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APPLICATION OF VAT TO FINANCIAL SERVICES

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Abstract: This study examines the application of VAT to the financial sectors and the implications of exempting financial services from VAT. An analysis of VAT collection from financial services and the consequences of VAT exemption from theoretical and practical points of view was conducted. The application of VAT to financial institutions is a very complex issue in the area of public finance. For various technical and practical reasons, financial services are generally exempt from VAT in most countries. The banking sector provides credit services and paid services to consumers. VAT exemption for financial services creates some distortions for banks and the real economy. Based on the results of the study, a conclusion was made on the application of VAT to financial services

Keywords: financial sector, financial services, banks, taxation, tax system, VAT, tax rate

Introduction

Today, most countries that have a value added tax (hereinafter referred to as VAT) exempt the financial sector from VAT to varying degrees. Due to the difficulties in determining the added value of most margin-based transactions, the financial sector has traditionally, and unlike most other sectors, been exempt from value added tax. In particular, Article 135(1) of the European Union (hereinafter referred to as the EU) VAT Directive does provide for a mandatory exemption from tax on most financial transactions involving credit, transfer, debt, etc. [1] Even if all financial services with a fixed fee are taxable, a significant part of the added value of the financial sector, especially the banking sector, whose added value consists mainly of the interest margin between lending and deposit activities, is exempt from tax. The question of how to tax the financial sector has been the subject of academic debate. The introduction of VAT on financial services provided for a fee, especially safe deposit boxes, has not been controversial, as there is consensus that they should be taxed [2]. However, there is no consensus on margin-based financial services. VAT is an indirect tax on the value added created at each stage of production. In most countries with a value-added tax (VAT) system, tax exemption is the standard way of taxing financial services. Under this approach, financial institutions can neither charge VAT on their sales nor receive input credits for VAT paid on input purchases. Thus, VAT is included in the price of the exempt financial services. As a result, the increase in the cost of financial services causes a number of distortions in the economy.

Literature review

The experience of applying VAT in the tax systems of various countries has shown its fiscal efficiency due to a number of its characteristics: it has a broad tax base, covering turnovers related to the sale of goods, works, services, property rights, including sales transactions, exchange transactions, gratuitous transfer, transfer of goods under a loan agreement in the form of things, transfer of a leased object by the lessor to the lessee, and others; it ensures automatic indexation of budget revenues depending on the inflation rate, since when determining the amount of VAT charged by the seller to the buyer of taxable goods, the cost of material resources and other expenses incurred by the manufacturer are included in the tax base; it ensures the uniformity of budget revenues, levied at each stage of the product's movement to the consumer and is characterized by a short reporting period; being relatively neutral for taxpayers due to its transfer to the end consumer as a result of pricing and its inclusion in the selling price, it reduces their desire to evade payment[3]. VAT taxation of financial services is one of the pressing problematic issues in the literature on public finance. The issues of taxation of financial services discussed in the scientific literature can be reduced to two main questions: "should financial services be subject to VAT?" and if financial services are taxed, "in what order should VAT be imposed on financial services?" [4,5]. However, in the conducted studies there is no single consensus on these two questions and no clear opinions on all other questions. The main argument against inclusion suggests that these types of services are not included in the consumer utility function and are thus considered a form of investment [6]. However, it is generally accepted in the literature that financial services are considered as taxable consumption [7]. According to Huizinga, EU financial services are exempt from VAT for technical reasons and that the exact taxable financial margin is unknown, since the cost of funds and risk premium data are difficult to calculate for each transaction. Thus, the added value due to interest margins, bid-ask spreads and insurance for each transaction is unknown [8].

