Option for Taxation of Financial Services in France

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1. INTRODUCTION

The question of whether or not financial services should be subject to VAT has been a recurrent issue since the introduction of the VAT system and, although the principle of exemption seems definitely accepted, the option to tax financial services is presently under discussion at a European level.[2] France is one of the few countries that have chosen an intermediate solution by making the VAT regime in respect of financial services optional. The conditions under which financial institutions may exercise the option for taxation have recently been amended[3] to the effect that the VAT regime has become more flexible,[4] which has brought French financial institutions into the difficult position of having to decide whether they should continue the option for taxation or revoke it. That decision does not only have VAT, but also commercial and operational consequences.

In the framework of the renewed interest in the VAT regime applicable to financial services, it is worth examining the French model, even though that model is affected by circumstances that are typically French and even outside the VAT system itself.

2. BACKGROUND OF THE FRENCH VAT TREATMENT OF FINANCIAL SERVICES

Under Art. 13(B)(a) and (d) of the Sixth Directive and Art. 261(C)(1) of the French Tax Code (*Code général des impôts*, CGI), financial services are in principle exempt from VAT, which reduces the VAT burden on those services if they are rendered to customers who are not entitled to deduct input VAT, because the financial service provider's "added value" is not taxed. On the other hand, the exemption has the effect that financial institutions are treated as final consumers, which means that they are not entitled to deduct input VAT and must absorb that non-deductible VAT into their selling prices. Passing on non-deductible input tax to customers who are entitled to deduct input VAT is clearly contrary to the principle of non-accumulation of the tax at subsequent stages of production and distribution of goods and services. However, in France, the "hidden tax" included in the financial institution's selling prices is not limited to its non-deductible input VAT, because the French VAT exemption is accompanied by the liability for payment of payroll tax,[5] which adds considerably to the effective tax burden on exempt financial services rendered to customers who, had those services been subject to VAT, would have been entitled to deduct the VAT.

In order to avoid the cascading effects of the exemption, the French law provides for an option for taxation in respect of banking and other financial services, with the exception of those which have expressly been excluded from the option,[6] such as the granting of loans, provision of guarantees, intermediary services relating to the issue of or transactions in securities and foreign currency, and insurance transactions.[7] Therefore, in theory, the French system enables financial institutions to avoid passing on non-deductible input VAT to their business customers by opting for taxation, and a majority of financial institutions have actually exercised that option from the time it was introduced in 1979. Until 2005, the option was irrevocable.[8]

In practice, the irrevocable option for taxation frequently turned out to be a bad choice for financial institutions, such as banks, stockbrokers, investment fund managers, etc., for several reasons.

Firstly, the French option for taxation is not available on a "client-by-client" basis. Ideally, financial institutions should be able to opt for taxation depending on the VAT status of their customers, i.e. they should be able to opt for taxation in respect of services rendered to customers entitled to deduct input VAT, and apply the exemption to services rendered to final consumers, such as private individuals and institutional customers. However, if taken up, the French option for taxation indiscriminately applies to services rendered to all customers. Consequently, what may have been a rational choice in the past, may turn into a disadvantage several years later depending on changes in the composition of the financial institution's customers. As a comparison, Germany allows companies to opt on a "client-by-client" basis. It seems, however, that only a few German financial institutions exercise the option because, in practice, it is difficult to derive a real benefit in terms of deductible input tax from that option (it is difficult to determine how the costs must be allocated to one client and not to another).

