempt and taxable components. Many regimes adopt design rules and anti-avoidance rules (such as deemed supplies at market value between associates and self assessment of offshore

³⁵ The potential for cascading in the property and casualty insurance sector is arguably greater than in other sectors when considering the various turnover and transactions taxes applicable.

³⁶ Often referred to as “reverse charge”.

acquisitions) to counteract the distortions.³⁷ These ‘integrity’ measures add further complexity, compliance costs and risks.

Definitional and characterization disputes

Offerings by financial service providers are constantly evolving to keep up with changing technology and market demands. As a result, the definition of “financial services” can quickly become dated leading to interpretive and characterization disputes of the various service offerings.

³⁷ For example, non-arm’s length supplies and imported taxable supplies are dealt with in section 155 and 217 of the *Excise Tax Act* respectively.

5 The Canadian Experience

The first two sections considered the rationale for governments to employ a VAT and the resultant problems when trying to apply VAT to the financial services sector. There is largely a global consensus around the conclusions drawn in the first two sections. Section 5 discusses the Canadian experience to date with GST and how it applies to the financial sector.

5.1 The Background

The history of sales tax in Canada dates back to 1920 when the federal government introduced a 1% sales tax on all non-retail transactions. Although initially intended to be temporary, sales taxes have existed in Canada since their inception in 1920 albeit constantly subject to close scrutiny. This scrutiny resulted in the introduction of the federal sales tax in 1924, and also gave rise to numerous commissions and sales tax review committees throughout the years which ultimately led to the introduction of GST in 1991.

It is important to be reminded that the purpose of taxation is to generate revenue sufficient to fund the operation of government and government programs. Although it is agreed that there can be other purposes for taxation, such as the encouragement or discouragement of certain activities or behaviors, the fundamental purpose of taxation is to generate revenue.

If revenue is the fundamental purpose of taxation, in the context of the financial services sector, the simplest form of taxation would be to determine the total amount of revenue required to be generated from this sector on an annual basis and divide that amount by the participants in the sector weighted by size, using a measurement already required to be audited for regulatory purposes. Tax payments would be made by all participants on an annual basis, and the government would be funded with the revenue from this sector necessary for its operations.

Although this method of taxation would appear to be a simple way of generating revenue and also attaining the fundamental purpose of taxation, it would likely be seen today as being extreme and to one side of the spectrum of available options.³⁸ With such a seemingly simple means of generating revenue and attaining the fundamental purpose of taxation, it is fair that we ask how we got to where we are now.

On June 18, 1987, the Minister of Finance published a White Paper proposing Sales Tax Reform of which the key measure was the introduction of a Multi-Stage Sales Tax. The view was that a Multi-Stage Sales Tax would address many of the faults and weaknesses of the federal sales tax that were uncovered over the course of numerous studies spanning many years. In the introduction to the White Paper, the Minister of Finance made the following comments:

The current federal sales tax is seriously flawed. It is too narrowly based. Many areas of economic activity are not currently taxed, with the result that many manufactured goods are treated in a clearly discriminatory way. The federal sales tax is biased against our exports and in favour of imports. It is becoming

³⁸ Having said that, an argument could also be made that the existing tax treatment of the financial services sector is equally extreme and just as far to the other end of the spectrum, at least from a compliance and administrative perspective.

increasing complicated, making compliance more difficult. It taxes goods capriciously, scattering and compounding its impacts through the distribution chain in a frequently unpredictable manner. It distorts consumer prices and is unfair to those in need. It creates barriers to economic growth and the creating of jobs and opportunities for Canadians.

A Multi-Stage Sales Tax was therefore intended to address the fundamental flaws of the federal sales tax described above and was ultimately realized in 1991 as the GST.

5.2 The Experience

As noted previously, a VAT is intended to be a broad based tax applicable at each stage of the production and distribution of goods and services. However, as identified earlier in this report, the taxation of financial services under such a system faces numerous challenges. The White Paper recognized these challenges and proposed to tax the financial services sector based on a Margin Tax. The Margin Tax was ultimately rejected (discussed later in this report) and it was determined that broad exemption, as applied elsewhere, would be the more appropriate way to tax the financial services sector.

Before we observe how the GST, in the context of the financial services sector, measures up against the fundamental flaws of the federal sales tax that it replaced, it is worth mentioning that a fundamental weakness of broad exemption for financial services that has arguably been created: the difficulty of defining a financial service in any consistent and predictable manner.

The Canadian experience has shown that the difficulty in defining financial services results in compliance issues for taxpayers and administrative issues (i.e., audit) for tax authorities, which leads to increased litigation and often times legislative changes to tax laws on a prospective and retroactive basis. Since the financial services sector is constantly evolving with new products and new methods of delivery, the difficulty in defining financial services becomes a cycle that tends to repeat itself and results in a fundamental lack of certainty for the sector as a whole.

Based on the flaws of the federal sales tax that the GST was intended to address, the application of GST to the financial services sector can effectively be observed in four key areas; its ability to:

- Promote economic growth and investment by eliminating tax on business inputs;
- Promote export and eliminate the bias on imports;
- Promote fairness and neutrality; and
- Function in an administratively simple manner.

A broad based exemption for financial services under the GST necessarily results in the general taxation of inputs for providers of financial services. Although it is acknowledged that there may also be valid rationale for exemption which may justify this treatment, it is undeniable that broad based exemption under GST, in principle, is counter-productive to the goal of eliminating tax on business inputs and thus undermines neutrality and efficiency.

Financial services provided to non-residents are generally zero-rated, which allow related business inputs to be acquired without any input tax. This allows the financial services sector to be able to export financial services on a more competitive basis. However, financial services provided to Canadian manufacturers still fall under broad exemption and are therefore effectively input taxed, which creates a bias against exports in general.

With respect to imports, depending on what and from whom a financial institution imports, a bias may exist against importation under the broad GST exemption of financial services, as imported inputs are generally taxed and in some cases, arguably over-taxed. For example, financial services imported by a financial institution from a related non-resident can be subject to GST where the same service would otherwise be exempt when received from an arm's length non-resident. As such, although the bias to import may have been eliminated, it has in some areas been replaced with a bias against imports, which creates a number of fairness and neutrality issues within the financial services sector.

Fairness and neutrality concerns exist under broad based GST exemption for financial services and can be manifested both through operating structures and financial product structures of participants in the financial services sector. Under the current regime for the input taxation of the financial services sector, inequities are created depending on operating structure of financial institutions. For example, the additional tax cost of outsourcing vs. in-sourcing, the import treatment of related party transactions vs. arm's length party transactions, and favorable input tax credit entitlements for holding corporations vs. holding partnerships and trusts. In addition, financial product structures are often subject to different tax treatment notwithstanding that the similarity in purpose of the product; most notably, the treatment of risk management products, such as insurance policies, warranty contracts, and financial derivatives.

In the eyes of many, the greatest weakness regarding the application of GST to the financial services sector is the lack of simplicity. In this regard, it is important that we highlight the very unique circumstances surrounding the application of GST in Canada. Canada is the only country in the world that imposes a federal value-added tax in all provinces, as well as a harmonized provincial value-added tax in some provinces at varying rates. Adding to the complexity is the existence of an entirely separate non-harmonized provincial value-added tax in Quebec. Also unique to Canada is the requirement to not only determine whether supplies are being made in Canada, but also the particular province in which a supply is being made based on complex sub-national place-of-supply rules. Finally, in order to ensure that these complex sub-national place-of-supply rules cannot be exploited by financial institutions (i.e., relocation within Canada), the intricate special attribution method for determining ultimate provincial HST liability is required to be used.

The uniqueness of the Canadian GST/HST landscape, as well as the general requirement under broad based exemption to apportion tax on inputs between creditable commercial activities and non-creditable exempt activities adds significant complexity to the Canadian GST/HST system and creates fundamental compliance challenges for financial institutions unseen in other VAT systems around the globe.

5.2.1 The Fund Sector in Canada

When looking at the Canadian experience one area warranting a specific comment is the application of GST to investment funds (e.g., mutual fund trusts, etc.). In 1991, when the GST was introduced the tax policy decision was made to subject the various expenditures of a fund (i.e., investment management fees, etc.) to the full rate of GST, which at the time was 7%. This matter was further aggravated with the introduction higher rates resultant from harmonization of the federal GST and a number of provincial sales taxes.

There are a couple of points worth mentioning in regards to this approach. The first has to do with neutrality vis-à-vis similar investment vehicles within the financial services sector. A fund typically does not have in-house labour or other resources and as a result it is required to essentially outsource all service needs to other persons.³⁹ Typically these suppliers must in turn charge GST/HST on the consideration levied. This differs from an investment product of another financial institution, such as a GIC, whereby the product per se does not suffer the full impact of the GST as the majority of resources supporting the product are provided by employees of the institution, with the result that the full value of those services is not subject to GST/HST. Rather, as outlined previously under section 4.4.1 only the external resources consumed by the institution are subject to GST/HST. Or to put it another way, the labour to support an investment fund is fully taxed whereas the labour to support a competing product such as a GIC is not taxed nearly to the same degree.⁴⁰ In the extreme, the application of GST to investment funds highlights the perils of outsourcing for the financial sector whereby the introduction of a supply results in an exempt financial intermediary suffering additional VAT costs.

The second point to mention is that many other VAT jurisdictions have taken specific steps to address this matter.

- The EU has a longstanding VAT exemption for the management of special investment funds as defined by the Member States.⁴¹ The objective here is to ensure that the VAT system is fiscally neutral in respect of the choice between direct investment in securities and investment through undertakings for collective investment.⁴²
- Australia requires an investment plan to pay full GST but generally allows the plan to claim a credit equal to 75% of the input tax that would otherwise be denied because of the exemption for financial services.⁴³
- The New Zealand legislation does not provide a specific GST exemption to services provided by fund managers of unit trusts and group investment funds. However, the Investment Savings & Insurance Association of New Zealand Inc. (“ISI”) has been successful in negotiating with

³⁹ Note that the trust is a separate person for GST/HST purposes.

⁴⁰ According to IFIC three-quarters to four fifths of fund costs is labour.

⁴¹ Article 135(1)(g) of the VAT Directive.

⁴² The European Court of Justice cases: *JP Morgan Fleming Claverhouse Investment Trust plc and the Association of Investment Trust Companies v. Commissioners of HM Revenue and Customs*, C-363/05; and *Abbey National plc and Inscape Investment Fund v. Commissioners of Customs & Excise*, C-169/04.

⁴³ See section 6.2.2 for more detail.

New Zealand Inland Revenue Department (“IRD”) protocol which provides for GST to be paid on only 10% of the management fees of unit trusts and collective investment funds.⁴⁴

- Finally, Singapore does not exempt the services provided to investment funds but rather provides relief for prescribed costs via a remission order to prescribed funds.⁴⁵

⁴⁴ See section 6.4.2 for more detail.

⁴⁵ See section 6.3.2 for more detail.

6 Reactions to Exemption / Solutions

This section explores the reaction from other jurisdictions to the problems identified in Section 4. The jurisdictions considered in detail are the EU, Australia, Singapore and New Zealand. The system in South Africa is also commented on briefly. Appendix B and Appendix C contain both Tier 1 and Tier 2 country surveys which provide details regarding the application of VAT to the financial service sector on a jurisdictional basis.

A special section will be devoted to the taxation of insurance and the resulting implications. Finally, theoretical models which have been developed over the course of the last 15 years but never implemented are explored.

Detailed “Option Work Sheets” can be found in Appendix I.

It should be appreciated from our earlier discussions that the exemption approach adopted internationally operates by means of a definition of financial services and not according to the status of the provider as a financial institution. To achieve neutrality of financial services across the market place, financial services are generally defined to be exempt without regard to whether the provider is a financial institution or not.

Professor Edgar observes that ideally:

The concept of financial services subject to exempt treatment under a VAT should bear a close relationship to the rationale for exemption. This relationship is not always clearly reflected, however, in country practice, which tends to involve the use of ‘activity based’ legislative definitions of exempt services rather than definitions that are based on the status of the service provider as a financial institution.

Edgar puts the view clearly⁴⁶ as follows:

The core intermediation functions reflected in the definition of ‘financial services’ should distinguish between the acquisition and holding of financial instruments, on the one hand, and the intermediation or market-making function, on the other hand. It is this intermediation service, along with the associated charge, that is the proper target of any definition of financial services.

Putting the input tax relief question to one side, the approaches in EU, Australia, New Zealand and Singapore follow different approaches on the scope of the exemption:

- a broad approach – consistent VAT treatment across a wide range of financial services; and
- a narrow approach – specific exemption applies albeit in a limited number of cases.

The scope of the exemption for the services of the financial sector is most broad in the EU, followed by Canada, New Zealand, Singapore, Australia and South Africa, which has the narrowest.

⁴⁶ Edgar, 2007, fn at 44, 153.

6.1 The Broad Base Exemption Approach - EU

Governments may seek to minimize the distortion between types of financial services by applying exempt treatment to an expansive definition of financial services. The objective of this approach is to maximize neutrality across financial services by reducing distortions between the consumption of different financial services. This is the approach adopted by the EU.

The aim of the EU is to ensure neutrality of exempt tax treatment across a broad range of financial services, rather than neutrality with fully taxable goods and services. The EU applies this principle even where it may be possible to apply full VAT treatment to a particular financial service. As Schenk notes:

The EU exempts many financial intermediation services, even if provided for explicit fees. That practice spread to many other countries that adopted a VAT.⁴⁷

The EU confirmed its broad exemption approach in a review conducted into the modernization and simplification of VAT rules for financial and insurance services in 2006.⁴⁸ The review arose from a concern that:

- the definition of exempt financial services, which date from 1977, had not kept up with innovations in the development of financial services; and
- different interpretations among member states due to influence of “private law”. This was particularly evident in the scope of the exemption in the VAT Directive for:
 - insurance and reinsurance transactions; and
 - the management of special investment funds.

Following from that review, the European Commission has adopted a proposal for a Directive (Com/20072747), an objective of which is:

...to ensure a more consistent application of the tax and deliver a level playing field in the internal market, at least as far as VAT is concerned.

Once adopted by the EU members, these objectives will be achieved by:

- expansion of the definition of exempt services.

This would broaden the exemption in the VAT Directive to include a number of services typically provided by non-financial institutions to financial institutions. This could include many more services, such clearing and settling, fund management, “arranging for”, data processing, trustee and custodial services and marketing.
- introduction of an industry specific exemption from VAT on cost sharing arrangements.

⁴⁷ Schenk, 2007 at 310.

⁴⁸ See [VAT on insurance and financial services - Taxation and Customs Union - European Commission](#)
European Commission, *Consultation Paper on modernising Value Added Tax obligations for financial services and insurances*, (2006).

This would provide exemption for goods and services supplied by umbrella organizations to members of a cost sharing association. Such treatment is often subject to restrictions such as members must be involved in exempt activities and the services acquired must be considered as necessary for the member to operate. Members reimburse the umbrella organization their exact share of the joint expenses. It is important to note that the supply from the umbrella organizations to the member is exempt, thus VAT is embedded in the transaction, but not necessarily on the 'value add' (i.e., wages and profit); and

- an option for banking and insurance companies to opt to tax their services if they wish.

This would allow the supplier / recipient to decide whether to treat the financial transaction as either exempt or taxable. The option could be applied on a transaction by transaction basis, by the type of transaction, by customer or by sector. While this does not eliminate all embedded VAT it does offer flexibility to suppliers and increases input tax recovery and arguably works well with a broad exemption.

The main objective is to expand the financial services exemption to ensure greater neutrality in tax treatment across a wider range of financial services. In providing the option to tax, the proposal acknowledges that a range of financial services that could be fully taxed will be subject to exempt treatment under the expanded definition.

While this may result in additional neutrality in the treatment of like financial services, it comes at the cost of less overall efficiency in the operation of the VAT. Some of these inefficiencies were acknowledged by the European Commission in the 2006 consultation paper, particularly the embedded taxes on B2B transactions and the disincentives created by the financial services exemption for businesses to outsource financial services supplies.

In *The Modern VAT*⁴⁹, the authors refer to the 'spread' of the scope of exemption as 'exemption creep' to explain the tendency. Once it is appreciated that the resources consumed in financial intermediation can be split into functions and sub functions, the distinction between the facilitation of financial transactions and the mere processing of elements of the transaction become blurred and difficult to distinguish on a principled basis. Professor Jun states in this regard:

A serious option could be to extend the VAT to financial services provided for explicit fees by financial intermediaries acting as agents, such as brokers and dealers, as under the Singapore VAT. This approach will have a base-broadening effect as well as reducing many of the distortions associated with the exemption method. Under this method, there might be an incentive to substitute margins for fees. However, as financial markets are deregulated and globalized, financial services tend to be unbundled and more individualized. Under this trend toward disintermediation, financial charges are less likely to be buried in margins.

The financial sector's ability and tendency towards 'disintermediation' and unbundling of functions of core financial intermediation has the consequence that the scope of the exemption expands to include the separate parts.

⁴⁹ Ebrill, 2001 at 89.

The “spread” of the exemption is not merely a feature of legislative change. The courts, in considering the scope of the exemption have held that the exemption extends to:

- co-branded credit cards⁵⁰,
- the operation and maintenance of accounts⁵¹,
- interchange fees⁵²,
- the execution of transfers, the management of deposits, purchase contracts and loans⁵³, and
- factoring and debt collection.⁵⁴

In legislative terms, the broad scope of financial services is achieved in the EU model through the extension of the definition to ‘negotiations’ and ‘dealings in’ the defined financial intermediation activities.⁵⁵ Unfortunately, the exemption creep has efficiency implications for the broader economy (i.e., more suppliers of VAT exempt services).

Please see Appendix M for the text of the proposed new exemption for the VAT Directive.

A final option to consider from the EU approach, which functions well with the broad exemption, is a broad VAT Grouping provision. This currently exists in the EU but is not universally adopted by Member States. Under this option there would be no taxable transactions between members of a VAT group. It rewards the cooperation within a group of legal entities and thus supports the efficient allocation of capital and human resources. It would ensure that branches and subsidiaries are treated similarly and allows business to grow with less concern regarding VAT issues.

In effect, connected legal entities are treated as a single entity for VAT purposes. With respect to VAT recovery, it is the group as a whole that would be subject to a single allocation methodology which would collectively consider the use of goods and services by group members. The broad VAT group offers significant compliance benefits for business (i.e., single VAT return, etc.) and a greater ease of administration for tax authorities (i.e., single audit, single tax payer in the system, etc.).

6.1.1 The EU Way – Effectiveness

The main objective of a broad exemption is to ensure greater neutrality in tax treatment across a wider range of financial services (i.e., savings, funds, etc.). The expansion of the exemption to businesses other than actual providers of financial services demonstrates that it is possible to alleviate the self-supply bias for very specific services and indeed the exemption has been pushed down to outsourcers. In providing the option to tax, the proposal acknowledges that a range of

⁵⁰ *Customs and Excise Commissioners v BAA*, [2003] S.T.C. 35.

⁵¹ *Customs and Excise Commissioner v. FDR Ltd*, [2000] S.T.C. 672.

⁵² *Diners Club*, [1989] 1 W.L.R. 1196.

⁵³ *Sparekassernes Datacentre (SDC) v. Skatteministeriet*, [1997] E.C.R. I-03017.

⁵⁴ *Finanzamt Gross Gerau v MKG Kraftfahrzeuge Factory GmbH*, [2003] S.T.C. 951.

⁵⁵ Under proposed amendments to the VAT Directive, the terms ‘negotiations’ and ‘dealings’ are to be replaced by the term ‘intermediation’ in the listed financial transactions (such as granting credit and supply of securities). The proposed change is a significant expansion, in our view, of the existing exemption.

financial services that could be fully taxed will be subject to exempt treatment under the expanded definition. In the case of the EU, greater neutrality within the financial services sector has been achieved by an expanding the scope of the exempt treatment for financial services.

While this may result in additional neutrality in the treatment of like financial services, it comes at the cost of less overall efficiency in the operation of the VAT; particularly the embedded taxes on B2B transactions, more exempt business in the system, and an overall disincentive to outsource financial services supplies.

6.2 Narrow Exemption: RITC - Australia

Whereas the EU has taken and proposes to take a deliberately expansive approach to exemption of financial services, Australia's GST is intended to be narrower. The Australian regime does not exempt:

- the arranging or negotiating of a financial transaction by a facilitator; or
- the supply of non-life insurance.

Many of the items that are contained in the broader exemption in the EU (and other countries for that matter) are subject to a special input tax credit regime, the reduced input tax credit or RITC. Thus, the supply to the financial services supplier is not exempt but limited input tax credits are allowed to the supplier to alleviate the full impact. These two approaches operate together to, in effect, tax the resources consumed in financial intermediation.

6.2.1 Scope of Exemption

Exempt treatment applies to narrowly defined financial services.⁵⁶ The starting point in establishing the scope of the exemption is the definition of financial supplies in the Australian law. The financial supplies that are identified as subject to input taxation is the provision, acquisition or disposal, for consideration, of property in the following types of transactions:

- deposit accounts with authorized deposit-taking institutions;
- credit facilities (i.e., borrowing and lending);
- security charges over property;
- superannuation schemes, annuities and pensions;
- life insurance business including re-insurance;
- guarantees and indemnities (but not warranties for goods or contracts of general insurance and reinsurance);
- currency and arrangements to buy and sell Australian or foreign currency;

⁵⁶ In the Australian law, the term "input taxed" is used for exempt supplies. The term is intended to convey the outcome of exemption - that is, that the activity is taxed on its inputs.

- securities, including shares, stocks, bonds, debentures and interests in partnerships and trusts; and
- derivatives.

The legislative scheme draws a distinction between the above transactions entered into by the provider of property as principal and those supplied as agent. Essentially, the financial services defined in this way reflect financial intermediation that might generally be expected to have its consideration determined by way of implicit fee, margin or spread.

The range of transactions is similar to that contained in the EU VAT Directive and its proposed amendments outlined above, with the exception that it excludes “intermediation”, “arranging” and “dealing” otherwise than by a party to the financial transaction.

The approach taken, therefore, exempts the provision of property in specified financial instruments whether the fee is explicit or implicit. The key issue is whether property in a financial instrument is acquired, provided or disposed of as principal.

6.2.2 Expansion Effect of Exemption through RITC

The narrower definition of financial supplies is accompanied by a special regime that grants recipients (being financial service providers) input tax relief for costs of specified kinds that relate to making financial supplies. The relief that is granted is 75% of the input tax that would otherwise be denied because of the financial services exemption.

The regime is directed at achieving neutrality between:

- financial intermediation undertaken by facilitators and principals to the financial transaction; and,
- the self-supply of incidental functions involved in financial services and the outsourcing of those services.

It is important to recognize that the Australian model views the RITC relief as equivalent to exempting the arranging, negotiation and management of financial transactions contained in the EU VAT Directive. The system is thought to counteract the bias to “self-supply” because a “self-supply” effectively reduces the VAT cost by the profit and wages of the insourced activity. It is arguable that the RITC can achieve equivalency with broad EU exemption but limit the spread of the exemption to other suppliers.

Consistent with the focus of the initiative on neutrality with the broader exemption to which the RITC applies, the relief is limited to 31 listed items contained in the GST Regulations. Please see Appendix K.2 for a list of the acquisitions eligible for an RITC.

6.2.3 Self Assessment

Because the Australian system is based upon the exemption of financial services, domestic financial institutions could be biased to access services from offshore suppliers. To counter this distortion,

the Australian system adopted a self assessment regime. RITC relief is available if the offshore service is one of the listed services that qualify for the RITC relief. As a consequence, the financial service provider will incur a net GST cost of 2.5%⁵⁷ of each payment made for qualifying self assessed services.

6.2.3.1 Closely Related In-house Services

The self assessment also operates for payments made to an offshore branch of the same entity.⁵⁸ In recognition of the fact that this approach might bring internally generated value added within the tax base (i.e., GST would be payable on the profit and wages of the related entity), broader RITC relief is available where there is a self assessment liability for acquisitions (or internal transfers) made from “closely related” enterprises operating outside of Australia. The broader relief is only available where the self assessment applies.

Whereas the list for normal RITCs focuses on the activities that are intermediation in the broader sense and incidental to financial intermediation, the RITCs for closely related activities cover what might generally be described as “in-house services”. The aim is to ensure that relief is given where “management services” are acquired from closely related enterprises such that it could be regarded as “internally generated” and include senior executive management, financial management, etc. Please see Appendix K.3 for a list of headings.

Under these rules, a financial service provider is entitled to RITCs of 75% of the self assessed GST liability on the payments it makes to the closely related enterprises offshore. As a consequence, the financial service provider will incur a net GST cost of 2.5% of each payment.

Importantly, an RITC is not available for those services to the extent that offshore enterprise acquired “external services” and “passes on” the charge in a way that the substance and character of the external service has not been changed. An example is where legal advice is acquired by an offshore branch from an external legal service provider and that legal advice is recharged by the offshore branch to the onshore branch.

More information regarding the rate can be found in Appendix K.

6.2.4 The Australian Way – Effectiveness

If the narrower exemption and RITC relief is examined against the recognized inefficiencies of a financial services exemption, it can be seen that its purpose is not to address the tax cascade⁵⁹ but to:

⁵⁷ The 2.5% is calculated as follows: 10% VAT rate * (100%-75% RITC relief).

⁵⁸ This is not the case in the EU – see *Ministero dell'Economia e delle Finanze, Agenzia delle Entrate v. FCE Bank plc*, C-210/04.

⁵⁹ The RITC regime is not intended to address the question of tax cascade and, because the economic effect of the regime is a reduction in the GST costs of the financial provider generally, it does not find its way to business consumers of financial services specifically. Hence, as a matter of design and practice it does not attack the inefficiencies arising from the tax cascade.

- extend neutrality of the exemption regime for intermediation services by principals to facilitators and agents; and
- achieve neutrality for business acquirers for:
 - outsourcing of “incidental” financial intermediation services; and
 - “in house” services acquired from offshore.

The RITC relief incorporates an assumption that the profit and wages of the service provider amounts to 75% of the charge to the financial services provider; that is, it provides relief equivalent to profit and wages comprising 75% of the price of the outsourced service.

6.2.4.1 Fixed 75% Rate

The fixed RITC percentage means it is more advantageous to outsource processing where the external costs of the outsource provider are greater than 25% of the price charged by the outsource provider to the financial institution. If the external costs of the processing service are less than 25% of the arms-length price of the processing service, the financial service provider is better off internalizing the service.

It can be appreciated that, because an RITC is available even where the outsourced provider is an associate of the financial institution, the RITC scheme encourages the establishment of the special purpose vehicles to provide processing services to the financial institution itself.

6.2.4.2 Consumers

As the regime only provides relief for incidental and arranging for services acquired by registered businesses, consumers suffer full GST costs for consumption of these services. As a result, there is evidence that arranging and incidental services will often be bundled upstream into the core intermediation product. Moreover, the narrow exemption also causes pressure to “spread” the exemption where non-core intermediation is provided to consumers.

6.3 Addressing Distortions of a Narrow Exemption – Special Deduction Regime - Singapore

Exempt treatment under the Singapore GST applies to defined financial services of a similar scope to EU but, like Australia, the Singapore definition excludes “arranging”. The overall result is a narrower exemption.

Please refer to Appendix N for a description of the exemption in Singapore.

Like Australia, the narrower exemption in Singapore also distorts relative prices of financial services for both business and consumers. The other distortions arising from exemption also arise for those services that fall within the exemption. Consequently, the Singapore GST includes

provisions intended to overcome the inefficiencies of exempt treatment of financial services⁶⁰, the Special Method and the Fixed Input Tax Recovery Method.

6.3.1 Addressing Distortions Through Input Tax Relief

As the definition of financial services is narrower input tax relief is granted to many providers of financial services. First, the Special Method treats otherwise exempt financial supplies made to registered persons as zero-rated. This requires an allocation of both outputs and inputs and the tracking of transactions and customers.

Second, under the Fixed Input Recovery Method, financial service providers are able to claim a fixed percentage of total input tax credits.⁶¹ The percentages are allocated according to the type of financial institutions and reflect an allowance for B2B relief. While the compliance costs of this approach may be less than under the Special Method, the fixed percentage is only an approximation and will not accurately reflect the true input costs of providing the services. The input tax recovery rate is not legislated. Rather, the Singapore GST legislation allows Regulations to be made to treat exempt supplies as taxable supplies so as to determine the entitlement to input tax credits.⁶² The Regulations also allow the Comptroller to determine a method of calculating input tax credits including one that treats exempt B2B as zero-rated supplies.⁶³

Burns 2008 explains the Fixed Input Recovery Method system as follows:

The Inland Revenue Authority of Singapore uses current statistics submitted to the banking regulator, the Monetary Authority of Singapore, to determine, on an annual basis, a separate input tax recovery ratio for each category of banking licence (i.e. full banks, restricted or wholesale banks, offshore banks, merchant banks) and finance companies.⁶⁴ An input tax recovery ratio may also be provided to certain categories of special purpose vehicle established by such financial institutions, such as those used for asset securitisation transactions.⁶⁵

The formula used to determine the input tax recovery ratio in respect of each category of banking licence and for finance companies for each annual period is, in essence:

⁶⁰ Burns, 2008; Edgar, 2007.

⁶¹ Note that the Fixed Input Recovery Method does not have the advantage of New Zealand's legislative formula for identification of recipients and formulaic apportionment. See subsequent discussion.

⁶² Sections 20(3) and 19 of the Singapore *Goods and Services Tax Act*.

⁶³ Regulation 30 of the *Goods and Services Tax (General) Regulations*.

⁶⁴ Refer Inland Revenue Authority of Singapore, *supra* at n.15 and Letter from Monetary Authority of Singapore to the Singapore Merchant Banker's Association of 17 October 1994, which contains the methodology used to determine the fixed input tax recovery ratio. The relevant statistics are those known as "ACU" and "DBU" statistics. Banks and merchant banks are required to report these statistics to the Monetary Authority of Singapore. "ACU" refers to an Asian currency unit. "DBU" refers to a domestic banking unit. Most banks in Singapore operate both an ACU and a DBU. The ACU is subject to fewer regulatory rules than the DBU. The distinction between ACU and DBU business was established to develop Singapore as a regional financial centre.

⁶⁵ Refer Monetary Authority of Singapore, *Tax Incentive to Develop the Asset Securitisation Market*, 28 June 2005, accessed on 9 June 2008 at http://www.mas.gov.sg/resource/news_room/announcements/2005/FDDC09-2005%20Asset%20Securitisation%20Mkt.pdf.

B2B and offshore loans x 100⁶⁶
total loans

The fixed input tax recovery rates for financial institutions for the period covering April 1, 2009 to March 31 2011 are as follows:

- Full banks – 78%
- Wholesale banks – 96%
- Offshore Banks – 96%
- Merchant banks – 96%
- Finance Companies – 49%.

6.3.2 Remission – Funds Management

The Singapore regime will tax custodial, management, administration and various compliance costs of investment funds. The Singapore model for input tax relief does not apply to funds. In response, the Singapore government has instituted a specific remission regime to relieve “prescribed funds” from the GST costs of “prescribed costs”, such as:

- Management fees;
- Trustee fees;
- Fund administration fees;
- Custodian, sub-custodian and depository fees;
- Registrar fees;
- Printing and distribution costs;
- Audit fees;
- Tax agent fees; and
- Legal fees.

The Inland Revenue Authority of Singapore calculates a fixed recovery rate each year based on the taxable supplies made by the industry. For January 22, 2009 to December 31, 2009, the fixed recovery rate was 93%.

6.3.3 Self Assessment

While the Singapore law contains a provision for a self assessment, to date services have not been prescribed in the regulations for the charge to take effect. Consequently, the domestic financial

⁶⁶ Refer to the Appendix to the Letter from Monetary Authority of Singapore of 17 October 1994, *supra* note 18.

services sector is, in theory, at a disadvantage compared to offshore suppliers who obtain zero-rating on financial services provided to Singapore customers.

6.3.4 The Singapore Way – Effectiveness

The Singapore system is designed to reduce the GST costs of financial service providers where the customer base is other GST registered entities or offshore recipients. By decreasing GST costs at an intermediate level of production, the system must improve efficiencies.

However, the fixed recovery rate substitutes for B2B full recovery and does not reflect the particular supplier's circumstances. As such, it is general relief for the financial institution's classification and not referenced to the particular circumstances of a supplier that would justify relief.

The fixed recovery rate approach provides relief from the outsourcing problem by granting higher relief generally. The fixed rate recovery approach also provides compliance and administrative simplicity.

But where the recipient of the financial service is not eligible for input tax relief, the Singapore model does not provide a solution. The Singapore regime imposes GST costs on outsourcing to the extent that the financial services provider cannot access B2B relief, (i.e., for financial service providers to consumers, the self-supply and offshore competition distortions remain).

By providing a general relief to classifications of financial institutions the potential application of any relief is limited. The insurance sector is not covered and Singapore has provided special relief for funds management industry through its remission system.

6.4 Relieving the Cascade Under the Broad Exemption - B2B Relief via Legislation - New Zealand

New Zealand, while initially⁶⁷ adopting a classical "exempt" regime for financial services and adopting a broad exemption similar to the EU model, moved to a zero-rate for B2B financial supplies with effect from January 1, 2005.

Please refer to Appendix O for the New Zealand definition of financial services.

6.4.1 B2B Relief

In 2005, the New Zealand Government changed the treatment of financial services between GST registered entities from exempt (i.e., no GST applied, no input tax credits claimed) to zero-rated (i.e., no GST applied, input tax credits claimed). At the same time, a self assessment was introduced on services acquired from abroad, which to some extent addressed the revenue gap resultant from introducing the B2B zero-rate.

⁶⁷ The New Zealand GST system commenced on October 1, 1986.

The zero-rating applies where the supply of financial services is made by a registered person to another registered person who has the predominant activity of making taxable supplies. The requirement that the financial services are made to a registered person making taxable supplies is to avoid consumers receiving zero-rated financial services. If a registered business made a zero-rated supply to another registered business making exempt supplies, the final supply to the end consumer would be zero-rated.

