

TAXATION OF FINANCIAL SERVICES (INCLUDING INSURANCE)  
UNDER A UNITED STATES VALUE ADDED TAX

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**I. Introduction**

The papers for this conference assume that any new federal tax on consumption will be a credit-invoice value added tax (VAT) – called a Goods and Services Tax (GST) in some countries -- similar to the VATs used by about 150 countries around the world. Except when the reference is to a particular GST system, the term VAT is used to describe both a VAT and a GST. Financial services and insurance warrant a separate paper for this conference both because these industries pose unique challenges for the design of a VAT and because they are significant sectors of the U.S. economy. For 2007, they represented 7.9 percent of the U.S. GDP.<sup>2</sup>

VAT generally is imposed on explicit prices charged in market transactions. When a bank charges explicit fees for its services, such as services from one of its 24-hour banker machines, the value of those services is the fees charged, and the fees fit into the VAT system. A bank, however, renders many of its services as an intermediary, such as –

- (a) in bringing together depositors and borrowers; and
- (b) in conducting foreign exchange transactions.

The value of these intermediation services is implicit in the margin between the interest charged on loans and interest paid for borrowed funds,<sup>3</sup> or in the margin between the buying and selling rates for a foreign currency.<sup>4</sup>

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<sup>2</sup> The components of this 8.3% were:

Federal Reserve banks, credit intermediation, and related activities	3.7%
Securities, commodity contracts, and investments	1.7%
Insurance carriers and related activities	2.4%
Funds, trusts, and other financial vehicles	0.1%

Bureau of Economic Analysis, U.S. Dep't. of Commerce, Vol. 89, No. 3, Survey of Current Business Online, Annual Industry Accounts, March, 2009 [hereinafter BEA Annual Industry Accounts], Value Added by Industry as a Percentage of Gross Domestic Product, 2002-2007.

[http://www.bea.gov/industry/gpotables/gpo\\_action.cfm?anon=92103&table\\_id=23975&format\\_type=0](http://www.bea.gov/industry/gpotables/gpo_action.cfm?anon=92103&table_id=23975&format_type=0).

<sup>3</sup> With the bank's ability to create money by issuing loans, and to borrow from other banks and from the Federal Reserve, the traditional formulation to measure the value of intermediation services may no longer hold. For simplicity, in this paper, the traditional formulation is used.

<sup>4</sup> The European Court of Justice, in *Customs and Excise Commissioners v First National Bank of Chicago*, Case C-172/96, [1998] All ER (EC) 744 (ECJ) ruled that the consideration for the currency transactions was the margin, or spread between the bid and the ask prices. The same rationale could be used in other margin transactions, such as interest rate swaps and other derivatives. See Kerrigan, *The Elusiveness of Neutrality – Why is it so Difficult to Apply VAT to Financial Services?*, \_\_ *Frontiers in Finance and Economics*[hereinafter Kerrigan, *Elusiveness of Neutrality*] at 21??.

A credit-invoice VAT system, as currently designed around the world, is not well equipped to handle many supplies of financial services, where the value of the supply is buried in interest rates. In part for this reason, under early VAT systems, supplies of financial services and insurance were exempt from VAT. While housing, medical care, education, and other services<sup>5</sup> commonly are exempt as well, the exemption for financial services and insurance is different. It is the only exempt service that is rendered in significant amounts in business-to-business (BTB) transactions. In fact, under those early VAT regimes, the exemption results in the under-taxation of financial services and insurance in business-to-consumer (BTC) transactions and the over-taxation of these services in BTB transactions.

It is the combination of the fact that –

- (a) the value of many financial and insurance services is buried in interest rates or measurable by a margin, and
- (b) financial services and insurance are exempt or partially exempt under most VAT systems,

that the taxation of financial services and insurance are as complex as they are under the VATs around the world.

If financial services and insurance were subject to a federal VAT, the VAT would co-exist with the existing web of state taxes imposed on these industries.<sup>6</sup> If the states convert their sales taxes to some form of VAT, the Quebec experience becomes relevant. Quebec has an almost harmonized provincial GST (QST), while its neighboring, highly industrialized province, Ontario, has a provincial sales tax that does not tax financial services. While the Canadian federal GST exempts many financial services, under threat from banks in Quebec that they might move their operations to Ontario, Quebec zero-rated financial services.

This paper discusses –

- (1) the inclusion of financial services and insurance in a consumption tax base;
- (2) the calculation of net VAT liability for each tax period, and a comparison between taxing and exempting midstream BTB transactions;
- (3) the distortions created when supplies of these services are exempt from VAT;
- (4) the approaches adopted in some countries, proposed in the U.S. Congress, and proposed by commentators to ameliorate the distortions associated with the exemption for these services; and
- (5) the challenges and recommendations on how these industries should be treated under a U.S. VAT.

## **II. Inclusion of Financial Services and Insurance in a Consumption Tax Base**

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<sup>5</sup> See, ch.14, “Proposals for U.S. Tax on Consumption,” in A. SCHENK & O. OLDMAN, *VALUE ADDED TAX: A COMPARATIVE APPROACH* [hereinafter Schenk & Oldman], Cambridge University Press 2007.

<sup>6</sup> On the taxation of financial institutions at the state level, see, for example, Rosen & Rathbone, *State Taxation of Financial Institutions*, 1 *State & Local Tax Law*. 51 (1996).

Applying to VAT the principle of neutrality with respect to consumer choices, the tax should be imposed on supplies of financial and insurance services to the extent that these services belong in a consumption tax base and the taxation of those services is administratively feasible, whether the supplier charges an explicit fee or the charge is implicit in the margin between separate supplies.

### A. Financial Services

A bank “provide[s] an intermediation service to both depositors and borrowers by channeling funds of persons with certain preferences regarding risk and liquidity to other persons with different preferences.”<sup>7</sup> For those intermediation<sup>8</sup> services, the bank receives the “margin” between the amount the bank pays in “interest” to depositors and the amount it receives in “interest” from borrowers. The principal transactions (the amount deposited or lent) do not represent consumption.<sup>9</sup> According to traditional economic thought, the pure cost of funds, which can be represented by the short-term rate on government securities,<sup>10</sup> is payment to postpone consumption<sup>11</sup> and should not be included in a consumption tax base either. The residual is the value of the intermediation services rendered to depositors and borrowers (including the risk premium). This value is includible in a consumption tax base.<sup>12</sup>

While the core services for many financial institutions remain intermediation services, many have expanded their range of “financial” services, and have even crossed-over into providing services that resemble insurance products. These institutions and their professional advisors developed derivatives and other “innovative financial

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<sup>7</sup> Henderson, “Financial Intermediaries under Value-Added Tax,” *New Eng. Econ. Rev.*, July-Aug., 1988, p. 37

<sup>8</sup> Casino and lottery operations raise similar problems under a credit-invoice VAT because the winners (the persons representing a large portion of the casino’s “business inputs”) are not within the VAT system and do not issue VAT invoices.

<sup>9</sup> For most transactions involving the transfer of financial instruments, the supply of the principal of the instrument is not includible in the tax base. That transfer is merely the transfer of purchasing power, not the exercise of the purchasing power to acquire goods or services. Poddar, VAT on Financial Services – Searching for a Workable Compromise, in R. KREVER & D. WHITE, ED’S., *GST IN RETROSPECT AND PROSPECT*[hereinafter Poddar, Workable Compromise], 194, citing *Customs and Excise Commissioners v. First National Bank of Chicago* Case C-172/96[1998] All ER (EC) 744, STC 850 (ECJ).

<sup>10</sup> It is not part of national income accounts. See generally, Schenk & Oldman, principal draftsmen, *Analysis of Tax Treatment of Financial Services Under a Consumption-Style VAT: Report of American Bar Association Section of Taxation, Value Added Tax Committee*, 44 Tax. Law. 181, 185-187.

<sup>11</sup> Even if not taxed as part of finance charges, the pure cost of funds (separate from intermediation services) is borne by a business borrower and, as a cost of doing business, the borrower can be expected to include that cost in product prices, when it will be taxed as part of the selling price of those products.

<sup>12</sup> While there is some dispute as to whether the risk premium belongs in a consumption tax base, it may not be feasible to separate out this premium on a transactional basis. A result comparable to the elimination of the risk premium is possible if the risk premium is included in the tax base, and the bank can reduce its tax base by its bad debts. See Schenk, “Taxation of Financial Services Under a Value Added Tax: A Critique of the Treatment Abroad and the Proposals in the United States,” 9 Tax Notes Int’l 823, 831-832 (Sept. 12, 1994)[hereinafter Schenk, Critique]. According to Carl Shoup, in his classic treatise, finance charges paid on loans to finance consumption are not part of national income accounts that measure production in the economy. See, C. SHOUP, *PRINCIPLES OF NATIONAL INCOME ANALYSIS* 105-106 (1947).

instruments.”<sup>13</sup> The instruments take so many different forms that it may be difficult to develop VAT rules to clearly identify the value of the services rendered to each party to an instrument that should be included in the VAT base. The global movements of money, internet banking, and global business have added to the complexity of international financial services. “[A]ll of these activities are combined by financial institutions in a complex structure reflecting a sophisticated mix of traditional and innovative activities, of short and long term positions as well as other dynamic variables.”<sup>14</sup>

This paper separates insurance from other financial services, concentrating on the latter. I use a “bank” as a surrogate for all suppliers of financial services, although the supplier may, for example, be a brokerage firm, an underwriter, an investment banker, a mutual or pension fund, or a lending unit of a business that is not regulated as a financial institution.