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2. On 14 March 2006, the European Commission released a Consultation Paper on modernizing VAT obligations for financial services and insurances, see under "VAT around the World" in this issue.
3. Art. 85 of the Amended Finance Law 2004, Law of 30 December 2004, No. 2004-1485.
4. The law also provided for new rules on placements of securities, which are now exempt under all circumstances (even under the option for taxation) and the management of funds, which now includes the management of SICAVs (open-ended investment companies). The administration has clarified the new rules in an important Administrative Statement of Practice of 3 August 2005, No. 3 L 3 05.
5. Indeed, under French tax law, the payroll tax (Art. 231 of the CGI), acts as a complement to VAT by taxing institutions which are not liable for VAT on at least 90% of their turnover. The tax basis corresponds to the gross salaries multiplied by the ratio of VAT-exempt income divided by total turnover (e.g. if the VAT ratio is 40%, and exempt income represent 60% of turnover, then 60% of gross salaries are subject to the tax). The tax rate is progressive and goes up to 13.6% (the average rate is between 12% and 13%). Accordingly, the option for VAT, by increasing the VAT ratio, reduces symmetrically the counter pro rata used to compute the payroll tax.
6. See Art. 260(C) of the CGI.
7. The scope of the option covers all financial services, except those excluded by Art. 260(C), which essentially concern capital gains, exchange rate gains, insurance, and income that can be compared to interest and guarantees. In addition, the amended Finance Act for 2004 broadens this scope and excludes commissions relating to the placement of shares (placement of bonds was already excluded from the scope of the option).
8. Under Art. 260(B) of the CGI.

Secondly, if taken up, the option for taxation does not only apply regardless of the VAT status of the customers, it also applies regardless of the nature of the services. Financial institutions are unable to exclude specific services from the option for taxation, which may produce adverse effects where, even though the financial institution's customers are corporate entities, their entitlement to deduct input tax is restricted on the basis of case law. For example, following the judgment of the European Court of Justice (ECJ) in *Satam*[9] and subsequent judgments, the French tax administration has taken a much stricter stance with regard to the entitlement to deduct input tax and, consequently, the situation of certain categories of business customers, such as holding companies, who initially recovered input VAT without much limitation, has worsened. Therefore, for the purpose of determining whether or not opting for taxation is a rational choice, financial institutions must not only distinguish between business and private customers, they must also take into account the limitations applicable to the entitlement to deduct input tax for specific categories of business customers.

Thirdly, the current method of determination of the entitlement to deduct input tax deprives the option for taxation of a full effect on input VAT incurred by financial institutions. In this respect, it should be noted that, under French law, businesses engaged in both taxable and exempt transactions must determine the amount of deductible input VAT on the basis of the pro rata, i.e. the proportion of turnover giving right to recovery to total turnover. Unlike, for example, the United Kingdom, France does not enable businesses carrying out "mixed" transactions, to deduct input VAT on the basis of actual use of the goods and services in question.[10]

In this respect, it should be noted that the pro rata is computed by reference to the financial institution's turnover derived from various sources. If it is derived from the granting of credit, which is exempt from VAT under all circumstances, the turnover is the gross amount of interest received from the borrowers, without taking into account the interest paid by the financial institution to depositors who have provided it with the funds necessary to grant the loan. On the other hand, turnover derived from intermediary services (subject to VAT under the option for taxation) is limited to the financial institution's commission. Consequently, if the financial institution opts for taxation, the effect on the pro rata of turnover derived from exempt services is much greater than that of turnover derived from taxable services. The diluting effect of interest on the pro rata in combination with the effects of the payroll tax may produce a negative tax result if the financial institution opts for taxation. That negative effect would be mitigated if, for the purposes of the pro rata, turnover derived from the granting of credit were determined on the basis of net interest, just like the financial institution's net margin applies to transactions in securities and foreign currency.[11] As compared to gross interest, the financial institution's net margin derived from credit transactions would be a better criterion for its "added value". However, the present wording of Art. 19 of the Directive, which mentions "turnover", does not seem to allow that concept to be interpreted as meaning "net margin".[12]

