FS taxation | External TAXUD study resets debate of reform options, incl. FAT

Dear all,

We wanted to follow-up with considerations and a more detailed overview of the policy options provided in **DG TAXUD's external study on financial sector taxation** as prepared by Syntesia et al, **meant to effectively reset the policy agenda** on the matter.

The study suggests six possible policy approaches, ranging from harmonising currently "problematic" definitions across Member States (MS) to overhauling the current VAT exemption framework and replacing it with a Financial Activities Tax (FAT).

Please find the links to study, annexes to the study, executive summary (also available in FR & DE).

CONSIDERATIONS AROUND FUTURE POSSIBLE COMMISSION PROPOSAL(S)

This study likely marks the beginning of renewed focus on FS sector taxation. Tax Commissioner Hoekstra was indeed tasked by President von der Leyen to "identify innovative solutions for a coherent tax framework for the EU's financial sector" at the start of the mandate.

It comes after several failed attempts to square the circle. The European Commission has several times attempted to amend the 1979 VAT for FS exemption including an aborted attempt in the previous mandate. In parallel, a 2013 proposal for Enhanced Cooperation to develop a common FTT was finally withdrawn by the European Commission in its 2026 Work Programme.

FS sector taxation is most likely a medium-term agenda item for DG TAXUD as it does not appear in the 2026 work programmes of the Commission or TAXUD's annual report. One potential accelerator could be Heads of State's search for new EU-wide taxes to finance the EU's next long-term budget.

A future proposal would likely have to respond to two main overarching objectives:

1. **simplification to enhance the EU Single Market's Competitiveness** – There is of course significant momentum behind delivering a simplified compliance framework for EU industry, including financial services, meaning that proposals that can effectively achieve this will be viewed in a more positive light.
2. **while maintaining government revenue** – We do not expect policies that effectively reduce hidden VAT, without replacing it with other revenue, to be well-received among Member States**.** In its most recent non-legislative report, the European Parliament (EP) has called for a fair and coherent tax framework for the financial sector, while falling short of explicitly proposing new revenue-generating instruments.

This latter point is **particularly relevant given the timing of the study, which has been released during a period in which EU leaders are more seriously turning towards negotiations on the EU's next long-term budget** – the Multi-annual Financial Framework (MFF) – as these negotiations are largely characterised by a growing debate over the need to develop new funding sources for the MFF in the face of combined pressures from the need to finance the bloc's strategic investment goals and increasingly restricted national budget space. Meanwhile, the **European Parliament's interim report on the MFF featured limited calls for taxation instruments on the financial sector, requesting the Commission to explore a capital gains levy for crypto assets**.

In a sense, policy consideration 3C, which involves replacing the VAT regime and sectoral taxes with a Financial Activities Tax (FAT), is a policy option that most ostensibly meets the objectives outlined above.

STUDY'S PROPOSED POLICY OPTIONS

In the study, the authors aim to address identified inefficiencies of the current EU tax framework for the financial sector, grouped into three themes:

1. Building block 1 – Modernisation and simplification of the current rules for VAT (1A & 1B),
2. Building block 2 – Introduction of measures to reduce non-deductible VAT for the financial sector (2A & 2B),
3. Building block 3 – Revisiting the VAT exemption for financial services and introduction of harmonisation measures in sectoral taxes (3A, 3B & 3C).

Below we focus on what the policy choices entail and their impact on MS revenue, as these will be the key considerations as outlined above if proposed and negotiated.

1A: Modernisation of the definitions of the VAT exemption

This policy, being focused on modernising several problematic definitions, was identified as having limited revenue-generating affects for MS. Instead, it would serve to improve the functioning of the existing framework – and the Single Market in general – by aligning definitions with current market practices and technologies across Member States.

As such, Policy consideration 1A could act as a horizontal enabler for other revenue-generating interventions by improving their functioning thanks to common interpretations and applications. However, authors are conscious it would likely not solve the structural problems of complexity and hidden VAT with the current framework

1B: Simplifying and harmonising the rules on proportional deduction

According to the study, problems with the current proportional deduction framework largely derive from difficulties in calculating such deductions for mixed inputs, or inputs from businesses carrying out both VAT-eligible and VAT-exempt activities.

The proposed tools are aimed at delivering administrative simplification and cross-border harmonisation, with overall limited effect on VAT revenues and neutral or slightly positive effects on market demand.

The study explores three policy options for addressing this:

- **Simplifying and harmonising proportional deduction assessment** – involving the clarification of the attribution rules and using the pro-rata method for assessing the share of recoverable VAT in mixed input situations. This would constitute a mostly revenue-neutral option with some estimated savings in administrative costs for cross-border operators, while improving legal certainty. However, benefits for administrative simplification would be limited as it would not affect the core deduction calculation methodology.
- **Fixing deduction rates** – involving a fixed VAT deduction rate calculated based on an average of current deduction rates, applied either mandatorily or with an opt-out possibility that would allow financial market participants the choice of calculating through the pro-rata method. This would likely generate no or limited extra revenue, with increased legal certainty for firms.
- **Introducing a super-deduction rate** – involving an increased deduction rate to reduce the bias against outsourcing generated by the hidden VAT. This would be associated with a significant decrease in government revenues, while saving operational costs for firms by reducing the role that hidden VAT plays in supply chain organisation, thus allowing for more efficient business operations and improving competitiveness.