Banks in the U.S. charge significant explicit fees for services related to checking and savings accounts, use of ATM machines, bounced checks, and many other services.<sup>15</sup> VAT can be imposed as a percentage of fees and listed on VAT invoices. While there is some controversy as to whether broker and other services related to the acquisition and disposition of investment assets belong in a consumption tax base,<sup>16</sup> the taxation of fee-based financial services can fit within the structure of a traditional credit-invoice VAT system.

## **B. Insurance Services**

Insurance represents almost one-third of the services rendered by the combined financial/insurance sectors, but there also are connections between the services they each provide. If they receive different VAT treatment, there may be distortions created when financial services are bundled into insurance products, or vice versa.

The principle of neutrality with respect to consumer choices requires that the value of intermediation services that are rendered by life and non-life insurance companies should be included in a credit-invoice VAT base.

Life insurance, or at least the total premium for whole life insurance, has been viewed as an inappropriate subject of a tax on personal consumption because savings is a

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<sup>13</sup> See, *Innovative Financial Instruments* ch. 4 in H. ZEE, ED., *TAXING THE FINANCIAL SECTOR: Concepts, Issues and Practices* (IMF 2004). “A financial derivative... is a financial instrument whose price depends on, or is derived from, the price of another asset. The asset underlying a derivative could be a commodity ..., a financial asset ..., or another derivative. There are two basic building blocks that can be used to construct derivatives: futures contracts traded in exchanges (or forward contracts traded in the over-the-counter market) and options contracts. Derivatives can be used for either hedging or speculative purposes (or both).” *Id.* at 45.

<sup>14</sup> Kerrigan, *Elusiveness of Neutrality*, *supra* note 4, at \_\_\_\_.

<sup>15</sup> According to Bankrate.com, checking account fees in 2008” have risen again to an all-time high.” Bankrate.com Surveys US Checking Account Fees, Oct. 27, 2008, at <http://www.paymentsnews.com/2008/10/a-look-at-us-ch.html>.

<sup>16</sup> See generally, Grubert & Mackie, “Must Financial Services be Taxed Under a Consumption Tax?,” 53 *Nat’l Tax J.* 23 (Mar. 2000).

significant component in that kind of policy. Some view life insurance as “either saving or investment, or costs incurred incident thereto”<sup>17</sup> and therefore not properly includible in a VAT base. Life insurance is almost universally exempt under VATs around the world, but the intermediation element in life insurance may be measurable for VAT purposes.<sup>18</sup> Even if the exemption for whole life policies can be justified, it is more difficult to use the “savings” or “investment” aspect of insurance as justification to exempt the intermediation services element in term life.

The intermediation service<sup>19</sup> rendered by a non-life carrier,<sup>20</sup> represented by the margin between the tax on premiums (output tax) and both the tax on claims paid (input tax) and the tax on business inputs (input tax),<sup>21</sup> can fit within and be taxed under a

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<sup>17</sup> P. MCDANIEL & S. SURREY, INTERNATIONAL ASPECTS OF TAX EXPENDITURES: A COMPARATIVE STUDY 83 (1985). According to McDaniel and Surrey, there are three elements in an ordinary life policy: “(1) a savings element (cash value); (2) payment for the risk or protection element of the policy; and (3) the load charge by the company.” *Id.* at 82. “The savings element and the load charge allocable to investment activities should not be included in the tax base. As to the protection element, it is argued that to the individual insured, ‘the premium is paid to mitigate the risk that he will not have saved and the amount which he desires to pass on to his heirs at death ... [and therefore] should not be included in the tax base either.’ *Id.*” A. SCHENK, REPORTER, VALUE ADDED TAX: A MODEL STATUTE AND COMMENTARY, A Report of the Committee on Value Added Tax of the American Bar Association Section of Taxation 172 (1989) [hereinafter ABA Model VAT]. Contrast this analysis with the similarity described by David Bradford, for income tax purposes, of whole life insurance and short-term capital gain. David Bradford wrote that “income tax treats the accruing value of a whole life insurance policy very much as it does a short-term capital gains asset”; that is, there is no deduction on purchase and no tax on the growing cash value until the policy holder or stock holder realizes it. Then there is a recovery of basis and taxation as ordinary income, unless the asset is held until death, in which case, there is no income tax payable on the increased cash value. D. BRADFORD, UNTANGLING THE INCOME TAX 204 (Harv. Univ. Press 1986).

<sup>18</sup> See, Edgar, “The Search for Alternatives to the Exempt Treatment of Financial Services under a Value Added Tax,” in R. KREVER & D. WHITE, ED’S., GST IN RETROSPECT AND PROSPECT, Part 3 on Financial Services [hereinafter Edgar, Alternatives to Exempt Treatment], 139, 160-161 (Brookers N.Z. 2007), citing the Second Report of the Advisory Panel on Goods and Services Tax to the Minister of Finance (Wellington: Inland Revenue, July 1985); Poddar, Workable Compromise, *supra* note 9, at 193. See also; Whalley & Fretz, *The Economics of the Goods and Services Tax*, Canadian Tax Paper No. 88, (Canadian Tax Foundation 1990); Barham, Poddar, & Whalley, *The Tax Treatment of Insurance Under a Consumption Type, Destination Basis VAT*,” 40 Nat’l Tax J. 171 (1987) Neubig & Adrion, “Value Added taxes and Other Consumption Taxes: Issues for Insurance Companies, 61 Tax Notes 1001, 1006 (1993).;

<sup>19</sup> The intermediation includes “attracting customers, writing policies, investing the pooled funds to earn additional income to operate the business and pay claims ... to those suffering covered losses.” Schenk & Oldman, *supra* note 5, at 344.

<sup>20</sup> See the unsuccessful attempt by the U.K in *Card Protection Plan Ltd v. Commissioner of Customs & Excise*, Case C-349/96, [1999] ECR I-973, to limit the exemption to firms licensed to engage in the insurance business.

<sup>21</sup> To measure an insurer’s value added, should the value of the insurer’s taxable output be measured by gross premiums or by the sum of gross premiums and net investment income? An insurer receives premiums in advance of claims and, to remain competitive, the insurer likely will shift some of the return on the investment of the premiums in the form of lower premiums to the insured. To date, countries that tax casualty insurance do not include net investment income in the GST base. If the gross premiums are taxed up front, does the tax base already include net investment income? More work may be needed to determine if the full value of non-life insurance services are taxed, without including the insurer’s net investment income.

credit-invoice VAT.<sup>22</sup> Consumers pay VAT on non-life insurance premiums and, upon the occurrence of a casualty, they use the settlement proceeds to replace the insured property.<sup>23</sup> A VAT-registered business should recover the tax (input VAT) charged on the business's insurance premium.

### III. Calculating Net VAT Liability and Midstream Exemptions

A VAT-registered business (the retailer in the below Table 1) calculates her net VAT liability for each tax period by crediting her input VAT on purchases against her output VAT; that is, the tax listed on VAT invoices received from her suppliers (input VAT) is credited against the tax chargeable on her taxable sales (output VAT).<sup>24</sup> In total, the government receives \$10,000 VAT that is charged by the retailer as output tax on her sales to the final consumers. The government receives that \$10,000 in two payments: \$6,000 from the supplier to the retailer, and \$4,000 from the retailer.

**Table 1**

	Retailer's VAT Return	Total VAT remitted to govt.
Supplier to retailer		6,000
Retailer		
Output tax on taxable sales 100,000 x 10% VAT	\$10,000	
Input tax on purchases 60,000 x 10% VAT	(6,000)	4,000
Tax remitted by retailer	4,000	
Tax remitted-supplier & retailer		10,000

If financial services and insurance provided before the retail stage (“midstream”) are exempt from VAT, the exemption breaks the chain of claiming VAT credits on business inputs, and creates the problems that are the major focus of this paper.

The following two tables illustrate the effect on consumer prices and VAT revenue when financial services (bank fees in the example) rendered in midstream business-to-business (BTB) transactions are taxed (Table 2) and when they are exempt (Table 3).

<sup>22</sup> There are issues relating to the taxation of insurance companies that go beyond the taxation of casualty insurance premiums and the recovery of tax on claims paid. For example, if an insurance company acquires damaged property in connection with an insurance settlement with an insured and resells that property, should those transactions be treated like any purchase and resale of used goods? If an insurer pays claims with replacement property it purchases rather than cash, should the insurer be treated as being engaged in the business of selling that replacement property, so that it is taxed on the spread between the retail price and the insurer's cost for that property? These and other similar issues are beyond the scope of this paper.

<sup>23</sup> If the insurance carrier includes VAT in the premiums and in the claims paid, the consumer's recovery can be used to replace the destroyed property plus VAT.

<sup>24</sup> The audit trail created by following GST invoices issued in business-to-business transactions is a useful enforcement tool for the tax authority. That trail is broken if a GST-registered business can claim credit for tax on a purchase from an unregistered person, or can claim credit for any portion of the tax of purchases of goods or services that are GST-exempt.

To highlight the effect, the example isolates the bank’s input (“supplier to bank”) used in the bank fees charged to the manufacturer. It also reports only the bank’s fees to this manufacturer, which is unrealistically included as the manufacturer’s only business input. At each stage, the tax on purchases (input VAT) is claimed as a credit against output tax on sales. The business recovers tax previously imposed on its purchases. The supplier to the bank (no inputs) remits 150. The bank remits 850; the manufacturer remits 49,000; and the retailer remits 20,000. The 70,000 total VAT remitted to the government in chunks is the same total tax that would be paid if there were a single-stage 10% retail sales tax imposed on 700,000. With a properly functioning VAT, the government should not receive any net VAT revenue until the sale is made to the consumer.