The irrevocable option for taxation taken up in 1978 by the vast majority of the French financial institutions (brokers, asset managers, but also banks) put them in a difficult position compared to new entrants, including EU financial institutions, to the increasingly liberalized French financial market. Regardless of whether or not they set up an establishment in France or rendered their financial services from their country of residence, the new entrants were not bound by an option taken up some 25 years ago and, if they were not established in France, they were not subject to the French payroll tax. In order to mitigate the binding effect of the option for taxation, with effect from 1 January 2005, Art. 85 of the Amended Finance Law 2004 enables French financial institutions to revoke the option after five years, which, to some extent, restores the level playing field with new entrants to the French market. Regrettably, the overall character of the option remains unchanged, which means that financial institutions are still unable to opt for taxation in respect of specific services or specific categories of customers.

3. OPTION AND REVOCATION

The option for taxation and revocation of that option are subject to strict legal conditions, which have given rise to some debate, particularly as regards the transitional regime (see 3.1.). Nevertheless, revocation of the option will have direct consequences for the financial institutions that will take that step (see 3.2.). After examination of those aspects, the main question to be addressed is: should French financial institutions revoke the option (see 4.)?

3.1. Conditions

The option for taxation and revocation of that option, in particular the five-year period, are subject to strict legal rules.

3.1.1. Option for taxation

The conditions for exercising the option for taxation have always been the same: the option is only available to professionals or, more generally, all institutions whose main activity is the rendering of financial services.

The option takes effect from the month following that in which the financial institution notified the tax

9. ECJ judgment of 22 June 1993 in *Sofitam (Satam) SA v. Ministre du budget*, Case C-333/91, [1993] ECR I-3513, in which the ECJ declared that the receipt of share dividends did not constitute an economic activity.

10. Under Art. 17(5)(c) of the Sixth Directive, Member States may authorize or compel the taxable person to make the deduction on the basis of the use of all or part of the goods and services.

11. See ECJ judgment of 14 July 1998 in *The First National Bank of Chicago v. Commissioners of Customs & Excise*, Case C-172/96, [1998] ECR I-4387. The computation of the VAT turnover pro rata in France includes foreign exchange and capital gains on securities (other than long-term investments which are outside the scope of VAT) for their net amount, i.e. after deduction of capital losses. Transactions in foreign exchange and securities are defined as services by law (Art. 256 IV CGI).

12. Technically, it would be possible to implement such a method as a specific method under Art. 17(5)(c) of the Directive, but this option has not yet been introduced in France. To facilitate such computation, a lump sum percentage deemed to represent the added value of the bank could be used.

administration (by means of a simple letter) of its intention to take up the option. It then affects all financial services, with the exception of those which are expressly excluded by law from the scope of the option. The taxable financial services are subject to the territoriality rule laid down by Art. 9(2)(e) of the Sixth Directive. Under that rule, financial services are deemed to be rendered at the place where the customer is established, unless the customer is a non-taxable person established in the European Union.

3.1.2. Option period

With effect from 1 January 2005, the law stipulates that the option is "tacitly renewed every five calendar years" and may be revoked by giving notice, two months prior to the renewal date.

Hence, if a financial institution opts for taxation in the course of year N, it can revoke the option with effect from 1 January of year N+5 by sending a letter of revocation by 31 October in year N+4.

The aim of the five-year period is to prevent financial institutions from taking opportunistic advantage, from year to year, of the consequences of the different tax regimes applicable to their services for their entitlement to deduct input tax. However, it would have been better if that five-year period had constituted a minimum period and if the tacit renewal did not tie the institution's hands for another five years, if it wished to revoke the option at a later date, subject to the two-month notice.

The tacit nature of the renewal of the option means that financial institutions that wish to maintain the option do not have to take any action. It may, however, trap some financial institutions that intended to revoke the option but forgot to give notice on time. Under the latter circumstances, the option automatically continues for another five years (until year N+10), which seems a somewhat harsh punishment for a simple oversight.