In its 2002 discussion paper, the New Zealand Inland Revenue Department identified the problems of tax cascading, self-supply bias and compliance costs as the reasons for reviewing its exemption treatment of financial services.⁶⁸ Of most concern to the New Zealand Government was the tax cascading from denial of input tax credits:

- tax cascading overtaxes financial services in B2B transactions compared to other goods and services; and
- a core principle of a VAT is that tax should not apply to B2B transactions.

The new B2B rules allow a registered person to make an election to treat, as zero-rated, financial services that are supplied to another registered person. For the zero-rate to apply, 75% of the total value of supplies made by the recipient must be taxable supplies (excluding zero-rated supplies of transactions between financial institutions).

Where the recipient of a financial supply is itself a supplier of financial services, the New Zealand rules provide for a deduction of input tax by reference to:

- the proportion of the total value of supplies made that are represented by the total value of the exempt financial supplies made to the other financial supplier; and
- the proportion of the total value of supplies made by the other financial supplier that are represented by taxable supplies of that other financial supplier.

In essence, the New Zealand B2B zero-rating rules allow an additional input tax deduction to a financial service provider by reference to the taxable status of the recipients of its financial supplies.

6.4.2 Funds Management

As stated by Inland Revenue in their letters to the Investment Savings & Insurance Association⁶⁹ and the Trustee Corporations Associations of NZ⁷⁰, effective October 1, 2010, the New Zealand regime taxes, at the standard GST rate of 15%, the following portion of funds management services:

- Composite fund management fees – 10%;
- Composite trustee service fees – 75%; and

⁶⁸ GST & financial services, a Government discussion document, the Policy Advice Division of the Inland Revenue Department New Zealand, October 2002 by (IRD 2002).

⁶⁹ Trezise, John. “Goods and Services Tax on Management Fees”. Letter to Deborah Keating. 15 October 2010.

⁷⁰ Trezise, John. “Goods and Services Tax on Corporate Trustee Service Fees, Investment Custodian Service Fees and Management Fees”. Letter to David B. Douglas. 15 October 2010.

- Investment custodian service fees – where a separate sub-management arrangement exists, the portion of the fee not charged to customers; otherwise, 33%.

It is worthwhile to note that in New Zealand the management of a superannuation scheme is considered to be a financial service and is exempt from GST.

6.4.3 Self Assessment

Because the New Zealand system involves the exemption of financial services to consumers, domestic financial institutions could be biased to access services from offshore suppliers. Accordingly, the movement to a B2B system of input tax relief was accompanied by a self assessment regime. Until then the GST regime did not apply to so-called “imported services”.

The self assessment rules operate where there is a supply by a non-resident to a resident and 95% of the recipient’s supplies are not taxable supplies (including zero-rated supplies). The 95% test requires an assessment to be made of the past 11 months and an estimate of the supplies to be made in the next 11 months. It does not apply if the imported services would otherwise have been exempt or zero-rated.

The New Zealand rules also apply to internal charges from an overseas head office or branch. However, the requirement to self assess does not apply to any part of an internal charge that relates to salary or wages, interest and other exempt supplies.

6.4.4 The New Zealand Way – Effectiveness

The New Zealand system is designed to reduce the GST costs of financial service providers where the customer base is other GST registered entities. By decreasing GST costs at an intermediate level of production, the system must improve efficiencies.

To the extent that full relief is available because the financial service provider is zero-rated, the bias in favour of self-supply is eliminated – again increasing efficiency.

The B2B approach provides relief from the outsourcing problem by bringing a large range of financial services within the “taxable” environment (albeit a zero-rated one). By extending taxable status to the output, relief for input tax flows automatically.

But where the recipient of the financial service is not eligible for input tax relief, the New Zealand model does not provide a solution. In fact, by the introduction of a self assessment, it extends the problem to offshore supplies as well as domestic.

The New Zealand regime imposes GST costs on outsourcing (whether domestically or overseas) to the extent that the financial services provider cannot access B2B relief (i.e., for financial services provided to consumers, the self-supply and offshore competition distortions remain).

6.5 Partial Taxation – Narrow Exemption

Historically, a key reason for exempting both the margin and explicit fees was to ensure a neutral application of the VAT regardless of the form of consideration. If explicit fees were taxed it is arguable that overtime providers of B2B financial services would shift towards fee based services whereas consumer transactions would transform into margin type charges. While there is no empirical evidence to suggest this to be the case in jurisdictions that have a narrow exemption, there has been some spread of the exemption in the consumer realm in Australia which operates a narrow exemption.

South Africa applies VAT to almost all explicit fees and non-life insurance. As a starting point financial services are VAT exempt. However, the scope of the South African exemption is narrower in three respects relative to the broad exemption in other VAT countries:

- Arranging and negotiating for a financial supply is not included in the exemption, nor is the management of a superannuation scheme.
- The exemption does not extend to “services to the extent that the consideration payable in respect thereof is any fee, commission, merchant’s discount or similar charge, excluding any discounting cost.”; and
- General insurance is taxable and an input tax deduction is allowed for indemnity payments made to insured vendors that are registered for VAT. The VAT registered insured is liable to pay output tax on receipt of this indemnity payment.

In effect, where an explicit fee or commission is charged the service is deemed not be a financial service. The only part of a financial transaction which is exempt is that which relates to a margin. This rule would apply to both principals and agents.

The IMF Fiscal Monitor of October 2010 recommended that consideration be given to expanding VAT bases by removal of exemptions, including the exemption for financial services.

6.5.1 Partial Taxation – Effectiveness

A narrow exemption should be easier to administer as all fees are subject to tax. The tax authority collects more VAT revenue but more input tax is recovered. Arguably the system is more efficient overall. There would be a question as to what fees, if any, should remain exempt. There still would be a requirement for an allocation methodology as a financial institution would continue to have a mix of both margin and fees. However, it should be easier for business to comply with and for the tax authority to administer.

Over time within the financial services sector there has been a shift toward explicit fees for services and the removal of the exemption for such charges would certainly lower the amount of irrecoverable input tax borne by the financial services sector. In this regard while a narrower exemption would address to a limited degree the problem of the cascade and the self-supply bias it would not address the core problems with the exemption.

6.5.2 Cash Flow Approach to Insurance in New Zealand, South Africa, Australia and Singapore – The Taxable Model

The New Zealand GST system predated discussion of a comprehensive cash flow approach to full taxation of financial services.⁷¹ New Zealand's⁷² treatment of property non-life insurance reflects the beginnings of this approach that has been followed for that sector in South Africa, Australia and Singapore.

In other jurisdictions, such as EU and Canada, the insurance function is exempt.

6.5.2.1 New Zealand

The New Zealand GST law exempts the following supplies, being defined as financial services, in section 3 of the GST Act:

(h) The provision, taking, variation, or release of a guarantee, indemnity, security, or bond in respect of the performance of obligations under a cheque, credit contract, equity security, debt security, or participatory security, or in respect of the activities specified in paragraphs (b) to (g) of this subsection

(i) The provision, or transfer of ownership, of a life insurance contract or the provision of reinsurance in respect of any such contract

Life insurance contract is defined to mean:

a contract lawfully entered into to the extent that it places a sum or sums at risk upon the contingency of the termination or continuance of human life, marriage, civil union or de facto relationship, or the birth of a child, but not to the extent that it provides for entitlements under Schedule 1, Part 5 of the Accident Insurance Act 1998 (which relates to entitlements arising from fatal injuries)

Insurance is defined in section 2 as follows:

*insurance or guarantee against loss, damage, injury, or risk of any kind whatever, whether pursuant to any contract or any enactment; and includes reinsurance; and **contract of insurance** includes a policy of insurance, an insurance cover, and a renewal of a contract of insurance*

Provided that nothing in this definition shall apply to any insurance specified in section 3 of this Act.

The result is that for 'general insurance' the gross insurance premium is subject to GST (unless a zero-rated export).

To ensure that only the margin between premiums and payout is subject the GST, the New Zealand law allows an input tax deduction for:

⁷¹ See 6.6.2 hereunder.

⁷² The New Zealand GST rate effective October 1, 2010 is 15% (increased from 12.5%).

An amount equal to the tax fraction⁷³ of any payment made during the taxable period by that registered person to another person pursuant to any contract of insurance.

Further, the GST law deems an insurance payment to be consideration for a taxable supply as follows:

if a registered person receives a payment under a contract of insurance, whether or not the person is a party to the contract, the payment is, to the extent that it relates to a loss incurred in the course or furtherance of the registered person's taxable activity, deemed to be consideration received for a supply of services performed by the registered person.

Through these mechanisms, it can be seen that:

- GST is paid at the standard rate on premium revenues;
- GST registered persons will generally obtain input tax relief for the GST payable on premiums;
- deductions are available to insurers to offset any GST payable on premiums for the notional GST component of claims payment made, irrespective of whether the recipient has obtained input tax relief on the premium paid;
- to ensure that deductions given to insurers is 'negated' where GST has been deducted on the premium, GST is payable by the recipient of the insurance payout if the payout relates to the taxable activity of the recipient; and
- insurance recoveries under rights of subrogation are taxable, having the result that payments between insurers are grossed up for GST with deductions allowed to the payer and GST liabilities for the payee.

This approach achieves, over time, GST collections on the margin between premiums paid and payouts. Premiums, recoveries and payouts between registered entities generally are "wash" transactions collecting no net revenue.

It is also important to note that the regime applies to reinsurance as well as direct insurance. Accordingly, reinsurance premiums are GST taxable, payouts and reinsurance payments received are GST taxable.

The approach, of course, requires insurers to "gross up" payouts to cover the cost of GST that will be incurred by the insured on property that has been damaged and secure net receipts that equal to the economic loss of the claimant.

Non-life insurers face complexity and compliance costs in their GST affairs in:

- remitting GST on premiums collected;
- assessing claims to ensure that the amounts paid under the policy meets the economic loss of the claimant and the GST liability of the claimant, where applicable;

⁷³ The tax fraction is defined to be the fraction calculated as $(r/100+r)$ where 'r' is the GST rate. .

- distinguishing between GST taxable revenues and exempt revenues from the investment income and life insurance premiums; and
- apportioning input tax deductions between exempt investment and life insurance income and taxable insurance premiums.

GST collections on the margin only apply, under this approach, to consumption of insurance by consumers – because premiums and payouts between registered taxpayers are generally “washed out”.

South Africa’s insurance regime operates in a similar fashion to New Zealand.

Budgetary words of caution

Schenk notes that except for the exclusion of net investment income, the New Zealand approach is consistent with the ideal model outlined in the introduction to this section.

It must be recalled that the deduction allowed to insurers for payouts need not be matched by a GST payment on the premium in the same period. Further, where only economic loss is compensated by payouts (i.e., for non-property loss or where property loss is not covered by replacement), the result can be a cost to the government that is not matched by revenue.

The following significant budgetary consequences should be noted from this model:

- it cannot be assured that the net GST collections will be positive over time, even in net present value terms:
 - GST collections from consumer expenditures of non-life insurance arise in periods earlier than the allowance of the offsetting deductions for payouts; and
 - payouts on claims are funded through both premium income (GST taxable) and investment earnings (GST exempt), but deductions are allowed based on a tax fraction of the total payout.

The benefit to the revenue therefore will only be positive and only in net present value terms if the GST deduction allowed at payout is less than aggregate GST on consumer premiums collected when measured in current dollar terms.

- In budgetary terms, GST collections at initiation of the GST system will arise in advance of payouts. In future years, the payouts will offset the premiums on current year policies. On a year by year basis, therefore, budgetary balance will be achieved if the growth in premiums collections matches the growth in payouts. In this regard, however, it must be appreciated that:
 - insurers will fund payouts from investment income, so high earnings growth will negate the need for premium increases to match payout expectations; and
 - underwriting losses would be expected to be recovered from future premiums.

Both of these factors illustrate that, for ‘long tail’ insurance liabilities, economic loss and catastrophe insurance, governments will be in reliance on long term profitability from premiums to ensure that the VAT treatment of insurance does not occur at a net cost to the budget.

6.5.2.2 Australia

Under Australia’s GST, gross premiums are subject to GST.

The financial services definition in Australia’s GST includes, as input taxed (exempt) supplies, the provision, disposal or acquisition of an interest in or under:

- a “guarantee, including an indemnity (except a warranty for goods or a contract of insurance or reinsurance)”; and
- life insurance and related reinsurance.⁷⁴

The effect is that non-life insurance premiums are subject to full rate GST⁷⁵ and, consequently, any agency or facilitation services relating to the general insurance activities will be eligible for full input tax relief.

The investment of the premium is likely to involve financial supplies, thus giving rise to the difficulties faced by financial supply providers generally.

Despite applying full rate GST to general insurance premiums, Australia (like New Zealand) seeks to collect GST only on the value of the insurance service consumed by consumers. Business insurance is largely excluded from the tax base (because the GST paid on premiums is claimed as an input tax credit).

Unlike the New Zealand system input tax relief on payouts can only be claimed to the extent that the insured is denied a credit on the premium paid. This has the effect that insurance companies can only claim a credit on the value of insurance payouts made to persons not registered for GST. Unlike New Zealand, there is no need to “gross up” payouts to business claimants – only the economic loss (net of input tax credits) needs to be compensated.

The special insurance regime is described in an Australian Taxation Office ruling as follows⁷⁶:

The insurance provisions ... are designed to ensure that an insurer will only pay GST on the value of services provided by the insurer. The legislation measures the value of the insurance services by imposing GST on the full amount of the premiums collected by the insurer and then reducing the insurer’s GST by way of a decreasing adjustment...

⁷⁴ Items 6 and 7, sub-regulation 40-5.06(3) (*A New Tax System (Goods and Services Tax) Regulations 1999*). Referred to in this paper as the ‘financial supply regulations’.

⁷⁵ Currently, the GST rate is 10%. Many State governments also impose stamp duties on general insurance premiums. The GST is calculated on the stamp duty exclusive premium.

⁷⁶ GSTR 2006/10.

The insurer is entitled to a decreasing adjustment⁷⁷ if the insured is not entitled to an input tax credit on the premium it pays under the insurance policy. The amount of the decreasing adjustment is equal to 1/11th of the settlement amount.

The Australian system has similar compliance costs, budgetary and administrative risks to New Zealand. However, the risk of non-collection of GST on payouts to registered entities is avoided. This integrity measure is offset by considerable compliance costs to the sector in the need to collect input tax credit details from the insured to determine the insurer's entitlement to relief on payouts made (and hence the value of the payment made).

Please see Appendix P for a description of the Singapore model.

6.5.3 Compensatory Tax

When a VAT regime moves to a zero-rate there is a loss of revenue borne by the government. To recover this lost revenue a compensatory tax could be levied on financial institutions to ensure their overall tax burden is comparable to what it might be were a broad exemption to apply.

When the province of Quebec aligned its provincial sales tax with the GST, most financial services took on a zero-rated status. This provided financial institutions with a refund of the tax paid on inputs (i.e., input tax refunds or ITRs). The rationale for this treatment can be best explained as trying to improve the attractiveness for financial institutions to base their operations in Quebec rather than other provinces that impose an unrecoverable provincial sales tax.⁷⁸ In addition, it was designed to encourage existing Quebec-based organizations to continue operating in Quebec. However, to ensure that the sector suffered the same tax burden consistent with that before the tax reform, a compensatory tax was introduced on July 1, 1992.

Generally speaking the compensatory tax is a fixed percentage levied on wages paid by a financial institution. Compensatory tax rates applicable in Quebec effective for taxation years ending after March 30, 2010 are⁷⁹:

⁷⁷ A decreasing adjustment is a mechanism similar to input tax relief.

⁷⁸ Bird, Richard M. & Gendron, Pierre-Pascal. *Sales Taxation in Canada: The GST-HST-QST-RST 'System'* (May 29, 2009). Revision of paper presented at American Tax Policy Institute Conference on Structuring a Federal VAT: Design and Coordination Issues, Washington, D.C., February 18-19, 2009.

⁷⁹ Refer to the Compensation Tax section of the Revenue Quebec website, accessed November 12, 2010 at <http://www.revenu.gouv.qc.ca/en/entreprise/impot/societes/declaration/compensatoire.aspx>

Industry	Tax Base	Taxation Year Ending Before April 1, 2010	Taxation Year Ending After March 30, 2010
Bank, loan corporation, trust corporation, corporation trading in securities	The sum of: <ul style="list-style-type: none"> • capital paid as established for the calculation of the tax on capital, excluding certain deductions, multiplied by the proportion of business carried on in Québec and the tax fraction of the number of days in the taxation year where the corporation was a financial institution. • salaries and wages paid by the corporation during the period(s) of the year that it was considered a financial institution. 	0.25% of capital paid Plus 2% of salaries and wages	0.25% of capital paid Plus 3.9% of salaries and wages
Insurance corporation	Total of all premiums payable and all taxable premiums on which tax must be paid during the year multiplied by the tax fraction of the number of days in the taxation year where the corporation was a financial institution.	0.35%	0.55%
Savings and credit union	Salaries and wages paid by the corporation during the period(s) of the year that it was considered a financial institution.	2.5%	3.8%

Industry	Tax Base	Taxation Year Ending Before April 1, 2010	Taxation Year Ending After March 30, 2010
Professional order	Premiums, administrative costs, contributions in regard to a group insurance plan or an insurance fund respecting professional liability and of all other costs inherent in the operation of such a plan or fund.	0.35%	0.55%
Bank, loan corporation, trust corporation, corporation trading in securities or savings and credit union that is ALSO an insurance corporation	The sum of: <ul style="list-style-type: none"> • the amount determined based on the type of financial institution • all taxable premiums paid on which tax must be paid during the year multiplied by the tax fraction of the number of days in the year where the corporation was a financial institution 	0.35%	0.55%
Any other corporation that is a financial institution	Salaries and wages paid by the corporation during the period(s) of the year that it was considered a financial institution.	1%	1.5%

In Quebec, funds are treated as fully zero-rated and are not subject to the compensatory tax.

6.5.3.1 Compensatory Tax – Effectiveness

While a compensatory tax is relatively easy to administer it does pose some challenges around compliance and economic efficiency.⁸⁰ For example, it may be difficult for complex multijurisdictional organizations to accurately determine the tax base where it is necessary to determine the proportion of business carried on in Quebec. Furthermore, the tax burden is borne by the taxpayer rather than by the end consumer as is the intention of a VAT and it is uncertain

⁸⁰ Bird, Richard M. & Gendron, Pierre-Pascal. *Sales Taxation in Canada: The GST-HST-QST-RST 'System'* (May 29, 2009). Revision of paper presented at American Tax Policy Institute Conference on Structuring a Federal VAT: Design and Coordination Issues, Washington, D.C., February 18-19, 2009.

whether the compensatory tax accurately offsets the advantage of zero-rating financial institutions.⁸¹ Another major concern is the ease with which the rate can be raised. For example, Quebec has recently increased the compensatory tax rates for taxation years ending after March 31, 2010.

6.5.3.2 Financial Activities Tax (“FAT”)

As an alternative to a compensatory tax, an FAT tax could be levied. As suggested in the November 2010 edition of the Fiscal Monitor published by International Monetary Fund (page 76):

This could be structured in various ways: as an addition method value-added tax (“VAT) on all compensation and profits of financial institutions; by exempting compensation and profits below a threshold level as a tax on economic rents in the financial sector; or by taxing only the higher returns, as a deterrent to excessive risk-taking. Which type of FAT is preferable depends on policymakers’ objectives.

6.5.4 Margin Tax

The Financial Margin Tax on Financial Institutions (“Margin Tax”) was introduced through the White Paper tabled by the Canadian Department of Finance in 1987 as part of the Sales Tax Reform package. However, due to a general lack of understanding of the practical application of the Margin Tax, as well as a number of fundamental weaknesses, the Tax was ultimately rejected in favor of a broad exemption for financial services.

The Margin Tax was intended to apply only to financial institutions. For non-financial institutions financial services were always intended to be treated as exempt from GST, much like the treatment of financial services under VAT systems globally at that time. Interestingly, at the time the idea of a Margin Tax was introduced, financial institutions generally did not include investment plans, such as, mutual fund trusts (unless they incurred salaries and wages) and registered pension plans. Since the Margin Tax would not have applied to these non-financial institutions, the general exempt treatment of financial services would presumably have been applicable with respect to these investment vehicles.

In broad terms, the Margin Tax would have applied on a financial institution’s tax base that included explicit fees charged for financial services, as well as financial margins. The financial margin for a financial institution can basically be viewed as being equal to financial revenues less financial costs. For a lender such as a bank, the spread between interest earned by the bank on loans and the interest paid on deposits would represent part of its financial margin. For an insurer, the excess of premiums received on insurance policies issued over claims paid and reserves under insurance policies would represent part of its financial margin.

⁸¹ Pierre-Pascal Gendron, *Value-Added Tax Treatment of Financial Services: An Assessment and Policy Proposal for Developing Countries*. ITP Paper No. 0701, International Tax Program, Joseph L. Rotman School of Management, University of Toronto (2007).

6.5.4.1 Margin Tax - Effectiveness

Although fairly simple from a conceptual perspective, the rules surrounding the application of the Margin Tax were complex. Certain revenues would be required to be accounted for on an accrual basis, others on a cash basis, and still others an amortized basis. In addition, there were a number of special rules designed to properly measure financial margin, including rules to deal with reserves, the treatment of equity funds vs. borrowed funds, investments in non-financial assets, and investments in connected corporations and other transactions with connected corporations. Finally, special rules existed to deal with the treatment of premium taxes, reinsurance, and segregated funds.

The Margin Tax would not provide full relief on business inputs due to the fact that tax paid by financial institutions will become embedded in the cost of financial services. Since financial services are often a key component of business costs, this embedded Margin Tax would cascade through the supply chain.

The Margin Tax would have the effect of impacting individuals and families that purchase more financial services than others. Although this may generally be fair, low-income individuals and families would typically be spending proportionately more on financial services relative to income, which is considered undesirable in the context of designing a fair and neutral sales tax. In addition, the Margin Tax increases the operating costs of domestic financial institutions in comparison with their foreign counterparts, which has the undesired result of putting Canadian financial institutions at a competitive disadvantage. Finally, it's important to note that the Margin Tax was only intended to apply to financial institutions. As such, it would not be neutral across financial services sector (i.e., financial institutions that are subject to the Margin Tax vs. non-financial institutions that are not subject to the Margin Tax).

6.6 Full Taxation at Zero-rate

6.6.1 Zero-rating of Financial Services

One alternative to the exemption model for financial services is zero-rating the consumption of these services. Under the exemption model there is no VAT applied by a financial institution on their services and financial institutions are not entitled to claim input tax credits. Alternatively, under a zero-rating model, there is no VAT applied by a financial institution on their services and financial institutions are entitled to claim input tax credits on all their inputs.

The argument in favor of full zero-rating is both conceptual and practical:

- Conceptually, because a zero-rate completely relieves financial services from VAT costs, the consumer and business consumption of financial services is not taxed. What might be regarded as an under taxation of consumers is argued to be a correct treatment of financial intermediation on the basis that taxation of the intermediation distorts inter-temporal consumption decisions. It must be remembered that while a VAT is a multi-stage tax, it seeks only to tax consumer expenditures. It is argued that as consumption of financial intermediation by consumers smoothes consumption of goods and services, the taxation of financial services “distorts the

choice between current and deferred consumption, as well as the choice to transfer consumption between good and bad states (the insurance function)⁸²;

- From a practical perspective, once it is accepted that exemption is a less than efficient approach, the extension of full zero-rate to financial services:
 - eliminates self-supply, cascade, and offshore supply distortions;
 - does not have a significant impact on the demand and substitution effect of lower tax costs for consumers – particularly if VAT is imposed at a lower rate;
 - minimizes the compliance costs and complexity arising from exemptions (including the need for self assessment); and
 - avoids the possibility of under-investment in the financial services sector and the danger of adoption of economically inefficient outsourcing.

The International Monetary Fund, in its report to Hong Kong SAR⁸³, recommended that consideration be given to a full zero-rate for financial services. The reasons for this recommendation were:

- the competitive market for financial services in the region;
- the importance that the sector played in Hong Kong's economy;
- zero-rating would eliminate the cascading that arises under an exemption approach; and
- the budgetary costs were not significant.

The scope of the zero-rate was to extend to all defined financial services whether an implicit or explicit fee were charged. Reflecting the international framework for the definition of financial services exemption, the proposed scope of the zero-rate was to include:

- Bank accounts
- Loans and mortgages
- Securities (i.e., shares and bonds)
- Bank deposits
- Money exchange
- Futures
- Stored value cards
- Certificates of deposit
- Derivatives

⁸² Harry Grubert & James Mackie, *Must Financial Services Be Taxed Under a Consumption Tax?* (2000) 53(4) *National Tax Journal* at 23-40. (Grubert and Mackie 2000).

⁸³ Policy and Administrative Issues in Introducing a Goods and Services Tax, January 2001.

- Currency
- Insurance
- Underwriting
- Mandatory provident funds and collective investment schemes
- Financial guarantees
- Precious metals
- Bills of exchange
- Trade finance
- Refining of precious metals

Consideration was to be given to the inclusion of “related” financial services (i.e., services provided by stock brokers and insurance brokers or “arranging” services) for zero-rating.

While the full zero-rate of financial services in a VAT environment addresses many of the deficiencies highlighted at the beginning of this paper, and is internationally and regionally competitive, the full zero-rate approach has a number of potential negative aspects:

- as input tax relief is only available for VAT registered entities, there is a distinction and hence a distortion between business entities and non-business entities⁸⁴ undertaking financial transactions;
- if the definition of financial services is given narrow scope, consumption of services by consumers that do not qualify for a zero-rate bear a relatively higher tax cost;
- the full relief from tax provides an incentive to segregate a financial charge as part of the price for an otherwise taxable supply of goods and services, thus reducing the GST payable on taxable commodities – the substitution effect⁸⁵; and
- a full zero-rate regime will result in a large number of entities claiming refunds from the revenue on a regular basis with the consequence of increasing risk of refund fraud.

Professor Edgar states that the case for comprehensive zero-rating of financial services suffers from two deficiencies:

- financial services for which an explicit fee can be charged and full VAT tax applied mean the case for a comprehensive zero-rate is not clear cut; and
- zero-rating entails a budgetary cost that may not be acceptable to government.⁸⁶

⁸⁴ For example, holding companies and investment companies are not regarded as carrying on an economic activity under the EU law – see *Polysar Investments Netherlands B v Inspectur Der Invoerrechten en Accijnzen, Arnhem* [C-60/90]; *Investrand BV v Staatssecretaris van Financiën*, C-435/05.

⁸⁵ *Debenhams Retail Plc v Commissioners of Customs and Excise*, [2004] E.W.H.C. 1540 (Ch).

6.6.2 Comprehensive Cash Flow or “TCA”

Cash flow taxation is an approach designed specifically to overcome the problem of identifying the margin bundled into the interest rate on financial services. The European Commission undertook a significant study, led by Satya Poddar, to consider the potential application in the EU. The objective of the cash flow approach is to replicate how full VAT taxation would apply to financial services through the use of cash flow accounting. The approach would work as follows.

- For B2B transactions, both the financial service provider and the registered business acquiring the service would keep separate, identical accounts, known as Tax Calculation Accounts (“TCA”). The TCA would account for cash flows between the financial service provider and the registered business, on which VAT would be paid, less an interest charge. The registered business would receive tax invoices from the financial service provider, on which input tax credits could be claimed.
- For final individual consumers, the TCA would allow the financial service provider to pass through VAT on services provided.

Professor Edgar concludes that after some ten years of development, the cash flow taxation approach is, “...an internally logical and coherent approach under a credit-offset VAT to the treatment of the implicit charges embedded in such margins”. However, he goes on to note that a pilot of this approach with a TCA in Europe indicated that it would entail, “some significant and unavoidable compliance costs.” Professor Burns notes⁸⁷ that for this reason, “no country has so far adopted this method.” The exception to this position is in “risk taking” financial intermediation.

The cash flow approach is significant in our examination of financial services in this report because it illustrates a distinction in the international value added tax model between risk-taking intermediation and other financial intermediation. In particular, some jurisdictions adopt a cash flow approach to insurance (and gambling activities), as discussed previously in a previous section of this report.

In New Zealand, Australia and Singapore, the premium paid for non-life insurance and non-life reinsurance⁸⁸ is subject to GST at the standard rate. Each jurisdiction allows input tax relief for claim settlement and other indemnity payments. While the amount of input tax relief and the treatment of the settlement payments in the hands of the insured varies between jurisdictions, the aim is to ensure that the margin between premiums and payouts to consumers is treated as private consumption expenditure. The investment earnings of insurance providers are, however, subject to the normal exemption treatment; that is, the investment business is taxed on the resources consumed and the insurance activities are taxed on the margin between premiums and payouts.

Significantly, this “cash flow” treatment does not apply to life insurance and reinsurance, in all likelihood because of the bundling of the life risk component with investment products.

Please see Appendix A for a more detailed overview and explanation of how the TCA model works.

⁸⁶ Edgar, 2007 at 142.

⁸⁷ Burns, 2008.

⁸⁸ In New Zealand and Australia but not in Singapore.

6.6.3 Hybrid Cash Flow + B2C Taxation

Recently a hybrid model of full taxation, zero-rating and cash flow models has been proposed. Rather than applying a single taxation model to financial services, Edgar proposes an option that seeks to replicate full VAT taxation of financial intermediation by ensuring that:

- full taxation of financial intermediation only applies to final consumption by consumers; and
- full credit is provided for B2B financial services transactions.

Edgar's model achieves this by separating the components of full VAT taxation of financial intermediation into its component parts and applying individual VAT treatment:

- for financial services where an explicit fee is charged, full VAT taxation is applied to consumers;
- for financial services where a margin is charged, a cash flow base would be used to tax financial intermediation, at an aggregate level; and
- business consumption of financial services would be zero-rated.

This approach seeks to maximize to the greatest extent the application of the VAT to final consumption by consumers.

The approach has the advantage of eliminating the deficiencies of the exemption model for business supplies of financial services (i.e., it eliminates the cascade, offshoring and self-supply biases) and treating consumption by consumers neutrally. On the other hand, by fully taxing consumption of consumers, domestic providers of financial services are disadvantaged relative to their offshore competitors. So far this option has received little attention.

In its report to the Australian Government on *Australia's Future Tax System*⁸⁹, the Australian Treasury commented on the inefficiencies of the exemption approach to the taxation of financial services. The Treasury considered mechanisms that could be used to relieve financial services from input taxation at a B2B level but to subject to full VAT, the value of financial intermediation consumed by consumers.

The mechanisms considered were similar to the approach of Professor Edgar. Treasury's finding and recommendation was:

To remove the adverse efficiency costs of input taxation on business and exports, financial services could be removed from the GST (effectively, made GST-free). However, this would have a large revenue cost and inappropriately exempt private consumption of financial services. The Australian government, in consultation with the financial sector, could further develop an alternative method of taxing domestic consumption of financial services to replace input taxation under the GST, or to complement a cash flow tax, to ensure that

⁸⁹ Australian Government, 2010, *Australia's Future Tax System* at http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm

consumption of financial services is treated equivalently to other forms of consumption.⁹⁰

⁹⁰ Edgar, 2007 at 151.

7 Incidence of VAT in the Financial Sector

This report has outlined the international approach for the application of VAT to financial services and found that there are difficulties in the final consumption of financial intermediation services. In response to these difficulties, international practice has been to apply exempt VAT treatment to financial services. Moreover, the inefficiencies associated with exemption has resulted in a number of partial solutions being developed to ameliorate the perceived impacts of the exemption. This section introduces a further evaluation criterion: who benefits from a reform, the financial service provider or business and consumers that use financial services?

As was demonstrated, the EU countries adopted an exempt treatment for financial services at an early stage in the development and implementation of the EU VAT system, in response to the challenges of applying a multi-stage, credit offset VAT. The international model is therefore a reflection of historical circumstance and precedent, rather than any detailed quantitative analysis of:

- the efficiency costs of exempt treatment; or
- the effects of the partial solutions intended to reduce these efficiency costs.

One reason why this quantitative analysis has not been undertaken is the difficulty in assessing:

- the economic incidence of the VAT – whether it is borne by business or consumers; and
- depending on the economic incidence, the responsiveness of consumer demand for financial services as a result of changes in price – the price elasticity.

Understanding the economic incidence of the embedded tax in the VAT exemption is a necessary first step in determining the effectiveness of any of the partial solutions to the exemption problem. This is because the partial solutions are based on particular assumptions as to the incidence of the embedded tax. As Professor Edgar points out:

- zero-rating business to business financial services transactions is based on the assumption that the cascading effect of the tax is passed on to consumers and therefore affects final consumption decisions; however,
- reduced input tax credits to address a self-supply bias are based on the assumption that financial service providers cannot pass the burden of the input tax forward to consumers, but must bear this tax themselves; if the embedded tax could be passed on, there would be no self-supply bias.

Professor Edgar concludes that the lack of any empirical evidence as to the economic incidence makes it difficult to make conclusive judgments as to the effectiveness or otherwise of the partial solutions:

But yet again, the choice of partial reform alternatives depends critically on the empirical issue of the extent of the shifting of the embedded input tax under an exemption system and we have no systematic empirical evidence.⁹¹

⁹¹ Edgar, 2007 at 151.

With no empirical evidence to support the validity of the economic incidence the choice of any of the partial solutions is arbitrary and potentially counterproductive.⁹²

Moreover, the economic incidence of the VAT depends not only on the nature of the tax itself but prevailing market conditions at a particular point in time. Ebril says that:

The effective incidence of a VAT, like that of any other tax is determined not by the formal nature of the tax but by market circumstances, including the elasticity of demand for consumption and the nature of competition between suppliers.⁹³

In other words, in a highly competitive financial services market where financial service providers are price takers or where the demand for financial services is highly price elastic, financial services providers will bear the burden of any embedded tax, as it will not be able to be passed on to final consumers.

As a consequence, the burden of any embedded tax will result in a lower rate of return on capital invested in the financial services sector (or lower employment in the sector), and lower investment in financial services than would otherwise be the case.