However, in most countries, financial services are exempt from VAT due to the difficulties in calculating financial value added and the lack of a clear method of taxing financial services. Given the significant growth in the size of the financial sector in the last decade, exempting financial services from VAT reduces tax revenues and creates imbalances in the country’s economy [9]. Exempting financial services from VAT creates several distortions. First, financial institutions cannot deduct all input VAT on non-financial transactions and therefore try to add this amount to their prices and, consequently, to customers. This results in over-taxation of businesses but under-taxation of households. Second, it creates incentives for vertical integration to avoid non-recoverable input VAT. In addition, distinguishing between exempt and non-exempt transactions entails compliance costs and complicates taxation [10]. Over-taxation of businesses and under-taxation of final consumers will have a positive effect on the demand for financial services (resulting in lower interest rates on loans and credits for input VAT) and a negative effect on households (taxation will increase consumer prices) [8]. In addition, indirect taxation of financial services does not affect the size of the financial sector. Alternative options for taxing financial services with VAT have been discussed in various academic studies. In the specific case of the European Union, the VAT exemption could be abolished and replaced by taxation at a zero reduced or standard VAT rate. A direct consequence of the abolition of the exemption would be that the financial sector would be allowed to deduct input VAT. The application of the sales tax would also be relatively simple from a technical point of view. Also, the absence of VAT in the financial sector due to the complexity of calculating the value added for individual transactions has led to the proposal to introduce a financial activity tax (hereinafter – FAT). In essence, the NFS is a tax on the sum of the sector's profits (the definition of cash flow) and the wages it pays to its workforce. Indeed, the value added can be thought of as the sum of profits and remuneration, allowing what is difficult to tax at the transaction level to be taxed at the level of the aggregate firm. The NFS does not abolish the VAT exemption, but it does make taxation easier. Since input VAT is not deductible, a lower rate (possibly equivalent to a reduced VAT rate) is proposed [11]. Several approaches to taxing financial services have been developed, many of which have been tested in different countries. However, no method has gained widespread acceptance. Simple methods, such as zero rates or fixed-rate services, do not generate high tax revenues, while others, such as the full settlement method, lead to a lack of liquidity. The separate tax rate method with commission tax allows for almost complete taxation of financial value added and is a relatively simple and practical method and is fully compatible with the credit invoice method [9].

Methods

The article examines scientific literature and research in the field of VAT application to financial services and provides an overview of scientific literature. From theoretical and practical points of view, an analysis of VAT collection from financial services and the consequences of exemption from VAT of financial services is carried out. Such methods as scientific abstraction, analysis and synthesis, induction and deduction, descriptive statistics, monograph, expert assessment, comparative analysis were used

Result and Discussion

More than 170 countries worldwide, including all European countries, levy a value added tax (VAT) on goods and services. VAT rates in EU member states vary between countries, although they are harmonised to some extent by the EU. The EU countries with the highest standard VAT rates are Hungary (27 per cent), Croatia, Denmark and Sweden (all 25 per cent). The lowest standard VAT rate is set in Luxembourg at 16 per cent, followed by Malta (18 per cent), Cyprus, Germany and Romania (all 19 per cent). The average standard VAT rate in the EU is 21 per cent, six percentage points higher than the minimum standard VAT rate required by EU rules (Table 1).

Table 1. VAT rates of the Member States of the European Union and the United Kingdom, 01.01. 2023 [12]

Countries	Minimum rate, %	Reduced rate, %		Standard rate, %
Austria		10	13	20
Belgium		6	12	21
Bulgaria		9		20
Croatia		5	13	25
Cyprus		5	9	19
Czech Republic		10	15	21
Denmark				25
Estonia		9		20
Finland		10	14	24
France	2.1	5.5	10	20
Germany		7		19
Greece		6	13	24
Hungary		5	18	27
Ireland	4.8	9	13.5	23
Italy	4	5	10	22
Latvia		5	12	21
Lithuania		5	9	21
Luxembourg	3	7	13	16
Malta		5	7	18
Netherlands		9		21
Poland		5	8	23
Portugal		6	13	23
Romania		5	9	19
Slovakia		10		20
Slovenia		5	9.5	22
Spain	4	10		21
Sweden		6	12	25
United Kingdom		5		20

Under the EU VAT Directive, which was drawn up in 1991, some EU countries applied reduced, super-reduced or zero rates to goods and services that were not specified in the new rules as falling under the zero or reduced rate categories. To facilitate the transition to the standard rate for these goods and services, a so-called "parking tariff" was allowed. Although it was supposed to be gradually phased out, some countries still apply it. From April 2022, in order to ensure the principle of equal treatment, EU countries may apply two reduced rates, not lower than 5 percent, to a number of goods and services, a minimum rate below 5 percent.