**Table 2**  
**Midstream BTB Transactions**  
**Fees for Financial Services Taxed**

	Purchases	Input VAT	Sales	Output VAT	VAT-incl. sales	VAT remitted
Supplier to bank			1,500	150	1,650	150
Bank services- fees	1,500	150	10,000	1,000	11,000	1,000 → (150)
Mfr	10,000	1,000	500,000	50,000	550,000	50,000 → (1,000)
Retailer	500,000	50,000	700,000	70,000	770,000	70,000 → (50,000)
Total prices to consumers Total rev.					770,000	70,000

In Table 3, the bank’s fees are exempt. The bank is denied credit for input VAT on its purchases attributable to those exempt fees. It is assumed that the bank increases its fees to the manufacturer by 150 for the unrecoverable (“blocked”) 150 input VAT. Since the manufacturer will not receive an invoice listing VAT on the bank fees, the bank cannot claim credit for any input VAT on the bank fees.

**Table 3**  
**Midstream BTB Transactions**  
**Fees for Financial Services Exempt**

	Purchases	Input VAT	Sales	Output VAT	VAT-incl. sales	VAT remitted
Supplier to bank			1,500	150	1,650	150
Bank services-fees	1,500	150	10,150	----	10,150	---- → (no credit)
Mfr	10,150	no VAT	500,150	50,015	550,165	50,015 → (no credit)
Retailer	500,150	50,015	700,150	70,015	770,165	70,015 →

						(50,015)
Total prices to consumers					770,165	
Total rev.						70,165

Table 3 shows that the government still receives 150 VAT on the 1,500 supply to the bank. The manufacturer’s cost for the bank services, between Tables 2 and 3, increases from 10,000 to 10,150, or 150. If the manufacturer increases its prices to cover that increased cost, the tax charged by the manufacturer increases by 10% of 150, or 15. As a result, in Table 3, consumers pay 165 more and the government receives 165 more revenue than where the bank fees were taxed in Table 2.

The same effect described in Table 3 would occur if the manufacturer purchased exempt insurance coverage instead of exempt bank services.

#### IV. Distortions Caused by Exemption in BTB and BTC Transactions

The EU and countries following that VAT model exempt most financial services and insurance, in part because of the difficulty fitting intermediation services within a transaction-based, credit-invoice VAT system. There is an extensive body of literature examining the taxation of financial services under a VAT, the rationale for the exemption, the deviations from that model in some countries, and proposals for additional changes. The exemption from tax is presumed to cause several distortions. The reforms enacted to date and various proposals are designed to address one or more of these distortions. Tim Edgar notes, however, that these “supposed distortions have not been the subject of any systematic empirical study.”<sup>25</sup> The distortions,<sup>26</sup> applicable to insurance as well, are:

1. The under-taxation of the household consumption of financial services compared with the consumption of other goods and services because the value added by financial institutions is not taxed.
2. The over-taxation of the consumption of financial services by VAT-registered businesses because any VAT buried in the costs of financial services is not recoverable as input tax credits. There likely is a cascade of tax resulting when any VAT buried in these costs is included in the prices of goods and services sold by the business users of these exempt financial services.
3. The incentive for a financial service provider to vertically integrate and self-supply services in order to avoid some or all of the unrecoverable VAT on its purchases from registered domestic traders. Smaller financial service providers may be less able to vertically integrate than larger providers, creating another kind of non-neutrality.

<sup>25</sup> Edgar, *Alternatives to Exemption*, *supra* note 18, at 136.

<sup>26</sup> These distortions are discussed in detail *id.* at 134-136.

4. The competitive advantage to an offshore financial service provider if it can render services to domestic household consumers or other domestic purchasers (such as units of government and other suppliers of exempt services) free of VAT.<sup>27</sup>

All countries continue to exempt at least some financial services and insurance under their VATs because they decided that it was too difficult to effectively tax the value of those services on a transaction-by-transaction basis and provide business users of those services an input credit for the tax imposed -- the measurement standard used under the universally-used credit-invoice VAT.<sup>28</sup>

Some newer VATs modified the EU exemption approach in order to reduce the distortions caused by the exemptions. The goals varied, but many had the effect of reducing the cascading of the tax on BTB transactions, expanding the taxation in business-to-consumer (BTC) transactions, and not losing too much revenue in the process. The revenue loss resulted from the unblocking of the input tax in BTB transactions. It should be emphasized that the development of a workable system to more fully tax financial services and insurance produces net revenue only for services rendered to final consumers (and to persons treated for tax purposes as final consumers).<sup>29</sup>

## **V. Review of Country Practices Governing Financial Services and Insurance**

### **A. Introduction**

Financial institutions rendering exempt services have an incentive to reduce their blocked input VAT –

(a) by self-supplying, or

(b) by obtaining free of VAT from foreign suppliers

services that they would otherwise purchase from domestic suppliers at prices that include VAT.

In a globalized marketplace, a VAT exemption, resulting in the denial of credit to the supplier of exempt services for tax on his business inputs, still provides revenue from those inputs to the country that taxed that input.<sup>30</sup> Most of the countries saddled with the EU exemption approach have found it difficult to reform their taxation of financial services, in part because the reform options, allowing financial institutions and insurance companies to recover more of the “blocked” VAT on their business inputs, may reduce VAT revenue received from that industry, at least in BTB transactions.

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<sup>27</sup> See *infra*, sec. IV(B)(3)(a), discussing New Zealand’s reverse charge system designed to prevent this competitive advantage.

<sup>28</sup> See generally, R. BIRD & P.P. GENDRON, *THE VAT IN DEVELOPING AND TRANSITIONAL COUNTRIES*, p. 96 (CUP 2007)[hereinafter Bird & Gendron], p. 97-104.

<sup>29</sup> Small businesses that are exempt from tax under a small business exemption are treated like final consumers to the extent that they cannot recover tax on their purchases.

<sup>30</sup> The loss of revenue also applies to services rendered to governments, non-profits, and small businesses that are outside the VAT net and that do not recover VAT on their purchases.

The reform options have taken a number of approaches. At least one country zero-rates BTB transactions. Most try to reduce the blocked input tax on purchases attributable to exempt financial services rendered in BTB transactions. Some do so by extending the exemption up one stage to cover some services rendered to financial institutions. Others grant credit for some or all input tax on purchases attributable to exempt services rendered to taxable traders.

## **B. Financial Services**

Almost every VAT in the world is a credit-invoice tax that relies on the destination principle to tax imports of goods and some services, and to zero-rate specified exports. This section covers most of the major approaches to the taxation of financial services under a VAT. There are some exceptions. This subsection does not cover the Venezuela tax on individual financial transactions, which taxes debits and credits to current and savings accounts, and payments on loans.<sup>31</sup>

Israel uses an addition method to calculate the value added by banks and insurance companies. Israel taxes compensation<sup>32</sup> and profit of these firms under a tax that is administered outside its VAT system. As a result, banks and insurance companies are subject to the equivalent of a turnover tax on their services because they cannot recover VAT on their business inputs, and they are taxed on their wages and profit. Business users of these services cannot recover this tax under the VAT system. There are many problems with an addition method of calculating VAT, even if the defects of the Israeli approach were corrected. For example, it would be difficult if not impossible to calculate, with precision, the VAT component in exported financial services in order to implement the destination principle.<sup>33</sup>

### **1. European Approach**

Under the European-style, credit-invoice VAT, most financial services (including insurance) have been exempt from VAT at least since 1977, when what is now the European Union (EU) issued the Sixth Directive,<sup>34</sup> providing the principles for the

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<sup>31</sup>There are some exemptions, and the tax applies to a broader list of transactions than those listed in the text. This tax was reinstated from Nov. 1, 2007 to Dec. 31, 2008. See, Venezuela, IBFD Tax News Service, Oct. 15, 2007.

<sup>32</sup>In the U.S., compensation paid to employees in the financial service and insurance industry accounts for about 55 percent of all of the value that they add. BEA Annual Industry Accounts, *supra* note 2, at Table 4, Components of Value Added by Industry Group as a Percentage of Value Added, 2003-2006.

<sup>33</sup>For this and other arguments against the addition method, see Cnossen, *VAT Treatment of Financial Services*, in G. LINDENCRONA, S. LODIN, AND B. WIMAN, EDs., INTERNATIONAL STUDIES IN TAXATION: LAW AND ECONOMICS – LIBER AMICORUM MUTÉN 91 (Kluwer 1999).

<sup>34</sup>Under the treaty establishing the European Community, the European Parliament (acting jointly with the Council), the Council and the Commission shall issue a directive. "A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods." Consolidated Version of the Treaty Establishing the European Community, Official Journal C 325 , 24 December 2002, Art. 249.

harmonized VAT required of all Member States. The issuance of the Sixth VAT Directive<sup>35</sup> provides a convenient starting point.

With the exception of the taxation of specified fee-based services like safety deposit box fees and financial advisory services and the zero rating of exported financial services, banks in the EU generally do not charge VAT on their financial services and they do not recover VAT paid on their business inputs used in rendering those exempt services.