The issues of incidence and elasticity take on even greater importance in a globalized, integrated and highly competitive international financial services sector. With greater competition in financial services markets, the more likely that financial service providers will bear the burden of any embedded taxes, with less ability to pass these costs through to final consumers.

⁹² Edgar, 2007 at 152.

⁹³ Ebril, 2001 at 15.

8 Model Costing

The following tables summarize the financial impact to the various industries of the treatment of financial services under the Canadian model as well as some of the alternative models presented in this report.

Please see Appendix R for all assumptions used in these models as well as the detailed calculations.

Banking and Securities - Generic Model

Summary of Crown Revenue by Alternative						
	Supplier	Bank	Business A	Consumer A	Consumer B	Crown
Canadian Model	-	2.50	-	-	5.06	7.56
Broad Exemption Model	1.25	-	-	-	5.03	6.28
Full Taxation Model	-	-	-	2.50	5.00	7.50
Full Zero-Rating	-	-	-	-	5.00	5.00
Narrow Exemption and RITC	-	1.25	-	-	5.03	6.28
B2B Zero-rate	-	1.25	-	-	5.00	6.25

Funds - Generic Model

Summary of Crown Revenue by Alternative				
	Investment Manager	Fund	Unit Holders	Crown
Canadian Model	-	5.00	-	5.00
Broad Exemption Model	1.25	-	-	1.25
Full Taxation Model	-	-	5.00	5.00
Full Zero-Rating	-	-	-	-
Narrow Exemption and RITC	-	2.50	-	2.50

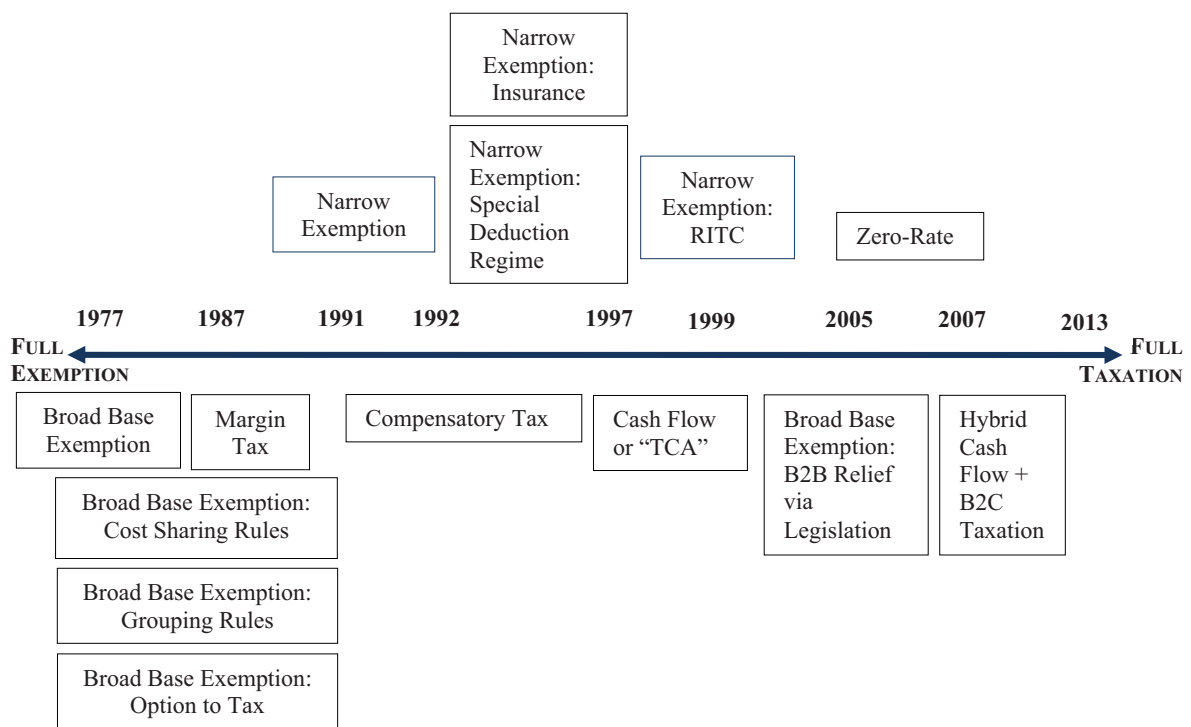
Life and Health Insurance - Generic Model

Summary of Crown Revenue by Alternative						
	Supplier	Insurance Co.	Business A	Consumer A	Consumer B	Crown
Canadian Model	-	2.50	-	-	5.06	7.56
Broad Exemption Model	1.25	-	-	-	5.03	6.28

9 Conclusions

Essentially, current VAT regimes are largely ill-equipped to deal with the concept of financial intermediation, which being represented by an implicit fee or margin between two positions, does not lend itself to the multi-stage, credit-offset model. In a global market, where capital is highly mobile, taxes imposed on financial services can be uncompetitive and result in under-investment.

As the diagram below demonstrates, over the course of the last 15 years there has been significant debate about the application of VAT to the financial services sector.⁹⁴



As a result of the continuing popularity of the VAT-type consumption tax and an increasing focus by authorities on indirect taxes generally, it is anticipated that the debate will continue to evolve. As evidenced by initiatives in other jurisdictions, the application of VAT to financial services is front of mind.

In terms of broad trends in country practices, partial reforms of exemption have tended to be preferred as a means to address perceived distortions of the pattern of consumption of financial services by businesses. More particularly, the focus here has been on mechanisms, other than the limitation of exemption to margin-based charges, to alleviate the perceived over-taxation of the

⁹⁴ This diagram is also available in Appendix H.

business consumption of financial services, as well as the bias to self-supply faced by financial service providers.

A handful of countries have adopted a limited range of reform alternatives intended to address the effects of exemption. The application of a B2B zero-rate for financial services and greater ability to claim input deduction appear to be the two partial reform alternatives on offer to address the over-taxation of such consumption by financial services providers under exemption. A greater ability to claim input deduction and the extension of exemption to a range of non-financial supplies made to financial service providers appear to be the two reform alternatives on offer to address the self-supply bias. Where revenue loss attributable to the availability of additional input tax credits is a concern, the extension of taxable status to a greater range of financial services consumed by consumers can provide a needed offset as could a special compensatory tax.

The impact of any reform can impact different service providers differently. Appendix J assesses how each option would impact a particular sector vis-à-vis another sector.

* * * * *

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A Academic Debate

A.1 Framing the Issues Presented by the Treatment of Financial Services under a Multi-Stage Credit-Offset VAT and the Alternatives to Exemption

by Professor Tim Edgar

The treatment of financial services under a credit-offset VAT hardly suffers from a lack of attention. Beginning in the late 1980s, there is some early conceptual and technical design work on the subject, the most important of which is probably that of Bakker and Chronican,⁹⁵ who thoroughly canvassed a range of alternatives to exemption in a short monograph that was published in the run up to the adoption of the GST in New Zealand. The development of alternatives to exemption nonetheless appeared to remain in the “too hard basket” until the publication of an article by Poddar and English⁹⁶ in which they built on some earlier work to describe versions of a system of cash-flow taxation as a comprehensive reform alternative to exemption. Their article seemed to spark a lively debate in the literature, with policy implications, over the taxable status of the household consumption of financial services. It also seemed to spark what is now a relatively deep survey and technical design literature, whereby the relevant policy issues presented by financial services under a credit-offset VAT are canvassed and reform alternatives to exemption are examined. At the same time, there appears to have emerged a greater willingness on the part of tax policymakers to explore partial reform alternatives to exemption.

This section of the paper frames the broad conceptual issues presented by the treatment of financial services under a credit-offset VAT. Those issues that are highlighted are: (i) the standard rationale for exemption and its associated behavioral distortions; (ii) the characterization of the household consumption of financial services as taxable; and (iii) the need to draw a boundary between taxable and exempt financial services where a range of such services are accorded exempt treatment. The section then outlines, in a general sense, the various alternatives to exemption articulated in the technical design literature, as well as trends in country practices focused on one or more of the distortions associated with exemption.

A.1.1 Rationale for Exemption and the Associated Distortions

Conventional wisdom holds that financial services are properly taxable under a VAT, while the return to savings should remain non-taxable in order to avoid distorting the choice between present and deferred consumption. The commonly-cited rationale for the application of exempt, rather than taxable, treatment of financial services is a perceived inability to identify and measure, on a transactional basis, those intermediation charges that are not explicit but are embedded in financial margins. In the apparent absence of an ability to impute financial margins to consumers of financial

⁹⁵ Carl Bakker & Phil Chronican, *Financial Services and the GST* (Wellington: Victoria University Press for the Institute for Policy Studies, Discussion paper, 1985).

⁹⁶ Satya Poddar & Morley English, “Taxation of Financial Services Under a Value-Added Tax” (1997) vol. 50, no. 1 *National Tax Journal* 89-111.

services on any means other than a formulaic basis, tax policymakers have tended to exempt a range of financial services from a VAT and deny any credit for offsetting tax on associated inputs consumed by the service provider. This approach is seen to cause four behavioral distortions. The first distortion involves demand effects on the household consumption of financial services. This particular distortion is seen to follow from the under-taxation of such consumption as compared to the consumption of other goods and services. The under-taxation occurs because of the failure to tax the value of financial services consumed by households. On the assumption that all or some portion of the tax on the cost of inputs is shifted forward by financial service providers, households are only taxed in part on their consumption of financial services. Depending on the price elasticity of consumer demand, the resulting under-taxation may result in an inefficient allocation of household resources to the consumption of tax-preferred⁹⁷ financial services.

The second distortion involves both demand and supply effects on the business consumption of financial services. This particular distortion is seen to follow from the over-taxation of the consumption of financial services by registered businesses as compared to the consumption of other business inputs. The most significant source of over-taxation is the double tax on business inputs used by financial service providers. The double tax occurs because of the input taxation of financial services rather than the full taxation of the value of such services with an offsetting input tax credit for consumers who are identified as registered businesses for VAT purposes. To the extent that the costs of business inputs used by financial service providers are shifted forward in prices charged to their business consumers and on to final consumers of non-financial goods and services, the inputs bear tax once as consumed by the financial service provider and again by consumers of the businesses that use financial services. Over-taxation also occurs because of the tax cascade that occurs as unrecoverable VAT on business inputs used by financial service providers is itself subject to tax when passed on in the form of higher prices to the final consumer of goods and services of a non-financial business using financial services. The over-taxation that results from this tax on a tax, as well as the double taxation of business inputs, can lead to competitive distortions and a misallocation of resources in the sense that there may be less consumption of goods and services that involve higher amounts of consumption of financial services. To the extent that the embedded tax on business inputs cannot be shifted forward to consumers in the form of higher prices or backward to suppliers in the form of lower prices for their goods and services, the tax may lower the after-tax returns to capital in the financial sector and result in under-investment in that sector.

The third distortion involves supply effects for financial service providers. It is seen to follow from the incentive that these service providers have under an exemption system to avoid non-recoverable VAT on out-sourced services by substituting in-sourced services. This substitution effect may impose efficiency costs to the extent that the out-sourcing of services is the preferred pattern of production, ignoring tax considerations. A misallocation of resources also arises to the extent that certain segments of the financial sector cannot engage in substitution, and there is a resulting shift in resources to those segments that can readily substitute one form of organization for another.

The fourth distortion again involves both demand and supply effects, but for business and household consumption of financial services. Whatever the extent of the shifting of the embedded tax under a system of exemption, offshore suppliers of financial services enjoy a competitive

⁹⁷ That is, VAT exempt.

advantage over domestic suppliers, to the extent that they can deliver services free of VAT. In response to this tax bias, domestic financial service providers may move the provision of certain services to domestic customers offshore, with revenue loss and possible inefficiencies associated with the different organizational structure. Furthermore, where there is no mechanism requiring financial service providers to self assess VAT on imported services, there is an incentive to substitute VAT-free offshore supplies of services for fully-taxed domestic supplies of services, which can distort patterns of production.

A substantial body of technical design literature, including a study commissioned by the European Commission,⁹⁸ describes various mechanisms that permit the taxation of financial services in a way that is consistent with a credit-offset VAT but does not tax interest charges. In general, alternatives to exemption are intended to address one or more of these four distortions.

A.1.2 Taxable Characterization of the Household Consumption of Financial Services

As an important conceptual matter, the technical design literature, which focuses on the available alternatives to exemption, has proceeded on an assumption that the household consumption of financial services is properly characterized as taxable consumption. A taxable characterization of the household consumption of financial services appears to be based on the proposition that the provision of such services, like the provision of any other services, uses up real resources and creates value added. A non-taxable characterization is limited to the consumption of financial services by registered businesses, which should be able to expense the associated charges. Difficulties in allocating implicit prices for expensing purposes are seen, however, to preclude this first-best treatment.

A contrary view, articulated most recently by Harry Grubert and James Mackie,⁹⁹ as well as William Jack,¹⁰⁰ posits that a range of household consumption of financial services should be considered non-taxable. The extreme position is that of Grubert and Mackie, who would extend a non-taxable characterization to the household consumption of financial services generally on the basis that such consumption does not enter the consumer utility function. That is, the household consumption of financial services only smoothes consumption of commodities that provide personal gratification for the consumer and thus enter the utility function. Accepting this non-taxable characterization as correct, they formally prove that taxation of the household consumption of financial services distorts the choice between current and deferred consumption, as well as the choice to transfer consumption from good to bad states (the insurance function).

Although generally in agreement with the basic premises adopted by Grubert and Mackie, Jack focuses on the efficiency properties associated with the form of the prices charged for the household consumption of financial services to suggest a narrower range of such consumption that should be

⁹⁸ European Commission, *The TCA System – a Detailed Description*. Reports and Studies Commissioned for the European Commission (Brussels: Taxation and Customs Union, 2000).

⁹⁹ Harry Grubert & James Mackie, “Must Financial Services Be Taxed Under a Consumption Tax?” (2000) vol. 53, no. 1 *National Tax Journal* 23-40.

¹⁰⁰ William Jack, “The Treatment of Financial Services Under a Broad-Based Consumption Tax” (2000) vol. 53, no. 4 *National Tax Journal* 841-51.

considered non-taxable. In this respect, he articulates three general categories of financial charges and their associated consumption tax treatment, which are said to follow from an efficiency-based analysis. One category consists of spread-based charges that are “proportional to the nominal value of the underlying financial transfer.” A second category consists of charges that are fixed in amount and cover administrative costs. These charges are a “form of non-linear pricing” that does not vary with the nominal amount of a transaction. A third category consists of “quasi-fixed fees” that are “proportional to the real value of the underlying transfer.” Jack argues that an efficiency-based analysis supports the proposition that only spread-based charges should be non-taxable under a consumption tax that attempts to avoid inter-temporal distortion of the relative price of consumption goods.

This strand in the literature challenging the accepted characterization of the household consumption of financial services as properly taxable has provoked two responses. One response, from Alan Auerbach and Roger Gordon,¹⁰¹ emphasizes the fundamental objectives of a VAT as the basis for deciding how to tax financial services. They argue that this category of intermediate production should be subject to VAT on the same basis as other sectors where resources are used up in the production process. In particular, Auerbach and Gordon rely on the equivalence of a labour income tax and a VAT to support the proposition that a VAT should be applied to tax all primary factors that enter into the production of financial services consistent with a tax on the income of all such factors. They reject the efficiency-based analysis of Grubert and Mackie, as well as Jack, by showing that the application of a VAT to the real resources consumed by the financial sector should not distort prices where the same costs remain and would otherwise be taxed under an equivalent labour income tax.

Another response, from Donald Rousslang,¹⁰² apparently accepts the premise that the real resources used up in the delivery of financial services should, as an initial proposition, be subject to VAT unless it can be shown that:

- the use of financial services to shift consumption inter-temporally is not wasted in its associated shifting of tax revenue; and
- imposition of the tax on financial services causes consumers to increase their consumption of such services.

Rousslang concludes that the first proposition is unlikely, and that the better answer to the second is “no.” The basis for the former is that the shifting of tax revenue inter-temporally is largely offset by lending and borrowing transactions, so that there are no positive externalities associated with such shifting of revenue. In short, the effort is largely wasted because of the offsetting positions. The basis for his second response is simply the proposition that there is no empirical evidence in support of the assumption that application of a VAT to financial services would result in increases in transaction costs that are proportional to nominal prices.

¹⁰¹ Alan J. Auerbach & Roger H. Gordon, “Taxation of Financial Services under a VAT” (2002) vol. 92, no. 1 *American Economic Review* 411-16.

¹⁰² Donald J. Rousslang, “Should Financial Services be Taxed Under a Consumption Tax? Probably” (2002) vol. 55, no. 2 *National Tax Journal* 281-91.

Disagreement remains, therefore, in the theoretical literature regarding the identities of the financial services, if any, that should be taxed under a VAT. As Auerbach and Gordon seem to suggest, the whole confusion arises because proponents of the non-taxation of savings complements implicitly are looking for an optimal tax regime, which recognizes the complementary and substitution relationships in setting tax rates. But in the absence of any empirical evidence that would support the choice of an optimal rate of VAT for financial services, full taxation of such services appears to be the preferred default position.

A.1.3 Boundary between Exempt and Taxable Financial Services

An important aspect of an exemption system is the need to draw a boundary between exempt financial services and other taxable services (financial and non-financial). Ideally, the concept of financial services subject to exempt treatment under a VAT should bear a close relationship to the rationale for exemption. This relationship is not always clearly reflected, however, in country practice, which tends to involve the use of activity-based legislative definitions of exempt services rather than definitions that are based on the status of the service provider as a financial institution. This definitional approach has arguably been developed with an unnecessary focus on the characterization of administrative and cash-management services, as well as agency and advisory services. This focus is driven, in part, by apparent concerns about the substitutability of the form of pricing structures as explicit fees or margin-based charges, which has led to an extension of the concept of exempt services.

The definitional approach characteristic of most country practices focuses on the classification of three general categories of services:

- core intermediation functions (deposit-taking intermediation, brokerage services, and the insurance function);
- administrative and cash-management services; and
- agency and advisory services.

All or most of the core intermediation functions are classified as exempt financial services on the basis that charges for these services are often not readily observable and measurable on a transactional basis. These core intermediation services are commonly defined legislatively to include dealings in money, shares, debt securities and cash-settled derivative financial instruments, the provision of credit (including guarantees and indemnities in respect of specified securities), and the writing of insurance. Although exemption should be limited, in principle, to those fees that are embedded in financial margins, exempt treatment is extended to explicit fees for these services on the apparent assumption that any attempt to tax them would induce undesirable changes in the form of pricing structures.

The classification of administrative and cash-management services depends on a characterization of these services as within the specified range of core intermediation functions or on a characterization of the provision of the relevant services as incidental to one or more of those functions. These

services include the operation and maintenance of accounts, data processing, debt collection, clearing and settlement services (including credit card operations), general accounting and record-keeping services, insurance adjustment and property appraisal, custodial services, and trust and estate administration. To the extent that the services are considered either within the definition of the core intermediation functions or incidental to those functions, they are generally classified as exempt. In effect, they take their character from an identifiable or related core service, whether or not the charge for the particular administrative or cash-management service is explicit or is embedded in financial margins associated with the core service. As with the treatment of explicit fees for the core intermediation services, exempt classification may be extended to a range of administrative and cash-management services on the assumption that a taxable classification would induce undesirable changes in the form of pricing structures. Application of taxable status may be limited to administrative and cash-management services that are provided independently by a person that is not a party to an underlying transaction that constitutes a related core intermediation function. In this instance, the services are considered taxable on the assumption that they are commonly explicitly priced. Presumably, the assumption is derived from the premise that the different identities of the providers of the core intermediation services and the related administrative services generally acts as a barrier to the ability to disguise an explicit price for the latter in the financial margin associated with the former.

Advisory services (including investment management services) provided in relation to the core intermediation functions are classified generally as taxable on much the same assumption as that underlying the taxable classification of other administrative and cash-management services. The same classification is commonly extended specifically to include professional services provided by an accountant, actuary, lawyer or notary in the course of a professional practice. In contrast, agency or facilitation services provided in connection with any of the core intermediation functions are generally classified as exempt financial services. In particular, they tend to fall within the concept of “agreeing to do, or arranging for” any of the core intermediation functions that are specified as exempt financial services. This extension of the definition of exempt financial services to include agency and facilitation services may again be based on assumptions about the ability to substitute pricing structures to attract different tax treatments. The extension may also be made, at least in part, to alleviate the bias to in-source services, which arises when a financial service provider must pay unrecoverable VAT on out-sourced services.

These broad features of the standard definitional approach to the category of exempt financial services create a boundary between incidental and non-incidental administrative and cash-management services, as well as a boundary between advising on a financial service and the arranging of such a service. Because of the associated differences in tax treatment, these boundaries are an obvious source of dispute between taxpayers and tax administrators. The result has been a seemingly endless stream of increasingly fine distinctions, which is driven, in part, by increased out-sourcing of services.

A.1.4 Nibbling Away at the Edges of Exemption

As alternatives to the exempt treatment of financial services, zero-rating and cash-flow taxation are the two principal approaches that are broadly consistent with a credit-offset VAT in the sense that

they explicitly address the need to measure and allocate prices on a transactional basis among consumers. They are also comprehensive alternatives in the sense that they potentially address the entire range of distortions associated with exemption.

A general application of zero-rating is based, in fact, on a rejection of the need to engage in the process of measuring and allocating financial margins among consumers. More particularly, zero-rating is based on a rejection of the assumption underlying the identification and measurement problem as a rationale for exempt treatment, and is the logical outcome of a characterization of the household consumption of financial services as non-taxable. By taxing financial services at a zero-rate, financial service providers are able to claim tax credits for VAT on associated inputs. Combined with the zero-rating of financial service providers, this availability of input tax credits eliminates any tax distortion for households in their choice between current and deferred consumption. Zero-rating also eliminates any competitive advantage that offshore providers of financial services enjoy, to the extent that they can provide services to households free of VAT.

In contrast with comprehensive zero-rating, the application of cash-flow taxation is based on an acceptance of a taxable characterization of the household consumption of financial services. The methodology attempts to surmount the identification and allocation problems commonly associated with financial margins. In particular, it is designed to measure financial margins consistent with a subtraction-method VAT, but in a way that permits the allocation of the aggregate margin and associated tax to consumers on a transactional basis. In effect, the cash-flow alternative to exempt treatment attempts to overcome the identification and measurement problems that are perceived to justify such treatment.¹⁰³

No country has adopted reform in the form of a comprehensive application of zero-rating or cash-flow taxation to financial services. The case for comprehensive zero-rating of the consumption of financial services can be seen to suffer from two principal deficiencies. First, the efficiency-based challenge to the taxation of the household consumption of financial services, which provides the conceptual basis for zero-rating, is probably at best, overstated in terms of the range of services that are properly considered non-taxable. Second, revenue implications and political perceptions severely undermine the feasibility of zero-rating for more than a limited range of services. As far as cash flow taxation is concerned, it is probably accurate to say that, after some ten years of development, its application to financial margins associated with each of the various types of financial intermediation (deposit-taking intermediation, brokerage services, and the insurance function) represents an internally logical and coherent approach. It does entail, however, a compliance burden for the financial sector, which has been identified in much of the literature as the principal weakness in the case for taxing financial margins. With the notable exception of property and casualty insurance, it would seem that tax policymakers continue to regard any form of comprehensive cash flow taxation with considerable wariness.

Rejection of these comprehensive reform alternatives leaves tax policymakers with a straightforward choice:

- apply exemption without any modification; or

¹⁰³ The basics of cash flow taxation are briefly described, along with some illustrative examples, in section A.1.5.

- modify the application of exemption through partial reform alternatives intended to suppress one of the perceived distortions.

Perhaps somewhat surprisingly, a lack of empirical knowledge regarding the dimensions of these distortions has left tax policymakers in a state of ignorance in choosing among a limited menu of partial reform alternatives. To the extent that country practice is in any way indicative, distortions in the pattern of consumption associated with the input taxation of the household consumption of financial services would appear to be seen as a secondary concern. In effect, the apparently casual empiricism of tax policymakers suggests that the household consumption of financial services is income elastic and price inelastic, so that under-taxation with exemption is not considered especially problematic. There is, however, some nibbling at the edges of exemption through the application of VAT to the household consumption of some financial services that are charged for in the form of explicit fees. Another modification of standard country practice involves the extension of a taxable characterization to all agency services. This type of extension attempts to limit the category of exempt financial services to those that are normally charged for in financial margins (that is, services provided as principal). Both of these modifications of standard country practice also reduce the number of fine distinctions along the exempt/taxable boundary and can be seen to reduce administrative and compliance costs without any significant loss of policy content.

In terms of broad trends in country practices, partial reforms of exemption have tended to be preferred as a means to address perceived distortions of the pattern of consumption of financial services by registered businesses, as well as perceived distortions of the pattern of production of financial service providers. More particularly, the focus here has been on mechanisms, other than the limitation of exemption to margin-based charges, to alleviate the perceived over-taxation of the business consumption of financial services, as well as the bias to self-supply faced by financial service providers. In fact, a handful of countries have adopted a limited range of reform alternatives intended to mute these effects of exemption. Zero-rating of the business consumption of financial services and a concessionary input tax credit appear to be the two partial reform alternatives on offer to address the over-taxation of such consumption under exemption. A concessionary input tax credit and the extension of exemption to a range of non-financial supplies made to financial service providers appear to be the two reform alternatives on offer to address the self-supply bias. Where revenue loss attributable to the availability of additional input tax credits is a concern, the extension of taxable status to a greater range of financial services consumed by households can provide a needed offset.¹⁰⁴

¹⁰⁴ See, in this respect, Harry Huizinga, "A European VAT on Financial Services?" (October 2002) vol. 35 *Economic Policy* 499-526 (suggesting that looseness in the use of formulas for allocation of input costs by financial service providers means that business consumption is already largely zero rated in the EU). See also Rita de la Feria & Ben Lockwood, "Opting for Opting In? An Evaluation of the European Commission's Proposals for Reforming VAT on Financial Services" (2010) vol. 31, no. 2 *Fiscal Studies* 171-202 (arguing that the European Commission's recently proposed option to tax is functionally equivalent to the zero rating of the business consumption of financial services where firms cannot co-ordinate their behaviour, and providing some upper bound estimates of possible revenue loss).

A.1.5 Cash-Flow Taxation and the Tax Calculation Account (“TCA”)¹⁰⁵

Cash-flow taxation treats all cash inflows from financial transactions as taxable sales subject to VAT. All cash outflows from financial transactions are treated as taxed purchases eligible for input tax credits. This same treatment applies equally to the cash flows realized by financial intermediaries and non-financial registered businesses that purchase financial intermediation services. This method measures and correctly taxes the implicit fees for financial intermediation embedded in financial margins, which are identified in terms of the net cash inflows or outflows associated with a financial transaction. This method also allocates the margin between borrowers and lenders. In effect, the taxable position of the financial intermediary is the mirror image of the position of the particular consumer of intermediation services. Accordingly, the cash-flow method can be applied on a transactional basis consistent with an invoice/credit VAT as a means of measuring financial margins, with registered businesses receiving appropriate input credits. Because households do not receive such credits, they effectively pay VAT on financial margins, assuming that the tax paid by the financial intermediary is shifted forward in the price paid by households for the intermediation services.

The application of cash-flow taxation to financial transactions is seen to suffer, however, from three significant problems that undermine its effectiveness. First, the requirement that registered business borrowers pay tax on cash inflows would create additional borrowing requirements and cash-flow problems attributable to the additional tax payment. Recovery of the tax on repayment of the borrowing would provide input tax credits as an offset on the initial cash inflow, but would not alleviate the cash-flow problem for non-financial businesses. Second, registered businesses would be required to carry out all of the necessary calculations in order to obtain input tax credits for cash outflows. This requirement would impose a compliance burden that would be particularly onerous for small and medium-sized registered businesses. Third, the correct amount of tax in respect of the financial margin associated with a financial transaction would be charged only where all capital inflows and outflows are subject to tax at the same rate. This condition would create obvious transitional problems on the initial application of cash-flow taxation and on subsequent changes in the VAT rate.

Modifications of cash-flow taxation attempt to maintain its basic principles as applied to financial transactions while addressing its perceived problems. For example, the TCA method addresses both the cash-flow problem for registered non-financial businesses and the transitional problems

¹⁰⁵ See generally Poddar and English, *supra* note 2; and *The TCA System*, *supra* note 3. See also Satya Poddar and Morley English, “Taxation of Financial Services under a VAT: Issues and Options,” paper presented at the National Tax Association Conference on Taxation of Financial Services, Clearwater, Florida, February 24-25, 1994; Morley English, David Leslie and Satya Poddar, *Treatment of Financial Services Under a VAT: Further Exploration of the Cash-Flow Method of Taxation* (Toronto: Report Prepared for the Commission of the European Communities, September 1994); and Ernst and Young, *Treatment of Financial Services under a VAT* (Toronto: A Report from Ernst and Young Prepared for the Commission of the European Communities). For an earlier articulation of the basic concepts underlying the application of cash-flow taxation to financial services, see Lorey A. Hoffman, Satya Poddar and John Whalley, “Taxation of Banking Services Under a Consumption Type, Destination Basis VAT” (1987) vol. 40, no. 4 *National Tax Journal* 547-54; Vicky Barham, Satya Poddar and John Whalley, “The Tax Treatment of Insurance Under a Consumption Type, Destination Basis VAT” (1987) vol. 40, no. 2 *National Tax Journal* 171-82; and John Whalley & Deborah Fretz, *The Economics of the Goods and Services Tax* (Toronto: Canadian Tax Foundation, Canadian Tax Paper no. 88, 1990), 100-15.

associated with the introduction of cash-flow taxation or a change in tax rates. This result is realized by creating a tax suspense account as a means of effectively taxing capital cash flows without requiring the payment of tax on inflows or the payment of input tax credits on outflows. The tax that would otherwise be payable or creditable on capital cash flows is, instead, debited or credited respectively to the TCA and is brought forward with an interest charge to subsequent tax periods. The TCA thus produces the same result as an unmodified system of cash-flow taxation, with the principal difference being the timing of the tax payments, which are equal in present value terms because of the deferral charge associated with debits and credits to the TCA. More particularly, the TCA consists of the following four basic features intended to modify the application of cash-flow taxation:

- Tax payable on cash inflows received by financial intermediaries and registered businesses in connection with a financial transaction is debited to the TCA;
- Tax credits on cash outflows paid by financial intermediaries and registered businesses in connection with a financial transaction are credited to the TCA;
- The balance in the TCA is subject to an interest deferral charge (referred to as an “indexing adjustment”); and
- The balance in the TCA that is payable or refundable periodically is determined after notionally closing out the account by subtracting an amount equal to the value of the relevant financial instrument at the end of the period multiplied by the tax rate.

Under the TCA method, financial intermediaries and registered businesses would maintain mirror TCAs. In present value terms, registered businesses would receive appropriate input credits on financial margins, while households would be taxed on their consumption of financial intermediation services. The truncated cash-flow method with TCA is intended to capture the benefits of the TCA but, in addition, address the compliance burden otherwise associated with the requirement of registered non-financial businesses to maintain TCAs in order to claim input credits for tax paid on financial margins. This goal is realized by shifting the tax accounting burden to financial intermediaries, who would be required to maintain TCAs in respect of their tax positions associated with a particular financial transaction, as well as the mirror image TCAs for registered non-financial businesses that are counterparties to the same transaction. Tax payable on positive margins would be remitted by the financial intermediary and claimed as an input tax credit by a registered business on the other side of the particular transaction. VAT calculated under the TCA on negative margins would be refunded to the financial intermediary and would be required to be remitted as tax payable by a registered business on the other side of the transaction. The financial intermediary would be required to provide registered businesses with periodic tax invoices, which would be the basis for input tax credit claims in respect of positive margins and tax payable in respect of negative margins.¹⁰⁶

¹⁰⁶ Howell Zee has recently proposed the use of a “modified reverse charging mechanism,” instead of the TCA account, as a means to reduce compliance costs. See Howell H. Zee, “A New Approach to Taxing Financial Intermediation Services Under a Value-Added Tax” (2005) vol. 58, no. 1 *National Tax Journal* 77-92. Under this proposal, a financial service

Using a simple deposit and loan transaction, an unmodified system of cash-flow taxation and the TCA method are illustrated below.¹⁰⁷

Assumptions

- Deposit interest 7%
- Loan interest 15%
- Riskless interest rate 12%
- Value of services to depositor 5%
- Value of services to borrower 3%
- Total value of financial services 8%
- VAT rate 10%

Example A - Cash-Flow Taxation: Consumer Depositor, Consumer Borrower

	Bank Inflows	Bank Outflows	Tax/Credits
Period 1			
Deposit	100		10
Loan		(100)	(10)
Subtotal	100	(100)	0
Period 2			
Loan repayment	100		10
Loan interest	15		1.50
Deposit withdrawal		(100)	(10)
Deposit interest		(7)	(0.70)
Total	115	(107)	0.80

provider would charge VAT on its outputs (interest income) and would reverse charge VAT on its inputs (interest expense). Financial margins would be allocated, first, by crediting the reverse-charged VAT against the output tax for borrowers. This result would be realized through a franking account similar to that used by some countries with dividend imputation systems. As a second step, the amount of VAT on the relevant margin would be split between borrowers and lenders using a percentage factor determined by the financial service provider.

¹⁰⁷ The examples are taken from Poddar and English, supra note 5. For a summary of the basic methodologies, as well as specialized design features, of cash-flow taxation applied to margins associated with different types of financial intermediation, see Tim Edgar, “Exempt Treatment of Financial Intermediation Services Under a Value-Added Tax: An Assessment of Alternatives” (2001) vol. 49, no. 5 *Canadian Tax Journal* 1133-1219 at 1194-99.