Financial services in the EU are exempt from VAT, meaning that VAT is not charged on financial services provided by banks, meaning that VAT paid on expenses incurred will not be reimbursed. However, some fee-based services are exempt from this rule, and fees for safe deposit boxes, financial advisory services and exported financial services are subject to zero tax rates. In Canada, the principle of exemption of financial services from GST is similar to the principle of European countries. However, there is a list of fee-based financial services[13]. In order to limit inflationary pressure or reduce losses from the use of financial services, gross interest rates on loans in Argentina are taxed at different rates of VAT. Under this type of VAT, businesses are entitled to a credit. In South Africa, most fee-based financial services are subject to VAT at general or zero rates. However, marginal services are not taxed. In Singapore, financial services provided to taxpayers are taxed at zero percent, which in turn allows financial institutions to account for the VAT received.[14]

In accordance with the Tax Code of Uzbekistan, from January 1, 2023, the standard VAT rate is set at 12 percent. In addition, taxation is carried out at a zero rate upon sale[15]:

1) goods exported from the territory of the Republic of Uzbekistan under the customs procedure of export;

2) goods exported from the territory of the Republic of Uzbekistan previously placed under the customs procedure of processing in the customs territory of the Republic of Uzbekistan, and (or) goods (processed products, waste and (or) residues) obtained (formed) as a result of processing goods placed under the customs procedure of processing in the customs territory of the Republic of Uzbekistan;

3) supplies exported from the territory of the Republic of Uzbekistan. For the purposes of this article, supplies are recognized as fuel and lubricants necessary to ensure the normal operation of aircraft;

4) services directly related to the carriage or transportation of goods placed under the customs procedure of customs transit during the transportation of foreign goods from the customs authority at the place of arrival in the territory of the Republic of Uzbekistan to the customs authority at the place of departure from the territory of the Republic of Uzbekistan;

5) services directly related to international transportation.

Exempt from taxation Financial services such as banking, bank card, deposit and credit transactions, but according to the changes to the tax code, banking services whose cost is set at a fixed amount are subject to VAT in the general established manner. By fully deducting input VAT, it completely eliminates the cascading taxation of businesses and the incentives for integration caused by VAT. Applying financial VAT to business-to-business (B2B) and business-to-consumer (B2C) services at a rate greater than zero eliminates under-taxation of consumers and thus increases revenue. Taxation of B2B and B2C services also eliminates the distinction between taxable and exempt services [9]. There is probably no disagreement, at least in principle, regarding the taxation of B2B transactions. There is a clear consensus that these transactions should not be taxed and this can be achieved in two ways: taxation in the normal manner (at the standard VAT rate) or zero-rating for B2B transactions. These two methods are considered equivalent for B2B transactions. The findings are consistent with the literature that full taxation of credit services improves welfare. However, research has shown that the benefits of full taxation would be even greater if income taxes were adjusted in such a way that low-productivity firms were excluded from the market and capital was transferred to high-productivity firms [16]. According to Mirrlees, exempting financial services from VAT contradicts the principle of taxation, making it impossible for financial institutions to recover input VAT, thus breaking the chain [17]. This clearly violates the nature of an indirect tax, and the VAT exemption turns this tax into a direct tax on production. The consequences of exemption from VAT are illustrated by comparing the performance indicators of two business entities: a business entity exempt from VAT and a business entity that is a VAT payer at a rate of 12% (Table 2).

Table 2. Comparative analysis of financial indicators of companies in different conditions for VAT, in monetary units

	Indicators	When exempt from VAT	When applying VAT at a rate of 12%
1	Net sales revenue	1000	1000
2	VAT on sales	-	120
3	Production costs are indicated without VAT	472	472
4	Cost of purchase of goods and services without VAT	200	200
5	VAT is included in the price	24	-
6	Deductible VAT amount	-	24
7	Profit before tax (1 row–3 row–4 row–5 row)	304	328
8	Corporate Income tax (7 row x 15/100)*	45,6	49,2
9	Net profit (7 row –8 row)	258,4	278,8
10	Profitability (9 row /1 row x 100)	25,8	27,9
11	Tax burden (8 row – 6 row)/1 row x100)	4,6	2,5
12	VAT paid to the budget (2 row -6 row)	0,0	96

Source: prepared by the author in conventional figures.

A comparative analysis shows that the profit before tax of a business entity that is a VAT payer under the general established procedure amounted to 328 monetary units, the profit before tax of a business entity that is exempt from VAT amounted to 304 monetary units or less than 24 monetary units. Also, exemption from value added tax had a negative impact on the net profit and profitability of the business entity. In addition, it was found that a business entity that is considered a VAT payer has a low tax burden and high tax revenues to the budget.

The negative consequences of VAT exemption for financial services in commercial banks were examined by comparing the financial performance indicators of the commercial bank participating in the selection (Table 3). As can be seen from the comparative data in the table, taxpayers who are exempt from VAT have lower net profit than VAT payers, and, all other things being equal, the level of the tax burden remains high in relation to net profit. In addition, full accounting of recorded VAT, application of a zero tax rate to loans and a standard rate to paid services can lead to a decrease in loan interest rates, an increase in bank profitability and additional budget revenues.