Financial institutions make both taxable and exempt supplies and therefore must allocate tax on their business inputs between these two categories of supplies. What is not known is the extent to which the tax authorities in the Member States vary in their willingness to accept aggressive approaches (1) to the direct allocation of inputs to taxable and to exempt supplies, and (2) the establishment of the ratios of taxable to total supplies.<sup>36</sup> Some Member States adopted concessions or special arrangements related to the allocation of input tax on financial transactions.<sup>37</sup>

The exemption for financial services creates a number of economic distortions, noted earlier, including the distortion of consumer demand for exempt services, and incentives for banks to purchase untaxed services offshore.<sup>38</sup> Financial institutions operating in the EU employ self-help approaches, like the self-supply of services they might otherwise purchase, in order to reduce the non-creditable tax on their business inputs. Exported financial services are zero-rated, so the VAT does not prevent the EU financial institutions from competing effectively with banks outside the EU. In several EU countries, banks can elect to treat supplies of financial services as taxable. That election could reduce the cascade effect in BTB transactions, but it is not widely used. One reason for its lack of use is that each Member States must authorize the election (few have), and the Member States set the rules governing its use.

The European Union requires unanimous approval for any change in the VAT rules. This approval requirement froze most of the rules governing financial services at 1977 levels. Even without the unanimity requirement, it is not clear that there would have been significant changes in the taxation of financial services. If the EU expanded the categories of taxable financial services, Member States might collect less VAT revenue from this sector. It is not known if the revenue actually would decline, in part because there is scant data on the current rate of recovery of input tax by EU financial

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<sup>35</sup> The Sixth Directive was updated as the VAT Directive -- Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ L 347/1.

<sup>36</sup> See, Study to Increase the Understanding of the Economic Effects of the VAT Exemption for Financial and Insurance Services Final Report to the European Commission, PWC, ¶¶62 & 88, (Nov. 2, 2006). See also, Kerrigan, "The Impact of VAT on financial services and insurances – the law of unintended consequences?" 4 *Frontiers in Finance and Economics* >> (2007).

<sup>37</sup> See, "VAT SURVEY: FINANCIAL SERVICES, Survey on the recovery of input VAT in the financial sector," Dec. 2006 (IBFD).

<sup>38</sup> See *supra*, sec. III. Countries have not been very successful in minimizing this incentive to purchase offshore by taxing the importer of these services under "reverse charge" rules. Edgar, *Alternatives to Exempt Treatment*, *supra* note 18, at 136.

institutions.<sup>39</sup> With expanded taxation of financial services, the bank's business customers could claim credit for the currently blocked input tax on their purchases of taxable financial services,<sup>40</sup> and the bank's business customers could recover tax paid on those services. Some of the lost revenue would be offset by increases in revenue from tax on services rendered to consumers.

Before discussing the European Commission's proposal to change the taxation of financial services, the following subsections examine how other countries tax these services. The dissatisfaction with the European exemption approach led other countries to question the wisdom of exempting most financial services and non-life insurance and to experiment with other approaches. As mentioned earlier, these experiments were undertaken without "any empirical evidence of the distortions in patterns of consumption and production that are conventionally attributed to exemption and are seen to necessitate the adoption of some type of reform alternatives."<sup>41</sup>

In some countries, the departures from the EU exemption approach were dramatic and transparent.<sup>42</sup> Some narrowed the scope of exempt financial services, while others reduced or eliminated the blocked input tax attributable to exempt financial services rendered to businesses, and some did both. This "unblocking" of the bank's input tax in BTB transactions reduced the bank's incentive to supply services in-house (self-supply) and reduced the competitive distortions between domestic and foreign suppliers of services to banks.

## 2. Canada

A Canadian White Paper on Sales Tax Reform recommended that financial services, including financial intermediation services, be taxed under a proposed sales-subtraction method GST. The taxable value of the financial intermediation services was to be the difference between listed financial receipts and the cost of funds.<sup>43</sup> The Canadian Goods and Services Tax, as enacted, is a credit-invoice tax, not a subtraction method tax. It basically follows the European pattern of exempting financial intermediation services, but it taxes an extensive list of fee-based services.<sup>44</sup> As will be discussed later, South Africa went somewhat further in taxing fee-based services. Canada has an atypical

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<sup>39</sup> Kerrigan, *Elusiveness of Neutrality*, *supra* note 4, at >>.

<sup>40</sup> Under domestic VAT law, allowable under the EC harmonization rules, Belgium, France, Germany, Estonia, and Lithuania permit financial institutions to elect to treat financial services as taxable. The rules are not uniform in the three countries.

<sup>41</sup> See, Edgar, *Alternatives to Exempt Treatment*, *supra* note 18, at 132-133.

<sup>42</sup> See, for example, the Argentina approach. Argentina started taxing gross interest as a measure to control inflation, and then exempted interest that politically could not be taxed and taxed some interest at half the rate on most interest. The treatment of interest continues to change.

<sup>43</sup> Tax Reform 1987: Sales Tax Reform 130 (June 18, 1987). Purchasers of financial services were denied credit for any GST embedded in the bank charges, resulting in a cascade effect.

<sup>44</sup> See Technical Information Bulletin B-060, *Listing of Taxable, Exempt and Zero-rated Products and Services of a Deposit-Taking Financial Institution* (August 1991).

provision that expands the exemption upstream to supplies to a financial institution by a related company.<sup>45</sup>

Canada zero-rates exported financial services, presumably mostly in BTB transactions. There remains some cascading in BTB transactions and also some of the other distortions created by exempting financial intermediation services and other exempt financial services.

### 3. New Zealand, South Africa, and Other Approaches

The New Zealand, South Africa, and other approaches to the taxation of financial services either reduce the scope of the exemption or unblock more input tax attributable to BTB transactions. They took one or more of the following approaches:

- a. expanded the kinds of financial services that are taxable,
- b. zero-rated rather than exempted BTB financial services, and/or
- c. granted credit for input VAT on some purchases used in rendering exempt services.

#### a. New Zealand

New Zealand introduced its GST<sup>46</sup> in 1986, and after exempting many financial services for over 15 years, it made major changes, effective in 2005. Like the rule in most other countries, New Zealand disallows tax on business inputs used in rendering exempt services.<sup>47</sup> A New Zealand<sup>48</sup> financial institution, however, can *elect* to treat a defined list of exempt financial services as taxable supplies for purposes of the input credit rules. By exempting these services (no tax on the sales) and granting input credits for tax on purchases related to those services, New Zealand effectively zero-rates those BTB financial services. To qualify, the services must be rendered to GST-registered customers whose taxable supplies account for at least 75 percent of their total supplies.<sup>49</sup> Supplies

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<sup>45</sup> See, R.S.C. 1985, c. E-15, Excise Tax Act, Part IX: Goods and Services Tax Act, §150. Subsection (1) provides: “For the purposes of this Part, where at any time a person who is a member of a closely related group of which a listed financial institution is a member files an election made jointly by the person and a corporation that is also a member of the group at that time, every supply between the person and the corporation of property by way of lease, licence or similar arrangement or of a service that is made at a time when the election is in effect and that would, but for this subsection, be a taxable supply is deemed to be a supply of a financial service.” This rule may have the effect of “unblocking” input tax attributable to exempt services to consumers that would be blocked in other countries.

<sup>46</sup> New Zealand Goods and Services Tax Act 1985, No. 141 [hereinafter NZ GST].

<sup>47</sup> New Zealand has a somewhat unusual rule that grants full input credit if an input is used for the principal purpose (more than 50%) of making taxable supplies, and denies credit, in full, if an input is not used for the principal purpose of making taxable supplies. There are change-in-use rules to adjust credits claimed or not claimed. See *id.*, at §3A(1)(a).

<sup>48</sup> For a more detailed explanation of New Zealand’s new treatment of financial services, see Schenk & Oldman, *supra* note5, at 331-333.

<sup>49</sup> The Inland Revenue provides some guidance on how a financial service provider can determine that its services qualify for this elective zero rating. See, “GST guidelines for working with the new zero-rating rules,” Inland Revenue Department, Oct. 2004, ¶¶ 37-39. In lieu of the transaction-by-transaction test, the service provider can apply to Inland Revenue to approve an alternative method if it “produces as fair and

by financial institutions to other financial institutions can also qualify for this zero-rating treatment if the purchasing bank meets the 75% test. The same defined list of services, if rendered to consumers and non-qualified businesses, remain exempt. The financial institution therefore is denied credit for input tax attributable to BTC services.

To offset the previous bias that encouraged banks rendering exempt financial services to import services free of GST rather than buy them domestically with GST added, New Zealand taxes (with a reverse charge rule) services imported by recipients who cannot claim credit for tax on such purchases if made domestically.<sup>50</sup>

The net effect of the New Zealand reforms is to effectively zero-rate the elected BTB financial services (each customer must be a qualifying business), and exempt other BTB and BTC services defined as financial services. The reverse charge rule prevents financial institutions rendering exempt financial services from outsourcing their services abroad in order to avoid the blocked input tax on domestic purchases of the same services.

## **b. South Africa**

South Africa enacted its VAT in 1991<sup>51</sup> and initially exempted most domestic financial services and zero-rated exported financial services. Starting in 1996, it dramatically expanded the scope of taxable financial services to include explicit charges for all fee-based financial services rendered domestically.<sup>52</sup>

The South African Revenue Service (SARS) worked with the banking industry to agree on the tax status of a list of banking services. The document agreed to by both parties in 1996,<sup>53</sup> and updated most recently as of March 1, 2006,<sup>54</sup> classifies each of the listed services as taxable, zero-rated, or exempt from VAT.<sup>55</sup> This approach added certainty both for SARS and the banks.