As a transitional rule,[13] financial institutions, which, on the date of entry into force of the new law, had exercised the option more than five years ago, benefit from more flexible revocation rules. In view of the complexity of the transition from the regime of taxation to that of exemption, those institutions may revoke the option every year, until the end of October 2009. If they have not revoked the option by that time, it will continue for another five-year period (i.e. until the end of 2015).

3.1.3. Input tax refunds

Under the new rules, revocation of the option is prohibited if the financial institution has received a refund of excess input tax. Under those circumstances, the option is automatically renewed for a five-year period following that "during which or at the end of which" the refund was obtained. That measure is aimed at financial institutions that have exercised the option but, under the place-of-supply-rules applicable to financial services,[14] remit little output VAT because their customers are predominantly located outside France. The rule has also highly been criticized because it creates a complex requirement to follow up input VAT to determine whether or not it arose in a tax year covered by the option. Moreover, the tax administration takes the view that the fact that a financial institution has obtained a refund of excess input tax retroactively cancels its revocation of the option, which may imply that the financial institution becomes liable to remit VAT in respect of financial services rendered in the past, which it has already charged without VAT to its customers.

3.2. Consequences of revocation

Revocation of the option for taxation should result in a reduction of the cost of services rendered to customers who cannot recover input VAT. However, it will increase the operating cost incurred by the financial institutions.

3.2.1. Deduction of VAT

Revocation of the option has the effect that services which were previously subject to VAT become exempt. Consequently, the financial institution's entitlement to deduct input VAT will be reduced by the reduced pro rata or under the effect of the allocation rule (input VAT relating to exempt supplies is not recoverable).

Financial institutions considering revoking the option must also examine the VAT status of their suppliers. They may have to adapt their relations with external suppliers, for example intermediaries, lessors of unfurnished premises, etc., depending on their VAT status, as a result of their own choice to opt for taxation.

They will also have to solve the problem of passing on the additional tax cost to their customers (see below).

3.2.2. Adjustment of input VAT

A significant reduction of the pro rata resulting from revocation of the option for taxation is likely to lead to a substantial liability for repayment of the VAT that has previously been deducted in respect of fixed assets[15] under the input tax adjustment rules. As regards movable goods, previously deducted input tax must be adjusted if the goods were acquired in the four preceding calendar years and, as regards immovable property, in the preceding 19 years (or nine years, if the property was acquired before 1 January 1996).

3.2.3. Payroll tax

The part of the salaries subject to payroll tax is inversely proportional to the ratio of exempt to total turnover. Therefore, a reduction of the pro rata should lead to a proportionate increase of the payroll tax in the following year, which constitutes a heavy penalty on financial institutions located in France that decide to revoke the option. Both the non-deductible input VAT and payroll tax can be passed on to the financial institution's customers by increasing its selling price but, by doing so, the financial institution must ensure that it does not harm its competitive position vis-à-vis other financial institutions which have opted for taxation or are located in another Member State (see example below). As compared to their non-resident competitors, French financial institutions have the disadvan-

13. Administrative Statement of Practice, see note 4.
14. Art. 259(B) CGI.
15. Arts. 210 and 215 of Annex II to the CGI.

tage that France is the only Member State that imposes a payroll tax.

4. SHOULD FINANCIAL INSTITUTIONS REVOKE THE OPTION?

As has been discussed above, revocation of the option for taxation initially results in a reduction of the VAT burden on services rendered to customers who are not entitled to deduct input VAT, and to an increase of taxes (non-deductible input VAT and payroll tax) borne by the revoking institution. Therefore, in order to determine the financial consequences of revocation of the option, financial institutions must analyse the VAT status of their customers, in particular the extent to which they are entitled to deduct input VAT. Naturally, if the majority of their customers are entitled to deduct input VAT, financial institutions would be better off by maintaining the option and avoid having to incorporate into their selling prices the non-deductible input VAT and payroll tax associated with the exemption.

