Arnulf Rabben and Aarne Røvik[1]

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Norwegian Economic and Legal Report

Content

Norwegian Economic and Legal Report 1
1 Introduction 2
2 Understanding taxation of the financial sector 3
2.1 Development of the financial sector in Norway 3
2.2 Describing the financial and insurance sector 6
2.3 Tax system and reforms in Norway 10
3 Present taxation of the financial sector 11
3.1 Corporate income 11
3.2 Value added 13
3.3 VAT exemption of financial services 15
3.3.1 Legal basis 15
3.3.2 Definition of exempted services 17
3.3.3 Inputs to financial services production 19
3.3.4 Cost-sharing 19
3.3.5 Option to tax 19
3.4 Financial transaction taxes 20
3.4.1 Stamp duties 20
3.4.2 Stock exchange charge on excess orders 20
3.5 Deposit insurance fee 21
4 Reviews of financial sector taxation 23
4.1 The Services VAT Committee (The *Storvik* Committee) 23
4.2 The Financial Crisis Committee 24
5 Follow-up and on-going work 26
5.1 Introduction of continuous deposit insurance fee 26
5.2 Practicing the current VAT exemption 28
5.3 Assessment of a Financial Activities Tax 29
5.4 Could the VAT base be expanded? 31
6 Conclusion – where are we today? 34

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[1] Arnulf Rabben has a master's degree in law (Cand.Jur) from the University of Bergen, and is senior tax adviser at the Tax Administration. Aarne Røvik has a master's degree in economics (Cand.Oecon) from the University of Oslo, and MSc Regulation from the London School of Economics and Political Science. Røvik is senior economist at the Tax Policy Department, Ministry of Finance. The authors thank colleagues for valuable advice and comments while preparing this article. Views expressed are on behalf of the authors only, and may not be policies of the Tax Administration or the Ministry of Finance.

1 Introduction

Discussing taxation of the financial and insurance sector in Norway, one enters an almost *terra incognita*. There is not much to build on neither of academic papers nor political documents – internationally and, even more so, for Norway in particular. Considering the importance of the financial sector for the economy and the importance of taxation for financial markets this scarcity appears remarkable and intriguing.

This article describes present taxation of the financial services and insurance industries – and finds wages and profits are considered according to ordinary tax rules. The corporate tax rate of 28 per cent implies a considerable taxation of value added in the financial sector since the profit share is larger than in other industries without resource rent incomes. Nevertheless – due to exemption from value added tax (VAT) – financial services and insurance appear under-taxed. Moreover, the VAT exemption provides incentives for inefficient in-house production in financial institutions, and increases the cost of financial services for VAT-registered businesses while households receive cheaper financial services than they would if the sector had been taxed in line with other industries. Except the banks' deposit insurance fee there is no alternative or special taxation of financial services or insurance in Norway. Former taxation of share transactions was removed as part of the liberalisation of financial markets in the 1980s.

To understand the regime today and shed light on how financial sector taxation may develop in future – the article explores historic events and initiatives as well as recent debates and reviews. Norway experienced a national banking crisis in the early 1990s. Recovery of the banking system had priority afterwards while the issue of taxation of the financial sector in particular was hardly raised at all. However, reforms of corporate taxation (1992) and VAT (2001) affected the financial sector. Where general rules could have an impact on financial institutions in particular, concerns of competitiveness were often emphasised. In contrast, the debate after the 2008 crisis[2] has to a considerable extent been about taxation as a measure for avoiding unsustainable expansion of financial activities, and for a fair contribution from the financial sector to public financing. This has been an international debate that certainly is influencing also the discussion in Norway.

The development of the financial and insurance industries, composition of the sector today, and the tax system and reforms in Norway explain taxation of financial services and insurance. Section 2 provides a short background, including relevant statistics and historical data.

[2] The recent financial crisis certainly continued after 2008, and it had started before (U.S. housing bubble peaked in 2006). However, the collapse in September 2008 of the U.S. investment bank Lehman Brothers is widely seen as the main incident that triggered a global crisis. For simplicity of language we refer to the 2008 financial crisis throughout this article.