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reasonable a result as identifying eligible customers on a transaction-by-transaction basis would.” *Id.* at ¶10.

<sup>50</sup> See, in general, Pallot, “GST and Financial Services – Rating Zero-rating,” in R. KREVER & D. WHITE, ED’S., *GST IN RETROSPECT AND PROSPECT* 163 (Brookers 2007).

<sup>51</sup> Value-Added Tax Act No. 89 of 1991 (South Africa) [hereinafter RSA VAT].

<sup>52</sup> A couple of countries bordering South Africa, Namibia and Botswana, followed the South African lead and tax fee-based financial services. See, for example, Value Added Tax Act, ch. 50:03, Second Schedule, ¶ 3 (Botswana).

<sup>53</sup> Value-Added Tax: Banking Services Provided and Fees Which May be Charged in Connection With Such Services, as prepared by the Council of South African Bankers and approved by the Commissioner for Inland Revenue, effective 1 October, 1996.

<sup>54</sup> Banking Services Provided and Fees Which May be Charged in Connection With Such Services, prepared by The Indirect Tax Standing Committee of The Banking Association South Africa, and approved by The South African Revenue Service, revised and agreed 2 Mar. 2006, effective date 1 March 2006. The document is almost 50 pages long. Any such document issued in the future will have the status of a binding class ruling under RSA VAT, *supra* note 51, at §41B.

<sup>55</sup> *Id.* This document classified services in eight different categories: general banking services, card services, treasury services, credit and lending services, motor and other asset finance, securities services, other services, and international services.

Even after the 1996 agreement on the tax status of various banking services, the banks and SARS continued to have disputes over the appropriate allocation of input tax between taxable and exempt supplies. In 2003, SARS, in an effort to reduce the areas of dispute, developed a standardized method of apportioning tax on business inputs between taxable and exempt banking services.<sup>56</sup>

In the absence of published data on the percentage of total input tax claimed by financial institutions operating in South Africa, it is difficult to determine if banks are being overly aggressive in claiming credit for input VAT attributable to taxable (including zero-rated) financial services. Have banks in South Africa repackaged their banking services in order to take advantage of the differences in treatment between taxable explicit fees and exempt financial intermediation services? In other words, do banks subject to the South African VAT charge fees on services rendered to business customers in order to recover tax on business inputs attributable to those services, and to enable its business customers to recover VAT on their purchased bank services? Likewise, do banks subject to the South African VAT bury charges for services rendered to borrowers in higher interest rates charged on consumer loans and services rendered to depositors (who are consumers) in lower interest rates paid on deposits in order to avoid charging VAT on the value of those services? There is no empirical data to answer these questions. There also does not appear to be any anecdotal evidence in South Africa or elsewhere that the banks have altered the pricing structure for these banking services to benefit VAT-wise.<sup>57</sup> In fact, to the contrary, the South African Competition Committee (anti-trust committee) reported in 2008 that banks conspired to charge, by international standards, high explicit fees for many banking services, especially services obtained from ATM machines.

### **c. Other Approaches to Reduce Blocked Input VAT**

The Singapore and Australia GSTs unblock a financial institution's tax on business inputs used in rendering financial services. Singapore, in effect, zero-rates some financial services that otherwise are GST-exempt if the services are rendered to businesses subject to GST.<sup>58</sup> Singapore also taxes some fee-based services, including many agency services more commonly exempt in the EU.

Australia substantially narrowed the definition of financial services, whether the services are rendered in BTB or BTC transactions, so more financial services exempt elsewhere are taxable in Australia.<sup>59</sup> The exemption "is limited to principal-to-principal financial transactions such as the borrowing and lending of money and the buying and selling of shares. It does not extend to arranging, broking or facilitating

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<sup>56</sup> See Practice Note, "VAT Apportionment Method for Financial Services Industry," (South Africa 2003). Satya Poddar proposed a method for a financial institution or insurance company to measure revenue for purposes of allocating input tax between taxable and exempt services. Poddar, *Workable Compromise*, *supra* note 12, at 198-203.

<sup>57</sup> See, Poddar, *Workable Compromise*, *supra* note 12, at 189, discussing the service tax in India.

<sup>58</sup> There are two methods to calculate allowable input tax credits attributable to exempt financial services. Goods and Services Tax (General) Regulations, (rg 1) Part V, Reg. 33, subject to regulations 34 and 35.

<sup>59</sup> A New Tax System (Goods and Services Tax) Act 1999, §40-5 (Australia).

services...”<sup>60</sup> Australia therefore taxes more financial services, including fee-based financial services, than are taxed under most other VATs. There is a de minimis rule that exempts financial services rendered for fees below a low threshold amount.<sup>61</sup>

The Australian GST contains rules that reduce some otherwise-blocked input tax attributable to exempt financial services. A GST-registered person who renders only a limited amount of exempt financial services can claim credit for all input tax on purchases attributable to those exempt financial services if the tax on those purchases comes under the “financial acquisition threshold.”<sup>62</sup> A person not eligible for this full input credit may still qualify for the following benefit.

To offset a GST-registered financial institution’s incentive to self-supply some services in order to reduce the level of blocked input tax on purchases related to exempt services, the Australian GST grants these institutions credit for 75 percent of the tax on business inputs that qualify as “reduced credit acquisitions.”<sup>63</sup> For example, if a bank purchased its bank forms and stationery from an outside supplier (instead of setting up its own print shop) and paid 10,000 GST on the purchase, the bank can claim credit for 75 percent of the 10,000 GST that the outside supplier charges for the forms and stationery, or 7,500.

It is not clear that the Australian approach has reduced the administration and compliance costs associated with the taxation of financial services. Instead of disputes over the dividing line between taxable and exempt financial services, under the Australian approach, there are disputes over the kinds of acquisitions that qualify or do not qualify for the 75 percent credit as “reduced credit acquisitions.”<sup>64</sup>

Financial service and insurance sector businesses in the EU do not favor the Australian and Singapore approaches to input tax deductions. In response to a consultation, most thought that these approaches, which used fixed or common recovery percentages, “would bring more disadvantages than advantages” because businesses in the EU were too diverse.<sup>65</sup>

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<sup>60</sup> Stitt, comment, “Financial Supplies and Reduced Input Tax Credits – An Australian Perspective,” in R. KREVER & D. WHITE, ED’S., *GST IN RETROSPECT AND PROSPECT* [hereinafter Stitt, *Australian GST*], 206 (Brookers 2007). It does not include “arranging type” services commonly exempt under other VAT systems. See, *A New Tax System (Goods and Services Tax) Regulations 1999*, Reg. 40-5.09 [hereinafter *Australia GST Regulations*].

<sup>61</sup> *Australia GST Regulations*, *supra* note 60, at Reg. 40-5.09(4). The threshold amount is AUD1,000.

<sup>62</sup> *Goods and Services Tax Ruling 2002/2*, *Goods and services tax: GST treatment of financial supplies and related supplies and acquisitions*, ¶3. To qualify, the total input GST attributable to those exempt financial services cannot exceed AUD50,000, or exceed 10 percent of its input credits otherwise available. *Id.* at ¶4.

<sup>63</sup> See, *Australia GST Regulations*, *supra* note 60, at Reg. 70-5.03. An impetus for this acquisition deduction is to remove the competitive inequities between large and smaller financial institutions. The reason is that with exemption treatment, large banks can insource some services, such as mortgage valuations services, but credit unions and other smaller financial institutions are not in a position to provide these services in house. Stitt, *Australia GST*, *supra* note 60, at 208.

<sup>64</sup> See Stitt, *Australia GST*, *supra* note 60, at 210.

<sup>65</sup> See, the European Commission’s summary of the results of a public consultation ([http://ec.europa.eu/taxation\\_customs/commo/consultations/tax/article\\_2447\\_en.htm](http://ec.europa.eu/taxation_customs/commo/consultations/tax/article_2447_en.htm)) on the modernization

#### 4. Europe Revisits Taxation of Financial Services

The Council of the European Union recognized that the VAT exemption for financial and insurance services under the VAT Directive was out of date. It decided to examine the impact of the rules governing these services on the EU firms providing those services.<sup>66</sup> Over the years, the national courts in Member States developed their own and somewhat diverse interpretations of the exemption for financial services under the VAT Directive, and the European Court of Justice (ECJ) increasingly was faced with disputes over the scope of that exemption.<sup>67</sup> In addition, the Commission was concerned that the current rules encouraged local firms rendering exempt financial services to purchase some of their business inputs outside the EU to the competitive disadvantage of local EU firms<sup>68</sup> or to move some of their operations to financial centers outside the EU.

In early 2008, after a lengthy study and public consultation process, the European Commission (EC) issued a Proposal for a Directive<sup>69</sup> and Proposal for a Council Regulation<sup>70</sup> designed to update the rules on the taxation of financial services and

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of the taxation of financial and insurance services under the EU VAT:

[http://ec.europa.eu/taxation\\_customs/resources/documents/common/consultations/tax/rep\\_financial\\_insurance\\_services\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/common/consultations/tax/rep_financial_insurance_services_en.pdf) [hereinafter Summary of Results of Consultation], at *Limited input tax deduction*. The major difference noted was a difference in labor costs among business sectors.

