The present and future VAT treatment of the financial sector

Financial Derivatives, the Borders of the Exemption

Charles-Albert Helleputte  
Partner  
+ 32 2 551 59 82  
chelleputte@mayerbrown.com

26 September 2017
Agenda

1. What are Financial Derivatives?
2. How are they Treated for VAT purposes?
3. Is there an Issue?, Do we need a reform?
What are Financial Derivatives?

• According to ISDA FAQ, a derivative is a risk transfer agreement, the value of which is derived from the value of an underlying asset

• The underlying asset could be an interest rate, a physical commodity, shares, equity index, currency or any other tradable instruments
What are Financial Derivatives?

- Typical forms: future, forward, options, swaps of all kinds (credit default, interest-rate, equity linked, etc.) Forex, weather, CfDs, etc.
- Cash settled or physical delivery.
- Could even be synthetic (in vacuum).
- Regulatory move from OTC (bilateral) to centrally cleared transactions. Collateral impacts.
What are Financial Derivatives?

• Back in times, commodity derivatives:
  – Opening of the Antwerp exchange (1515) with contract for future delivery (under the form of bill of exchange).
  – Structured as options related to delivery dates and quality at delivery. Evolved with an option to take up delivery or pay a fixed fee instead.
  – It developed then to a secondary market ... before getting banned in 1541 (and moved elsewhere).
What are Financial Derivatives?

• And it went on, again:
  – In 1975 roughly 80% of foreign exchange transactions involved the real trading of a product or a service. The remaining 20% were speculative (economist Bernard Lietaer).
  – In 1997 the percentage of foreign exchange which involved transactions in the “real economy” was only 2.5%.
  – In 2011 only 0.6% of foreign exchange could be traced to genuine international trade in goods and services (Global Policy Forum).
  – An estimated $5.3tn changes hands every day in the foreign exchange markets (2011 figures).

http://www.isda.org/statistics/otc.html
How are derivatives treated for VAT purposes

• Commonly accepted understanding?
  – Derivative trades qualify as supply for VAT purposes.
  – Establishing the VAT liability (and related aspects such as input VAT recovery) of a derivative depends from (i) what is contemplated at maturity (cash settled \( \textit{versus} \) physical delivery) and (ii) the nature of the underlying (shares, commodity, indexes, currency, etc.).
  – Specific approach to what should be common concepts such as “consideration” (e.g., consideration in CDS contracts \( \textit{versus} \) consideration in IRS).
  – Is this right and how can this be substantiated?
### How are derivatives treated for VAT purposes

- **Snapshot (OECD report, 1998)**

<table>
<thead>
<tr>
<th></th>
<th>Belgium</th>
<th>Germany</th>
<th>Japan</th>
<th>Norway</th>
<th>Austria</th>
<th>Finland</th>
<th>New Zealand</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Future</strong></td>
<td>Outside the scope (unless lead to supply of goods)</td>
<td>Outside the scope</td>
<td>Outside the scope</td>
<td>Outside the scope</td>
<td>Exempt</td>
<td>Taxable (unless relating to currency or securities)</td>
<td>Exempt only if done on a future exchange</td>
<td>Zero rated on the TMO</td>
</tr>
<tr>
<td><strong>Options</strong></td>
<td>Outside the scope, exempt or taxable</td>
<td>Taxable</td>
<td>Outside the scope</td>
<td>Outside the scope</td>
<td>Taxable</td>
<td>Taxable (unless relating to currency or securities)</td>
<td>-</td>
<td>Zero rated on the TMO or taxable</td>
</tr>
<tr>
<td><strong>Swaps</strong></td>
<td>Outside the scope on commitment, exempt at maturity</td>
<td>Exempt</td>
<td>Outside the scope, exempt or taxable</td>
<td>Outside the scope</td>
<td>Exempt</td>
<td>Exempt</td>
<td>-</td>
<td>Exempt</td>
</tr>
</tbody>
</table>

*Note: TMO refers to the Taxation on the Movement of Goods.*
How are derivatives treated for VAT purposes

- Where would you look to find the answer?
  - VAT Directive: Not much, especially in the taxation *versus* exemption discussion
  - VAT (implementing) regulation(s): Rather unsuccessful
  - CJEU: Limited findings
  - Domestic practices, guidelines, etc.: unless you are based in an informed minority of countries, you will still get lost
  - ISDA Master Agreements: Non-issue
How are derivatives treated for VAT purposes

- VAT Directive (focusing on taxation *versus* exemption)
  - Article 135: which one will you pick and choose?
    - (a) insurance and reinsurance transactions, including related services performed by insurance brokers and insurance agents;
    - (d) transactions, including negotiation, concerning deposit and current accounts, payments, transfers, debts, cheques and other negotiable instruments, but excluding debt collection;
    - (f) transactions, including negotiation but not management or safekeeping, in shares, interests in companies or associations, debentures and other securities, but excluding documents establishing title to goods, and the rights or securities giving their holder de jure or de facto rights of ownership or possession over immovable property;
    - (i) betting, lotteries and other forms of gambling, subject to the conditions and limitations laid down by each Member State;
How are derivatives treated for VAT purposes