On the other hand, if the majority of their customers are not entitled to deduct input VAT, the financial institution must assess its ability to pass on to them the taxes associated with the exemption, which, in theory, should be possible, whilst keeping the total prices for those customers below or equal to the previously applicable "all-inclusive" prices.

Example

	Under option	Under exemption
labour cost	60.00	60.00
other expenses (exclusive of VAT)	20.00	20.00
(non-deductible) input VAT (19.6% of 20)	–	4.00
payroll tax	–	7.00
profit margin	20.00	20.00
total	100.00	111.00
VAT (19.6% of 100)	19.60	–
total price	119.60	111.00

By revoking the option for taxation, the financial institution would initially be able to reduce the total price for customers who are not entitled to deduct input tax by 8.60 (119.60 – 111), whereas, if the institution wishes to keep the same margin of 20, the costs for customers who are entitled to deductions are potentially increased by 11 (111 – 100). This example shows that revocation allows significant opportunities in terms of competitiveness or profitability for financial institutions operating on the retail market (B2C), while the option is generally, but not always, more favourable in respect of B2B activities.

In order to neutralize those changes for both categories of customers, the financial institution would have to renegotiate the selling prices applicable to both categories of customers.

In addition, revoking the option could lead to an overhaul of the financial institution's IT and accounting procedures, which will require substantial work that should be taken into account from the outset.

For these practical and commercial reasons, revocation of the option for taxation will probably be a gradual process. Nevertheless, it seems certain that a large number of financial institutions will rapidly move to revoke their option, as already has happened with asset managers.

5. CONCLUSION

The provisions that entered into force on 1 January 2005, under which the option for taxation of financial services may be revoked, should be welcomed because they provide for more flexibility in respect of a system that was particular for France and that previously distinguished French financial institutions from their non-resident competitors by the obligation that the former had to charge French VAT to their French and non-taxable EU customers, which generally could not be recovered. The new revocation mechanism thus makes the option what it always should have been: an open choice for financial institutions enabling them to optimize their VAT position or that of their customers who are entitled to deduct input VAT, and designed to make the tax (VAT) system as neutral as it can be for business customers. Maintaining the option can be worthwhile, since it enables financial institutions whose clients are entitled to deduct input VAT to continue to charge VAT on the services in question. This is in keeping with the principles of the original VAT system, which intend to give the tax a broad scope in order to prevent the charging of hidden VAT. Moreover, the European Commission has repeatedly expressed its desire to reduce the scope of the exemptions.

For financial institutions whose customers are not entitled to deduct input VAT, revocation of the option will enable them to reduce the cost of their services and to improve their position as compared to their European competitors who, under the European law, have access to the French financial market without the obligation to set up a branch in France or charge VAT to French business customers.[16] However, other factors continue to negatively affect the competitive position of French financial institutions: payroll tax due by financial institutions whose services are exempt from VAT, a comparatively high rate of VAT (19.6% versus, for example, 17.5% in the United Kingdom), unfavourable deduction rules (the obligatory pro rata) and the "ORGANIC contribution" (a social contribution imposed on gross turnover at the rate of 0.16%[17]).

16. Financial services rendered by non-resident financial institutions are subject to the reverse charge mechanism, under which the customer must account for VAT on the value of the received services.

17. Oddly enough, that contribution was not found to constitute a duty or charge characterized as a turnover tax prohibited under Art. 33 of the Sixth Directive because, technically, it was not a tax, but a social contribution calculated on the basis of the total annual turnover without directly affecting the price of goods or services (ECJ judgment of 27 November 1985 in *SA Rousseau Wilmot v. Caisse de compensation de l'Organisation autonome nationale de l'industrie et du commerce (ORGANIC)*, Case 295/84, [1985] ECR 3759). However, when they have to pay it, French companies do not see much difference between a tax and a social contribution. The French payroll tax was recently transformed from a tax into a social contribution, probably for the purpose of avoiding the risk that it would be challenged under European law.