<sup>66</sup> See, for example, in a major study the EC commissioned Ernst & Young to undertake 10 pilot studies to tax intermediation services and allocate the input tax among business users of the services. See, [http://europa.eu.int/comm/taxation\\_customs/publications/reports\\_studies/taxation/tca/TCA.system.htm](http://europa.eu.int/comm/taxation_customs/publications/reports_studies/taxation/tca/TCA.system.htm).

<sup>67</sup> For example, the explanatory memorandum to the Proposal for the Council Directive states that the directive “clarifies that the exemption covers the supply of any constituent element of an insurance or financial services, which constitutes a distinct whole and has the specific and essential character of the exempt service concerned.” Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax, as regards the treatment of insurance and financial services [hereinafter Proposal for a Council Directive], COM/2007/747 final (Nov. 28, 2007). The Proposal, as finally adopted, must be implemented by the Member States. There are cases in domestic courts and in the ECJ involving this issue. See, for example, the U.K. case, *Customs and Excise Commissioners v. FDR Ltd.*, [2000] STC 672 (Ct. App. U.K.). For an explanation of a directive in the EU, see *supra* note 34.

<sup>68</sup> If the outsourced services could be classified as components of exempt financial services, the import of those services would be exempt as well and therefore could not be taxed under a reverse charge rule.

<sup>69</sup> Proposal for a Council Directive, *supra* note 67. Generally, a Directive takes effect when Member States enact implementing legislation.

<sup>70</sup> Proposal for a Council Regulation laying down implementing measures for Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, as regards the treatment of insurance and financial services, COM/2007/746 final (Nov. 28, 2007). The regulations are designed to increase legal certainty and reduce the administrative burden for operators and administrations. The regulations provide examples of services that come within and those that do not come within the exemption. For example, mortgage loans constitute the “granting of credit,” but an installment sale agreement relating to a supply of goods or the provision of debit card services is not the “granting of credit.” In the EU, a Regulation “shall have general application. It shall be binding in its entirety and directly applicable in all Member States.” Consolidated Version of the Treaty Establishing the European Community, Official Journal C 325 , 24 December 2002, Art. 249.

insurance services rendered by the “economic operators;” that is, by the insurance companies and financial service providers.<sup>71</sup>

This EC “modernization” proposal is designed to provide uniform and more precise guidance on the scope of the exemption,<sup>72</sup> using objective economic criteria. Currently, the Member States have the authority to decide whether, and under what conditions, a financial institution or insurance company can elect to treat its exempt services as taxable. The Proposal radically changes this “option to tax.” If adopted and enacted into domestic law, it will be the financial institution or insurance company operating in a Member State that can make this election.<sup>73</sup> By allowing the supplier of exempt services to make the election, the Proposal gives the supplier the power to decide that financial services are going to be taxable and that otherwise blocked input tax is recoverable. The decisions by the operators presumably will be based in part on a comparison of the cost to comply with the election procedure and the benefits to itself and its customers of the “tax” election.

There are other changes to VAT made in the Proposal, principally to deal with transfers of services that are exempt if rendered within a group of taxable persons within the EU.<sup>74</sup> It does not appear to change the exempt treatment of BTC and many BTB financial intermediation services and other financial services that are not taxable services under the EU VAT Directive. Exports of financial services remain zero-rated, as before.

While the total global value of the intermediation services rendered by a financial institution can be calculated, no method acceptable within the EU or by any other government and industry group has been devised to calculate the value of the services rendered to each depositor and borrower on a transaction-by-transaction basis, so that it could be applied under a credit-invoice VAT described in this paper. However, it has been suggested that data can be obtained from current information reporting, sufficient to calculate and then allocate the margin on financial services rendered in BTB transactions for VAT purposes.<sup>75</sup>

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<sup>71</sup> The Directive modifies the definition of the exempt services and, consistent with some decisions of the ECJ, applies the exemption to some discrete outsourced elements of the business of financial institutions, described as “the supply of any constituent element of an insurance or financial service, which constitutes a distinct whole and has the specific and essential character of the exempt service.” Proposal for a Council Directive, *supra* note 67, Art. 1, amending Art. 135, by inserting new ¶ 1a.

<sup>72</sup> The exemption in some Member States is based on an interpretation of the terms, such as insurance, on national private law concepts. Proposal for a Council Directive, *supra* note 67, at Explanatory Memorandum, section 1 on Grounds for and objectives of the proposal. With respect to insurance, the Proposal, as amended, covers intermediation transactions.

<sup>73</sup> The proposal will also allow economic operators to join as a group, without adverse VAT consequences, in buying investments that they then re-distribute to their members. The re-distribution is an exempt transaction under the proposal, even if it occurs as part of a cross-border pooling arrangement *Id.*

<sup>74</sup> Proposal for a Council Directive, *supra* note 67, at proposed new Art. 137b.

<sup>75</sup> Andrew Kerrigan suggested that, within the EU, with current information reporting, it is possible to calculate “the total taxable base for VAT purposes... from the sources used in the statutory income statement of a financial institution,” and with many adjustments, it is possible to “compute the taxable margin for VAT purposes” and then allocate that margin to individual business-to-business transactions. Kerrigan, *Elusiveness of Neutrality*, *supra* note 4, at >>>. Kerrigan suggests that some of the proposed methods may provide reasonably accurate results.

## C. Insurance

As discussed earlier, the intermediation services rendered by insurance providers to consumers belongs in a consumption tax base,<sup>76</sup> and exempting these services makes the VAT less neutral. Concerns about the ability to tax these services under a credit-invoice VAT and traditions of taxing these services under “in lieu” taxes led countries with early VATs to include insurance within the definition of a financial service that is exempt from VAT.

### 1. Life Insurance

The premium on a whole life insurance policy is exempt under most VATs on the theory that a significant portion of the premium represents savings and savings does not belong in a consumption-based tax. Israel is the exception, and Israel taxes insurance under a tax administered by the income tax department. The intermediation services associated with a whole life policy has not been carved-out for taxable treatment under other VAT regimes. In theory, it resembles the service rendered by a broker to an investor who purchases or sells stock or other securities.

### 2. Non-Life Insurance

Most VAT regimes exempt non-life insurance products, such as health, property, casualty, and other risk-based insurance as part of the definition of financial services exempt from VAT. Israel taxes an insurance company’s wages and profits under a tax administered outside the VAT system, and these companies also must bear the Israeli VAT on their business inputs, effectively taxing most of the insurance premiums.<sup>77</sup>

For countries that exempt the intermediation services associated with non-life insurance in BTB transactions, there is over-taxation (cascading of tax) of those business inputs. The exemption of non-life insurance services in BTC transactions under-taxes the services because the value of the insurance company’s intermediation services is not taxed.

New Zealand, Australia, and others now tax non-life insurance under their VATs. New Zealand was the innovator. After consultation with the non-life insurance industry and the accounting profession, New Zealand imposed GST on gross premiums charged on covered non-life insurance policies, both in BTB and BTC transactions. The insurer can claim credit both for input VAT on purchases attributable to taxable insurance and for the VAT component in the claims that it pays.<sup>78</sup> As a result, there is no cascading of tax in those BTB transactions. The tax is neutral with respect to consumer choices, and the government receives net revenue from the value of these services rendered to

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<sup>76</sup> See *supra* sec. II(5).

<sup>77</sup> See, Gliksberg, “Israel’s Value Added Tax Law,” *Intl VAT Monitor*, July 1992.

<sup>78</sup> NZ GST, *supra* note 46, at §20(3)(d).

consumers. South Africa followed New Zealand's lead.<sup>79</sup> So did Australia<sup>80</sup> and Singapore.

Some commentators and an industry group recommended that insurance sold to business should be zero-rated.<sup>81</sup> Zero-rating, even if it does not reduce net revenue from those transactions, reduces the neutrality of the VAT.

## **VI. Treatment of Financial and Insurance Services Under U.S. Congressional Proposals For a Federal Tax on Consumption**

Starting with the first post-World War II proposal for a federal value added tax by House Ways and Means Chair Al Ullman (1979 & 1980),<sup>82</sup> there have been a series of congressional proposals for a broad-based tax on consumption relying on a variety of methods to calculate tax liability and called by a variety of names -- a VAT, a Business Activities Tax, a Flat Tax, a National Retail Sales Tax, a USA Tax System, and several others. They either exempt financial services (including insurance) or tax those services, or provide for a combination of the two, and most of the proposals that tax services represented by a margin (intermediation services) do not include rules to determine how to calculate the amount subject to tax, or how to allocate tax on individual transactions so that the business user can recover that tax. This section covers a variety of these proposals.

Congressman Ullman's proposal for a European-style, credit-invoice VAT exempted financial intermediation services, but called for the taxation of intermediation services by insurance companies. The proposed tax base for insurance companies was the excess of insurance premiums over the actuarial cost to the insurer of providing that coverage. Congressman Dingell proposed a VAT that followed the Ullman approach.<sup>83</sup>

Senator Hollings proposed a European-style VAT that relied on the American Bar Association Section of Taxation Committee on Value Added Tax's Model VAT Act. That model provided for the taxation of financial intermediation services, but left to others the task of determining how to calculate the amount subject to tax.<sup>84</sup>

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<sup>79</sup> RSA VAT, *supra* note 51, at § 2(1)(i), treating only long-term insurance (whole life) as a financial service exempt under §12.