Taxation of the financial sector has many elements, which are described in section 3. Corporate income and value added in the financial sector is discussed as well as the deposit insurance fee. Furthermore, former stamp duties, notably a tax on share transactions levied last in 1988, are de-scribed. A stock exchange charge on excess orders – recently introduced at *Oslo Børs* – provides evidence on incentives-based taxation and how seemingly small changes in margins can thoroughly affect behaviour in financial markets.

Tax reviews that considered *inter alia* taxation of the financial sector are discussed in section 4. The Services VAT Committee[3] assessed the exemption of financial and insurance services. Remedies to avoid future crises and for improving the functioning of financial markets, taxation as well as regulation, were considered by the Financial Crisis Committee[4].

Follow-up and on-going work are discussed in section 5. From 2013, the deposit insurance fee has to be paid continuously, i.e. irrespective size of the Banks' Guarantee Fund. The Ministry of Finance is considering measures to neutralise the VAT exemption of financial services and insurance – either by expanding taxation by the ordinary credit-invoice method where applicable, or by introducing a Financial Activities Tax (FAT).

Some conclusions are suggested in section 6. Taken together, the discussion provides some clues to understand where taxation of the financial sector stands in Norway today – while it remains to see whether the ambitious concepts for new tax designs outlined in the last bills on the state budget will be accomplished.

2 Understanding taxation of the financial sector

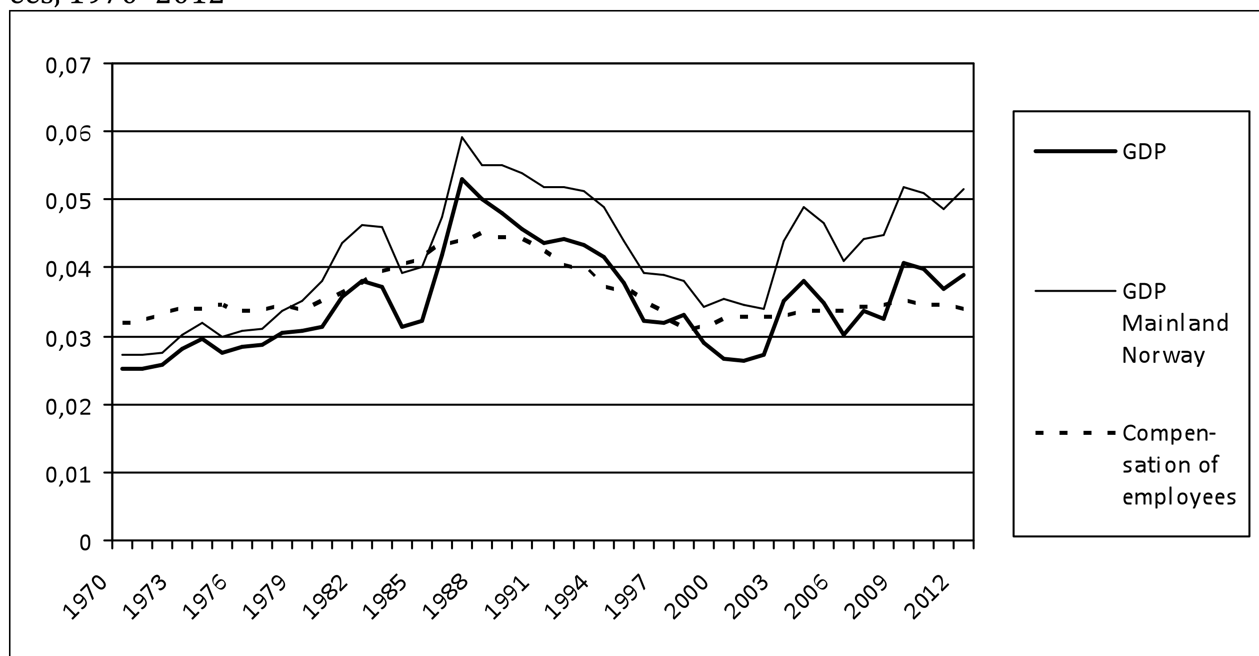
2.1 Development of the financial sector in Norway