Example B – Cash-Flow Taxation: Consumer Depositor, Business Borrower

Tax payments by bank = 0.80 (see example A)			
Tax payments by business borrower			
	Borrower's Inflows	Borrower's Outflows	Tax/Credits
Period 1			
Loan	100		10
Period 2			
Loan repayment		(100)	(10)
Loan interest		(15)	(1.50)
Subtotal			(11.50)
Gov't Revenues			
Period 1 tax 10			
Interest earned @12% 1.20			
Period 2 tax (0.8 – 11.50) = (10.70)			
Total = (11.20 – 10.70) = 0.50 which is 10% of value of services to consumer depositor			

Example C – TCA: Loans by a Bank

	Amount	TCA
Loan	(100)	(10)
TCA indexing		(1.2)
Interest	15	1.5
Loan repayment/closing value	100	10
Net tax due		0.3

Example D – TCA: Deposits with a Bank

	Amount	TCA
Deposit	100	10
TCA indexing		1.2
Interest	(7)	(0.7)
Withdrawal/closing value	(100)	(10)
Net tax due		0.5

B Tier 1 Country Surveys

Surveys were conducted of the treatment of financial services for the following countries:

- Australia
- Canada
- France
- Germany
- Netherlands
- New Zealand
- Singapore
- UK

	1. GST/VAT on financial services
AUSTRALIA	Financial services in Australia are exempt supplies for GST purposes. In Australia, an exempt supply is referred to as an "input taxed supply" and suppliers of financial services are not liable to pay GST on the financial supplies that they make but are not able to claim input tax credits for the GST component of goods and services acquired in making input taxed financial supplies. However, there are two major exceptions to this rule. Firstly, financial services that qualify as an export are zero-rated (called GST-free in the Australian GST law). If a financial supply is GST-free, it is not treated as an input taxed supply and consequently, input tax credits can be claimed to the extent that acquisitions relate to making the GST-free supply. Secondly, specified acquisitions (referred to as reduced credit acquisitions or RCAs) that are for use in making financial supplies qualify for a fixed input tax recovery of 75% of the GST component of the RCAs. This input tax credit is referred to as a Reduced Input Tax Credit (RITC).
CANADA	Financial services in Canada are exempt supplies for GST purposes. This means financial institutions do not charge tax on the supply of exempt financial services to domestic consumers or businesses, but are not entitled to claim input tax credits for GST paid on purchases for use in making these exempt supplies. Certain financial services rendered to non-residents are generally zero-rated. As a result, the supplier does not collect tax, but is entitled to input tax credits.
FRANCE	Financial services are VAT-exempt, as provided under EU legislation. However, it is possible to opt for taxation except on listed services. The financial institutions have no recovery right in proportion to the turnover which is VAT-exempt, except where service rendered to clients established in non-EU countries. A specific tax on wages ("taxe sur les salaires") applies to the turnover where the latter has not been subject to VAT for more than 90%. It is a progressive rate.
GERMANY	Financial services in Germany are VAT exempt, i.e. German financial institutions do not charge VAT on the supply of VAT exempt financial services and are, therefore, not entitled to claim input VAT.
NETHERLANDS	Financial services in The Netherlands are mostly exempt supplies for VAT purposes. This means financial institutions do not charge VAT on the supply of exempt financial services to customers, but are (to that extent) not entitled to claim input VAT on costs. As certain transactions by financial institutions are VAT taxable, and as financial services to customers outside the EU give right to input VAT deductions, financial institutions can partially reclaim Dutch input-VAT on costs.
NEW ZEALAND	Financial services in New Zealand are exempt supplies for GST purposes. This means taxpayers do not charge tax on the supply of exempt financial services to domestic consumers or businesses, but are not entitled to claim input tax credits for GST paid on purchases to the extent used in making the exempt supplies. Certain financial services rendered to non-residents can be zero-rated. Where services are provided to other registered persons (with some restrictions) the financial institution is entitled to claim inputs relating to these services.
SINGAPORE	Financial services made in Singapore are exempt supplies for GST purposes. This means that financial institutions are not required to charge GST on the supply of exempt financial services to domestic consumers or businesses and are not entitled to claim input tax credits for GST paid on purchases used for the making of these exempt supplies. If the exempt financial service also qualifies for zero-rating as an international service (i.e. when certain financial services are rendered to consumers or businesses belonging outside Singapore), zero-rating would prevail over exemption in which case, the supplier is entitled to the input tax credits even though no GST is collected.
UK	Financial services in the UK are generally exempt supplies for VAT purposes. This means financial institutions do not charge VAT on the supply of exempt financial services to domestic consumers or businesses and are not entitled to input tax recovery for VAT incurred on costs used to make the exempt supplies. The UK law is based on the exemptions laid down in EU law. Generally, financial services supplied to non-EU recipients are outside the scope of VAT but carry an entitlement to input tax recovery on associated costs. Financial services supplied to non-UK but EU recipients are also outside the scope of VAT but do not carry any entitlement to input tax recovery on associated costs.

	1. GST/VAT on financial services
	1.1 General
AUSTRALIA	The Australian GST legislation and regulations contain several provisions relating to financial supplies, the main elements of the legislative scheme commence by the exclusion of input taxed supplies from the definition of taxable supplies. One of the specified input taxed supplies is a "financial supply" which is defined in the regulations (rather than the Act itself, to facilitate ease of amendment) to be the provision, acquisition of property in or under listed items (see 1.2.2 below). The exemption without credit feature of the law is contained in the provision dealing with input tax credit entitlements. An entity is entitled to input tax credits for acquisitions made in the course or furtherance of an enterprise (the Australian term equivalent to commercial activity). However, input tax credits are not available to the extent that the acquisitions relate to the making of supplies that would be input taxed. This general rule is subject to a number of exceptions, including the following. Firstly, acquisitions that relate to borrowings that are used for taxable or GST-free supplies are not denied ITCs. Secondly, a de minimis rule applies so that input tax denial is not required for acquisitions falling beneath a particular threshold. Thirdly, the significant part of the Australian framework that alters the eligibility for input tax relief in relation to financial supplies is the adoption of a narrow definition of financial supplies which does not extend to arranging and facilitation of financial supplies. Instead, a list of acquisitions are specified in the regulations for which acquirers of the specified services are entitled to a RITC of 75%. Many of the items specified as RCAs are similar to those services in the EU that have been found to be exempt "facilitation" including management of funds, commission for co-branded credit cards and processing of account information. In addition, while a reverse charge provision exists, financial suppliers that acquire specified offshore services from closely held associates are eligible for an RITC on those services. Examples of the services that are eligible for this reverse charge relief are senior executive management services, human resource support, in-house legal services and credit operational and risk management services.
CANADA	The legislation contains several provisions relating to the supply of financial services. These provisions define what constitutes financial services and what entities are considered to be financial institutions. There are also rules for calculating input tax credits when financial institutions are engaged in both taxable (including zero-rated) and exempt activities, treatment of imported services from related parties, export provisions and reporting obligations.
FRANCE	
GERMANY	
NETHERLANDS	The Dutch VAT legislation is based on the EU VAT directive, and - very roughly - sets out which transactions fall within the scope of a VAT exemption. Further guidance can be found in a "banking resolution" (last updated in 1986) and in case law. This also includes rules on how to determine a partial exemption method.
NEW ZEALAND	The legislation contains several provisions relating to the supply of financial services. These provisions define what constitutes financial services. There are also rules for calculating input tax credits when financial institutions are engaged in both taxable (including zero-rated) and exempt activities, treatment of imported services from related parties, export provisions and reporting obligations.
SINGAPORE	The legislation contains several provisions relating to the supply of financial services. These provisions provide the list of financial services that are GST-exempt and define what constitute financial services and what entities are considered to be financial institutions. Where an entity including financial institutions make both taxable (including zero-rated) and exempt supplies, they are required to adopt certain rules to compute the amount of recoverable GST as their input tax credits. However, if the financial institutions are accorded with certain licenses to carry out banking and financing activities in Singapore, they are currently granted a fixed input tax recovery percentage. The rate assigned to each financial institution is dependent on the type of banking license accorded to them. There are also provisions for export and import of goods and services as well as reporting obligations and penalties for non-compliance with the GST legislation.
UK	



	1. GST/VAT on financial services			
	1.1 General			
	1.1.1 Does your country apply a broad GST/VAT exemption for financial services? y/n	1.1.1a Additional comment, if applicable	1.1.2 Does the financial services exemption include any management or administration fees?	1.1.2a Additional comment, if applicable
AUSTRALIA	NO		NO	
CANADA	YES		YES	
FRANCE	YES		YES	
GERMANY	YES	(For well-defined financial services)	YES	Given that such fees are consideration for a VAT-exempt financial service.
NETHERLANDS	YES		YES	
NEW ZEALAND	YES		YES	
SINGAPORE	YES		NO	
UK	YES		YES	

	1. GST/VAT on financial services		
	1.1 General		
	1.1.3 If yes, please comment briefly as to what types of fees are exempt.	1.1.4 Does your country apply GST/VAT on multi-level jurisdictional basis? y/n	1.1.5 If yes, please note the application of the multiple rates that apply within your jurisdiction.
AUSTRALIA		NO	
CANADA	NSF charges, account maintenance fees, account administration fees, statement printing, and balance information are just a few examples of exempt management / administration fees.	YES	Under Canada's Harmonized Sales Tax (HST) system there are multiple rates for provinces. The straight GST rate is 5%, the rate for BC is 12%, the rate for Ontario, New Brunswick and Newfoundland is 13% and the rate for Nova Scotia is 15%.
FRANCE	<p>The exemption covers management or administration fees which are strictly related to:</p> <ul style="list-style-type: none"> (i) real asset management services of a fund (UCITS); (ii) management of accounts; (iii) wiring operations; and (iv) means of payment. <p>The exemption does not cover management and administrative fees which consist in a are purely administrative activity or an loan operation (i.e., management of a loan by the person who has not granted said loan).</p>	YES	
GERMANY	All fees which are consideration for VAT-exempt financial services are VAT-exempt.	NO	
NETHERLANDS	The management of credit by the person granting the credit; the (investment) management of collective funds.	NO	
NEW ZEALAND	Any supply which is reasonably incidental and necessary to the supply of financial services is exempt. Fees for management and administration of a superannuation fund are also exempt.	NO	N/A
SINGAPORE	Generally, management and administration services are subject to GST unless these services relate to the operation of current, deposit or saving account.	NO	N/A
UK	Management of credit (where provided by the lender) and fund management services (where supplied to qualifying funds) are two of examples of such exempt services.	NO	

1. GST/VAT on financial services	
1.1 General	
1.1.6 Is the financial services sector subject to a special tax calculation mechanism? (i.e. Existence of formulas for allocating tax among jurisdictions)	1.1.6.1 Please list the current domestic GST/VAT rate
AUSTRALIA	10%
CANADA	Yes. For many financial institutions the amount of HST due to the Canada Revenue Agency is determined by a formula - the Special Attribution method - designed to calculate tax based on the degree of presence / economic activity in the province. GST is 5%. See 1.1.4
FRANCE	19.6% (Metropolitan France) and 8.5% (overseas department)
GERMANY	The domestic VAT rate is 19%
NETHERLANDS	The general VAT rate is 19% (other existing rates are 6% and 0%).
NEW ZEALAND	GST as of 1 Oct 2010 is 15% (prior to 1 Oct 2010 GST was 12.5%. There are a number of transitional rules relating to this rate change that will affect the financial services area in the short term)
SINGAPORE	GST is 7%.
UK	Standard rate (17.5% but increasing to 20% from 4.1.11), reduced rate (5% i.e. for domestic fuel/power), zero-rate (i.e. for books, transport)

	1. GST/VAT on financial services	
	1.2 Services in the Area of Credits, Loans and Deposits	
	1.2.1 Is there a different GST/VAT treatment depending on whether the consideration for the financial services is expressed as a fee / commission or as margin?	1.2.2 Please comment.
AUSTRALIA	NO	Exempt financial supplies are defined as the acquisition, provision or disposal of legal property in or under 11 listed items, including debts, securities, bank accounts, life insurance and currency. Services of "facilitators" by way of arranging or facilitating financial supplies made by other entities are NOT financial supplies, but are often RCAs. The consequence is that the acquisition, holding and sale of financial instruments are often within the defined exemption but facilitating the exempt supply is taxable. Often, however, the recipient financial supply provider is entitled to a RITC. Effectively, arranging and facilitating is subject to a 2.5% non-recoverable GST.
CANADA	NO	There are no instances where a financial margin (i.e., interest) is subject to GST. There are many instances of explicit fees subject to the exemption.
FRANCE	NO	There is no difference since credit, loan, deposit should be VAT-exempt whether commission or margin. For loan/credit, for the computation of the recovery ratio, the turnover is considered on a gross basis of the full amount received, without deduction of the refinancing costs.
GERMANY	NO	A margin (i. e. sales price minus purchase price) cannot be the taxable basis for German VAT purposes - as opposed to commissions/fees etc..
NETHERLANDS	NO	There are no instances where a financial margin (i.e. interest) is subject to VAT. There are many instances of explicit fees subject to the exemption.
NEW ZEALAND	NO	NO
SINGAPORE	NO	The GST treatment is not dependent on the term used to describe the consideration for the financial services but rather it depends on whether the supplier acts in its capacity as an agent or principal in respect of the supply of the financial services.
UK	NO	NO



	1. GST/VAT on financial services	
	1.2 Services in the Area of Credits, Loans and Deposits	
	1.2.3 Is special relief provided for financial services linked to the export of goods and services? y/n	1.2.3a Additional comment, if applicable
AUSTRALIA	NO	
CANADA	NO	
FRANCE	NO	But recovery right is granted for financial services to clients established outside the EU or for operations in relation to export of goods.
GERMANY	NO	But input VAT is recoverable in cases of a link to exports to non-EU countries.
NETHERLANDS	YES	
NEW ZEALAND	NO	Some "exported" financial services can be zero-rated.
SINGAPORE	YES	Certain financial services which are supplied directly relating to the export of goods outside Singapore are zero-rated. Insurance coverage, factoring of receivables and negotiation and collection of payment in respect of letter of credit are a few examples of such zero-rated financial services.
UK	YES	Generally for services provided to non-EU customers only

	1. GST/VAT on financial services			
	1.2 Services in the area of Credits, Loans and Deposits			
	1.2.4 Are specific fees related to the following taxable or exempt:			
	1.2.4.1 Loan origination? taxable/exempt	1.2.4.1a Additional comment, if applicable	1.2.4.2 Factoring? taxable/exempt	1.2.4.2a Additional comment, if applicable
AUSTRALIA	EXEMPT	For the fee received by the lender for the loan	EXEMPT	For the assignment of the debt by the assignor
CANADA	EXEMPT		EXEMPT	
FRANCE	EXEMPT	Under specific administrative tolerance	EXEMPT	With possibility to opt
GERMANY	EXEMPT	Please note that exemption may be waived in certain cases.	EXEMPT	Depends on type of factoring: if it is considered as granting a loan for VAT purposes, factoring is VAT-exempt; if it is considered as debt collection, factoring is VATable.
NETHERLANDS	EXEMPT		TAXABLE	
NEW ZEALAND	EXEMPT		EXEMPT	
SINGAPORE	EXEMPT		EXEMPT	Certain financial services which are supplied directly relating to the export of goods outside Singapore are zero-rated. Insurance coverage, factoring of receivables and negotiation and collection of payment in respect of letter of credit are a few examples of such zero-rated financial services.
UK	EXEMPT	The sale is exempt, assignment of equitable interest only is outside the scope of VAT	EXEMPT	Discounting and electronic transfer of funds are exempt, sales administrative services are taxable

	1. GST/VAT on financial services			
	1.2 Services in the area of Credits, Loans and Deposits			
	1.2.4 Are specific fees related to the following taxable or exempt:			
	1.2.4.3 Loan Syndication? taxable/exempt	1.2.4.3a Additional comment, if applicable	1.2.4.4 Securitization? taxable/exempt	1.2.4.4a Additional comment, if applicable
AUSTRALIA	EXEMPT	For the supply of the loan but not for a fee in arranging a loan by another entity	EXEMPT	For the assignment of the security by the originator or holder of the security, but not for the servicing
CANADA	EXEMPT		EXEMPT	
FRANCE	EXEMPT	Except commission of leader / no possibility to opt	EXEMPT	With possibility to opt
GERMANY	EXEMPT	Granting of credit is generally VAT-exempt; credit administration for a different taxable person is VATable; very different set-ups in the market.	EXEMPT	Generally VAT-exempt
NETHERLANDS	EXEMPT		EXEMPT	Only exempt if it concerns a VAT exempt asset (i.e. mortgage loan)
NEW ZEALAND	EXEMPT		EXEMPT	
SINGAPORE	EXEMPT	Any consideration for advising, arranging, underwriting or broking in relation to these transactions are taxable. For instance, the management fee received for arranging the syndicated loan is taxable.	EXEMPT	Any consideration for advising, arranging, underwriting or broking in relation to these transactions are taxable. For instance, the management fee received for arranging the syndicated loan is taxable.
UK	EXEMPT	But service fees will be taxable	EXEMPT	Assignment of assets/securities will be outside the scope of VAT, payment collection service will be exempt (but taxable if outsourced)



	1. GST/VAT on financial services	
	1.3 Services in the area of Money	
	1.3.1 What is the GST/VAT treatment of foreign exchange transactions? taxable/exempt	1.3.1a Additional comment, if applicable
AUSTRALIA	EXEMPT	But there is a possibility of a zero-rate where the counterparty is a non-resident or if the supply is of foreign currency (awaiting High Court decision on the latter due 29 Sept 2010)
CANADA	EXEMPT	
FRANCE	EXEMPT	Without possibility to opt
GERMANY	EXEMPT	
NETHERLANDS	EXEMPT	
NEW ZEALAND	EXEMPT	
SINGAPORE	EXEMPT	
UK	EXEMPT	



	1. GST/VAT on financial services	
	1.3 Services in the area of Money	
	1.3.2 Money transfers and identity of service providers	
	1.3.2.1 What is the GST/VAT treatment to clearing and settlement payments? taxable/exempt	1.3.2.1a Additional comment, if applicable
AUSTRALIA	TAXABLE	Settlement and clearance fees are generally taxable supplies because they are facilitation of the exempt financial supply made by the holder of the financial instrument. In many cases the settlement fee is eligible for RITCs. In some cases, the fee is implicit in the purchase and on-sale by the clearance entity itself - as this is the dealing in the security it is exempt.
CANADA	TAXABLE	Clearing and settlement services are taxable unless provided by Canadian Payments Association or its members.
FRANCE	EXEMPT but possibility to opt	
GERMANY	EXEMPT	
NETHERLANDS	EXEMPT	
NEW ZEALAND	EXEMPT	
SINGAPORE	Clearing and settlement services relating to collection and payment of any note/order for payment, cheque, or letter of credit is exempt.	
UK	EXEMPT	



	1. GST/VAT on financial services	
	1.3 Services in the area of Money	
	1.3.2 Money transfers and identity of service providers	
	<i>1.3.2.2 What is the GST/VAT treatment of payment systems services? taxable/exempt</i>	1.3.2.2a Additional comment, if applicable
AUSTRALIA	TAXABLE	
CANADA	TAXABLE	
FRANCE	TAXABLE	
GERMANY	EXEMPT	VAT-exempt (unless to be considered as i.e. data processing for VAT purposes)
NETHERLANDS	TAXABLE	There is a discussion going on to what extent certain payment processing systems can may be covered by the VAT exemption
NEW ZEALAND	TAXABLE	Assumption is that services are provided by a third party. If not, GST treatment of the services will depend on whether services are necessary / incidental to providing a financial service
SINGAPORE	EXEMPT	We have read this question to mean some sort of services rendered by a person who is involved in credit card, charge card or similar payment card operation to a person who accepts the card used in that operation for payment of goods and services supplied by the latter.
UK	EXEMPT	

	1. GST/VAT on financial services			
	1.4 Services in the Area of Shares and Securities			
	1.4.1 What is the GST/VAT treatment for underwriting? taxable/exempt	1.4.1a Additional comment, if applicable	1.4.2 What is the GST/VAT treatment of M&A fees? taxable/exempt	1.4.2a Additional comment, if applicable
AUSTRALIA	EXEMPT	Where underwriting is an agreement to use "best endeavours" to place an issue of debt or equity, the supply is taxable. Exemption applies for an agreement to take if the underwriter cannot place.	TAXABLE	
CANADA	EXEMPT		TAXABLE	There is an arranging for provision in the legislation and a CRA policy statement that could make this exempt; however, the bar is set quite high.
FRANCE	EXEMPT	Without possibility to opt (i.e., guarantee)	TAXABLE	
GERMANY	No definition of underwriting in Germany; process of issuing shares and securities: (a) For the issuer, the issuing should be beyond the scope of VAT; (b) For a third party supporting this process, exemptions may apply.		Depends on the supply	Depends on whether to be considered as advisory services (VATable) or financial intermediary services (VAT exempt) for VAT purposes.
NETHERLANDS	EXEMPT	Pending ECJ Case C-540/09: Is Article 13B of the Sixth VAT Directive (Article 135(1) of the Council Directive on a common system of value added tax 1) to be interpreted as meaning that the tax exemptions provided for therein also include services (underwriting) which involve a credit institution providing, for consideration, a guarantee to a company which is about to issue shares, where under that guarantee the credit institution undertakes to acquire any shares which are not subscribed within the period for share subscription?	TAXABLE	
NEW ZEALAND	EXEMPT		TAXABLE	
SINGAPORE	TAXABLE		TAXABLE	
UK	EXEMPT		TAXABLE/ EXEMPT	

	1. GST/VAT on financial services
	1.4 Services in the Area of Shares and Securities
	1.4.3 Please comment on the treatment of M&A fees?
AUSTRALIA	The RCA list contains a number of items that are eligible for RITCs if incurred in relation to making financial supplies - i.e., arrangements for the provision, acquisition or disposal of an interest in a security, including ... Management of the issue of securities, arranging flotations and privatizations, arranging mergers and acquisitions and underwriting. However, mere advice and due diligence costs will generally not qualify for a RITC.
CANADA	To qualify as a service of "arranging for" the supply of a financial service, each of the following elements should be present: the intermediary will help either the supplier or the recipient or both, in the supply of a financial service, the supplier and/or the recipient count on one or more intermediaries for assistance in the course of a supply of a financial service, and the intermediary is directly involved in the process of the provision of a financial service and will therefore, expend the time and effort necessary with the intent to effect a supply of a service described in paragraphs (a) to (i) of the definition of financial service.
FRANCE	Intermediation in M&A operation is not considered as intermediary in financial operation except if agent grants a warranty or a loan or receives commission for a loan (in which case, the operation would be exempt).
GERMANY	See previous comments; intermediation means doing all that is necessary in order for two parties to enter into a contract, without the intermediary having any interest of his own in the terms of the contract.
NETHERLANDS	There is Dutch case law on M&A fees (by investment banks), in which it was decided that these fees were VAT taxable. The argument that it concerned a (VAT exempt) negotiation service relating to shares was not accepted by the Court.
NEW ZEALAND	Arranging a financial service is an exempt supply, however, advising on the provision of financial services is a taxable supply.
SINGAPORE	It is provided in the legislation that the provision of arranging services relating to financial services is taxable except when such services relate to reinsurance which is exempt. The word "arranging" is not defined in the legislation. Nonetheless, the tax authority would regard the intermediary as providing "arranging services" if the intermediary acts in its capacity as an agent in the identification of counterparties with matching requirements to participate in a financial deal. Essentially, the intermediary is not a party to the supply of financial service and thus, is not liable for the risks nor entitled to the rewards arising from the supply.
UK	Pure advisory services will be taxable whereas intermediary services where underlying supply is a sale of securities may fall within the intermediary exemption. The intermediary must bring together a party looking to receive a financial service with a party looking to provide a financial service (and must generally also perform work preparatory to the conclusion of contracts). Negotiation of the terms of the contract is often a key indicator of exemption. YES

	1. GST/VAT on financial services					
	1.4 Services in the Area of Shares and Securities					
	1.4.4 As regards M&A fees which could be treated GST/VAT exempt do they maintain this status if the transaction is aborted? y/n	1.4.4a Additional comment, if applicable	1.4.5 What is the GST/VAT treatment of trading fees on an exchange? taxable/exempt	1.4.5a Additional comment, if applicable	1.4.6 What is the GST/VAT treatment of data provided by specialized providers (i.e. brokerage houses, exchanges, etc.)? taxable/exempt	1.4.6a Additional comment, if applicable
AUSTRALIA	YES		TAXABLE	Eligible for RITC for customers that are GST registered financial suppliers	TAXABLE	
CANADA	NO		TAXABLE		TAXABLE	
FRANCE	N/A		EXEMPT	With possibility to opt	EXEMPT	With possibility to opt
GERMANY	YES		EXEMPT		TAXABLE	
NETHERLANDS	n/a		EXEMPT		TAXABLE	
NEW ZEALAND	YES	Yes but note that arranging fees are typically success based fees	EXEMPT		TAXABLE	Data provision is taxable unless it is necessary or incidental to the supply of financial services.
SINGAPORE	NO		TAXABLE		TAXABLE	
UK	YES		Exempt where underlying supply is trade of securities, taxable where trade of physical commodities		TAXABLE	

	1. GST/VAT on financial services			
	1.4 Services in the area of Shares and Securities			
	1.4.7 What is VAT/GST treatment of the following:			
	1.4.7.1 Safekeeping/custody? taxable/exempt	1.4.7.1a Additional comment, if applicable	1.4.7.2 Investment advice / advisory services? taxable/exempt	1.4.7.2a Additional comment, if applicable
AUSTRALIA	TAXABLE	Eligible for RITC for customers that are GST registered financial suppliers	TAXABLE	
CANADA	TAXABLE		TAXABLE	
FRANCE	TAXABLE		TAXABLE	Unless rendered within the scope of fund management (UCITS)
GERMANY	TAXABLE		TAXABLE	
NETHERLANDS	TAXABLE		TAXABLE	
NEW ZEALAND	EXEMPT	There are different positions taken depending on the view of the actual service performed and the linkage with other services provided	TAXABLE	Assuming advisory and not arranging
SINGAPORE	TAXABLE		TAXABLE	
UK	TAXABLE	But global custody is exempt	TAXABLE	

	1. GST/VAT on financial services			
	1.4 Services in the area of Shares and Securities			
	1.4.7 What is VAT/GST treatment of the following:			
	1.4.7.3 Management of investment funds? taxable/exempt	1.4.7.3a Additional comment, if applicable	1.4.7.4 Clearing and settlement, payment systems services? taxable/exempt	1.4.7.4a Additional comment, if applicable
AUSTRALIA	TAXABLE	Eligible for RITC for customers that are GST registered financial suppliers	TAXABLE	Eligible for RITC for customers that are GST registered financial suppliers
CANADA	TAXABLE		TAXABLE	
FRANCE	EXEMPT	With possibility to opt	EXEMPT	With possibility to opt (unless pure IT activity)
GERMANY	EXEMPT		EXEMPT	See previous comments
NETHERLANDS	EXEMPT	Provided it concerns a collective fund	EXEMPT	
NEW ZEALAND	EXEMPT	The management of superannuation funds is considered the supply of financial services and is exempt. Other vehicles have agreed apportionment rates for the taxable component of their services.	EXEMPT	Clearing and settlement exempt. Per 1.3.2.2, payment systems service may be taxable assuming the services are provided by a third party. If not, GST treatment of the services will depend on whether services are necessary / incidental to providing a financial service
SINGAPORE	TAXABLE		TAXABLE	
UK	EXEMPT	Where fund is "qualifying" fund	EXEMPT	

	1. GST/VAT on financial services			
	1.4 Services in the area of Shares and Securities			
	1.4.7 What is VAT/GST treatment of the following:			
	1.4.7.5 Administration and data processing services? taxable/exempt	1.4.7.5a Additional comment, if applicable	1.4.7.6 Initial and/or deferred sales charge? taxable/exempt	1.4.7.6a Additional comment, if applicable
AUSTRALIA	TAXABLE	RITCs apply to a broad range of transaction banking, cash management, payment and fund transfer services including processing account information and processing, settling, clearing and switching transactions	TAXABLE	
CANADA	TAXABLE		EXEMPT	
FRANCE	TAXABLE		Depends on the supply	If the commission/fee is in exchange for a sale of share/securities (excluding fund units) it should be qualified as "commission on securities" and therefore exempt but with possibility to opt. However, please note that in the specific case of distribution (restricted to the term "placement") of bonds/shares, it is exempt without possibility to opt.
GERMANY	TAXABLE		Depends on the supply	
NETHERLANDS	TAXABLE		EXEMPT	
NEW ZEALAND	TAXABLE	Assuming not necessary / incidental to providing a financial service	EXEMPT	
SINGAPORE	TAXABLE		TAXABLE	
UK	TAXABLE		EXEMPT	Exempt where underlying supply is trade of securities

1. GST/VAT on financial services				
1.4 Services in the area of Shares and Securities				
1.4.7 What is VAT/GST treatment of the following:				
	1.4.7.7 Trailers/trailing commissions? taxable/exempt	1.4.7.7a Additional comment, if applicable	1.4.7.8 Redemption fees? taxable/exempt	1.4.7.8a Additional comment, if applicable
AUSTRALIA	TAXABLE	Eligible for RITC for customers that are GST registered financial suppliers	TAXABLE	If charged by the trustee but eligible for RITC for GST registered financial suppliers
CANADA	EXEMPT	Not free from doubt in light of CRA comments in Notice 250	EXEMPT	
FRANCE	Depends on the supply	Trailers fees should only be considered as specific by the type of remuneration. As a consequence, principles explained under 1.4.7.6a apply: exemption with possibility to opt, except in case of distribution (restricted to the term "placement") of bonds/shares (it is exempt without possibility to opt).	EXEMPT	With possibility to opt (redemption fees)
GERMANY	Depends on the supply	Exempt if these are fees to an agent for negotiation of financial services	EXEMPT	Transactions liable to create, alter or extinguish parties' rights and obligations in respect of securities are exempt
NETHERLANDS	EXEMPT	This is the common viewpoint of the taxpayer, and seems to be defensible	EXEMPT	
NEW ZEALAND	EXEMPT	This assumes that commissions relate to implementation or arranging of a financial service. Monitoring will be taxable	EXEMPT	
SINGAPORE	TAXABLE		TAXABLE	
UK	EXEMPT	Exempt where underlying supply is trade of securities	EXEMPT	Exempt where underlying supply is trade of securities

	1. GST/VAT on financial services			
	1.4 Services in the area of Shares and Securities			
	1.4.7 What is VAT/GST treatment of the following:			
	1.4.7.9 Fees based on assets under management? taxable/exempt	1.4.7.9a Additional comment, if applicable	1.4.7.10 Referral fees? taxable/exempt	1.4.7.10a Additional comment, if applicable
AUSTRALIA	TAXABLE	Eligible for RITC for customers that are GST registered financial suppliers	TAXABLE	If charged by the trustee but eligible for RITC for GST registered financial suppliers
CANADA	TAXABLE		TAXABLE	
FRANCE	EXEMPT	With possibility to opt	EXEMPT	If considered as distribution fees ("placement")
GERMANY	Depends on the supply	Management of special investment funds is exempt; VAT treatment of other asset management is disputed.	Depends on the supply	Exempt if it is for exempt financial intermediation, See previous comments
NETHERLANDS	TAXABLE	The (investment) management of collective funds is VAT exempt	EXEMPT	Provided it qualifies as negotiation in securities
NEW ZEALAND	EXEMPT	This assumes that fees relate to implementation or arranging of a financial service. Monitoring will be taxable	EXEMPT	Taxable if advisory
SINGAPORE	TAXABLE		TAXABLE	
UK	EXEMPT	Where fund is "qualifying" fund	EXEMPT	Where acting as an exempt intermediary

	1. GST/VAT on financial services		
	1.4 Services in the area of Shares and Securities		
	1.4.7 What is VAT/GST treatment of the following:		
	1.4.7.11 RRSP and other such fees? taxable/exempt	1.4.7.11a Additional comment, if applicable	1.4.7.12 If taxable please comment briefly
AUSTRALIA	EXEMPT		The Regulations exempt the supply of an interest in a superannuation fund, an annuity or pension. The management of such a fund or annuity by an entity other than the provider is taxable.
CANADA	TAXABLE		Historically such fees are viewed as exempt. However, recent amendments to the legislation have created uncertainty as to the GST treatment.
FRANCE	N/A	We have no private pension funds, or equivalent entities, registered in France.	
GERMANY	Depends on the supply	Generally taxable, exemptions may apply for certain structures.	
NETHERLANDS	TAXABLE		Pension premiums are VAT exempt; pension handling is in principle VAT taxable (although there are some exceptions). Investment management of pension funds is normally VAT taxable, but can be VAT exempt if funds are pooled in collective funds;
NEW ZEALAND	EXEMPT	No New Zealand equivalent to a personal superannuation fund. However, managing a superannuation fund is exempt	Note that typically such services are bundled in New Zealand so that they may be treated as exempt if they are "necessary and incidental" to a primary exempt supply. This is the case for management of investment funds for example.
SINGAPORE	EXEMPT	In Singapore, if a person invests in a financial product that falls within the criteria of the Supplementary Retirement Scheme (i.e. SRS), the amount invested will be exempt.	N/A
UK	TAXABLE		Ongoing case law - pension fund management services could be held to be exempt



	1. GST/VAT on financial services	
	1.4 Services in the area of Shares and Securities	
	1.4.8 Are sub-brokerage fees taxable or exempt?	1.4.8a Additional comment, if applicable
AUSTRALIA	TAXABLE	Eligible for RITC for customers that are GST registered financial suppliers
CANADA	TAXABLE	
FRANCE	EXEMPT	With possibility to opt and insofar as the sub-broker provides financial services
GERMANY	EXEMPT	Generally VAT-exempt (disputed)
NETHERLANDS	EXEMPT	
NEW ZEALAND	EXEMPT	
SINGAPORE	TAXABLE	
UK	EXEMPT	

	1. GST/VAT on financial services				
	1.5 Services in the area of Insurance				
	1.5.1 What is the GST/VAT treatment of life and health insurance? taxable/exempt	1.5.1a Additional comment, if applicable	1.5.2 What is the GST/VAT treatment of property and casualty? taxable/exempt	1.5.2a Additional comment, if applicable	1.5.2.1 Where the answer to 1.5.1 or 1.5.2 is taxable are there special accompanying rules?
AUSTRALIA	EXEMPT	Health insurance is GST-free	TAXABLE		In addition, general insurance is a taxable supply but input tax relief is available for a cash settlement made by the insurer where the insured is not eligible for an input tax credit for the premium paid. Effectively, over time, the margin between premiums and payouts on insurance supplied to non-registered entities is subject to GST at the standard 10% rate.
CANADA	EXEMPT		EXEMPT		N/A
FRANCE	EXEMPT		EXEMPT		N/A
GERMANY	EXEMPT		EXEMPT		
NETHERLANDS	EXEMPT		EXEMPT		
NEW ZEALAND	EXEMPT / TAXABLE	Life insurance is exempt; Health insurance is taxable	TAXABLE		YES
SINGAPORE	EXEMPT	We have read this question to mean the non-life insurance (i.e. health insurance) is sold as a rider to the life policy. Please note that any stand-alone non-life policies whether for individual or group coverage are taxable.	TAXABLE		NO
UK	EXEMPT	But potentially subject to IPT at 5% (6% from 4.1.11)	EXEMPT	But potentially subject to IPT at 5% (6% from 4.1.11)	

	1. GST/VAT on financial services	
	1.5 Services in the area of Insurance	
	<i>1.5.2.2 Where the answer to 1.5.2 is exempt are their special rules applied regarding claims?</i>	<i>1.5.2.3 Please comment briefly on any other special rules regarding insurance?</i>
AUSTRALIA		Guarantees and indemnities are exempt but not warranties for goods or contracts of insurance or reinsurance. A cash settlement payment made under a contract of insurance is eligible for the special relief described in 1.5.2.3 but this relief is not available for warranties that are not contracts of insurance.
CANADA	Canada has adopted the net-of-GST method which provides that the amount paid by an insurer to indemnify an insured will exclude the applicable tax portion if the insured is eligible to claim an input tax credit or tax rebate for the tax portion of the repair or replacement expense.	Warranties and insurance provided by a person other than an insurer are excluded from the exemption for insurance.
FRANCE		
GERMANY	Insurers' payments exclude VAT etc. which are recoverable for insured	Exemption covers insurance and reinsurance transactions including related services; there is also an IPT regime in Germany.
NETHERLANDS	NO	Insurance provided by a person other than an insurer may also qualify for the VAT exemption. Please note that The Netherlands has an IPT for some kinds of insurance.
NEW ZEALAND	N/A	The insurer can treat a claim as generating an input tax credit even if the payment is not to a registered person. There are also special subrogation rules. Services provided under a warranty are considered taxable.
SINGAPORE	N/A	Any arranging (except for reinsurance), broking, underwriting or advising services is excluded from exemption, i.e. taxable.
UK	Where supplies of claims-related goods or services are made to the insured party and the claim relates to their VAT registered business, any VAT incurred on those supplies may be deducted as input tax subject to normal rules. Where the insured party is able to recover the VAT charged, the insurer will normally be responsible for paying only the net amount due (less any excess payable by the insured party) under the insurance claim.	Insurance provided by a person other than an insurer will not qualify for exemption. Certain warranties can qualify for exemption.