<sup>80</sup> See, [www.ato.gov.au/content/downloads/n3427.pdf](http://www.ato.gov.au/content/downloads/n3427.pdf)

<sup>81</sup> See Schenk Critique, *supra* note 12, at 840, discussing the claim that property and casualty insurance and group health insurance sold to businesses should be zero-rated (or alternatively should be taxable at a positive rate) and property and casualty insurance sold to consumers should be exempt from VAT.

<sup>82</sup> See, H.R. 7015, 96<sup>th</sup> Cong., 2d Sess., 126 Cong. Rec. 7481 (1980). Congress considered but did not enact a federal retail sales tax to finance World War II. See, "Considerations Respecting a Federal Retail Sales Tax," Treas. Dept., Div. of Tax Research, Oct. 12, 1943. A VAT was rejected by a task force appointed by President Nixon in 1969. See "Business Taxation: The Report of the President's Task Force on Business Taxation," Sept. 1970.

<sup>83</sup> H.R. 15, National Health Insurance Act, 109th Cong., 1<sup>st</sup> Sess. (Jan. 5, 2005), is the most recent of a series of like bills he introduced since 1993.

<sup>84</sup> ABA Model VAT, *supra* note 17.

The Danforth-Boren Business Activities Tax (BAT),<sup>85</sup> a sales-subtraction VAT that taxed financial intermediation services (including insurance), allowed intermediaries to deduct business inputs used in rendering these taxable services. To prevent the cascading of the BAT, the proposal required intermediaries to report to business customers, within 45 days after their tax period ended, the implicit charge for the intermediation services that were included in finance charges.<sup>86</sup> Business users then could take that charge into account in calculating their net BAT liability.

Senator Shelby's Flat Tax<sup>87</sup> proposal was an origin principle VAT with two separate tax components. The business portion of the tax was a tax on business activity. Contrary to classic VATs, the Flat Tax granted a deduction for compensation paid. The compensation portion of a firm's value added was taxed to wage earners under the individual income tax portion of the Flat Tax. The Shelby bill taxed financial intermediation services rendered by financial institutions as part of the business activity tax,<sup>88</sup> but it did not provide any detailed guidance on how that part of the tax base was to be calculated.

The Unlimited Savings Allowance (USA) Tax, originally a product of the Strengthening of America Commission, was introduced by Senators Nunn and Dominici.<sup>89</sup> The proposal that preceded the bill explained the need to measure the value of "financial intermediation services in different lines of financial services." It also explored the possible formulae that could be used to measure that value.<sup>90</sup>

At least one national retail sales tax bill, the Chambliss Fair Tax,<sup>91</sup> taxed explicit and implicit charges for financial intermediation services under a complicated formula that appears to have been patterned after the Poddar/English cash flow approach, discussed in the next section. As discussed by Schenk and Oldman:

"Implicit charges for financial intermediation include the gross imputed amount in relation to any underlying interest-bearing investment accounts or debts.<sup>92</sup> The gross imputed amount on an interest-bearing investment or account (such as a bank deposit) is the account balance multiplied by the excess of the applicable interest rate<sup>93</sup> over the rate paid on the investment.<sup>94</sup> The gross imputed amount on interest bearing debt (such as a

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<sup>85</sup> The Comprehensive Tax Restructuring and Simplification Act of 1994, 140 Cong. Rec. S 6527.

<sup>86</sup> *Id.* at §10034(d).

<sup>87</sup> S.1040, Tax Simplification Act of 2003, 108<sup>th</sup> Cong., 1<sup>st</sup> Sess. (May 12, 2003).

<sup>88</sup> *Id.* at §102(a).

<sup>89</sup> S.722, USA Tax Act of 1995, 104<sup>th</sup> Cong., 1<sup>st</sup> Sess., 141 Cong. Rec. S.5664 (Apr. 24, 1995).

<sup>90</sup> See USA Tax System: Description and Explanation of the Unlimited Savings Allowance Income Tax System, 66 Tax Notes 1485, 1548 et seq..

<sup>91</sup> See Senator Chambliss's Fair Tax Act, S.25, The Fair Tax Act of 2005, 109<sup>th</sup> Cong., 1<sup>st</sup> Sess., Jan. 24, 2005 [hereinafter Chambliss Fair Tax].

<sup>92</sup> [Chambliss Fair Tax, *supra* note 91,] at §801(3)(a).

<sup>93</sup> *Id.* at §512(a).

<sup>94</sup> *Id.* at §801(a)(3)(B)(i).

bank loan) is the debt balance multiplied by the excess (if any) of the interest rate on the debt over the applicable interest rate.<sup>95</sup>

The Chambliss bill requires financial intermediaries to calculate and collect tax on financial intermediation services only when the financial institution issues statements on the investment account or debt, but at least quarterly.<sup>96</sup> Special place of supply rules are provided to determine if the financial intermediation services are provided within or without the United States.<sup>97</sup> Special rules also are provided to separate the principal and interest components of a financing lease.<sup>98,99</sup>

## VII. Other Proposals to Tax Intermediation Services

Two cash flow methods have been proposed to value financial intermediation services for VAT purposes. They are –

- (a) the Poddar/English Truncated Tax Calculation Account (TCA), adapted from an earlier TCA system, and
- (b) the Zee modified reverse-charging proposal.

The Poddar/English method has been field tested, but neither proposal has been adopted by any country. The Truncated TCA is a suspension system that measures the value of margin transactions of financial institutions by taking account of the cash inflows and outflows. 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 as the benchmark. It is proposed that a short term inter-bank rate (either 1-month or 3-month rate) be used for the indexing rate.”<sup>100</sup>

Howell Zee proposed a modified reverse charge method of taxing intermediation services,<sup>101</sup> and allocating the tax on loans to borrowers on a transaction-by-transaction basis. At the risk of oversimplifying an intricate system, a bank issues a “virtual” VAT

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<sup>95</sup> *Id.* at §801(a)(3)(B)(ii).

<sup>96</sup> *Id.* at §803.

<sup>97</sup> *Id.* at §806(a). The services are deemed to be used or consumed in the United States if the person (or related party) purchasing the services is a resident of the U.S. A related party is any affiliated firm (§205(e)). Such a firm exists when “1 firm owns 50 percent or more of the voting shares in a corporation or the capital interests of a business that is not a corporation.” *Id.* at §2(a)(1).

<sup>98</sup> *Id.* at §804(c).

<sup>99</sup> Schenk & Oldman, *supra* note 5, at 455-456.

<sup>100</sup> [http://europa.eu/int/comm/taxation\\_cusoms/publications/reports\\_studies/taxaton/tca/TCA.system.htm](http://europa.eu/int/comm/taxation_cusoms/publications/reports_studies/taxaton/tca/TCA.system.htm), at Executive Summary.

<sup>101</sup> See, Zee, *A New Approach to Taxing Financial Intermediation Services Under a Value-Added Tax*, 58 *Natl. Tax J.* 77 (Mar. 2005). For some other methods of taxing financial services that have not been adopted to date, see Gendron, *VAT Treatment of Financial Services: Assessment and Policy Proposals for Developing Countries*, *Bull. For Intl. Taxation*, Nov. 2008, 494, 499-501.

invoice to itself (reverse charge) to cover the interest the bank pays on its deposits.<sup>102</sup> The bank uses that input VAT as a credit, through a franking mechanism, against tax on loan interest, on a transaction-by-transaction basis. The net serves as the equivalent of the bank's output tax on those intermediation services. The bank will have to keep account of the tax on the intermediation service rendered to each borrower and notify business borrowers of the amount that they can claim as input VAT on that service, like the credit available on any of its other purchased inputs. Zee's system differs from the Poddaar/English method because it does not rely on principal amounts for deposits and loans.

In November, 2005, President Bush's Advisory Panel on Federal Tax Reform issued its report recommending that the U.S. federal tax system move closer to a consumption tax base. The recommended tax, the Growth and Investment Tax Plan (GITP), was "a progressive tax on labor income and a flat-rate tax on interest, dividends, and capital gains with a single-rate tax on business cash flow."<sup>103</sup> The GITP, described by the Panel as a tax that resembled a subtraction method VAT, but with a deduction for wages and other compensation,<sup>104</sup> anticipated the need for special rules governing financial service providers. The report included only a broad outline for such rules. The "financial institutions would treat all principal and interest inflows as taxable and deduct all principal and interest outflows."<sup>105</sup> Another tax, considered, but not recommended by the Panel, was a "Partial Replacement VAT," a broad-based credit-invoice VAT. The panel recommended that the taxation of financial services under this VAT be similar to that provided under the GITP.

There are alternatives to full taxation, zero-rating, or exemption for financial services. Supplies of financial services could be taxed at a lower than standard rate. Boadway and Keen claim that a lower than standard VAT rate is justified for financial services.<sup>106</sup>

## VII. Policy Choices for the Taxation of Financial Services and Insurance

As Richard Bird and Pierre-Pascal Gendron put it, "(n)o convincing conceptually correct *and* practical solution for capturing the bulk of financial services under the VAT has yet been developed."<sup>107</sup> The following policy choices are structured to maximize the taxation of financial and insurance services rendered to consumers in BTC transactions and to minimize exemptions in BTB transactions, taking into account the principle of neutrality, the desire to minimize the VAT administration and compliance costs, and the

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<sup>102</sup> How should the bank account for interest paid on its loans, such as inter-bank loans or loans from the Federal Reserve?

<sup>103</sup> The President's Advisory Panel on Federal Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System, Nov. 2005, p. 151.