2A: Review of VAT grouping and cost sharing arrangements (CSAs)

This would involve amending the rules regarding VAT grouping and cost-sharing arrangements (CSAs) to address the issue of hidden VAT.

The authors propose three potential approaches, all of which would reduce MS revenues due to their focus on tackling hidden VAT on intra-group supplies:

- **Mandatory VAT grouping** – involving extending the existing VAT grouping mechanism to the five MS which have not yet implemented it. The impacts of this policy would be limited due to its concentration on five MS, with limited reductions in VAT revenues and administrative costs and somewhat positive impacts on the Single Market.
- **Cross-border VAT grouping** – involving expanding VAT grouping possibilities across MS, thereby granting cross-border groups similar competitive conditions to those of domestic groups. The measure would deliver significant reductions in hidden VAT and, consequently, VAT revenues, with similar effects across different types of financial services. This would involve sizeable positive VAT neutrality and Single Market effects at the cost of high administrative complexity due to the requirement to create new mechanisms for cross-border taxation rights, audit, and compliance.
- **Re-introduction of CSAs** – involving making the option of CSAs for financial services providers mandatory in all MS, whereas the previous CSA provision was incrementally phased-out to result in it being available in just six MS. This would have a meaningful impact on reducing hidden VAT and VAT revenues, while falling short of the effect of cross-border VAT grouping due to the more limited scope of

CSAs. However, this policy would be associated with lower administrative costs and complexity and would deliver similar level-playing field fixes between domestic and cross-border groups.

2B: Mandatory option to tax for Member States

This policy would make it mandatory for all MS to grant financial service providers the option to apply VAT to otherwise exempt input purchases, which would then allow them to deduct VAT on related costs for the same input.

The impact of this policy depends on the design of the regime, which differs depending on whether the option is applied at a transaction of entity level in addition to the scope of entities covered.

- **Entity-level application** – involving a broader application of the option to tax which includes customers not typically entitled to deduct input VAT. This design would increase VAT revenues, especially if extended to the insurance sector.
- **Transaction-based approach** – involving the option to apply VAT only to customers eligible to full deduction rights. This would increase input VAT recovery and limit additional output VAT, thereby reducing VAT revenue, especially if applied to the insurance sector.

This policy would also address fragmentation across MS and thus entail a positive contribution to the functioning of the Single Market by reducing cross-border distortions and divergences.

It would, however, generate one-off administrative costs for businesses due to the need to amend IT systems and internal processes, with transaction-based approaches being associated with greater complexity and cost than entity-based approaches. These increased costs would also be mirrored for national tax authorities, which would be required to increase monitoring and control activities.

3A & 3B: Removal of the exemptions and Insurance Premium Taxes (IPTs)

This would involve removing the VAT exemption for some, or all, financial services, in addition to certain sectoral taxes such as Insurance Premium Taxes (IPTs). These policies would have a marginal effect on demand, depending on the specific tool.

3A: Removal of the VAT exemption for financial services and replacement with standard VAT treatment – involving potential variants that would either abolish or preserve sectoral taxes.

- Replacing sectoral taxes with VAT would lead to declining government revenues because standard-rate VAT would not compensate for the removal of sectoral taxes. Naturally, applying VAT while retaining sectoral taxation would lead to increased government revenues. Alternatively, revenue-neutral configurations of these measures are possible so as to avoid changes in government tax receipts.

- This would remove the distortions associated with the current VAT exemption, thus allowing for more efficient supply chain organisation and remove the disincentive for investing in innovative solutions. It was also found to improve trade and financial sector competitiveness, without providing disproportionate advantages to third-country suppliers or specific subsectors. However, this solution may also introduce complexity and uncertainty due to the difficulty in applying VAT to interest-based services.

3B: Removal of the VAT exemption for fee-based services, while preserving it for interest-based services –

- This measure has similar impacts as the previous one. Replacing sectoral taxes with VAT would lead to declining government revenues, while applying VAT while retaining sectoral taxation would lead to increased government revenues. As before, revenue-neutral configurations are also possible.
- Similarly, this policy would remove the VAT distortions and improve operational efficiency, while also being associated with positive effects on competitiveness. However, these benefits would be less pronounced in the banking sector due to the associated complexity of distinguishing fee-based and interest-based services.

3C: Introduction of an FAT for all financial services, with VAT zero-rating and removal of existing sectoral taxes

For the authors, the Financial Activities Tax (FAT) would entail the application of a tax on the sum of a financial institutions' added value, including both wages and profits.

The rationale behind the introduction of an FAT would be to replace the revenue-generating effects of VAT while minimising the associated administrative and operational complexity. It would be applied at the entity level over a given time period, with no FAT deductions at other stages in the supply chain.

According to the study, the main benefit of FAT implementation would be simplification with respect to the current framework, in addition to the harmonisation entailed by the removal of sectoral taxes. Together, these would be reflected in limited reduced compliance costs for firms, while the revenue-generating or reducing effect depends on the FAT itself. However, these effects would vary by sector, and the FAT costs would be embedded in the output of the services and therefore would not entirely address existing value chain distortions.

As ever, please do not hesitate to reach out with further questions.

Kind regards,

FH Team

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