	1. GST/VAT on financial services					
	1.5 Services in the area of Insurance					
	1.5.3 What is GST/VAT treatment of the following:					
	<i>1.5.3.1 Intermediary services? taxable/ exempt</i>	1.5.3.1a Additional comment, if applicable	<i>1.5.3.2 Advisory services? taxable/ exempt</i>	1.5.3.2a Additional comment, if applicable	<i>1.5.3.3 "Arranging for" services? taxable/exempt</i>	1.5.3.3a Additional comment, if applicable
AUSTRALIA	TAXABLE	Commission paid by a financial supplier to a facilitator are eligible for RITC	TAXABLE		TAXABLE	Eligible for RITC for customers that are GST registered financial suppliers
CANADA	EXEMPT		TAXABLE		EXEMPT	
FRANCE	EXEMPT	If regulated	EXEMPT	If rendered by a person subject to insurance regulations within the scope of an insurance activity	EXEMPT	If rendered by a person subject to insurance regulations within the scope of an insurance activity
GERMANY	EXEMPT	Generally VAT-exempt; difficult in multi-tier structures	TAXABLE		EXEMPT	See "intermediary services"
NETHERLANDS	EXEMPT		TAXABLE		EXEMPT	Exempt if it can be qualified as a service closely connected to insurance provided by insurance brokers/ insurance agents
NEW ZEALAND	TAXABLE	The treatment of the services follow the treatment under 1.5.1 and whether the services is merely incidental to that service	TAXABLE		TAXABLE	
SINGAPORE	TAXABLE		TAXABLE		TAXABLE	
UK	EXEMPT		TAXABLE		EXEMPT	

	1. GST/VAT on financial services	
	1.6 “Arranging for” or Brokering of Financial Services	
	1.6.1 What is the GST/VAT status of services provided by agents, salespersons, brokers and dealers whose principal business (or one of whose principal businesses) is arranging for financial services? taxable/exempt	1.6.1a Additional comment, if applicable
AUSTRALIA	TAXABLE	Eligible for RITC for customers that are GST registered financial suppliers
CANADA	EXEMPT	
FRANCE	EXEMPT	We stress that there is no specific status of agency: the regime depends on the category of service. For example, intermediation on credit is exempt (without possibility to opt). Operation on securities is exempt but possibility to elect for VAT).
GERMANY	EXEMPT	See previous comments
NETHERLANDS	EXEMPT	
NEW ZEALAND	EXEMPT	This is done on a transactions basis (not a business test). Most entities will have mixed supplies i.e. an agent for a life insurer will have taxable commissions for health insurance and exempt commissions for life insurance.
SINGAPORE	TAXABLE	
UK	EXEMPT	

1. GST/VAT on financial services				
1.6 "Arranging for" or Brokering of Financial Services				
	1.6.1.1 Where the answer is exempt are there specific criteria that must be satisfied (i.e., principal business of provider, special licensing required, etc.)	1.6.1.1a Additional comment, if applicable	1.6.2 What is the GST/VAT status of third party services which are preparatory to or ancillary to the provision of financial services (i.e. promotional services, credit administration, credit management services)? taxable/exempt	1.6.2a Additional comment, if applicable
AUSTRALIA			TAXABLE	Some debt collection and administration services are eligible for RITCs
CANADA	See 1.4.3		TAXABLE	
FRANCE		The criteria have been determined by the ECJ in CSC financial case law 235/00 of 13th December 2001.	TAXABLE	
GERMANY		See previous comments	TAXABLE	
NETHERLANDS	Negotiation in financial transactions is VAT exempt. There is ongoing case law on this issue, repeating that: Negotiation is a service rendered to and remunerated by a contractual party as a distinct act of mediation. In that regard, the purpose of such an activity is to do all that is necessary in order for two parties to enter into a contract, without the negotiator having any interest of his own in the content of the contract On the other hand, it is not negotiation where one of the parties entrusts to a sub-contractor some of the clerical formalities related to the contract		TAXABLE	
NEW ZEALAND			TAXABLE	
SINGAPORE	N/A		TAXABLE	
UK	See 1.4.3.		TAXABLE	

	2. Group Relief				
	2.1 Does your Jurisdiction Offer the Following:				
	2.1.1 VAT grouping? y/n	2.1.2 Specific cost sharing? y/n	2.1.2a Additional comment, if applicable	2.1.3 Other similar regimes? y/n	2.1.3a Additional comment, if applicable
AUSTRALIA	YES	NO			
CANADA	NO	NO		YES	
FRANCE	NO	YES		NO	
GERMANY	YES	NO	Not for the financial services industry	NO	Not for the financial services industry
NETHERLANDS	YES	YES		NO	
NEW ZEALAND	YES	NO		NO	
SINGAPORE	YES	NO		NO	
UK	YES	NO	Available under EU law but not yet implemented into UK law	YES	

	2. Group Relief
	2.1 Does your Jurisdiction Offer the Following:
	2.1.4 Where you answered yes to any of the above please briefly describe the regime.
AUSTRALIA	The Australian law allows companies within a 90% owned group to form a GST group with a nominated representative entity is liable for GST on supplies and eligible for ITCs for acquisitions made by the group. Internal taxable supplies are not taxable. In ascertaining the entitlement for ITCs, the group is treated as a single entity and not the separate entities that comprise the group. Grouping is also available for closely held partnerships, trusts and companies.
CANADA	For Canadian GST purposes the legislation provides for exempt treatment of certain supplies between any two members of a closely related group of which a listed financial institution is a member. The entities must file an election. This is a limited form of grouping. There is no wider VAT group per se and for a broader application multiple elections are required. The relief is targeted at services and leases/licenses. Certain transactions are precluded from the relief (e.g., real property).
FRANCE	Under Article 261 B of the French Tax Code (implementing Article 132.1 f of VAT Directive 2006/112/EC), France provides for VAT-exemption of services rendered to members of group where: <ul style="list-style-type: none"> - member's activity is outside the scope of VAT or VAT-exempt; - the services are directly contributing to a non-taxable operation (VAT-exempt or outside the scope); - the compensation claimed from members corresponds exactly to their share in the common expenditure.
GERMANY	There is a VAT group where (a) corporation(s) is/are financially, economically and organizationally integrated in the business of one taxable person. Supplies between the VAT group members are not subject to German VAT. The effects of the fiscal unity are limited to internal transactions performed within the German territory between the VAT group members; extensive case law.
NETHERLANDS	VAT grouping is possible for entities that are closely bound together by a financial, organizational and economical links. A cost sharing exemption is (under conditions!) available for groups of (exempt) institutions, who outsource certain functions to an "umbrella entity", who recharges the costs to the participating members. Furthermore there is (pure Dutch) "cost for joint account"-method, where, under conditions, prefixed percentages of shared costs can be recharged without VAT.
NEW ZEALAND	Entities can join/form a GST group where they meet the grouping requirements for income tax (to group for GST purposes an income tax group is not necessary). The entities must elect to form a group. Intra-group transactions are effectively ignored for GST purposes.
SINGAPORE	In Singapore, where related companies are involved in substantial inter-co transactions, they may opt for group GST registration upon satisfaction of certain qualifying conditions (e.g. control and relationship amongst the members) as the supplies amongst the members of the GST group are disregarded. Under this scheme, the members are allowed to submit one GST return as a group instead of reporting individually. One of the members will be nominated as the representative member for the submission of the GST return. Where some of the members are partly exempt entities or accorded with fixed input tax recovery percentage, the group can only claim their input taxes based on the lowest recovery percentage granted to any of its members. Please note that the tax authority reserves the right not to approve any GST group application for revenue protection purposes.
UK	VAT grouping available for UK established entities under common control (or those with fixed UK establishment). Aims to achieve reduced administration/compliance burden. Key consequence of VAT grouping is that intra-group supplies are disregarded for VAT purposes. European Economic Interest Groupings (EEIGs) - relatively new opportunity which seeks to facilitate/develop economic activity by pooling resources. EEIGs can form/join VAT groups.

	2. Group Relief		
	2.2 Holding Companies		
	2.2.1 Are holding companies that only hold shares entitled to GST/VAT deduction or credits? y/n	2.2.1a Additional comment, if applicable	2.2.2 If yes, please elaborate.
AUSTRALIA	NO		In practice many do claim credits. Such entities are proposed to be eligible to be GST registered for the purposes of joining a GST group from 1 July 2012. Once grouped the costs of the holding company may be eligible for ITCs for the group where the costs relate to the commercial activity of the single entity.
CANADA	YES		Corporations that are holding companies or companies established to acquire other corporations and that have no commercial activities are able to register to benefit from the rules in section 186, which entitle them to input tax credits for tax payable on their investment-related costs. This relief only applies to corporations and not to partnerships or trusts. In addition there is an inequity in that a branch entity of a foreign headquartered insurer can participate in the grouping whereas a branch of a foreign headquartered bank cannot. Similar activities undertaken by a partnership or trust do not benefit.
FRANCE	NO		
GERMANY	NO		The mere holding of shares is beyond the scope of VAT. However, there may be economic activity in terms of VAT law where the holding company actively interacts with and/or manages its subsidiaries.
NETHERLANDS	NO	Unless included in a VAT group.	
NEW ZEALAND	YES		Holding companies must either join a GST group (provided that group meets the necessary requirements) or the business to business regime to be able to claim GST input tax.
SINGAPORE	NO		N/A
UK	NO	Unless included in VAT group with trading subsidiary - EU Commission currently challenging this in UK and several other Member States	

	3. Addressing the Effects of Exemption			
	3.1 Does your jurisdiction have an option to tax financial services transactions? y/n	3.1a Additional comment, if applicable	3.2 If yes, is it far reaching or limited to certain services or products? far-reaching/limited	3.3 If limited, to what products and services does it apply?
AUSTRALIA	NO		N/A	N/A
CANADA	NO		N/A	N/A
FRANCE	YES		Limited to certain services but covered a large number of services : option to VAT applies to all financial services, except those not listed	For example, option applies to : - operations on credit and warranty (except interest and similar) - operations on accounts and checks - operations on fund management (UCITS)x - operations on factoring - commission on stock-exchange orders
GERMANY	YES		Limited conditions apply.	Well-defined financial services
NETHERLANDS	NO		N/A	N/A
NEW ZEALAND	NO	The business to business regime is effectively an option to tax financial services at a zero-rate.	N/A	N/A
SINGAPORE	NO		N/A	N/A
UK	NO			

4. ITC Allocation Methodology / Partial Exemption		
	4.1 Is it a requirement to agree an allocation methodology or partial exemption method with the tax authority? y/n	4.1a Additional comment, if applicable
AUSTRALIA	NO	
CANADA	YES	
FRANCE	NO	
GERMANY	NO	
NETHERLANDS	NO	
NEW ZEALAND	NO	
SINGAPORE	NO	Businesses which make both taxable and exempt supplies are required to adopt the input tax apportionment method as stipulated in the legislation or IRAS guidelines. The tax authority's prior approval is required only if the businesses wish to adopt an alternative method which deviates from the standard requirement.
UK	Potentially although no agreement/approval required to operate the "Standard Method" of partial exemption	

	4. ITC Allocation Methodology / Partial Exemption		
	4.2 If yes, please describe the process briefly.	4.3 Are direct attribution / allocation of inputs to taxable or exempt activities a requirement? y/n	4.3.a Additional comment, if applicable
AUSTRALIA	ITCs are available to the extent that the acquisition is made in carrying out the entity's enterprise (commercial activity) but do not relate to making input taxed (exempt) supplies. The entity is able to apply for a binding ruling to set a method for apportioning inputs between the two activities.	YES	
CANADA	Where a financial institution satisfies certain criteria they are required to seek pre-approval of their allocation methodology. It is typically larger institutions that are required to seek this pre-approval. Where pre-approval is not required there are certain legislated criteria that needs to be followed (i.e., direct attribution, etc.)	YES	
FRANCE	N/A	YES	
GERMANY	N/A	YES	
NETHERLANDS		NO	There is a "banking resolution" on basis of which banks/insurance companies partially deduct input VAT on a turnover-ratio-basis.
NEW ZEALAND	However there are industry agreements which cover ITC allocation and apportionment between exempt and taxable supplies.	NO	
SINGAPORE	N/A	YES	
UK	Where the standard method of partial exemption does not give a "fair and reasonable" result, a business will be required to agree a special method of partial exemption with the UK tax authorities. This generally involves submitting a proposal method to (and possibly entering into negotiations with) the tax authorities. Although not required to do so, a business may also apply for a special method if it wishes to.	YES	

4. ITC Allocation Methodology / Partial Exemption	
4.4 If yes, please elaborate.	
AUSTRALIA	Where an acquisition is solely for the purpose of input taxed supplies, no ITC is available. Where the acquisition relates only partly to input taxed supplies, the ITC is apportioned on the basis of the percentage purpose that relates to input taxed supplies. In this sense, direct attribution is required but if there is a duality of purpose, apportionment is required.
CANADA	Direct attribution of inputs to taxable or exempt activities is required wherever possible. Inputs not directly attributable to either taxable or exempt activities (i.e. overhead charges) can be pooled together and a Commercial Activity Rate, which is expressed as a percentage, must be determined to calculate the recoverable portion of GST in that pool.
FRANCE	Each expense should be allocated to a specific turnover in order to place all expenses under the general recovery ratio. However, there is an option to avoid direct allocation.
GERMANY	First, where feasible, inputs have to be attributed to taxable and exempt activities respectively. The input VAT is recoverable / irrecoverable. Second, the remaining input VAT is recoverable according to a pro-rata.
NETHERLANDS	
NEW ZEALAND	The Act requires an apportionment which is "fair and reasonable". Typically this is turnover based.
SINGAPORE	Direct attribution of input tax to taxable or exempt activities is required, wherever possible. Input tax which cannot be directly attributable to the making of taxable or exempt supplies, i.e. residual input tax, has to be apportioned. Only the portion of residual input tax that is proportional to the value of taxable supplies using the standard input tax formula / alternative input tax formula approved by the Comptroller is claimable. However, financial institutions, which are accorded with fixed input tax recovery rate, is not required to perform any direct input tax attribution.
UK	Direct attribution of input tax to taxable/exempt supplies is required wherever possible. Input tax not directly attributable to specific supplies should then be directly allocated as far as possible to an income generating area of the business and recovered in line with that area's taxable activities. Remaining input tax (residual or "pot") is then recovered at the residual recovery percentage of the whole business.

	5. Outsourcing		
	5.1 Does your jurisdiction have any special rules to address the negative impact of outsourcing to third parties in the financial services sector? y/n	5.1a Additional comment, if applicable	5.2 As regards your answer in 5.1, please provide any brief comments as appropriate.
AUSTRALIA	YES		As described in 1 above, Australia's RITC regime is designed to allow a fixed recovery rate for a number of "outsourced" facilitation and data processing arrangements. 75% of the full ITC is an approximation of the extent of profit + wages of the outsourced provider.
CANADA	NO		The group election described at 2.1.4 only applies to closely related entities. The rules function in such a way that exempt services acquired from a third party situated outside of Canada receive a more beneficial treatment than services acquired from a related party abroad.
FRANCE	NO		In practice, financial institutions are implementing cost-sharing groups whenever possible (i.e., intra-group transactions)
GERMANY	NO		In order to be VAT-exempt, an outsourced service has to be a distinct whole fulfilling the specific, essential functions of the exempt transaction.
NETHERLANDS	NO		However, ECJ case law has created some opportunities to VAT exempt outsource services (see C-2/95 (SDC), C-169/04 (Abbey National II), C-453/05 (Volker Ludwig), C-124/07 (JCM Beheer))
NEW ZEALAND	YES	Management of a superannuation fund is an exempt supply	The "reverse charge" rule reinforces the negative impact of outsourcing.
SINGAPORE	NO		The reverse charge mechanism is currently suspended and hence, the import of services would be regarded as neither taxable nor exempt. As regards the taxable supplies, where the financial institutions are not able to recover its input tax in full, outsourcing of taxable activities should be minimized so as not to mitigate the amount of non-recoverable input tax incurred.
UK	NO		

	5. Outsourcing				
	5.3 Do GST/VAT exemptions extend to the outsourced services? y/n	5.3a Additional comment, if applicable	5.4 Are there any special provisions that could provide relief to outsourcing? y/n	5.4a Additional comment, if applicable	5.5 Please describe any other special relieving rules that apply to outsourcing.
AUSTRALIA	NO		YES		See 1.1, 5.1 and 5.2
CANADA	YES		NO		N/A
FRANCE	YES	But it is highly sensitive (i.e., requires very strict conditions)	NO		N/A
GERMANY	YES	Generally yes	NO		N/A
NETHERLANDS	YES	Only under certain conditions	YES		Cost sharing exemption (although conditions are strict), and cases mentioned in 5.2
NEW ZEALAND	YES	If the outsourced services are themselves not taxable supplies	YES	The reverse charge excludes salary and interest costs if the provide is related	N/A
SINGAPORE	NO	Please see our comments in 5.7	NO		N/A
UK	YES	If the outsourced service qualifies for exemption in its own right e.g. cash settlement/claims handling	NO		N/A

	5. Outsourcing	
	5.6 Does the outsourcing relief apply equally to the banking, insurance and funds sector? y/n	5.7 If no please comment briefly.
AUSTRALIA	NO	The list of RCAs contains a number of different services depending on the nature of the financial service to which the service relates. Different services are eligible for RITCs for banks, fund managers, life insurers, trusts and credit unions, for example.
CANADA	NO	Outsourcing relief generally impacts small financial institutions disproportionately (Including investment plans) as they are unable to provide many services in-house and only have the option to outsource. For investment plans (i.e., mutual fund trusts) the group relief provision does not apply and the exemptions are narrow (i.e., management and administrations fees are taxable). There is an exemption for certain insurance services (i.e., appraisers).
FRANCE	N/A	Because there is no special legal rule as mentioned above. However, please note that the insurance sector cannot use liberal EU case law unlike the banking sector.
GERMANY	N/A	
NETHERLANDS	NO	Outsourcing relief is very difficult to apply in the insurance branch; in the banking industry this relief may have a (little) broader range (further to ECJ case law), and in the funds sector it is basically applicable to outsourcing the essential functions of the management of collective funds.
NEW ZEALAND	NO	N/A
SINGAPORE	NO	The provision that relates to exemption of financial services is silent on whether the service provider must be a financial institution. However, the wordings used in the said provision may limit the flexibility to extend the exemption to outsourced services. For instance, the issue of Cashier's Order is exempt. When a financial institution outsources the administrative work relating to the issuance of its Cashier's Order to a third party, the outsourced service rendered by the third party to the financial institution is taxable. However, if the third party issues its own Cashier's Order at the request of the financial institution, the third party's service can be exempt.
UK	N/A	

	5. Outsourcing		
	5.8 Recognizing that investment funds do not have any employees and are thus required to buy in all services are special relieving provisions available?	5.8a Additional comment, if applicable	5.9 If yes, please describe briefly.
AUSTRALIA	YES		RITCs are available for trustee services and fund management and administration of investment funds (including processing of distributions and contributions).
CANADA	NO		
FRANCE	NO		N/A
GERMANY	No explicit rules on outsourcing; however, exemption for management of special investment funds may also apply to outsourced services as the case may be.		Management of special investment funds is VAT-exempt; this may also apply to outsourced services as the case may be.
NETHERLANDS	YES		Further to ECJ case law (Abbey National II C-169/04) outsourcing the essential functions of the management of collective funds are treated as VAT exempt.
NEW ZEALAND	See previous comments for superannuation funds		
SINGAPORE	There is a special remission order that relieves certain types of services.		Remission order applies to “prescribed costs” such as: management fees; trustee fees; fund administration fees; custodian, sub-custodian and depository fees; registrar fees; printing and distribution costs; audit fees; tax agent fees; and legal fees.
UK	No explicit rules on outsourcing; however, broad exemption for management of special investment funds may also apply to outsourced services as the case may be.	Trustee can register for VAT for the fund.	Management of special investment funds is VAT-exempt; this may also apply to outsourced services as the case may be.

	6. Cross-Border Financial Transactions			
	6.1 Are services from abroad subject to GST/VAT via self-assessment or reverse charge? y/n	6.1a Additional comment, if applicable	6.1.1 If yes, does this extend to head office to branch or branch-to-branch transactions? y/n	6.1.1a Additional comment, if applicable
AUSTRALIA	YES		YES	Australia's reverse charge applies to branch to branch transfers but excludes the services of employees of the offshore branch. The special category of RITCs that applies to closely held associates provides 75% relief for other specified services from the offshore branch.
CANADA	YES		YES	
FRANCE	YES		NO	
GERMANY	YES	If the service is VATable in Germany	NO	
NETHERLANDS	YES		NO	
NEW ZEALAND	YES		YES	
SINGAPORE	NO		NO	
UK	YES		NO	Although there are anti-avoidance provisions which can impose a reverse charge where certain services are bought in by a partly exempt VAT group from an overseas branch/head office.

6. Cross-Border Financial Transactions		
	6.1.2 Where financial services are acquired from abroad and would be GST/VAT exempt if sourced domestically, does the exemption apply? y/n	6.1.3 If no, please comment briefly.
AUSTRALIA	YES	
CANADA	YES	The services acquired from abroad from a related party are technically exempt. However, there are special rules that require the Canadian entity to self-assess on the non-risk component of most exempt services bought in. In effect where exempt services acquired from a non-resident related part GST applies to the labor component. Similar services acquired from a domestic related party would not be subject to GST on the labor component.
FRANCE	YES	Please note that option by foreign supplier is possible if the option on said services is available.
GERMANY	YES	
NETHERLANDS	YES	
NEW ZEALAND	YES	
SINGAPORE	NO	The legislation provides for reverse charge provision. However, the services that are subject to reverse charge mechanism have not been prescribed by the Ministry . Hence, financial services which are acquired abroad would be treated as neither taxable nor exempt.
UK	YES	

	6. Cross-Border Financial Transactions			
	6.2 Exported Services			
	6.2.1 What is the GST/VAT treatment of exported financial services? taxable/exempt	6.2.1a Additional comment, if applicable	6.2.2 If taxable, exempt with right of deduction or outside the scope in input relief provided in a branch-to-branch scenario? y/n	6.2.2a Additional comment, if applicable
AUSTRALIA	TAXABLE	GST-free / zero-rated	YES	
CANADA	TAXABLE		YES	
FRANCE	EXEMPT	With a right to recover	YES	
GERMANY	Not subject to German VAT		N/A	
NETHERLANDS	EXEMPT		YES	
NEW ZEALAND	TAXABLE	These supplies are capable of being zero-rated	YES	Input tax deductions arise as a result of zero-rating
SINGAPORE	TAXABLE		NO	The supply of exported financial services is taxable for which input tax relief is allowed (i.e. is not limited to only in a branch-to-branch scenario).
UK	TAXABLE	Outside the scope of VAT without input tax recovery where provided to EU recipients, outside the scope with input tax recovery where provided to non-EU recipients	Input tax recovery available to the extent that the branch uses the services for "taxable" activities	



	7. Financial Transaction Through E-commerce			
	7.1 Are there any special rules dealing with Internet-based or virtual banks? y/n	7.2 If yes, please describe briefly.	7.3 What is the GST/VAT status of online brokerage services, similar to services provided by human investment dealers (i.e., electronic dealing / trading platforms)? Taxable/exempt	7.4 What is the GST/VAT status of online brokerage services, similar to services provided by human investment dealers (i.e., electronic dealing / trading platforms)? Taxable/exempt
AUSTRALIA	NO	N/A	TAXABLE	TAXABLE
CANADA	NO	N/A	TAXABLE	
FRANCE	NO	N/A	EXEMPT	
GERMANY	NO		TAXABLE	(Disputed)
NETHERLANDS	NO	N/A	EXEMPT	
NEW ZEALAND	NO	N/A	EXEMPT	
SINGAPORE	NO	N/A	TAXABLE	
UK	NO		EXEMPT	

	8. Financial Transaction Through E-commerce		
	8.1 Other than GST/VAT returns are there special reporting requirements targeted at financial institutions? y/n	8.1a Additional comment, if applicable	8.2 Based on your experience is the GST/VAT compliance burden for financial institutions – more or less than income tax?
AUSTRALIA	NO		Generally, the income tax burden is more onerous but the systems set up and maintenance costs are higher for a GST.
CANADA	YES		Generally within the tax department income tax is the bigger burden. However, much of the GST compliance burden increasingly falls on persons outside the tax group making the true cost difficult to ascertain.
FRANCE	NO		VAT compliance is as heavy as for ICT: - one monthly return - various impact on the ERP - recovery right to compute - tax on wages ("taxe sur les salaires") to compute and pay
GERMANY	NO		More reporting obligations
NETHERLANDS	YES		Generally within the tax department income tax is seen as the bigger burden. However, much of the VAT compliance burden increasingly falls on persons outside the tax group making the true cost difficult to ascertain.
NEW ZEALAND	YES	Not specifically but industry agreements often contain additional reporting requirements	Generally within the tax department income tax is the bigger burden. However, much of the GST compliance burden increasingly falls on persons outside the tax group making the true cost difficult to ascertain.
SINGAPORE	NO		Generally, financial institutions which have been licensed to carry out their business activities as a bank or finance house, have lesser GST compliance burden because they are currently granted the administrative concessions to report only 5 boxes in the GST return (i.e. they are not required to report the values of zero-rated and exempt supplies as well as zero-rated purchases).
UK	NO		VAT compliance generally involves submission of quarterly/monthly returns (as opposed to annual return) and this is prepared by reference to transactional basis, so the compliance can be significant.

	8. Financial Transaction Through E-commerce			
	8.3 In the last 5 years has the GST/VAT compliance burden for financial institutions increased? y/n	8.3a Additional comment, if applicable	8.4 As regards GST/VAT charging decisions for taxable supplies are there any sub-national place of supply rules? y/n	8.4a Additional comment, if applicable
AUSTRALIA	YES		NO	
CANADA	YES		YES	
FRANCE	YES		NO	
GERMANY	YES		NO	
NETHERLANDS	YES	This is also caused by the horizontal monitoring approach by the Dutch tax authorities, which implies that the taxpayer build a "tax control framework"	NO	
NEW ZEALAND	YES		NO	
SINGAPORE	YES		NO	
UK	YES	i.e. SAO requirements, "fair and reasonable" declaration for partial exemption	NO	We assume this refers to State v Federal

	9. Significant Reforms Underway or Proposed	
	9.1 Currently is there GST/VAT legislative proposal applicable to the financial sector proposed? y/n	9.2 If yes, please describe briefly.
AUSTRALIA	YES	Changes to the financial services GST arrangements are proposed to be implemented on 1 July 2012. The changes do not alter the fundamental design but extend the scope of some RITCs and limit others. Hire Purchase is proposed to be fully taxable and the de minimis threshold increased three fold.
CANADA	YES	Canada is in the process of implementing major reforms to the Canadian GST system as a result of sales tax harmonization. Moreover, in response to unfavorable court rulings there have been new rules introduced in the realm of financial services. Special rules for pension plans have been implemented, allocation methodology and imported services have been enacted. Canada takes the view that the totality of these changes relates to a mini-review of this sector. There has been a commitment by the authorities to review the existing legislation and framework.
FRANCE	YES	The proposal is not issued by the French administration but on the EU level (draft of proposal for a new directive and regulation). The main issues cover : - new definition of terms, in particular by taking into account the ECJ's case law (i.e., intermediation); - notion of supply of good or service ancillary to financial VAT-exempt service.
GERMANY	YES (on European level)	Update of rules for financial services sector
NETHERLANDS	YES	The European Commission proposed to modernize the VAT clauses with regard to financial and insurance transactions (see http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/VAT_insurance/index_en.htm). A lot of discussion has followed and this appears to be a long term plan.
NEW ZEALAND	YES	The methodology of input tax apportionment for persons with mixed taxable/exempt supplies is proposed to change. A financial service provided will be entitled to claim input tax based on their intended taxable use. They will be required to adjust this based on actual use. This is expected to significantly impact their compliance costs. The zero-rating of land is also proposed. This coupled with a domestic reverse charge where the land will not be fully used for taxable purposes. The practical impact on a financial institutions own position is expected to be limited (as they tend to lease rather than acquire). However, the change is expected to lower the priority of their security for loans.
SINGAPORE	NO	N/A
UK	YES	EU Insurance and Financial Services review in consultation stage - aimed at modernizing and simplifying VAT treatment of insurance/FS throughout EU. Cost Sharing Exemption - currently available under EU law, consultation in process around potential implementation in UK.

	9. Significant Reforms Underway or Proposed			
	9.3 Have significant reform been studied or proposed but not implemented? y/n	9.4 If yes, please describe briefly.	9.5 Has the legislation applicable to the financial services sector been revised in the last 10 years to take into account new products, services and business practices? y/n	9.5a Additional comment, if applicable
AUSTRALIA	YES	See 9.1 and 9.2	NO	
CANADA	NO	N/A	NO	
FRANCE	NO	N/A	YES	(In particular, Islamic finance tools)
GERMANY	NO		NO	
NETHERLANDS	YES	See 9.2	NO	
NEW ZEALAND	NO	N/A	YES	
SINGAPORE	NO	N/A	YES	
UK	YES	EU Insurance and Financial Services review in consultation stage - aimed at modernizing and simplifying VAT treatment of insurance/FS throughout EU. Cost Sharing Exemption - currently available under EU law, consultation in process around potential implementation in UK.	YES	

	10. Retroactive Legislation		
	10.1 Is retroactive legislation possible in your legal system for GST/VAT matters? y/n	10.1a Additional comment, if applicable	10.2 If yes, what are the criteria?
AUSTRALIA	YES		Retrospective application of legislation is possible but rarely, if ever, undertaken. Changes to the GST law must be agreed to by all of Australia's states and territories. The GST revenue is paid to the States and Territories in the form of a grant from the Federal Revenue.
CANADA	YES		Canada frequently uses retroactive legislation both for relieving and taxing provisions. The criteria are: unintended result of the legislation, double taxation and revenue risk. There are often complicated coming into force provisions.
FRANCE	NO		Fiscal legislation should not be retroactive. Only the ECJ case law may have such effect.
GERMANY	YES	In very rare cases	Where there is no protection for reliance on existing law (anti-abuse regulations)
NETHERLANDS	NO		
NEW ZEALAND	YES		Although not regular, New Zealand does occasionally use retrospective legislation both for relieving and taxing provisions. The criteria are: unintended result and reasonable contemplation.
SINGAPORE	NO		N/A
UK	YES	Possible but never applied in practice.	



	10. Retroactive Legislation	
	10.3 If yes, how frequently do the tax authorizes use this mechanism?	10.3a If yes, please provide a brief example.
AUSTRALIA	As stated above, this is rare and occurs on a case by case basis.	
CANADA	In the past retroactive legislation was used frequently where relief was being granted. In recent years it is used more for the implementation of taxing provisions.	Specific rules for imported taxable services and the meaning of 'arranging for'.
FRANCE	N/A	N/A
GERMANY	Exceptionally	
NETHERLANDS	N/A	N/A
NEW ZEALAND	Generally, legislation adversely impacting taxpayers will be prospective (often from the date of announcement of the policy change). There have been recent occurrences where taxpayer friendly legislation is retrospective.	Zero-rating for non-residents is an example of taxpayer friendly retrospective legislation.
SINGAPORE	N/A	N/A
UK	Never applied in practice.	