<sup>104</sup> *Id.* at 162.

<sup>105</sup> *Id.* at 166. "Customers would disregard financial transactions for tax purposes." *Id.*

<sup>106</sup> Boadway & Keen, Theoretical Perspective on the Taxation of Capital Income and Financial Services, ch. 2, in P. HONOHAN, ED., TAXATION OF FINANCIAL INTERMEDIATION: THEORY AND PRACTICE FOR EMERGING ECONOMIES (World Bank 2003).

<sup>107</sup> Bird & Gendron, *supra* note 28. While the book is designed to provide guidance to developing and transitional countries, the authors' analysis applies to developed countries as well.

desire to minimize the economic distortions when there are exemptions in midstream BTB transactions. This analysis must take into account Tim Edgar’s conclusion that the economic distortions have not been subjected to systematic empirical study.

- Countries justify the exemption for financial services and insurance either because –
- (a) of the difficulty in taxing BTB transactions in a way that grants business users a recovery of the tax on a transaction-by-transaction basis; or
  - (b) of the history of imposing alternative taxes on these services (see France) as a surrogate for taxing them under the VAT.

The policy choices assume that the tax is a credit-invoice VAT, with a territorial reach based on the destination principle.<sup>108</sup> One goal, to tax financial and insurance services in BTC transactions, maximizes the neutrality of the tax with respect to consumer choices. Another goal, to tax BTB transactions and allow businesses to recover the input VAT, should minimize the cascading of tax, and should neither encourage financial service firms to vertically integrate their operations nor outsource their services to foreign suppliers.

Even if all financial and insurance services achieved the desired tax treatment when supplied domestically, the VAT law still needs safeguards to prevent foreign suppliers from selling those services to domestic consumers free of VAT to the competitive disadvantage of domestic suppliers of the same services.

This section discusses –

- (1) how to define the scope of the exemption for financial and insurance services,
- (2) how to reduce the cascading of tax in BTB transactions, and
- (3) how to reduce the incentive for financial institutions and insurers to outsource or self-supply services in order to avoid the unrecoverable VAT on domestic purchases used in rendering exempt services?

## **A. Scope of the Exemption**

### **1. Financial Services**

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<sup>108</sup> Unlike goods that physically cross the border and can be taxed upon entry, services commonly are intangible and are difficult to identify and tax. As a result, imported services generally are not taxed. The failure to tax imported services gives VAT-free imported services a competitive advantage over taxable services purchased domestically. The competitive advantage does not exist if the importer can claim credit for VAT paid on its business inputs. In that case, the importer of services pays the same after-tax price, whether it purchases the services domestically or from a foreign supplier. It is becoming more common for countries to impose tax on imported services under what is referred to as a “reverse charge” rule. The tax is imposed and must be reported and paid by the person receiving the service, not necessarily the person importing the service. Since it is not feasible to collect tax on imported services from individual consumers and the government would not receive any net VAT revenue if tax were imposed on importers that could claim credit for the tax on the import, the tax commonly is collected only from businesses, non-profits, governments, and others that cannot recover the VAT paid on those services.

One way to significantly reduce the cascading of tax and other distortions caused by exempting financial services is to narrow the scope of the exemption. Australia and South Africa seem to have gone further than other countries in exempting only a narrow range of financial services. Australia narrowly defines exempt “financial services.” Australia’s exemption applies mainly to principal-to-principal, not agency transactions.

South Africa taxes all (or almost all) fee-based financial services, but exempts intermediation services and other financial services buried in bank charges. Both countries zero-rate exports of financial services. Both approaches therefore tax at a positive rate a broad range of financial services in BTB and BTC transactions.

Under the Australian or South African approach, the exemption is limited mainly, but not exclusively, to margin transactions, including financial intermediation services rendered by banks, currency transactions, and several others. Even under this approach, there remains some non-neutrality -- some financial services rendered to consumers (and businesses) are exempt and some are taxable. While there is some cascading of tax in exempt BTB transactions, the cascading is less than under the EU exemption approach. There is no indication that the tax authorities and taxpayers in these countries are having any significant problems in administering and complying with these rules under credit-invoice VATs.

If, in addition to adopting the Australian or South African approach, or a combination of both, a U.S. VAT also taxed financial intermediation services, the resulting tax would be more neutral with respect to consumer choices and would result in less cascading in BTB transactions. No country, other than Israel, taxes financial intermediation services and Israel does so under a tax administered outside the Israeli VAT system. The proposals to tax financial intermediation services under a credit-invoice VAT are complex. If implemented under a U.S. VAT, there is no data to predict the effect that this pioneering effort would have on the international competitive position of banks in the United States.

The EU model is not an attractive choice. The EU’s VAT Directive that exempts a broad range of financial services in principal-to-principal and agency transactions has been adopted by most countries with a VAT. Even if a U.S. VAT were to add the “option to tax” under the European Commission’s Proposal for a Directive, the EU model still distorts consumer choices and results in the cascading of tax in BTB transactions not covered by the “option to tax” election.

Zero-rating domestic supplies of financial services will prevent multiple taxation of BTB financial services, and may make domestic suppliers of those services more competitive internationally. However, the uniform zero-rating of such services would under-tax those services rendered to consumers and would make the VAT system less neutral with respect to consumer choices.<sup>109</sup> Bird and Gendron acknowledge that zero-rating is simpler than exemption, but they list the following disadvantages of zero-rating:

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<sup>109</sup> The economic operators (the insurance companies and financial service providers) recognize that zero rating is inconsistent with the principle of neutrality and would create competitive distortions between

1. “(F)inal consumers are taken out of the VAT net.”
2. “(A)ll revenue from taxation of inputs under the exemption system is lost.”<sup>110</sup>

## **2. Insurance**

To be consistent with the principle of neutrality with respect to consumer choices, the VAT base should include intermediation services rendered by an insurer under a non-life policy. These services are taxed under the New Zealand GST. The taxation of these services is workable administratively, it produces a broader tax base, and it avoids the cascading of tax in BTB transactions that occur in countries that exempt these services.<sup>111</sup>

To be consistent with neutrality principles, the VAT base should include intermediation services rendered by an insurer under a life insurance policy (and comparable products). While these services do not appear to be taxed other than by Israel (where they are taxed under a tax administered by the Income Tax department), as discussed earlier, commentators have suggested that there is theoretical justification to tax these services. The savings portion of the policy should not be included in the tax base. Additional work is needed to consider the impact of being the only country to tax these services under a VAT.

To the extent necessary to prevent unfair competition from foreign insurers, imports of insurance services should be taxed under a reverse charge rule or foreign insurers should be brought within the VAT net as persons engaged in the insurance business in the United States. Exports of insurance services (taxable if supplied domestically) should be zero-rated.

### **B. Reduce Cascading From Exempt Financial and Insurance Services**

New Zealand, Singapore, and Australia have GST rules designed to reduce the cascading of GST in otherwise exempt BTB transactions.

New Zealand, in effect, zero-rates listed financial services rendered in BTB transactions by treating these services as taxable for purposes of the input tax credit rules. By retaining the exemption for these financial services, and granting credits for tax on business inputs used in rendering these services in BTB transactions, the services receive zero-rate treatment. New Zealand exempts (without input credit) the same financial services when rendered in BTC transactions. Singapore essentially does the same.

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financial service and insurance providers compared with businesses providing other goods and services. See, Summary of Results of Consultation, *supra* note 65.

<sup>110</sup> Bird & Gendron, *supra* note 28, at 102.

<sup>111</sup> Additional work is needed to determine the extent to which an insurance company’s net investment income must be included in its GST base in order to fully tax the value of intermediation services it renders, whether the GST is imposed not only on non-life insurance, but on life insurance and similar “savings” products.

Australia reduces the cascading of GST when some suppliers render exempt financial services. If a GST-registered person (not a bank or other financial institution) renders only a small amount of exempt financial services, the supplier receives full credit for tax on inputs used in rendering those exempt services. Australia also grants a financial service provider a credit for 75 percent of the tax paid on business inputs used in rendering exempt services to business customers (BTB transactions) if the business customers are in the business of making taxable sales.

Zero-rating BTB supplies of otherwise exempt financial services serves the beneficial economic effect of reducing the cascading of tax in BTB transactions. It also reduces revenue from otherwise blocked input VAT. On the other hand, it singles out an industry for special treatment. It provides cash flow advantages not available to other domestic BTB transactions, and may prompt requests to expand zero-rating for other domestic supplies which, if successful, may undermine the structure of the credit-invoice VAT. If all BTB transactions are zero-rated, we would have a single-stage retail sales tax.

### **C. Reduce Incentives to Outsource or Self-Supply Services**

The VAT rules should not distort competition by encouraging financial institutions and insurance companies rendering exempt services to self-supply or import services used in rendering those exempt services in order to avoid or reduce the non-recoverable VAT on domestic purchases of the same services.

The VAT should not encourage financial service and insurance companies to move their operations offshore in order to render their services back home, especially to business customers, free of VAT.

Where necessary to prevent or minimize the above distortions, financial institutions and insurers rendering exempt services should be taxed on imported services under a reverse charge rule and, to the extent administratively feasible, they should be taxed on services brought in-house. It is difficult to determine which services should be included within self-supply rules. The Australian approach discussed in (B) above (a credit for 75% of the tax on business inputs) discourages self-supply and outsourcing.

To the extent that the scope of exempt financial and insurance services is narrowed, a person's incentive to engage in this behavior is reduced.