• Aborted VAT Directive and Regulation (2007)
  – No improvements in the draft Directive
  – Some elements in the draft (implementing) Regulation
    • The definition of guaranteeing of debts provided for in point 3 of article 135a (new) shall cover the provisions of at least the following: credit default swaps; [...]
    • The definition [...] shall not cover the handling over of assets to be used as collateral for a debt non resulting from the granting of credit
How are derivatives treated for VAT purposes

• Implementing Regulations (282/2011 and 1777/2005)
  – Article 9 282/2011 (similar to Article 5 of 1777/2005):
    • The sale of an option where such a sale is a transaction falling within the scope of point (f) of Article 135 of the VAT Directive shall be a supply of a services within the meaning of Article 24(1) of that Directive.
    • That supply of services shall be distinct from the underlying transaction to which the service relate.
  – How to know whether 135 (f) applies or not (especially considering aborted proposals language, e.g., for CDS)
How are derivatives treated for VAT purposes

• CJEU, a research on “swap”, “derivative”, “future”, “foreign exchange” and “forward” only provides for two relevant hints:
  – C-350/10, Nordea Pankki Suomi Oyj (the SWIFT case)
    • Nothing related to derivatives in the case as such
    • Reference to domestic law (Paragraph 42 of the Law on value added tax) providing that “dealing in securities includes the sale and brokerage of shares and comparable interests and claims and derivatives agreements, even when they are not made out in documentary form”
  – C-172/96, First National Bank of Chicago
How are derivatives treated for VAT purposes

• CJEU, a research on “swap”, “derivative”, “future”, “foreign exchange” and “forward” only provides for two relevant hints:
  – C-172/96, First National Bank of Chicago:
    • Transactions between parties for the purchase by one party of an agreed amount in one currency against the sale by it to the other party of an agreed amount in another currency, both such amounts being deliverables on the same value date, constitute supplies of services effected for consideration.
    • In foreign exchange transaction in which no fees or commission are calculated with regard to specific transactions, the taxable amount is the overall result of the transaction of the supplier of the services over a given period of time.
How are derivatives treated for VAT purposes

- Domestic practices, guidelines, etc.:
  - Option to tax (with great variations as to scope, most of them not covering derivatives transactions).
  - From wide ranging (although not general) in France to strictly limited (e.g., in Belgium).
  - Irrespective of scope, the difficulty to qualify derivatives trades (supply, consideration, input VAT deduction, etc.) may lead to variation of treatment from country to country.
How are derivatives treated for VAT purposes

• Domestic practices, guidelines, etc.:
  – Guidelines and zero-rating (UK model): see VAT notice 701/49 (section 8 for financial derivatives) and VAT notice 701/9 for commodities derivatives and terminal markets
  – Dutch system: cash settled trades treated as exempt financial supplies (impact on recovery ratio), physically settled (supply of the underlying)
Is there an Issue?, Do we need a Reform?

• Option to tax and diversity of approaches amongst Member States are not a good outcome
• Harmonized treatment to be preferred, but what’s next?
• Could we take something out of the aborted 2007 proposals:

<table>
<thead>
<tr>
<th>Zero rating</th>
<th>Extension of the scope of the exemption</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uniform limited input VAT deduction</td>
<td>Option to tax (broad)</td>
</tr>
</tbody>
</table>

• Let’s keep in mind key EU VAT guiding principles (neutrality in its wide sense) and take into account the level of complexity
Questions?
Thanks for your attention.
Notice

• The material in this presentation is provided for informational purposes only and does not constitute legal or other professional advice. You should not and may not rely upon any information in this presentation without seeking the advice of a suitably qualified attorney who is familiar with your particular circumstances. Mayer Brown Practices assumes no responsibility for information provided in this presentation or its accuracy or completeness and disclaims all liability in respect of such information.

• Mayer Brown Practices is, unless otherwise stated, the owner of copyright of this presentation and its contents. No part of this presentation may be published, distributed, extracted, reutilized or reproduced in any material form (including photocopying or storing it in any medium by electronic means and whether or not transiently or incidentally to some other use of this publication) except if previously authorized in writing.

• Mayer Brown is a global legal services organization comprising legal practices that are separate entities (the “Mayer Brown Practices”). The Mayer Brown Practices are: Mayer Brown LLP and Mayer Brown Europe – Brussels LLP; two limited liability partnerships established in the United States, Mayer Brown International LLP, a limited liability partnership incorporated in England and Wales; JSM, a Hong Kong partnership, and its associated entities in Asia; and Tauil & Chequer Advogados, a Brazilian law partnership. The Mayer Brown Practices is known as Mayer Brown JSM in Asia.