	11. Role of Jurisprudence
	11.1 Have the courts been forced to address contentious issues vis-à-vis the application of GST/VAT to the financial services sector? If so, please comment briefly on the impact of such decisions.
AUSTRALIA	There have been several cases involving the operation of the financial services provisions. To date, the approach of the courts has not significantly challenged, nor has it clarified, the revenue's approach to the law.
CANADA	There have been a number of key court decisions regarding the characterization of products and services. There have been significant gaps of time where by the legislation was not reviewed and has become dated in that it has not keep up with new business practices. Unfortunately, key court decisions have resulted in retroactive legislation.
FRANCE	YES - As a preliminary remark, please note that the EU case law has had the most important impact in the financial services sector, even if the French Tax Administration considers that ECJ decisions are binding only if they involve France - The areas where case law has been the most important is: intermediation, outsourcing, notion of ancillary services.
GERMANY	Where the courts merely "interpret" current law, legislation does not necessarily have to be changed.
NETHERLANDS	Most of the relevant court cases come from the European Court of Justice, and influence the Dutch VAT practice.
NEW ZEALAND	There have been a number of key court decisions regarding the characterization of products and services. These have not resulted in a change of legislation. One case has resulted in an extension of the definition of financial services.
SINGAPORE	NO
UK	Yes. Almost all aspects of the VAT treatment of financial services have been tested in the UK and EU courts and, as such, case law is constantly evolving in this area.

C Tier 2 Country Survey

C.1 South Africa

South Africa commenced its VAT in 1991.

C.1.1 Scope of Exemption

Financial services are exempt without credit in line with the general treatment of financial services in UK, New Zealand and Canada at the time. However, the scope of the South African exemption is narrower in three respects from the broad exemption in those countries:

- arranging and negotiating for a financial supply is not included in the exemption, nor is the management of a superannuation scheme;
- the exemption does not extend to “services to the extent that the consideration payable in respect thereof is any fee, commission, merchant’s discount or similar charge, excluding any discounting cost.”; and
- general insurance is taxable (in line with the New Zealand model) and an input tax deduction is allowed for indemnity payments made to insured vendors that are registered for VAT. The VAT registered insured is liable to pay output tax on receipt of this indemnity payment.

C.1.2 Scope of Input Tax Relief

The South African model includes partial exemption input tax relief to the extent that goods or services are acquired by the vendor for the purpose of making taxable supplies. Relief is available, therefore, in relation to exported financial services.

C.1.3 Scope of Commercial Activity

The definition of “enterprise” (the equivalent to commercial activity in Canada) excludes activities to the extent that it involves exempt supplies.

C.2 Hong Kong

On July 18, 2006, the Hong Kong SAR Financial Secretary released a consultation document in relation to the proposal for a GST in Hong Kong. The document included a proposal for a full zero-rate for financial services.

In December 2006, the Government announced that it had not been able to convince the majority of the public to accept GST and would not advocate GST in the rest of the consultation period. At this stage, there are no plans to introduce a GST in Hong Kong SAR.

The consultation document for the (unsuccessful) proposal proposed a zero-rate of financial services for both explicit and implicit fees. No final decision was made about the treatment of “arranging” and “brokerage”. The document observed that the negative outcomes associated with exempting financial services are:

- high compliance costs caused by the need to allocate purchases between taxable and exempt activities;
- disincentives to outsource services;
- tax cascades;
- higher costs associated with “stuck” non-creditable input tax;
- reduced competitiveness of the sector; and
- greater incentives for tax avoidance.

The decision for a full zero-rate was favored on the basis that VAT should be simple, easy to administer and not undermine competitiveness as a major international financial centre.

The paper observes that “This approach would make Hong Kong a pioneer insofar as no major financial centre in the world has yet moved to a full zero-rating of its financial supplies, although the international trend is moving in that direction.”

C.3 GCC

All members of the Gulf Cooperation Council (GCC) are likely to introduce a VAT system by the end of 2013. Current indications are that:

- the VAT rate will be 5%;
- financial services (including insurance) could be zero-rated, but variations may occur across other GCC states; and
- there may be lengthy delays for refund of VAT credits because only one claim per annum will be available.

The zero-rate for financial services could also be applied to Islamic finance to achieve neutrality between the two. It is understood that there are practicalities of determining the finance charge that is embedded in Islamic products.

Like the proposal in Hong Kong, further consideration is being given to the extension of the zero-rate to “arranging”.

While differences in detail may emerge between the GCC members, other common design features are likely to be:

- place of supply of goods will be similar to the rules in EU;
- no VAT of intra-UAE goods movements but VAT may be charged on intra GCC movements;

- place of supply for services will be where the supplier is established for B2B supplies;
- compulsory VAT registration threshold set at approximately USD 1 million to limit inflationary worries with voluntary VAT registration from USD 0.5 million;
- Dubai free trade zones will fall outside of VAT regime; and
- monthly and quarterly VAT returns are under consideration.

C.4 Malaysia

Malaysia currently imposes a turnover tax at 5% (service tax) on some fees charged by financial institutions and a 10% sales tax on the manufacture many goods.

A GST Bill was introduced into Parliament and proposes:

- a VAT at the likely rate of 4% to replace the service and sales tax; and
- an exemption for financial services with neutral treatment of Islamic finance and Takaful (Islamic insurance).

The treatment for financial services is being developed with consultation through Malaysia's central bank - Bank Negara Malaysia ("BNM") and the association of banks that come under BNM's supervision.

The second reading of the Bill has been deferred on two occasions and the present likely date of implementation is 2013. For financial services, the design features that are under consideration are:

- South Africa's narrow exemption and taxation of explicit fees;
- Singapore's fixed input tax recovery rate based on the value of supplies that are B2B and exports as a proportion of total value of supplies; and
- a self assessment for imported services.

Consideration is being given to the remission of the GST component of specified acquisitions of qualifying managed funds. This is not available through a zero-rate because funds are unlikely to qualify as carrying on a "business".

C.5 China

Like Malaysia, China currently imposes a tax on turnover (business tax) at rates of between 3% and 25%. A VAT applies to goods at a standard rate of 17.5%.

A full VAT is being considered with a likely commencement date of 2013. The treatment of financial services has not been the topic of public discussion. However, if an approach was to be favored that reflects the existing arrangements we might expect:

- a broad exemption from VAT – resulting in full input taxation of financial services;
- a selective low flat rate on fees and margin based revenue;

- a zero-rate for exported financial services; and
- a self assessment for imported services.

C.6 Ireland (Funds only)

Ireland operates a VAT with a broad exemption.

- Where an Irish-based fund management company provides management services to a fund in another Member State the fund manager is entitled to full deduction of input VAT. This is different than most other Member States.
- Where a management company provides services to domestically regulated funds the services are exempt from VAT. The list of defined funds is very broad and includes all Irish-regulated funds such as UCITS, Variable Capital Companies and Limited Liability Partnerships.
- The exemption applies to functions that are fund management services and received in respect of a specific Irish fund. The exemption applies to collective portfolio management as described in the UCITS directive. This includes investment management, fund administration and marketing. The exemption also applies to sub-delegated service providers.

C.7 Luxembourg (Funds only)

Luxembourg operates a VAT with a broad exemption.

- Where a Luxembourg-based fund management company provides management services to a fund in another Member State the fund manager is not entitled to full deduction as the supply is considered VAT exempt.
- Where a management company provides services to domestically regulated funds the services are exempt from VAT. Only management services provided to such funds subject to the Luxembourg financial supervisory body benefit from the exemption.
- The exemption applies to the following fund management services: daily management of the portfolio; research and consulting in investment; accounting; calculation of the NAV; issue and repurchase of the shares; and other administrative services. Fund management includes: customer inquiries; maintenance of unit-holder register; distribution of income; contract settlements; and record keeping.

D VAT Treatment of Banking, Insurance and Securities / Funds Services

The following table incorporates a general description of all items in the banking, insurance and securities/funds sectors in five jurisdictions (plus the assumed treatment in the Hong Kong zero-rate) proposal that are either exempt¹⁰⁸ or RITC. Canada has also been included for comparative purposes.

Item	EU	New Zealand ¹⁰⁹	Singapore	Hong Kong	Australia ¹¹⁰	Canada
Banking						
Operation of any current, deposit or savings account	Exempt	Exempt	Exempt	Zero-rated	Exempt	Exempt
Credit arrangements, loans, letters of credit.	Exempt	Exempt	Exempt	Zero-rated	Exempt	Exempt
Guarantees, securities for money etc	Exempt	Exempt	Exempt	Zero-rated	Exempt	Exempt
Credit component of hire purchase ¹¹¹	Exempt	Exempt	Exempt	Zero-rated	Exempt	Exempt
Exchange of currency, money transfers	Exempt	Exempt	Exempt	Zero-rated	Exempt	Exempt
ATM fees	Exempt	Exempt	Exempt	Zero-rated	Exempt	Exempt
ATM support services, replenishment of cash, software etc	Taxable	Taxable	Taxable	Taxable ¹¹²	Taxable	Taxable
A credit card, or charge card operation / interchange fees / payment system charges	Exempt	Exempt	Exempt	Zero-rated	Taxable / RITC	Exempt
Debt collection	Taxable	Exempt	Exempt	Zero-rated	Taxable / RITC	Taxable
Assignment of debts	No supply ¹¹³	Exempt	Exempt	Zero-rated	Exempt	Exempt
Leasing	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable
Financial advisory services	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable
Loan application, management and processing	Taxable	Taxable	Taxable	Taxable	Taxable / RITC	Taxable ¹¹⁴

¹⁰⁸ Exports will generally be zero-rated and not exempt.

¹⁰⁹ If exempt, zero-rated on B2B.

¹¹⁰ "Input taxed" are referred to as exempt for ease of comparison.

¹¹¹ "Hire purchase" refers to a lease with an option to purchase.

¹¹² The zero-rate in Hong Kong was intended to be narrowly defined. Therefore any non financial services under that definition are subject to tax at the normal rate.

¹¹³ Outside the scope of the tax.

¹¹⁴ For activities outsourced to a third party the supply will be subject to tax (exempt if performed by the financial institution).

Item	EU	New Zealand ¹¹⁵	Singapore	Hong Kong	Australia ¹¹⁶	Canada
Securities and Funds						
Dealing in securities, stock, bonds, trust units, LLP	Exempt	Exempt	Exempt	Zero-rated	Exempt	Exempt
Issue of shares	No supply	Exempt	Exempt	Zero-rated	Exempt	Exempt
Derivatives, options, futures trading (non-deliverable)	Exempt	Exempt	Exempt	Zero-rated	Exempt	Exempt
Broking / arranging / intermediary / facilitator	Exempt	Exempt	Taxable	Zero-rated	Taxable / RITC	Exempt ¹¹⁷
Processing of account information	Exempt	Taxable	Exempt	Taxable	Taxable / RITC	Taxable
Portfolio management	Exempt	Exempt if arranging	Taxable ¹¹⁸	Taxable	Taxable / RITC	Taxable
Bailment fees	Exempt	Taxable	Taxable	Taxable	Taxable	Taxable
Underwriting	Exempt	Exempt	Exempt	Zero-rated	Exempt	Exempt
Nominee services	Exempt	Taxable	Taxable	Taxable	Taxable / RITC	Taxable
Safe custody	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable
Trustee services (management and administration of funds)	Exempt ¹¹⁹	Exempt ¹²⁰	Taxable/ Remission of GST ¹²¹	Taxable/ ITC	Taxable / RITC ¹²²	Taxable
Custodial services	Taxable	Taxable	Taxable	Taxable	Taxable / RITC	Taxable
Management of pension schemes	Taxable	Exempt	Taxable	Zero-rated	Taxable / RITC	Taxable
Transaction processing of trade finance, derivative trading	Exempt	Taxable	Taxable	Taxable	Taxable / RITC	Exempt
Share / unit registry	Taxable	Taxable	Taxable	Taxable	Taxable / RITC	Taxable
Acquisitions of transaction cards, deposit and other forms, passbooks, and credit reference services by account operator	Taxable	Taxable	Taxable	Taxable	Taxable / RITC	Exempt

¹¹⁵ If exempt, zero-rated on B2B.

¹¹⁶ Input taxed are referred to as exempt for ease of comparison.

¹¹⁷ Preparatory services such as investment management services, facilitatory services (such as market research, document preparation or processing, advertising, etc.) and credit management services are treated as taxable.

¹¹⁸ The remission order is much broader than trustee fees. Refer to section 6.3.2 of this report for a more detailed list.

¹¹⁹ For activities aimed at realizing the investment objectives of the investment fund concerned.

¹²⁰ For funds management – 90% of trustee fee under agreement with industry.

¹²¹ For specified funds and specified acquisitions.

¹²² Scope of RITC for bundled services to be narrowed.

Item	EU	New Zealand ¹²³	Singapore	Hong Kong	Australia ¹²⁴	Canada
Insurance						
Lenders mortgage and/or title insurance	Exempt	Taxable / deemed ITC on settlement	Taxable / deemed ITC on settlement	Taxable	Taxable / ITC on settlement ¹²⁵	Exempt
Life insurance / reinsurance	Exempt	Exempt	Exempt	Zero-rated	Exempt	Exempt
Life insurance intermediation	Exempt	Exempt	Taxable	Zero-rated	Taxable / RITC	Exempt
Life insurance administration	Taxable	Taxable	Taxable	Taxable	Taxable / RITC	Taxable
Non-life insurance / reinsurance	Exempt	Taxable / deemed ITC on settlement	Taxable / deemed ITC on settlement Exempt for reinsurance	Zero-rated	Taxable / ITC ¹²⁶ on settlement	Exempt
Non-life insurance intermediation	Exempt	Exempt	Taxable	Zero-rated	Taxable / RITC	Exempt

¹²³ If exempt, zero-rated on B2B.

¹²⁴ Input taxed are referred to as exempt for ease of comparison.

¹²⁵ Referred to as decreasing adjustment.

¹²⁶ Proposed treatment for investment funds.

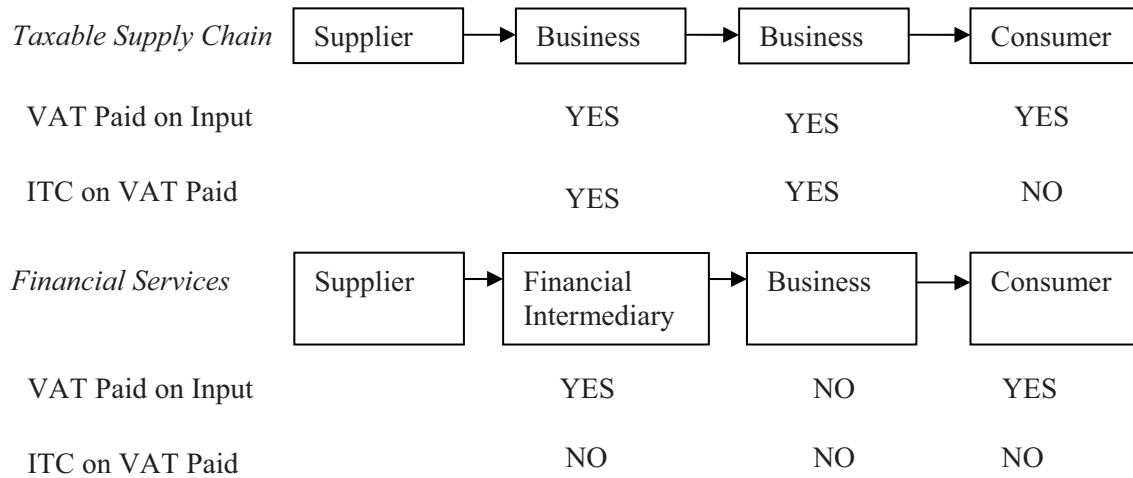
E OECD Principles/Guidelines

The following is a listing of VAT principles and guidelines as outlined by the Organisation for Economic Co-Operation and Development (“OECD”) in the February 2006 paper titled *International VAT/GST Guidelines*.

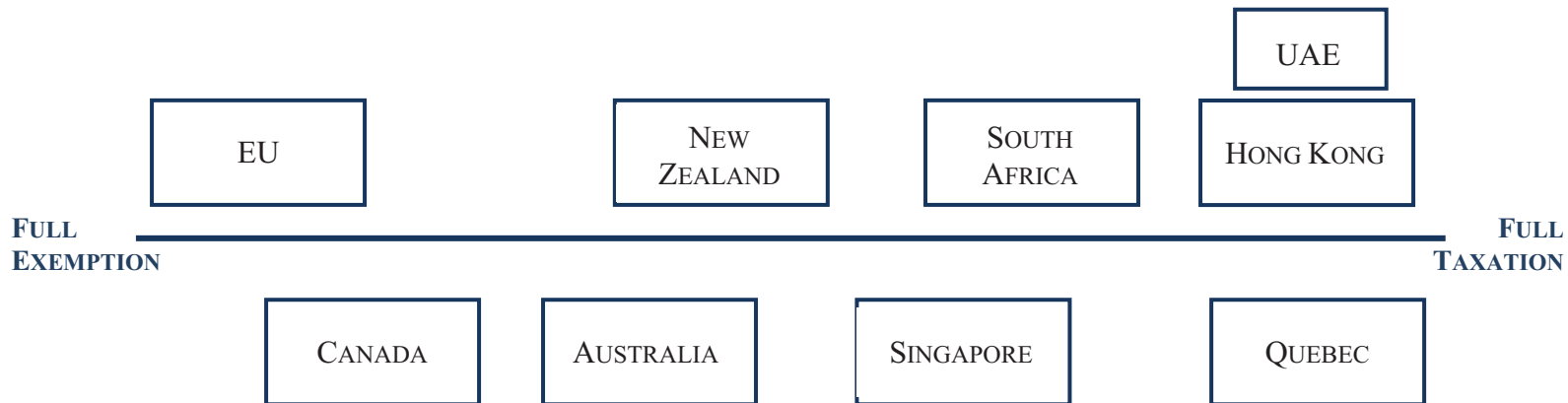
Principle	Description
Neutrality	Taxation should seek to be neutral and equitable between forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.
Efficiency	Compliance costs for taxpayers and administrative costs for the tax authorities should be minimized as far as possible.
Certainty and simplicity	The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences of a transaction, including knowing when, where and how the tax is to be accounted.
Effectiveness and fairness	Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimized while keeping counter-acting measures proportionate to risks involved.
Flexibility	The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

F Cascade

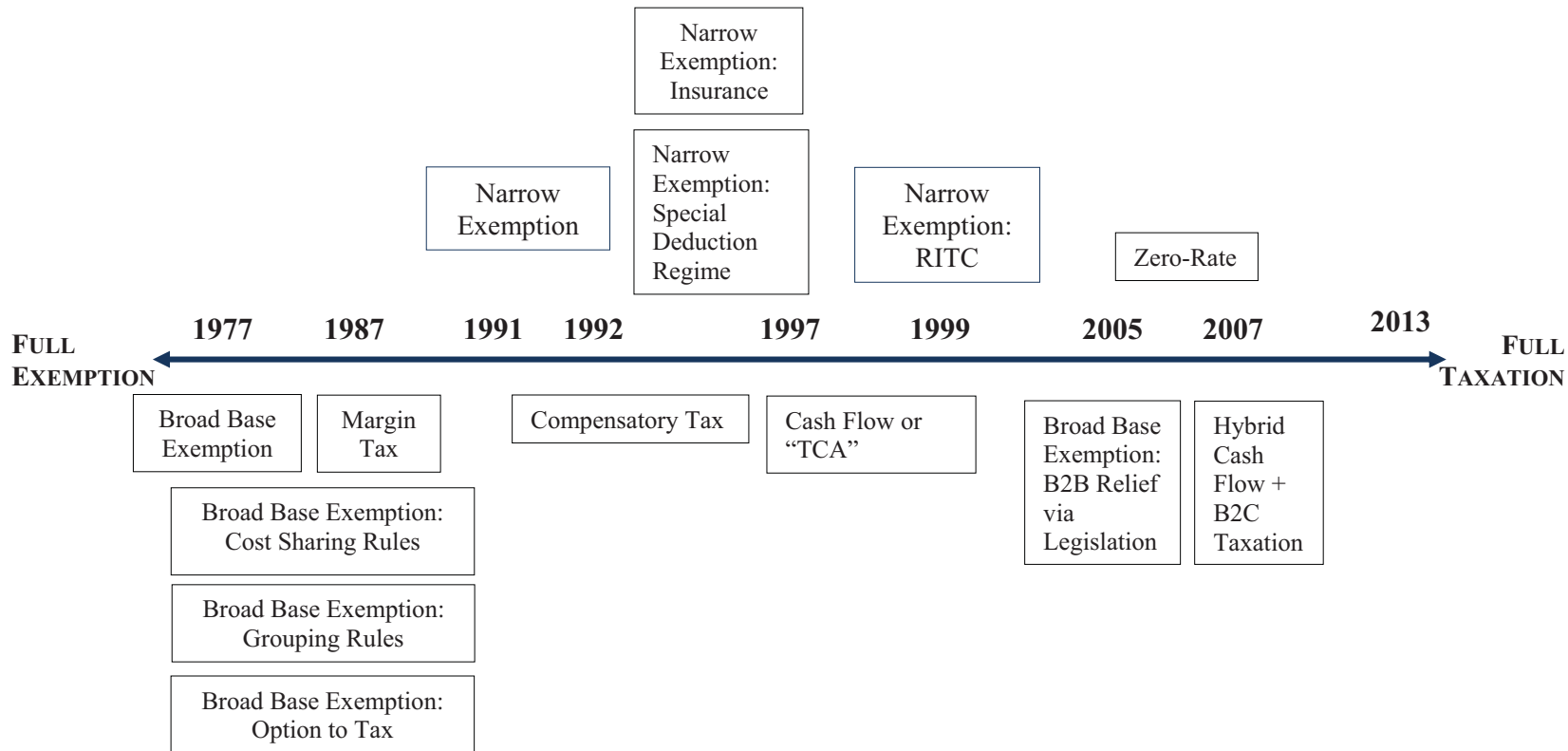
The following diagram depicts the flow of VAT in a fully taxable supply chain and compares it to the cascade effect of exempting financial services. Where exemption is introduced into the supply chain, unrecoverable VAT is borne by the financial intermediary.



G The Evolution of VAT – By Country



H The Evolution of VAT – By Option



I Options Worksheets

OPTION:	Broad Base Exemption
Description:	Broaden the exemption to include a number of services typically provided by non-financial institutions to financial institutions. This could include many more services, such clearing and settling, fund management, “arranging for”, data processing, trustee and custodial services, marketing. May result in over taxation on the financial sector and less tax on consumption of financial services.
Currently in use in the following jurisdictions:	European Union

PRO’s	CON’s
<ul style="list-style-type: none"> Minimizes distortion across financial services products (i.e., can treat different sectors more equitably) (except, in Canada, funds) 	<ul style="list-style-type: none"> Cascade of taxes
<ul style="list-style-type: none"> “Value add” not subject to GST (i.e., profit and labour) 	<ul style="list-style-type: none"> More exempt business with resulting administrative and compliance burdens (i.e., partial exemption); overall less efficient system
<ul style="list-style-type: none"> Treat margin-based and fee-based services similarly 	<ul style="list-style-type: none"> Uncompetitive internationally
<ul style="list-style-type: none"> Can offer opt out clause and cost sharing 	<ul style="list-style-type: none"> Interpretive issues as to what qualifies for exemption
<ul style="list-style-type: none"> Addresses issue of bundled supplies / incidental supplies (except, in Canada, for funds) 	<ul style="list-style-type: none"> Exacerbates non-neutrality between financial services and other taxable goods and services
<ul style="list-style-type: none"> Reduced importance of “commercial activity” vs. consumer 	<ul style="list-style-type: none"> Increase inefficiencies – “spread of exemption”; push down the supply chain
<ul style="list-style-type: none"> Neutrality with offshore acquisition – relief from self assessment 	<ul style="list-style-type: none"> Requires allocation methodology
<ul style="list-style-type: none"> Neutrality for consumption of different financial services by consumers 	<ul style="list-style-type: none"> Exacerbates non-neutrality between financial products and financial product providers

OPTION:	Broad Base Exemption: Cost Sharing Rules
Description:	Provide exemption for goods and services supplied by umbrella organizations to members of a cost sharing association. Often subject to restrictions such as members must be involved in exempt activities and the services acquired must be considered as necessary for the member to operate. Members reimburse the umbrella organization their share of the joint expenses. It is important to note that the supply from the umbrella organizations to the member is exempt, thus VAT is embedded in the transaction, but not necessarily on the 'value add' (i.e., profit and labour).
Currently in use in the following jurisdictions:	EU – Mixed application and varying rules

PRO's	CON's
<ul style="list-style-type: none"> • GST not levied on the profit and labour. • Address outsourcing 	<ul style="list-style-type: none"> • Difficult to operate in cross border situation • Distorts competition for service providers not part of a cost sharing group
<ul style="list-style-type: none"> • Works for shared service centers (i.e., Credit Union Central) 	<ul style="list-style-type: none"> • Entity providing services is involved in exempt activity thus restricting input tax recovery
<ul style="list-style-type: none"> • Unlike VAT grouping ownership and control issues are less important 	<ul style="list-style-type: none"> • Exacerbates the cascade
<ul style="list-style-type: none"> • More apt to work in a closed environment (i.e., the EU Internal Market) • Reimburse exact share 	<ul style="list-style-type: none"> • Less efficient on system – Increases the administrative and compliance burden • Not a structural fix – see Australia RITC
	<ul style="list-style-type: none"> • Possible transfer pricing issues if cross border angle pursued

OPTION:	Broad Base Exemption: Grouping Rules
Description:	Allow connected legal entities to be treated as a single entity, therefore no GST levied on intra-group transactions. GST recovery would be determined by use of goods / services by any group member. Canada has a variation of the broad EU VAT group – the section 150 election. Can incorporate relief from self assessment for profit and wages.
Currently in use in the following jurisdictions:	EU – UK, Germany, NL and many other EU jurisdictions
	Australia
	New Zealand
	Singapore

PRO's	CON's
<ul style="list-style-type: none"> Salary element of charges between group members not subject to GST (i.e., similar to domestic branch to branch transactions) 	<ul style="list-style-type: none"> Difficult to manage in cross-border situations
<ul style="list-style-type: none"> Ease of administration / compliance: one return encompassing all group members, one return for tax authority to deal with 	<ul style="list-style-type: none"> Often subject to anti-avoidance rules (i.e., UK and section 43(2)(a))
<ul style="list-style-type: none"> Address outsourcing issue within a group 	<ul style="list-style-type: none"> Potential for complex allocation methodology
<ul style="list-style-type: none"> Manage GST across business as they expand by internal growth or acquisition 	<ul style="list-style-type: none"> Strict eligibility criteria
<ul style="list-style-type: none"> Treat branches and subsidiaries the same 	<ul style="list-style-type: none"> Commercial activity vs consumption distinction becomes critical (i.e., treatment of trusts, passive investment vehicles)
	<ul style="list-style-type: none"> Not a structural fix

OPTION:	Broad Base Exemption: Option to Tax
Description:	Allow the supplier / recipient to decide whether to treat the financial transaction as either exempt or taxable. The option could be applied on a transaction by transaction basis, by the type of transaction, by customer or by sector.
Currently in use in the following jurisdictions:	EU – France, Germany, Austria, Belgium, Estonia, Lithuania

PRO's	CON's
<ul style="list-style-type: none"> Allows for B2B transactions to be taxable, thus giving rise to deduction 	<ul style="list-style-type: none"> Complex for administrative and compliance purposes (i.e., allocation methodology); must be clear to handle option
<ul style="list-style-type: none"> Works well for types of transactions or certain sectors (i.e., payment processing) 	<ul style="list-style-type: none"> Potential tracking of transactions
<ul style="list-style-type: none"> Addresses cascade to a certain extent 	<ul style="list-style-type: none"> Domestic suppliers of financial services could be at disadvantage vis-à-vis non-resident suppliers
<ul style="list-style-type: none"> Can apply to services acquired from non-residents 	<ul style="list-style-type: none"> Often implemented with onerous restrictions, such as Germany
<ul style="list-style-type: none"> Offers flexibility to suppliers 	<ul style="list-style-type: none"> Efficiency limited to scope of input tax relief for recipient (i.e., B2B makes sense)
	<ul style="list-style-type: none"> Interpretive and qualification problems
	<ul style="list-style-type: none"> Issue for fee vs. margin charges

OPTION:	Narrow Exemption
Description:	Takes steps to greatly narrow the exemption. Seek to tax transactions with explicit fees or commissions.
Currently in use in the following jurisdictions:	South Africa

PRO's	CON's
<ul style="list-style-type: none"> • Less cascade 	<ul style="list-style-type: none"> • B2C bears higher GST costs
<ul style="list-style-type: none"> • More neutrality for financial services vis-à-vis other taxable goods and services 	<ul style="list-style-type: none"> • Bias between fee-based and margin-based services
<ul style="list-style-type: none"> • Less interpretation – all explicit fees and commissions are subject to GST (i.e., addresses some definitional issues) 	<ul style="list-style-type: none"> • Commercial activity vs. consumption distinction becomes critical (i.e., treatment of trusts, passive investment vehicles)
<ul style="list-style-type: none"> • Consistent with the way the sector is evolving 	<ul style="list-style-type: none"> • Tax base determined by how the service is paid for
<ul style="list-style-type: none"> • More taxable revenues for authorities 	<ul style="list-style-type: none"> • Not a structural fix – does not directly address cascade or outsourcing
<ul style="list-style-type: none"> • Less compliance burden 	<ul style="list-style-type: none"> • Emphasizes scope input tax relief
<ul style="list-style-type: none"> • Less administrative burden 	
<ul style="list-style-type: none"> • More neutrality between fund and non-fund products 	

OPTION:	Narrow Exemption: Reduced Input Tax Credit (“RITC”)
Description:	Introduce a narrower exemption of financial services accompanied by a special regime that grants financial services providers input tax relief for costs of a specified kind that relate to making financial services. The amount of relief granted would be roughly equivalent to the labour/profit component of the identified service. In Australia the relief that is granted is 75% of the input tax that would otherwise be denied because of the exemption for financial services and is described as an RITC. The remaining 25% is subject to normal allocation methodology.
Currently in use in the following jurisdictions:	Australia

PRO’s	CON’s
<ul style="list-style-type: none"> Addresses the self-supply bias / outsourcing concerns 	<ul style="list-style-type: none"> AP process needs to deal with different recovery options: full recovery, nil recovery, partial recovery, RITC recovery and RITC recovery plus partial
<ul style="list-style-type: none"> Addresses distinction between domestic branch to branch v. subsidiary to subsidiary 	<ul style="list-style-type: none"> Disputes over what qualifies for RITC
<ul style="list-style-type: none"> Address neutrality of the exemption regime for intermediation services by principals to facilitators and agents 	<ul style="list-style-type: none"> Does not address the GST cascade matter directly
<ul style="list-style-type: none"> Could work very well for the fund industry 	<ul style="list-style-type: none"> New business practices / models require updating of the list
<ul style="list-style-type: none"> In synch with industry drive for efficiency and competitiveness 	<ul style="list-style-type: none"> Narrow exemption creates distortion between fee-based services v. margin based
	<ul style="list-style-type: none"> Trend is to transparency and fee based services to consumers (i.e., credit charge surcharge, financial planning, ATM fees)
	<ul style="list-style-type: none"> Promotes bundling through associated entities
	<ul style="list-style-type: none"> Percentage can be arbitrary
	<ul style="list-style-type: none"> Commercial activity vs. consumer distinction becomes critical (i.e., treatment of trusts, passive investment vehicles)

OPTION:	Narrow Exemption: Insurance
Description:	Apply GST to all non-life insurance products. For life products maintain the exemption to ensure neutrality with other savings and investment products. To ensure that only the margin between premiums and payout is subject to GST it is necessary to allow a special input tax credit. Would also apply to similar types of reinsurance. ‘Arranging for’ and ‘brokerage’ of all insurance policies would be taxable. Possible to tax group life products.
Currently in use in the following jurisdictions:	New Zealand
	Australia
	South Africa
	Singapore

PRO’s	CON’s
<ul style="list-style-type: none"> Address distortion with similar products (i.e., warranties) 	<ul style="list-style-type: none"> Complex allocation methodology (i.e., GST taxable revenue v. exempt investment income)
<ul style="list-style-type: none"> Focus on B2C, as most businesses entitled input tax credit 	<ul style="list-style-type: none"> Difficult to understand the status of the insured party regarding ability to claim input tax credits
<ul style="list-style-type: none"> Internationally competitive as ‘zero-rating’ should apply 	<ul style="list-style-type: none"> Potential to overtax the intermediation
<ul style="list-style-type: none"> Operates in other countries at present (i.e., Australia, New Zealand, Singapore, etc.) 	<ul style="list-style-type: none"> Budgetary risk in years of high settlements
	<ul style="list-style-type: none"> Inconsistent treatment of risk intermediation (i.e., derivatives, guarantee)
	<ul style="list-style-type: none"> Other explicit insurance taxes

OPTION:	Narrow Exemption: Special Deduction Regime
Description:	<p>Regime allows for ‘effective zero-rating’ of financial services to GST registered customers. The regime is essentially exemption with recovery of attributable input tax. Each year the tax authority publishes a fixed input tax recovery rate for specified types of financial institutions. These rates are calculated annually based on industry statistics and focus on domestic consumption. The rates vary:</p> <ul style="list-style-type: none"> • Offshore banks 96% • Wholesale banks 96% • Merchant banks 96% • Full banks 76% • Finance companies 43% <p>Narrow exemption for financial services. Remission order required for funds sector. No relief for insurers.</p>
Currently in use in the following jurisdictions:	<p>Singapore</p> <p> </p> <p> </p>