Table 3. Comparative analysis of the bank's financial indicators in different conditions for VAT, million soums [18]

№	Indicators	Current status	In case of application of VAT at a zero interest rate on loans and at a rate of 15% on paid services.
1	Income, total	2373380,7	2373380,7
	including, paid services	161607,6	161607,6
2	VAT on sales	2665,4	24241,1
3	VAT resulting in expenses	3150,6	0,0
4	Deductible VAT amount	128,2	3278,8
5	Profit before taxes	280074,0	283224,6
6	Accrued corporate income tax *	60079,2	60709,3
7	Net profit *(5 row - 6 row)*	219994,8	222515,3
8	Profitability *(7 row /1 row x 100)*	9,3%	9,4%
9	Tax burden *(6 row -4 row)/1 row x 100)*	2,5%	2,4%
10	VAT paid to budget	2537,2	20962,3

Note: as of 01.07.2024 the ruble exchange rate is 147.37 sum. *the current 20% income tax rate is adopted.

Perhaps the biggest inequality is the incentive for financial institutions to reduce the non-deductible VAT for financial institutions in order to ensure vertical integration. In addition to the imbalances regarding the vertical integration of external suppliers, turning financial institutions into conglomerates can cause them to be “too big to fail”. This is because the costs of financial institutions are differentiated across the EU, and exemption from taxation can create other imbalances, meaning that higher costs for financial institutions reduce their competitiveness.[13] According to academic economists, three key distortions that should be exempted from taxation are: self-sufficiency bias in the banking sector; consumption distortions; cost distortions and tax cascades. In addition, moving from a preferential regime to full taxation of credit services increases welfare by about 4%.[15]

Banks pool labour and taxable deposits to provide financial services but can reclaim part of the VAT paid on the cost of acquiring them. The unrecovered part of the VAT is included in the cost of financial services provided to households and firms. It should be noted that large enterprises usually have the opportunity to use other convenient financing instruments, for example, to attract capital, many small and medium-sized firms mainly carry out their investments through financing through financial intermediaries, i.e. banks. This suggests that the increase in financing costs due to tax breaks reduces efficiency, hinders firms from entering the market and forces them out of the market.

The abolition of the financial services tax exemption will mean that consumers will be able to pay a tax of 12% on bank financial products and services (according to the current tax legislation) and allows reducing the cost of deducting VAT paid to banks. The abolition of the VAT exemption for financial services will reduce the pressure on banks and create a level playing field for them with other companies, while at the same time increasing government revenues. The only losers from the VAT exemption are consumers. This may also improve efficiency because excessive financial services are discouraged by consumers. Also, taxing marginal transactions (such as loans) at zero may reduce VAT revenues, but the loss of these revenues will be offset by increased profits before taxes and VAT paid on bank charges.

Conclusion

In general, the exemption of financial services from VAT is inconsistent with the principles of taxation and limits the ability of banks to account for the VAT received, which leads to a break in the chain. This leads to a violation of the essence of VAT, which means that the exemption from this tax will make this tax a direct tax on production. Today, most countries with a value added tax (VAT) exempt the financial sector from VAT to some extent. Due to the difficulties in determining the added value of most margin-based transactions, the financial sector has traditionally been exempt from value added tax, unlike most other sectors. Therefore, VAT taxation for financial institutions is a very complex issue in the field of public finance. The exemption from taxation creates some distortions for the financial sector and the real economy. According to the analysis, the abolition of the preferential regime and the transition to full taxation of credit services reduces the cost of entry into the production sector, stimulates the emergence of new firms and reduces capital costs for all firms.

Exemption of financial services from VAT leads to the following three main imbalances: dependence of the banking sector on satisfying its own needs; consumption disruption; disruption in the implementation of offsets and tax cascade. The amount of net profit received by taxpayers exempt from VAT, compared to VAT payers, is low, and, all other things being equal, the level of tax burden on net profit is high. In addition, full accounting of recorded VAT, application of a zero tax rate to loans and a standard rate to paid services can lead to a decrease in loan interest rates, an increase in bank profitability and additional budget revenues.

To determine tax rates (zero rate and standard rates) when introducing VAT, it is important to divide financial services into paid and marginal services. The application of VAT at a zero interest rate on loans and a standard rate on paid services will be of interest to developers and implementers of tax policy who want to increase budget revenues and improve the efficiency and neutrality of VAT.

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