PRO’s	CON’s
<ul style="list-style-type: none"> • Addresses the cascade 	<ul style="list-style-type: none"> • Limited application in diverse economy
<ul style="list-style-type: none"> • No need to track transactions, therefore simplified administration and compliance 	<ul style="list-style-type: none"> • Limited to financial institutions - not broad application
<ul style="list-style-type: none"> • Focus on international competition 	<ul style="list-style-type: none"> • Risks zero-rating B2C transactions
<ul style="list-style-type: none"> • Less input taxation of sector improves efficiency generally 	<ul style="list-style-type: none"> • Fixed percentage is only an approximation (v. New Zealand’s formulaic approach, which is legislated)
<ul style="list-style-type: none"> • Operates as a proxy to relieve GST on B2B services and exports 	<ul style="list-style-type: none"> • Biases between the identified industry categories
<ul style="list-style-type: none"> • Ease compliance for large and small businesses 	<ul style="list-style-type: none"> • Commercial activity vs consumer distinction becomes critical (i.e., treatment of trusts, passive investment vehicles)
<ul style="list-style-type: none"> • Less compliance and administration 	<ul style="list-style-type: none"> • Different treatment of risk intermediation and life insurance

OPTION:	Broad Base Exemption: B2B Relief via Legislation
Description:	<p>Introduce a zero-rate for business to business (B2B) financial services. This rule allows a GST registered person to make an election to treat, as zero-rated, financial services that are provided to a customer registered for GST and entitled to recover 75% or more of their input tax. The result is additional input tax deduction to a financial service provider by reference to the taxable status of the recipients of its financial services. The broad exemption can remain essentially the same. Note that self assessment regime for imported services was introduced at same time.</p>
Currently in use in the following jurisdictions:	<p>New Zealand</p> <p> </p> <p> </p>

PRO's	CON's
<ul style="list-style-type: none"> • Address status of customer by relying on standard industry classification codes 	<ul style="list-style-type: none"> • Establish and monitor the input tax recovery status of every customer.
<ul style="list-style-type: none"> • Legislation with formula 	<ul style="list-style-type: none"> • Domestic suppliers of financial services to B2C are at disadvantage vis-à-vis B2B suppliers
<ul style="list-style-type: none"> • Competitive for different types of sectors 	<ul style="list-style-type: none"> • Broad exemption still requires relieving provisions (i.e., special rule on funds)
<ul style="list-style-type: none"> • Increased efficiency through less input taxation of sector 	<ul style="list-style-type: none"> • Commercial activity vs. consumer distinction becomes critical (i.e., treatment of trusts, passive investment vehicles)
<ul style="list-style-type: none"> • Outsourcing issues addressed somewhat by virtue of broader input tax relief 	<ul style="list-style-type: none"> • Does not address outsourcing for retail providers
	<ul style="list-style-type: none"> • Query whether benefits flow to B2B – incidence
	<ul style="list-style-type: none"> • Commercial activity vs. consumer distinction becomes critical (know the customer)

OPTION:	Cash Flow or “TCA”
Description:	<p>The “Tax Calculation Account” introduces a tax suspension account to ensure that no payment of tax is required on capital flows. The TCA “allocates the total margin earned by the financial institution (being the difference between the interest rate charged on the loans and paid on the deposits) between the borrowers and depositors using the indexing rate (short term inter-bank rate) as the benchmark.”</p> <p>A variation on the TCA is to allow B2B ‘zero-rating’ and thus only apply to B2C transaction. As a result no need to issue invoices (for input tax credit purposes) and margins are not disclosed.</p> <p>Please also refer to Insurance option worksheet.</p>
Currently in use in the following jurisdictions:	Formally considered in the EU

PRO’s	CON’s
<ul style="list-style-type: none"> • Tested and proven to calculate tax on financial service products correctly 	<ul style="list-style-type: none"> • Concerns over complexity and resultant administrative and compliance challenges
<ul style="list-style-type: none"> • Possible models in games of chance treatment (i.e., margin between bets laid and winning bets paid) 	<ul style="list-style-type: none"> • Concerns over disclosure of margins earned by financial institutions
	<ul style="list-style-type: none"> • B2C supplies subject to GST
	<ul style="list-style-type: none"> • Approach untried by national tax authority
	<ul style="list-style-type: none"> • Limitation to financial institutions
	<ul style="list-style-type: none"> • Operation for collective investment vehicles

OPTION:	Compensatory Tax
Description:	<p><i>Quebec</i></p> <p>Zero-rate applied to most financial services with a compensatory tax levied as percentage. For example:</p> <ul style="list-style-type: none"> • Banks – mixture of capital paid and salaries / wages (3.9%) • Insurers – calculation based on premiums payable (0.55%) • Savings and credit union – salaries and wages (3.8%) <p>A variation would be to apply a rate of tax to an identifiable amount, such as gross interest on a borrowing transaction. As a result there is no need to understand the margin. The rate would be determined accordingly.</p>
Currently in use in the following jurisdictions:	<p>Quebec</p> <hr/> <hr/>

PRO's	CON's
<ul style="list-style-type: none"> • Addresses interpretation issues 	<ul style="list-style-type: none"> • Direct tax which is reliant on financial services providers and not consumption – incidence
<ul style="list-style-type: none"> • Linked to income tax reporting 	<ul style="list-style-type: none"> • Rate can be moved easily
<ul style="list-style-type: none"> • Addresses cascade and outsourcing of a VAT / GST 	<ul style="list-style-type: none"> • Does not realize full benefit of full zero-rate
<ul style="list-style-type: none"> • Simple to administer 	<ul style="list-style-type: none"> • Proxy only for accurate taxation of financial intermediation
	<ul style="list-style-type: none"> • May under tax or over tax the financial services sector as it is focused on sector taxation and not consumption

OPTION:	Hybrid Cash Flow + B2C Taxation
Description:	<p>Separate the components of full GST taxation of financial intermediation into its component parts and apply individual treatment:</p> <ul style="list-style-type: none"> • For B2C, where explicit fee is charged, full GST applies • For B2C, where a margin is charged, a cash flow base would be used to tax financial intermediation, at an aggregate level • B2B financial services would be zero-rated • Exported financial services would be zero-rated
Currently in use in the following jurisdictions:	Recommended by Australia's future Tax System Review

PRO's	CON's
<ul style="list-style-type: none"> • Maximize application of GST B2C 	<ul style="list-style-type: none"> • Domestic provider of financial services suffer competitive disadvantage vis-à-vis international suppliers
<ul style="list-style-type: none"> • Addresses cascade 	<ul style="list-style-type: none"> • Risk of B2C not subject to tax
<ul style="list-style-type: none"> • Addresses outsourcing 	<ul style="list-style-type: none"> • Untested
<ul style="list-style-type: none"> • Accurate taxation of consumption of financial intermediation service, not taxation of the financial services sector 	<ul style="list-style-type: none"> • Complex to calculate value to consumers
<ul style="list-style-type: none"> • Zero-rating of B2B should create a competitive advantage for a Canadian financial institution 	<ul style="list-style-type: none"> • Commercial activity vs. consumer distinction becomes critical (i.e., treatment of trusts, passive investment vehicles)
	<ul style="list-style-type: none"> • Limit to financial institutions
	<ul style="list-style-type: none"> • Treatment of risk intermediation
	<ul style="list-style-type: none"> • Explicit fees subject to tax for B2C

OPTION:	Full Zero-Rate
Description:	Full, broad based zero-rate of all financial intermediation. This would put Canada in extremely competitive position internationally.
Currently in use in the following jurisdictions:	Formally considered in Hong Kong and recommended by IMF
	Under consideration in the UAE

PRO's	CON's
<ul style="list-style-type: none"> • No cascade 	<ul style="list-style-type: none"> • Large revenue gap to fill
<ul style="list-style-type: none"> • Promotes investment 	<ul style="list-style-type: none"> • Regular cash refunds to financial service providers
<ul style="list-style-type: none"> • Addresses outsourcing concerns 	<ul style="list-style-type: none"> • Substitution bias
<ul style="list-style-type: none"> • Greater ease of administration and compliance – “simple” 	<ul style="list-style-type: none"> • Public perception
<ul style="list-style-type: none"> • Removes self assessment obligation 	<ul style="list-style-type: none"> • Under taxation of consumption of financial intermediation
<ul style="list-style-type: none"> • Internationally competitive 	<ul style="list-style-type: none"> • Requires equivalence with risk intermediation (insurance)
<ul style="list-style-type: none"> • Removes the “spread” tendency 	

J Industry Specific Considerations

INDUSTRY SPECIFIC CONSIDERATIONS	
BROAD BASE EXEMPTION	
Banks	More outsourced services are exempt (i.e., clearing and settlement)
	Margin and fee based services are treated the same
	Not internationally competitive
	Potential uncertainty over scope of exemption
	More exempt services therefore less ITCs
Life and Health Insurers	More outsourced services are exempt (i.e., investment management services)
	More exempt services therefore less ITCs (i.e., services to seg funds)
Credit Unions	More outsourced services are exempt (i.e., clearing and settlement)
Property and Casualty Insurers	More outsourced services are exempt
Investment and Securities Dealers	More outsourced services are exempt (i.e., clearing and settlement)
	More exempt services therefore less ITCs (i.e., services to seg funds)
	More exempt services therefore less ITCs
Investment Funds	More outsourced services are exempt (i.e., fund management)
	Fund manager offer exempt services therefore less ITCs
	More neutral with other products

INDUSTRY SPECIFIC CONSIDERATIONS	
BROAD BASE EXEMPTION: COST SHARING RULES	
Banks	Allows shared service centers to perform back office functions (i.e., a joint venture)
	Requires broad exemption or suffer higher embedded tax amount
	Support smaller and mid-size entities
Life and Health Insurers	Allows shared service centers to perform back office functions (i.e., a joint venture)
	Requires broad exemption or suffer higher embedded tax amount
	Support smaller and mid-size entities
Credit Unions	Similar to current Canadian regime
Property and Casualty Insurers	Allows shared service centers to perform back office functions (i.e., a joint venture)
	Support smaller and mid-size entities
	Requires broad exemption or suffer higher embedded tax amount
Investment and Securities Dealers	Allows shared service centers to perform back office functions (i.e., a joint venture)
	Requires broad exemption or suffer higher embedded tax amount
	Support smaller and mid-size entities
Investment Funds	Allows shared service centers to perform back office functions; however, this represents a small part of the tax cost differential

INDUSTRY SPECIFIC CONSIDERATIONS	
BROAD BASE EXEMPTION: GROUPING RULES	
Banks	Treat branches and subsidiaries the same
	Easier compliance and administration (i.e., one group return and one group audit)
	Charges between group members not subject to tax (i.e., salaries)
Life and Health Insurers	Treat branches and subsidiaries the same
	Easier compliance and administration (i.e., one group return and one group audit)
	Charges between group members not subject to tax (i.e., salaries)
Credit Unions	Easier compliance and administration (i.e., one group return and one group audit)
	Charges between group members not subject to tax (i.e., salaries)
Property and Casualty Insurers	Treat branches and subsidiaries the same
	Easier compliance and administration (i.e., one group return and one group audit)
	Charges between group members not subject to tax (i.e., salaries)
Investment and Securities Dealers	Treat branches and subsidiaries the same
	Easier compliance and administration (i.e., one group return and one group audit)
	Charges between group members not subject to tax (i.e., salaries)
Investment Funds	Current HST elections (i.e., consolidated filing) strive for grouping benefits

INDUSTRY SPECIFIC CONSIDERATIONS	
BROAD BASE EXEMPTION: OPTION TO TAX	
Banks	Potential to increase ITC eligibility
	Flexibility of tax treatment based on customer / situation
	Increased compliance burden (i.e., tracking opted services)
	More competitive internationally
	Margin vs. fee analysis required
Life and Health Insurers	Limited application – typically does not apply to insurance products
Credit Unions	Potential to increase ITC eligibility
	Flexibility of tax treatment based on customer / situation
	Increased compliance burden (i.e., tracking opted services)
	Margin vs. fee analysis required
Property and Casualty Insurers	Limited application – typically does not apply to insurance products
Investment and Securities Dealers	Potential to increase ITC eligibility
	Flexibility of tax treatment based on customer / situation
	Increased compliance burden (i.e., tracking opted services)
	More competitive internationally
	Margin vs. fee analysis required
Investment Funds	Limited application in the retail market

INDUSTRY SPECIFIC CONSIDERATIONS	
NARROW EXEMPTION	
Banks	Less interpretation – all explicit fees and commissions are subject to GST
	Potential to increase ITC eligibility
	Consistent with the way the sector is evolving, but potential bias (i.e., fees vs. margin)
	More competitive internationally
	Easier compliance and administration
Life and Health Insurers	Life insurance difficult to tax due to savings component
	Health and group life can be taxed.
	Other taxes on premiums to be addressed
	Potential to increase ITC eligibility
Credit Unions	Less interpretation – all explicit fees and commissions are subject to GST
	Potential to increase ITC eligibility
	Consistent with the way the sector is evolving, but potential bias (i.e., fees vs. margin)
	Easier compliance and administration
Property and Casualty Insurers	General insurance can be taxed
	Other taxes on premiums to be addressed
	Potential to increase ITC eligibility
	Other taxes on premiums and embedded in premiums to be addressed
Investment and Securities Dealers	Less interpretation – all explicit fees and commissions are subject to GST
	Potential to increase ITC eligibility
	Consistent with the way the sector is evolving, but potential bias (i.e., fees vs. margin)
	More competitive internationally
	Easier compliance and administration
Investment Funds	Suffer increased costs in absence of special relief
	Brings costs of other competing products closer to funds, but there would be further negatives if commissions become taxable

INDUSTRY SPECIFIC CONSIDERATIONS	
NARROW EXEMPTION: REDUCED INPUT TAX CREDIT	
Banks	Addresses outsourcing concerns
	Addresses distinction between branch v. subsidiary
	Increased compliance burden (i.e., tracking different services)
	Disputes over list of eligible services and rate
Life and Health Insurers	Addresses outsourcing concerns
	Addresses distinction between branch v. subsidiary
	Increased compliance burden (i.e., tracking different services)
	Disputes over list of eligible services and rate
Credit Unions	Addresses outsourcing concerns
	Increased compliance burden (i.e., tracking different services)
	Disputes over list of eligible services and rate
Property and Casualty Insurers	Addresses outsourcing concerns
	Addresses distinction between branch v. subsidiary
	Increased compliance burden (i.e., tracking different services)
	Disputes over list of eligible services and rate
Investment and Securities Dealers	Addresses outsourcing concerns
	Addresses distinction between branch v. subsidiary
	Increased compliance burden (i.e., tracking different services)
	Disputes over list of eligible services and rate
Investment Funds	Addresses outsourcing concerns
	Increased compliance burden (i.e., tracking different services)
	Disputes over list of eligible services and rate

INDUSTRY SPECIFIC CONSIDERATIONS	
NARROW EXEMPTION: INSURANCE	
Banks	N/A
Life and Health Insurers	Life insurance difficult to tax due to savings component
	Health and group life can be taxed.
	Other taxes on premiums to be addressed
	Potential to increase ITC eligibility
Credit Unions	N/A
Property and Casualty Insurers	General insurance can be taxed
	Other taxes on premiums to be addressed
	Potential to increase ITC eligibility
	Increased compliance burden (i.e., separating business vs. consumers)
	Other taxes on premiums and embedded in premiums to be addressed
Investment and Securities Dealers	N/A
Investment Funds	N/A

INDUSTRY SPECIFIC CONSIDERATIONS	
NARROW EXEMPTION: SPECIAL DEDUCTION REGIME	
Banks	Easier compliance and administration, although risk with arbitrary percentage
	Internationally competitive
	Benefit for small and medium-sized entities.
	Easier compliance and administration, although risk with arbitrary percentage
	Biases within sector (i.e., retail vs. investment banks)
Life and Health Insurers	Fixed percentage could provide relief
	Not currently applicable to insurance
	Operates in a regime where general insurance is taxable
Credit Unions	Easier compliance and administration, although risk with arbitrary percentage
	Benefit for small and medium-sized entities.
Property and Casualty Insurers	Fixed percentage could provide relief
	Not currently applicable to insurance
	Operates in a regime where general insurance is taxable
Investment and Securities Dealers	Easier compliance and administration, although risk with arbitrary percentage
	Internationally competitive
	Benefit for small and medium-sized entities.
	Easier compliance and administration, although risk with arbitrary percentage
	Biases within sector (i.e., retail vs. investment banks)
Investment Funds	Puts funds and fund managers on a more level playing field with other products/providers
	Fixed percentage could provide relief for funds
	Increased compliance and administration (i.e., pay tax and recover)
	Special remission order to relieve from GST fund management services

INDUSTRY SPECIFIC CONSIDERATIONS	
BROAD BASE EXEMPTION: B2B RELIEF VIA LEGISLATION	
Banks	Formulaic approach in legislation
	Status of customer (i.e., B2B vs. B2C) important and monitoring could be onerous
	Applies equally for different types of banking sectors
	Increased ITC recovery
	Outsourcing issues addressed by virtue of broader input tax relief
Life and Health Insurers	Not currently applicable to insurance
	Operates in a regime where general insurance is taxable
Credit Unions	Formulaic approach in legislation
	Status of customer (i.e., B2B vs. B2C) important
	Increased ITC recovery
	Outsourcing issues addressed by virtue of broader input tax relief
Property and Casualty Insurers	Not currently applicable to insurance
	Operates in a regime where general insurance is taxable
Investment and Securities Dealers	Formulaic approach in legislation
	Status of customer (i.e., B2B vs. B2C) important
	Increased ITC recovery
	Outsourcing issues addressed by virtue of broader input tax relief
Investment Funds	No significant benefit for retail market.
	Special ruling exempting 90% of fund management fee

INDUSTRY SPECIFIC CONSIDERATIONS	
CASH FLOW or “TCA”	
Banks	Proven to calculate tax on financial service products correctly
	Concerns over complexity and resultant administrative and compliance challenges
	Concerns over disclosure of margins earned by financial institutions
	Untried approach
	Limited to financial institutions
Life and Health Insurers	Proven to calculate tax on financial service products for banks only
	Concerns over complexity and resultant administrative and compliance challenges
	Untried approach
Credit Unions	Proven to calculate tax on financial service products correctly
	Concerns over complexity and resultant administrative and compliance challenges
	Concerns over disclosure of margins earned by financial institutions
	Untried approach
	Limited to financial institutions
Property and Casualty Insurers	Proven to calculate tax on financial service products for banks only
	Concerns over complexity and resultant administrative and compliance challenges
Investment and Securities Dealers	Proven to calculate tax on financial service products correctly
	Concerns over complexity and resultant administrative and compliance challenges
	Untried approach
	Limited to financial institutions
Investment Funds	No suitable model for funds yet developed.

INDUSTRY SPECIFIC CONSIDERATIONS	
COMPENSATORY TAX	
Banks	Easier compliance and administration (i.e., coupled with zero-rate)
	Increase in ITCs
	Unclear whether it applies uniformly vs. other sectors
	Rate can be moved easily
	Unclear whether it achieves the correct amount of taxation
Life and Health Insurers	Easier compliance and administration (i.e., coupled with zero-rate)
	Increase in ITCs
	Unclear whether it applies uniformly vs. other sectors
	Rate can be moved easily
	Unclear whether it achieves the correct amount of taxation
Credit Unions	Easier compliance and administration (i.e., coupled with zero-rate)
	Increase in ITCs
	Unclear whether it applies uniformly vs. other sectors
	Rate can be moved easily
	Unclear whether it achieves the correct amount of taxation
Property and Casualty Insurers	Easier compliance and administration (i.e., coupled with zero-rate)
	Increase in ITCs
	Unclear whether it applies uniformly vs. other sectors
	Rate can be moved easily
	Unclear whether it achieves the correct amount of taxation
Investment and Securities Dealers	Easier compliance and administration (i.e., coupled with zero-rate)
	Increase in ITCs
	Unclear whether it applies uniformly vs. other sectors
	Rate can be moved easily
	Unclear whether it achieves the correct amount of taxation
Investment Funds	Easier compliance and administration (i.e., coupled with zero-rate)
	Increase in ITCs
	Unclear whether it applies uniformly vs. other sectors
	Rate can be moved easily
	Unclear whether it achieves the correct amount of taxation

INDUSTRY SPECIFIC CONSIDERATIONS	
HYBRID CASH FLOW + B2C TAXATION	
Banks	Increase an ITCs (i.e., for outsourcing)
	Domestic could suffer vs. international suppliers
	Complex to calculate charges to consumers (i.e., cash flow on margin)
	Untested
	Zero-rating B2B should create competitive advantage for Canadian financial institutions
	Limited to financial institutions
Life and Health Insurers	Increase an ITCs (i.e., for outsourcing)
	Domestic could suffer vs. international suppliers
	Complex to calculate charges to consumers (i.e., cash flow on margin)
	Untested
Credit Unions	Increase an ITCs (i.e., for outsourcing)
	Domestic could suffer vs. international suppliers
	Complex to calculate charges to consumers (i.e., cash flow on margin)
	Untested
	Limited to financial institutions
Property and Casualty Insurers	Increase an ITCs (i.e., for outsourcing)
	Domestic could suffer vs. international suppliers
	Complex to calculate charges to consumers (i.e., cash flow on margin)
	Untested
	Limited to financial institutions
Investment and Securities Dealers	Increase an ITCs (i.e., for outsourcing)
	Domestic could suffer vs. international suppliers
	Complex to calculate charges to consumers (i.e., cash flow on margin)
	Untested
Investment Funds	No suitable model for funds yet developed.

INDUSTRY SPECIFIC CONSIDERATIONS	
FULL ZERO-RATE	
Banks	Addresses outsourcing concerns
	Greater ease of administration and compliance (i.e., recover ITCs)
	Internationally competitive
	Price advantage in the market place
Life and Health Insurers	Addresses outsourcing concerns
	Greater ease of administration and compliance (i.e., recover ITCs)
	Price advantage in the market place
Credit Unions	Addresses outsourcing concerns
	Greater ease of administration and compliance (i.e., recover ITCs)
	Price advantage in the market place
Property and Casualty Insurers	Addresses outsourcing concerns
	Greater ease of administration and compliance (i.e., recover ITCs)
	Price advantage in the market place
	Addresses cascading of taxes due to multiple taxes applying in that sector
Investment and Securities Dealers	Addresses outsourcing concerns
	Greater ease of administration and compliance (i.e., recover ITCs)
	Internationally competitive
	Price advantage in the market place
Investment Funds	Increased compliance burden (i.e., recovering ITCs); however, do not have complicated series calculations
	Price advantage in the market place

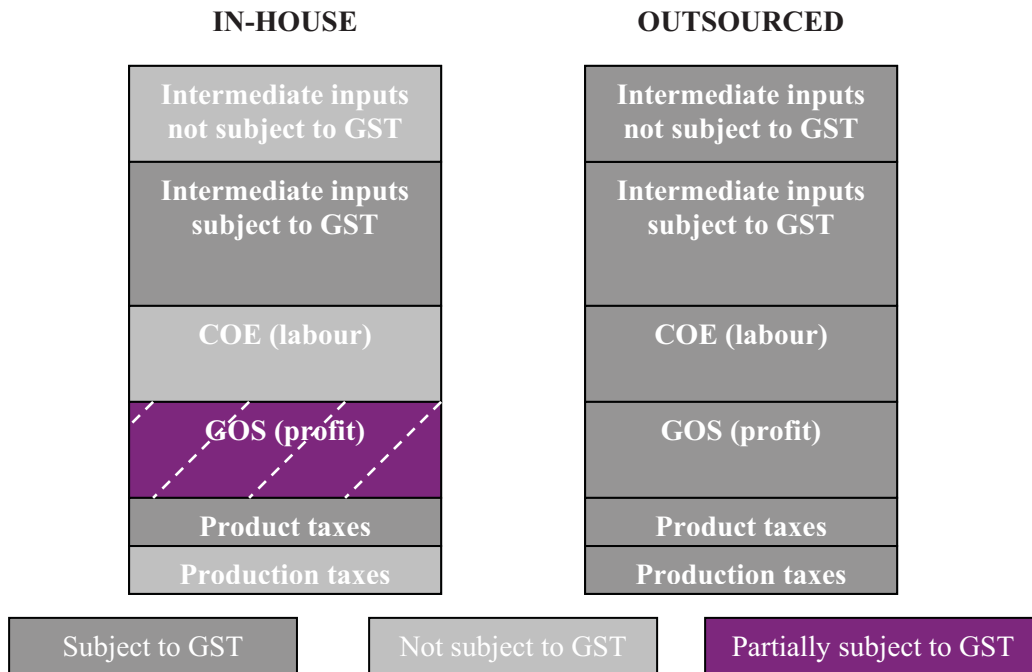
K Reduced Input Tax Credits

K.1 RITCs – Setting the Rate

The RITC was introduced for the financial sector in an attempt to correct some of the distortions that occur as a result of this sector being input taxed.

When a business is not able to claim tax credits for inputs, this creates an incentive to switch from outsourcing activities, to conducting them in-house. For example, if a business purchases an input to production, they must pay GST on the entire value of the purchase. If instead, they produce the same input in-house, they need only pay GST on part of the value of production. So if possible, a business will switch towards producing the input in-house. To explore this concept further an example of the cost structure of potentially outsourced inputs is presented in the figure below.

Figure: Cost Structure of an input, both in-house and outsourced.



As can be seen from the figure above, the cost structure is broken into a number of components:

- the intermediate input component, which consists of intermediate inputs subject to GST and those not subject to GST; and
- the value added component, which consists of compensation of employees (COE), gross operating surplus (GOS) and taxes.

K.2 Acquisitions Eligible for an RITC: Illustrative List

The acquisitions, in respect of which an RITC entitlement attaches, in general terms, include:

- outsourced account keeping activities such as operating, maintaining and performing transactions in respect of an account;
- processing services in relation to account information such as statement processing;
- providing credit reference and credit scoring assessments;
- services entailing the access to credit, debit and charge-card payment systems;
- processing on a settling, clearing and switching transactions for credit and debit, cheque, EFT and light transactions;
- arranging for the supply of interests in securities such as mergers and acquisitions, flotation's and settling trades;
- securities and unit registry services in relation to securities;
- mortgage brokering, arranging syndicated loans and introducing and brokering;
- lender's mortgage, title and loan protection insurance;
- loan application, management and processing services;
- debt collection services;
- arranging hire purchase financial supplies;
- arranging derivative and forward contract transactions;
- portfolio management services;
- administration functions for superannuation schemes and life insurance policies; and
- trustee and custodial services.

It can be recognized that the list incorporates both:

- financial intermediation by way of facilitation (such as arranging for financial supplies and managing portfolios); and
- services rendered to financial supply providers that might be regarded as "unbundled" or incidental financial intermediation.

These two categories have been discussed previously in this report. The policy underlying the RITC regime, in this context, should be understood not merely from a self-supply bias arising from outsourcing activities but, rather, a quest for neutrality between the following types of intermediation:

- principal to principal core financial intermediation;

- arranging, dealing and negotiating core financial intermediation by facilitators; and
- incidental financial services (including processing of account information, settling trades, etc.).

This broad classification of financial services, under the Australian regime are divided between:

- input taxed (i.e., exempt) financial supplies (principal to principal core financial intermediation); and
- taxable with 75% RITC relief (arranging, etc. by facilitators and incidental services).

The two approaches, while different, have the aim of taxing core and non-core financial services on their inputs but, for RITCs, the inputs are arbitrarily determined to be of a value of 25% of the price of the service.

The extension of the exemption regime through the RITC classifications shows the “spread” or “expansion” of the exemption occurs for the same types of services even where the RITC regime applies.

K.3 List of In-house Management Services Under RITC Regime

In-house management services fall under the following headings:

- senior executive management;
- human resources support;
- corporate marketing and communications;
- financial management;
- supply procurement and management;
- credit, operational and risk management;
- relationship management;
- in-house legal services;
- technology systems; and
- business services.

L Further Rationale for EU Reform: Excerpt from European Commission Staff Working Document

The VAT Directive exempts most main-stream financial services and insurances. In consequence, these industries are not required to charge tax on the services which they supply but they are also generally unable to recover the VAT they pay on the goods and services which they acquire to operate their businesses. This non-recoverable tax is a significant source of revenue to the tax administrations of the Member States. It is also one which automatically increases as financial and insurance institutions increase their use of specialist third party service providers (outsourcers) or consolidate their operations on across-border basis (such as through shared cost centres).

The legislation has never been revisited since it was adopted in 1977 and has been showing its age in recent time. The work undertaken by DG Taxud in the preparation of this impact assessment has demonstrated that there are growing problems in ensuring a clear and consistent application of the exemption across the Community. This is mainly attributable to the way in which the industries have become more sophisticated and complex over the last thirty years but also in how the move towards a single market has highlighted inconsistencies.

New products have been developed as well as new ways of delivering these products to consumers. Institutions build up operational relationships, sometimes with companies who would not normally be considered to be financial or insurance institutions and it is not always easy to see whether these activities should be treated as exempt financial services.

This uncertainty has led to a significant growth in litigation with the ECJ being asked to interpret the legislation with increasing frequency. This process can be initiated by either businesses or tax administrations, both of whom are faced with ambiguity and uncertainty. It is a slow and cumbersome way of delivering clarity and the outcome is often uncertain. For tax administrations, they see risks to revenue here and attach importance to re-establishing long-term certainty. For businesses, uncertainty also inhibits long term planning and causes the diversion of significant resources to the resolution of tax problems. DG Taxud has concluded that modernising the definitions should therefore be regarded as a priority. Ideally, this should be achieved as far as is reasonably possible in a tax neutral way that respects both the general limits of the current exemption and the relevant jurisprudence of the ECJ.

The preparatory work has also shown that the EU's financial services and insurances industries are less efficient than their international competitors, particularly US institutions. As a consequence, EU industry in general faces higher costs for financial services and insurances.

There are many factors which contribute to this and VAT is probably some way down the list. Nevertheless, embedded or non-recoverable VAT plays at least some contributory role and certainly increases the cost of financial services to business.¹²⁷

¹²⁷ SEC(2007) 1554.

M Text of the Proposed New Exemption for the VAT Directive

The broad exemption proposed for the EU VAT Directive includes the following activities:

- granting of credit including the lending of money or the promise to lend money;
- guaranteeing of debts resulting from the granting of credit, including the acceptance of liability for the debt of another person;
- transactions concerning financial deposits and account operation;
- the exchange of currency of bank notes or coins normally used as legal tender;
- the supply of tradable instruments representing financial value represented by:
 - equity in a company or other association;
 - a creditor's debts;
 - units in collective investment in the securities;
- intermediation in insurance and financial transactions listed above; and
- management of investment funds.

Significantly, “intermediation” is proposed to be defined to be the supply of services to a party to one of the transactions by a third party intermediary. The clause dealing with “intermediation”, therefore, is proposed to occupy the area of the existing “negotiation” and “arranging” terms employed in the VAT Directive.

Both terms illustrate the desire to expand the area of services that benefit from the exemption.

It can be seen from the above that the definition incorporates a range of activities and transactions that fall within the categories of intermediation referred to earlier in this report:

- deposit-taking intermediation;
- risk-taking intermediation; and
- brokerage.

To some extent, as indicated earlier, the ‘risk-taking’ intermediation overlaps with “deposit-taking brokerage”. Savings and investment are sometimes combined with risk based life insurance. Arranging and management of investment is sometimes combined with underwriting and guarantees.

N Financial Services in Singapore Subject to Exemption

The financial supplies that are identified as subject to exemption include:

- the operation of any current, deposit or savings account;
- the exchange or grant of an option for the exchange of currency other than the supply of a note or a coin as a collector's item, investment article or item of numismatic interest;
- any supply by a person carrying on a credit card, charge card or similar payment card operation made directly in connection with that operation to a person who accepts the card used in the operation when presented to him in payment for goods or services;
- the issue, payment, collection or transfer of ownership of any note or order for payment, cheque or letter of credit or the notification of the issue of a letter of credit;
- the issue, allotment, transfer of ownership, drawing, acceptance or endorsement of a debt security;
- the issue, allotment or transfer of ownership of an equity security;
- the provision of any loan, advance or credit;
- the provision of the facility of installment credit finance in a hire-purchase, conditional sale or credit sale agreement for which a separate charge is made and disclosed to the recipient of the supply of goods;
- the transfer or assignment of the provision of the facility of installment credit finance in a hire-purchase agreement;
- the grant of a right or option relating to an obligation to pay interest or the exchange or grant of an option for the exchange of obligations to pay interest;
- the renewal or variation of a debt security, equity security or contract for the provision of any loan, advance or credit;
- the provision, or transfer of ownership, of a life insurance contract;
- the provision or assignment of any futures contract including a futures option transaction, which does not lead to a delivery of any goods from the seller to the buyer;
- the provision or assignment of any option or contract for the sale of any unallocated commodity, which does not lead to a delivery of the commodity from the seller to the buyer;
- the grant of a right or option to acquire any unallocated commodity where the right is exercisable at a future date and any sale resulting from the exercise of the right would be a sale, which does not lead to a delivery of the commodity from the seller to the buyer;
- the issue or transfer of ownership of a unit under any unit trust;
- the arrangement, provision, or transfer of ownership, of any contract of re-insurance; and

- the provision of financing by a financial institution in connection with a qualifying Islamic financial arrangement in relation to non-residential property, for which the financial institution derives an effective return.

The Singapore definition also illustrates the distinction that is drawn between:

- managing risk over otherwise taxable transactions (deliverable futures contracts) and mere risk taking intermediation;
- non-life insurance and life insurance risk; and
- undertaking risk (i.e., guarantees) over exempt financial transactions.

The difficult distinctions illustrate that non-neutralities can arise because of the extension of exemptions to risk-taking intermediation in relation to those transactions but not to risk-taking intermediation over non-financial risk. Policy decisions as to the scope of the exemption affect behavior in the market place, distortions and inefficiencies.

O New Zealand's Definition of Financial Services

New Zealand's financial services definition includes¹²⁸:

- the exchange of currency;
- the issue, allotment or transfer of cheques, letters of credit and various debt, equity and collective investment securities;
- underwriting or sub-underwriting the issue of equity, debt or other securities;
- the provision of credit or the renewal or variation of a debt, equity or other security or credit contract;
- the provision of guarantees, life insurance, superannuation and futures contracts¹²⁹;
- the management of a superannuation scheme; and
- agreeing to or arranging for any of the above.

It can be appreciated that the above is similar in breadth to the EU. The “agreeing or arranging” has a similar effect to the “negotiating”, “dealing in” and “intermediation” in the EU model.

This broad definition ensures neutrality within the financial services sector of similar services irrespective of whether:

- the service is acquired from offshore;
- the fee is implicit or explicit;
- the service is provided by a principal to the financial transaction; or
- the consumer is a household.

¹²⁸ New Zealand taxes general insurance at the standard rate. This is discussed in section 6.5.2 of this report.

¹²⁹ As mentioned earlier, because the “risk-taking” intermediation is often combined with the savings and investment function, life insurance and similar risk-taking also contains “deposit-taking” intermediation. For this reason, life insurance, pensions and underwriting and guarantees are included within exemptions where the risk covered is a financial instrument covered by exemption or a life risk. Non-life insurance and warranties over goods are covered under the Insurance Sector referred to in section 6.5.2 of this report.

P Singapore Model of Non-Life Insurance

The supply of a life insurance contract is exempt from GST. This exemption is not extended to brokerage services and services of arranging for sale of life policies.

For GST purposes, a life insurance contract is a life policy within the meaning of the Insurance Act. Also exempt is the arrangement, provision, or transfer of ownership, of any contract of re-insurance.

The scheme of the GST law in Singapore, therefore, is similar to Australia and New Zealand in that the supply of general insurance is a taxable supply of services unless the supply qualifies as a zero-rated export.

Singapore, like Australia and New Zealand also recognize that to fully tax premiums without relief for payouts would over tax consumption of the intermediation. Accordingly, Singapore allows a credit for input tax deemed incurred on the cash settlement payments under the following limited conditions¹³⁰:

- the settlement payment is made as a result of the occurrence of an insured event under an insurance policy;
- the policyholder is either:
 - not GST registered at the effective date of the insurance policy;
 - the claiming the input tax incurred on the premiums is restricted¹³¹; or
 - GST registered sole-proprietor who buys insurance policies in their private capacity; and
- the supply of the policy was a standard rated taxable supply¹³².

The amount of the credit is calculated as:

$$\frac{\text{GST rate}}{100 + \text{GST Rate}}$$

Where GST rate is the same rate of GST that was applied to the insurance premiums for the relevant period of the insurance cover that gave rise to the Cash Payment.

Recoveries (not including reinsurance recoveries) by an insurance company that has claimed the special credit require adjustment to be made to the GST liability of the company when the recovery is received.

The Singapore system has similar compliance costs, budgetary and administrative risks to New Zealand. Like Australia, the risk of non-collection of GST on payouts to registered entities is avoided but with similar compliance costs to the insurer as the Australian system.

¹³⁰ This new deemed credit applies for policies issued after January 1, 2007.

¹³¹ For example, regulations 26 and 27 of the GST (General) Regulations disallow a GST registered policyholder from claiming input tax incurred on medical and accident insurance premium and motor car insurance premium.

¹³² Note that exports are zero-rated and reinsurance is exempt for GST in Singapore.

Q Costing Information

The following table has been reproduced from section D4 of *Australia's future tax system, Report to the Treasurer, December 2009, Part Two, Detailed Analysis, volume 1 of 2*. It highlights the estimated cost of the GST regime in Australia

Q.1 Cost of Exempt Tax Treatment of Financial Supplies in Australia

	2008-09 \$m	2009-10 \$m	2010-11 \$m	2011-12 \$m
Households	3,580	3,710	3,890	4,090
Businesses	-690	-720	-760	-790
Total	2,880	2,990	3,140	3,290

Source: Treasury estimate, against benchmark of taxing household final consumption at 10 per cent rate.

R Model Costing

The following is a list of the costing models included in this appendix:

Industry	Reference
Banks and Securities	1
Funds	9
Life and Health Insurance	16



Banks and Securities Industry - Generic Model

Introduction

The following tables set out the financial impact of the treatment of financial services in the banking and securities industries. The first table illustrates the financial impact under the Canadian model. The subsequent tables illustrate the financial impact of some of the alternatives presented in this report. Each table is based on the following scenario (unless otherwise noted):

- Supplier incurs a taxable input cost in the supply of goods and services to Bank.
- Bank, in turn, supplies financial services to both Business A and Consumer A.
- Business A, in turn, resupplies the financial services as an input into the supply of taxable services to Consumer B.

Assumptions and Factors

The following assumptions and factors apply under the scenario noted above (unless otherwise noted):

Supplier's cost of goods and services	25.00
GST Rate	5%
Supplier's Commercial Activity Rate	100%
Bank's Commercial Activity Rate	0%
Business A's Commercial Activity Rate	100%
RITC Rate	50%
% of Revenues from B2B transactions	50%
% of Revenues from B2C transactions	50%
Goods and services inputs (net of embedded tax) : profit + wages throughout supply chain	50:50
Embedded tax is passed through the supply chain in the form of higher prices	-



Banks and Securities Industry - Generic Model

Exemption Model (Canada)

Under the current Canadian exemption model, the supply to Bank is a taxable supply.

	Supplier	Bank	Business A	Consumer A	Consumer B	Crown
Inputs						
Goods and Services	25.00	50.00	51.25	51.25	101.25	
<u>Tax Payable</u>	<u>1.25</u>	<u>2.50</u>	<u>-</u>	<u>-</u>	<u>5.06</u>	
Gross Goods and Services Cost	26.25	52.50	51.25	51.25	106.31	
Profit and Wages	25.00	50.00	50.00	-	-	
<u>Tax Payable</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	
Gross Profit and Wages	25.00	50.00	50.00	-	-	
<u>Recoverable Tax</u>	<u>(1.25)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	
Net Input Cost	50.00	102.50	101.25	51.25	106.31	
Outputs						
Sale Amount	50.00	102.50	101.25	-	-	
<u>Tax Collectible</u>	<u>2.50</u>	<u>-</u>	<u>5.06</u>	<u>-</u>	<u>-</u>	
Total Sales Price	52.50	102.50	106.31	-	-	
Revenue to the Crown	-	2.50	-	-	5.06	7.56
<u>Benchmark</u>	<u>-</u>	<u>2.50</u>	<u>-</u>	<u>-</u>	<u>5.06</u>	<u>7.56</u>
Difference	-	-	-	-	-	-
% Change	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%



Banks and Securities Industry - Generic Model

Broad Exemption Model (EU Model)

Under the broad exemption model in place in the EU, the supply to Bank is an exempt supply. The following assumptions override the assumptions noted above:

Supplier's commercial activity rate = 0%

	Supplier	Bank	Business A	Consumer A	Consumer B	Crown
Inputs						
Goods and Services	25.00	51.25	50.63	50.63	100.63	
<u>Tax Payable</u>	<u>1.25</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>5.03</u>	
Gross Goods and Services Cost	26.25	51.25	50.63	50.63	105.66	
Profit and Wages	25.00	50.00	50.00	-	-	
<u>Tax Payable</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	
Gross Profit and Wages	25.00	50.00	50.00	-	-	
<u>Recoverable Tax</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	
Net Input Cost	51.25	101.25	100.63	50.63	105.66	
Outputs						
Sale Amount	51.25	101.25	100.63	-	-	
<u>Tax Collectible</u>	<u>-</u>	<u>-</u>	<u>5.03</u>	<u>-</u>	<u>-</u>	
Total Sales Price	51.25	101.25	105.66	-	-	
Revenue to the Crown	1.25	-	-	-	5.03	6.28
<u>Benchmark</u>	<u>-</u>	<u>2.50</u>	<u>-</u>	<u>-</u>	<u>5.06</u>	<u>7.56</u>
Difference	1.25	(2.50)	-	-	(0.03)	(1.28)
% Change	100.00%	-100.00%	0.00%	0.00%	-0.62%	-16.94%



Banks and Securities Industry - Generic Model

Full Taxation Model

Under a full taxation model, all supplies are taxable and full input tax credits are available to the extent the entity is a registrant. In this model the following assumptions override the assumptions noted above:

Bank's commercial activity rate = 100%

	Supplier	Bank	Business A	Consumer A	Consumer B	Crown
Inputs						
Goods and Services	25.00	50.00	50.00	50.00	100.00	
<u>Tax Payable</u>	<u>1.25</u>	<u>2.50</u>	<u>2.50</u>	<u>2.50</u>	<u>5.00</u>	
Gross Goods and Services Cost	26.25	52.50	52.50	52.50	105.00	
Profit and Wages	25.00	50.00	50.00	-	-	
<u>Tax Payable</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	
Gross Profit and Wages	25.00	50.00	50.00	-	-	
<u>Recoverable Tax</u>	<u>(1.25)</u>	<u>(2.50)</u>	<u>(2.50)</u>	<u>-</u>	<u>-</u>	
Net Input Cost	50.00	100.00	100.00	52.50	105.00	
Outputs						
Sale Amount	50.00	100.00	100.00	-	-	
<u>Tax Collectible</u>	<u>2.50</u>	<u>5.00</u>	<u>5.00</u>	<u>-</u>	<u>-</u>	
Total Sales Price	52.50	105.00	105.00	-	-	
Revenue to the Crown	-	-	-	2.50	5.00	7.50
<u>Benchmark</u>	<u>-</u>	<u>2.50</u>	<u>-</u>	<u>-</u>	<u>5.06</u>	<u>7.56</u>
Difference	-	(2.50)	-	2.50	(0.06)	(0.06)
% Change	0.00%	-100.00%	0.00%	100.00%	-1.23%	-0.83%



Banks and Securities Industry - Generic Model

Full Zero-Rating of Financial Services

Under a full zero-rating model, financial services are zero-rated and input tax is recoverable, to the extent the business is a registrant. In this model the following assumptions override the assumptions noted above:

Bank's Commercial Activity Rate = 100%

	Supplier	Bank	Business A	Consumer A	Consumer B	Crown
Inputs						
Goods and Services	25.00	50.00	50.00	50.00	100.00	
<u>Tax Payable</u>	<u>1.25</u>	<u>2.50</u>	<u>-</u>	<u>-</u>	<u>5.00</u>	
Gross Goods and Services Cost	26.25	52.50	50.00	50.00	105.00	
Profit and Wages	25.00	50.00	50.00	-	-	
<u>Tax Payable</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	
Gross Profit and Wages	25.00	50.00	50.00	-	-	
<u>Recoverable Tax</u>	<u>(1.25)</u>	<u>(2.50)</u>	<u>-</u>	<u>-</u>	<u>-</u>	
Net Input Cost	50.00	100.00	100.00	50.00	105.00	
Outputs						
Sale Amount	50.00	100.00	100.00	-	-	
<u>Tax Collectible</u>	<u>2.50</u>	<u>-</u>	<u>5.00</u>	<u>-</u>	<u>-</u>	
Total Sales Price	52.50	100.00	105.00	-	-	
Revenue to the Crown	-	-	-	-	5.00	5.00
<u>Benchmark</u>	<u>-</u>	<u>2.50</u>	<u>-</u>	<u>-</u>	<u>5.06</u>	<u>7.56</u>
Difference	-	(2.50)	-	-	(0.06)	(2.56)
% Change	0.00%	-100.00%	0.00%	0.00%	-1.23%	-33.88%



Banks and Securities Industry - Generic Model

Narrow Exemption and Reduced Input Tax Credit

Under this model the bank is entitled to a reduced input tax credit (RITC) of 50% of the VAT paid on inputs into supplies of financial services.

	Supplier	Bank	Business A	Consumer A	Consumer B	Crown
Inputs						
Goods and Services	25.00	50.00	50.63	50.63	100.63	
Tax Payable	1.25	2.50	-	-	5.03	
Gross Goods and Services Cost	26.25	52.50	50.63	50.63	105.66	
Profit and Wages	25.00	50.00	50.00	-	-	
Tax Payable	-	-	-	-	-	
Gross Profit and Wages	25.00	50.00	50.00	-	-	
Recoverable Tax	(1.25)	(1.25)	-	-	-	
Net Input Cost	50.00	101.25	100.63	50.63	105.66	
Outputs						
Sale Amount	50.00	101.25	100.63	-	-	
Tax Collectible	2.50	-	5.03	-	-	
Total Sales Price	52.50	101.25	105.66	-	-	
Revenue to the Crown	-	1.25	-	-	5.03	6.28
Benchmark	-	2.50	-	-	5.06	7.56
Difference	-	(1.25)	-	-	(0.03)	(1.28)
% Change	0.00%	-50.00%	0.00%	0.00%	-0.62%	-16.94%



Banks and Securities Industry - Generic Model

B2B Zero-rate

Under this model, the supply of financial services to a registered business is treated as zero-rated and full ITCs are available on related inputs. The supply of financial services to consumers will be treated as exempt supplies and no ITC recovery is available. In this model it is necessary for the bank to be able to allocate costs directly attributable to business as well as consumer revenues.

	Supplier	Bank	Business A	Consumer A	Consumer B	Crown
Inputs						
Goods and Services	25.00	50.00	50.00	51.25	100.00	
<u>Tax Payable</u>	<u>1.25</u>	<u>2.50</u>	<u>-</u>	<u>-</u>	<u>5.00</u>	
Gross Goods and Services Cost	26.25	52.50	50.00	51.25	105.00	
Profit and Wages	25.00	50.00	50.00	-	-	
<u>Tax Payable</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	
Gross Profit and Wages	25.00	50.00	50.00	-	-	
<u>Recoverable Tax</u>	<u>(1.25)</u>	<u>(1.25)</u>	<u>-</u>	<u>-</u>	<u>-</u>	
Net Input Cost	50.00	101.25	100.00	51.25	105.00	
Outputs						
Sale Amount	50.00	101.25	100.00	-	-	
<u>Tax Collectible</u>	<u>2.50</u>	<u>-</u>	<u>5.00</u>	<u>-</u>	<u>-</u>	
Total Sales Price	52.50	101.25	105.00	-	-	
Revenue to the Crown	-	1.25	-	-	5.00	6.25
<u>Benchmark</u>	<u>-</u>	<u>2.50</u>	<u>-</u>	<u>-</u>	<u>5.06</u>	<u>7.56</u>
Difference	-	(1.25)	-	-	(0.06)	(1.31)
% Change	0.00%	-50.00%	0.00%	0.00%	-1.23%	-17.36%



*GST Applicability to the Financial Services Sector in Canada
TS35-01 (Indirect Tax 35-01)
February 11, 2011*

Banks and Securities Industry - Generic Model

Summary of Crown Revenue by Alternative								
	Supplier	Bank	Business A	Consumer A	Consumer B	Crown		
Canadian Model	-	2.50	-	-	5.06	7.56	0.00%	
Broad Exemption Model	1.25	-	-	-	5.03	6.28	-16.94%	
Full Taxation Model	-	-	-	2.50	5.00	7.50	-0.83%	
Full Zero-Rating	-	-	-	-	5.00	5.00	-33.88%	
Narrow Exemption and RITC	-	1.25	-	-	5.03	6.28	-16.94%	
B2B Zero-rate	-	1.25	-	-	5.00	6.25	-17.36%	



Funds Industry - Generic Model

Introduction

The following tables set out the financial impact of the treatment of financial services in the funds industry. The first table illustrates the financial impact under the Canadian model. The subsequent tables illustrate the financial impact of some of the alternatives presented in this report. Each table is based on the following scenario (unless otherwise noted):

Investment Manager incurs a taxable input cost and other internal costs in the supply of goods and services to the Fund.
The Fund, in turn, supplies financial services to Unit Holders.

Assumptions and Factors

The following assumptions and factors apply under the scenario noted above (unless otherwise noted):

Investment Manager's cost of goods and services	25.00
Investment Manager's internal costs	25.00
GST Rate	5%
Investment Manager's Commercial Activity Rate	100%
Fund's Commercial Activity Rate	0%
Unit Holders' Commercial Activity Rate	0%
RITC Rate	50%
Goods and services inputs (net of embedded tax) : profit throughout supply chain	50:50
Embedded tax is passed through the supply chain in the form of higher prices	-



Funds Industry - Generic Model

Exemption Model (Canada)

Under the current Canadian exemption model, the supply to Investment Manager is a taxable supply.

	Investment Manager	Fund	Unit Holders	Crown
Inputs				
Goods and Services	25.00	100.00	105.00	
Tax Payable	1.25	5.00	-	
<u>Internal Costs</u>	<u>25.00</u>	<u>-</u>	<u>-</u>	
Gross Goods and Services Cost	51.25	105.00	105.00	
Profit	50.00	-	-	
<u>Tax Payable</u>	<u>-</u>	<u>-</u>	<u>-</u>	
Gross Profit	50.00	-	-	
<u>Recoverable Tax</u>	<u>(1.25)</u>	<u>-</u>	<u>-</u>	
Net Input Cost	100.00	105.00	105.00	
Outputs				
Sale Amount	100.00	105.00	-	
<u>Tax Collectible</u>	<u>5.00</u>	<u>-</u>	<u>-</u>	
Total Sales Price	105.00	105.00	-	
Revenue to the Crown	-	5.00	-	5.00
<u>Benchmark</u>	<u>-</u>	<u>5.00</u>	<u>-</u>	<u>5.00</u>
Difference	-	-	-	-
% Change	0.00%	0.00%	0.00%	0.00%



Funds Industry - Generic Model

Broad Exemption Model (EU Model)

Under the broad exemption model in place in the EU, the supply to Fund is an exempt supply. The following assumptions override the assumptions noted above:

Investment Manager's commercial activity rate = 0%

	Investment Manager	Fund	Unit Holders	Crown
Inputs				
Goods and Services	25.00	101.25	101.25	
Tax Payable	1.25	-	-	
<u>Internal Costs</u>	<u>25.00</u>	<u>-</u>	<u>-</u>	
Gross Goods and Services Cost	51.25	101.25	101.25	
Profit	50.00	-	-	
<u>Tax Payable</u>	<u>-</u>	<u>-</u>	<u>-</u>	
Gross Profit	50.00	-	-	
<u>Recoverable Tax</u>	<u>-</u>	<u>-</u>	<u>-</u>	
Net Input Cost	101.25	101.25	101.25	
Outputs				
Sale Amount	101.25	101.25	-	
<u>Tax Collectible</u>	<u>-</u>	<u>-</u>	<u>-</u>	
Total Sales Price	101.25	101.25	-	
Revenue to the Crown	1.25	-	-	1.25
<u>Benchmark</u>	<u>-</u>	<u>5.00</u>	<u>-</u>	<u>5.00</u>
Difference	1.25	(5.00)	-	(3.75)
% Change	100.00%	-100.00%	0.00%	-75.00%



Funds Industry - Generic Model

Full Taxation Model

Under a full taxation model, all supplies are taxable and full input tax credits are available to the extent the entity is a registrant. In this model the following assumptions override the assumptions noted above:

Fund's commercial activity rate = 100%

	Investment Manager	Fund	Unit Holders	Crown
Inputs				
Goods and Services	25.00	100.00	100.00	
Tax Payable	1.25	5.00	5.00	
<u>Internal Costs</u>	<u>25.00</u>	<u>-</u>	<u>-</u>	
Gross Goods and Services Cost	51.25	105.00	105.00	
Profit	50.00	-	-	
<u>Tax Payable</u>	<u>-</u>	<u>-</u>	<u>-</u>	
Gross Profit	50.00	-	-	
<u>Recoverable Tax</u>	<u>(1.25)</u>	<u>(5.00)</u>	<u>-</u>	
Net Input Cost	100.00	100.00	105.00	
Outputs				
Sale Amount	100.00	100.00	-	
<u>Tax Collectible</u>	<u>5.00</u>	<u>5.00</u>	<u>-</u>	
Total Sales Price	105.00	105.00	-	
Revenue to the Crown	-	-	5.00	5.00
<u>Benchmark</u>	<u>-</u>	<u>5.00</u>	<u>-</u>	<u>5.00</u>
Difference	-	(5.00)	5.00	-
% Change	0.00%	-100.00%	100.00%	0.00%



Funds Industry - Generic Model

Full Zero-Rating of Financial Services

Under a full zero-rating model, financial services are zero-rated and input tax is recoverable, to the extent the business is a registrant. In this model the following assumptions override the assumptions noted above:

Fund's Commercial Activity Rate = 100%

	Investment Manager	Fund	Unit Holders	Crown
Inputs				
Goods and Services	25.00	100.00	100.00	
Tax Payable	1.25	5.00	-	
<u>Internal Costs</u>	<u>25.00</u>	<u>-</u>	<u>-</u>	
Gross Goods and Services Cost	51.25	105.00	100.00	
Profit	50.00	-	-	
<u>Tax Payable</u>	<u>-</u>	<u>-</u>	<u>-</u>	
Gross Profit	50.00	-	-	
<u>Recoverable Tax</u>	<u>(1.25)</u>	<u>(5.00)</u>	<u>-</u>	
Net Input Cost	100.00	100.00	100.00	
Outputs				
Sale Amount	100.00	100.00	-	
<u>Tax Collectible</u>	<u>5.00</u>	<u>-</u>	<u>-</u>	
Total Sales Price	105.00	100.00	-	
Revenue to the Crown	-	-	-	-
<u>Benchmark</u>	<u>-</u>	<u>5.00</u>	<u>-</u>	<u>5.00</u>
Difference	-	(5.00)	-	(5.00)
% Change	0.00%	-100.00%	0.00%	-100.00%



Funds Industry - Generic Model

Narrow Exemption and Reduced Input Tax Credit

Under this model the bank is entitled to a reduced input tax credit (RITC) of 50% of the VAT paid on inputs into supplies of financial services.

	Investment Manager	Fund	Unit Holders	Crown
Inputs				
Goods and Services	25.00	100.00	102.50	
Tax Payable	1.25	5.00	-	
<u>Internal Costs</u>	<u>25.00</u>	<u>-</u>	<u>-</u>	
Gross Goods and Services Cost	51.25	105.00	102.50	
Profit	50.00	-	-	
<u>Tax Payable</u>	<u>-</u>	<u>-</u>	<u>-</u>	
Gross Profit	50.00	-	-	
<u>Recoverable Tax</u>	<u>(1.25)</u>	<u>(2.50)</u>	<u>-</u>	
Net Input Cost	100.00	102.50	102.50	
Outputs				
Sale Amount	100.00	102.50	-	
<u>Tax Collectible</u>	<u>5.00</u>	<u>-</u>	<u>-</u>	
Total Sales Price	105.00	102.50	-	
Revenue to the Crown	-	2.50	-	2.50
<u>Benchmark</u>	<u>-</u>	<u>5.00</u>	<u>-</u>	<u>5.00</u>
Difference	-	(2.50)	-	(2.50)
% Change	0.00%	-50.00%	0.00%	-50.00%



Funds Industry - Generic Model

Summary of Crown Revenue by Alternative					
	Investment Manager	Fund	Unit Holders	Crown	
Canadian Model	-	5.00	-	5.00	0.00%
Broad Exemption Model	1.25	-	-	1.25	-75.00%
Full Taxation Model	-	-	5.00	5.00	0.00%
Full Zero-Rating	-	-	-	-	-100.00%
Narrow Exemption and RITC	-	2.50	-	2.50	-50.00%



Life and Health Insurance Industry - Generic Model

Introduction

The following tables set out the financial impact of the treatment of financial services in the life and health insurance industry. The first table illustrates the financial impact under the Canadian model. The second table illustrates the financial impact of the broad exemption model presented in this report. Each table is based on the following scenario (unless otherwise noted):

Supplier incurs a taxable input cost in the supply of goods and services to Insurance Co.
Insurance Co., in turn, supplies insurance to both Business A and Consumer A.
Business A, in turn, resupplies the financial services as an input into the supply of taxable services to Consumer B.

Assumptions and Factors

The following assumptions and factors apply under the scenario noted above (unless otherwise noted):

Suppliers cost of goods and services	25.00
GST Rate	5%
Supplier Commercial Activity Rate	100%
Insurance Co. Commercial Activity Rate	0%
Business A Commercial Activity Rate	100%
% of Revenues from B2B transactions	50%
% of Revenues from B2C transactions	50%
Goods and services inputs (net of embedded tax) : profit + wages throughout supply chain	50:50
Embedded tax is passed through the supply chain in the form of higher prices	-



Life and Health Insurance Industry - Generic Model

Exemption Model (Canada)

Under the current Canadian exemption model, the supply to Insurance Co. is a taxable supply.

	Supplier	Insurance Co.	Business A	Consumer A	Consumer B	Crown
Inputs						
Goods and Services	25.00	50.00	51.25	51.25	101.25	
<u>Tax Payable</u>	<u>1.25</u>	<u>2.50</u>	<u>-</u>	<u>-</u>	<u>5.06</u>	
Gross Goods and Services Cost	26.25	52.50	51.25	51.25	106.31	
Profit and Wages	25.00	50.00	50.00	-	-	
<u>Tax Payable</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	
Gross Profit and Wages	25.00	50.00	50.00	-	-	
<u>Recoverable Tax</u>	<u>(1.25)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	
Net Input Cost	50.00	102.50	101.25	51.25	106.31	
Outputs						
Sale Amount	50.00	102.50	101.25	-	-	
<u>Tax Collectible</u>	<u>2.50</u>	<u>-</u>	<u>5.06</u>	<u>-</u>	<u>-</u>	
Total Sales Price	52.50	102.50	106.31	-	-	
Revenue to the Crown	-	2.50	-	-	5.06	7.56
<u>Benchmark</u>	<u>-</u>	<u>2.50</u>	<u>-</u>	<u>-</u>	<u>5.06</u>	<u>7.56</u>
Difference	-	-	-	-	-	-
% Change	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%



Life and Health Insurance Industry - Generic Model

Broad Exemption Model (EU Model)

Under the broad exemption model in place in the EU, the supply to Insurance Co. is an exempt supply. The following assumptions override the assumptions noted above:

Supplier's commercial activity rate = 0%

	Supplier	Insurance Co.	Business A	Consumer A	Consumer B	Crown
Inputs						
Goods and Services	25.00	51.25	50.63	50.63	100.63	
<u>Tax Payable</u>	<u>1.25</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>5.03</u>	
Gross Goods and Services Cost	26.25	51.25	50.63	50.63	105.66	
Profit and Wages	25.00	50.00	50.00	-	-	
<u>Tax Payable</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	
Gross Profit and Wages	25.00	50.00	50.00	-	-	
<u>Recoverable Tax</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	
Net Input Cost	51.25	101.25	100.63	50.63	105.66	
Outputs						
Sale Amount	51.25	101.25	100.63	-	-	
<u>Tax Collectible</u>	<u>-</u>	<u>-</u>	<u>5.03</u>	<u>-</u>	<u>-</u>	
Total Sales Price	51.25	101.25	105.66	-	-	
Revenue to the Crown	1.25	-	-	-	5.03	6.28
<u>Benchmark</u>	<u>-</u>	<u>2.50</u>	<u>-</u>	<u>-</u>	<u>5.06</u>	<u>7.56</u>
Difference	1.25	(2.50)	-	-	(0.03)	(1.28)
% Change	100.00%	-100.00%	0.00%	0.00%	-0.62%	-16.94%



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Life and Health Insurance Industry - Generic Model

Summary of Crown Revenue by Alternative							
	Supplier	Insurance Co.	Business A	Consumer A	Consumer B	Crown	
Canadian Model	-	2.50	-	-	5.06	7.56	0.00%
Broad Exemption Model	1.25	-	-	-	5.03	6.28	-16.94%

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T Glossary

Brokerage services: In relation to financial services, the intermediary standing between buyers and sellers of commodities, currencies, debt and equity securities. The provision of brokerage services involves three distinct cash flows: (i) payment by a purchaser to the intermediary of the purchase price for a specified item; (ii) receipt by a seller through the intermediary of the sale price for a specified item; and (iii) the fee charged by the intermediary for the provision of the intermediation services. Jurisdictions take very different views as to the VAT treatment of such services.

Cash-flow taxation: A method of calculating the taxable value of financial services, based on treating cash inflows as taxable sales and cash outflows as taxable purchases. Significant work in this area has been undertaken by Satya Poddar.

Credit-invoice mechanism: The mechanism by which VAT is collected and paid, which works by levying tax at each transaction in the production and distribution chain. A liability to charge tax arises every time a registered person makes a supply. Tax is also imposed on imports. Credits for tax paid on a registered person's purchases means that the tax rolls forward at each intermediate transaction until the point of sale to a final consumer.

Deposit-taking intermediation: This involves the making of deposits and debt investments with an intermediary who provides the relevant funds to users of capital in the form of loans. Deposit-taking intermediation involves five distinct cash flows: (i) the advance of a principal sum by the supplier of capital through the intermediary to the user of capital; (ii) the repayment of the principal sum by the user of capital through the intermediary to the supplier of capital; (iii) the pure time-value return or interest charge that compensates the supplier of capital for the use of its funds by the user of capital; (iv) the premium charged by the intermediary to compensate for the risk of default on payment obligations by users of capital; and (v) the fee charged by the intermediary for intermediation services.

Exempt supplies: A supply that is not subject to VAT but for which the supplier is unable to claim an input tax credit. In the context of the reforms proposed in this discussion document, exempt supplies include supplies of financial services to final consumers (households), financial intermediaries and businesses that have more than an incidental activity of supplying financial services.

Exemption-without-credit: This is the technical description for the current treatment of financial services. Briefly, it means that a financial intermediary does not charge VAT on the supply of a financial service and is unable to claim an input tax credit for any VAT incurred in producing that service. This treatment is a proxy for taxing final consumption as it ensures that the intermediary expressly bears the tax cost. This term is used frequently in the EU.

Final consumers/households: VAT is a tax on the supply of goods and services and is ultimately borne by the last person in the production-distribution chain, who is often referred to as the final consumer. The tax is borne by final consumers as they are unable to claim an offsetting credit for the tax paid when acquiring the goods or services.

Financial intermediary: In its broadest sense, the term "intermediary" includes any person who serves to bring other persons together. Intermediation is the service provided by a person in

bringing together suppliers and consumers of particular goods and services. Intermediaries therefore reduce transaction costs otherwise associated with matching suppliers and consumers. “Financial intermediation” can be divided in to four categories:

- intermediation between suppliers and users of financial capital;
- intermediation between persons with different exposures and/or tastes for risk;
- intermediation between persons with exposure to similar risks; and
- intermediation between buyers and sellers of commodities, currencies, debt and equity securities.

In addition to these intermediation services, firms may also provide advisory and administrative services, such as record-keeping and cash management functions and credit and investment evaluation.

Price elasticity: The impact of price changes on sales volumes.

Income elasticity: The impact of income changes on sales volumes.

Input tax credits: Registered persons are entitled to an offsetting credit for VAT paid on purchases of goods and services acquired for the principal purpose of making taxable supplies. Often referred to as input VAT deduction.

Insurance: This involves the pooling of funds to spread exposure to risk among a number of persons or a number of different investments. Insurance involves three distinct cash flows: (i) payment by the insured of premiums (or savings in the case of diversification) to an intermediary for coverage in respect of a specified risk; (ii) payment by the intermediary to the insured of proceeds in respect of the occurrence of the specified risk; and (iii) the fee charged by the intermediary for intermediation services.

Reduced input tax credits (RITCs): An Australian concession to allow registered persons to claim a percentage of input tax credits that would not otherwise be allowed for tax paid on their purchases. The purpose of the credit is to remove the bias for financial intermediaries to provide activities from within their own resources and thereby reduce the impact of VAT. In Australia, where the RITC is used, the rate of input tax recovery is set at 75% of the GST paid on certain prescribed taxable supplies of goods and services.

Reverse Charge: a self imposed VAT, known in Canada as “self assessment”.

Risk intermediation: This involves the acceptance by the intermediary of exposure to a specified risk that the transferor is unwilling to bear, and the transfer by the intermediary of that exposure to another person willing to accept it. Risk intermediation involves three distinct cash flows: (i) the payment by the losing counterparty to a bet of the amount of that losing position to the intermediary; (ii) the payment by the intermediary of the amount of the losing bet to the winning counterparty; and (iii) the fee charged by the intermediary for intermediation services. The first two cash flows are channeled through the intermediary, who does not bear the risk associated with either side of the bet. The only risk assumed by the intermediary is, in fact, the credit risk associated with the chance that a losing party to a bet might default on its payment obligations, leaving the

intermediary to make good on those obligations. A portion of the intermediation charge compensates for the assumption of this default risk.

Self-supply bias: The term describes the behavior of providing necessary goods and services “in-house”. In the case of financial intermediaries, the behavior may arise from the inability to recover the GST paid on their purchases of goods and services. If the financial intermediary cannot pass on these costs, or faces tightening margins, it may elect to reduce the cost of supplies by replicating external supplies internally. Often referred to as a vertical integration bias.

Self-supply tax: A tax that is imposed, in theory, to achieve parity between internally generated supplies and those that could otherwise be sourced from third parties. It is designed, therefore, to remove the bias faced by some registered persons to in-source supplies of goods and services owing to the inability to claim input tax credits. The rate of tax should be equal to the standard rate of VAT/GST. The application of a self-supply tax would involve the complex issue of how to value internally created supplies.

Tax cascade: Tax cascades can arise where a supplier of a financial service cannot recover the VAT paid on the purchase of goods and services used to make those supplies. To compensate, the financial intermediary either raises the price of the services or absorbs the VAT cost. If the irrecoverable VAT cost is passed on to businesses through higher prices, this may increase the prices charged by businesses for their products.

Taxable supply: Taxable supplies are supplies subject to VAT , either at the standard rate, reduced rate or, in certain circumstances, at zero percent.

Zero-rating: Zero-rated supplies of goods and services are taxed at the rate of zero-percent. No tax is payable but input tax credits are allowed in respect of supplying the goods and services