After ten years of strong growth until 2007 the financial sector has seen moderate growth the last years. Figure 1 shows the development of the share of financial and insurance activities in GDP since 1970. The relative position of the financial sector becomes more pronounced when deducting oil and gas extraction in the denominator, which may be reasonable since resource rent accounts for a major part of value added from oil and gas. In the ten-year period till 2007 value added in the financial sector grew by 7 1/2 per cent per year, while GDP of the whole economy increased on average 2 1/2 per cent per year. Although the international financial crisis in 2008 explains the timing of the trend shift, it is obvious that the financial sector in Norway, which services

[3] NOU 1990: 11 *Generell merverdiavgift på omsetning av tjenester*.
[4] NOU 2011: 1 *Bedre rustet mot finanskriser* (including summary in English).

mainly domestic customers, could not have continued growing faster than the rest of the economy for a prolonged period.

Figure 1 Financial and insurance activities share of GDP and of compensation of employees, 1970–2012



Source: Authors' calculation based on Statistics Norway, National Accounts.

Growth of the financial sector from the late 1990s should be viewed in the light of a shrinking sector the preceding fifteen years. Liberalization of financial markets, as well as a booming economy in the mid-1980s, led to a fast expansion of the financial industries culminating i 1987, when value added of the sector peaked in relative terms at 5.3 per cent of GDP (5.9 per cent of GDP Mainland Norway). A combination of economic slowdown and overexposure to risk due to fast credit growth left banks with large non-performing portfolios of commercial loans in particular. By 1991, the crisis reached systemic proportions, and the central bank intervened with liquidity support while the Government Bank Investment Fund was established for equity investments.[5] As a result, the state became the sole owner of three of the largest banks. Even though the crisis had been solved by 1993 – what is illustrated by a successful public share issuing by the second largest bank – the relative decline of the financial sector continued well into the late 1990s. The subsequent growth may be considered as much a recovery after the financial crisis of the early 1990s, as an over-expansion of financial activities. Today value added of financial and insurance activities is approximately 4 per cent of GDP – what appears neither particularly high nor particularly low com-

[5] Vale, B, "The Norwegian Banking Crisis", in Moe, T, Solheim, J, and Vale, B (eds), *The Norwegian Banking Crisis* (2004) Norges Banks skriftserie / Occasional Papers 33, 2–21.

pared to other countries[6]. Even when deducting oil and gas extraction in the denominator, the financial sector does not make up more than approximately 5 per cent of Mainland GDP.

What does this short history lesson mean for taxation of financial services? After 1987, fifteen years of decline and subsequent recovery of the banking sector implied the idea of taxing the industry more was hardly raised at all. The main government concerns for the financial sector in the mid-1990s were privatizing banks, improving regulation and supervision, and strengthened deposit-insurance. Except financing of the banks' deposit-insurance, taxation of the financial sector was not on the agenda. What about the subsequent decade of strong growth – was it a lost "window of opportunity" for tax reform? However, a window of opportunity for policy change does seldom open without a preceding public or academic debate[7] – and that debate did not emerge until after the financial crisis of 2008.

Optimal taxation of the financial sector has become more a question of taxing profits – and less a question of taxing wages. Structural and technological changes of financial and insurance activities have implications for tax design. Development of the share of financial and insurance activities in total compensation of employees for the period 1970–2012 is also shown in figure 1. The recent expansion took place without the financial sector hardly increasing its share of total labour compensation, in contrast to the 1980s expansion which was to a considerable degree based on the financial sector increasing employment. While around 1990 an additional tax on wage costs could have appeared appropriate for increasing taxation of financial activities, a wage tax alone would cover only a minor part of the 2000s expansion that came mainly through increased profits. Conversely, a tax on value added including profits could provide counter cyclical incentives since tax payments would increase in upturns and decrease in downturns. Increased taxation of profits in an upturn would *ceteris paribus* reduce core capital of banks and accordingly the regulatory limits on lending.

2.2 Describing the financial and insurance sector

Characterisation and delineation of various financial institutions is essential in regulation of financial markets. First, supervision of financial institutions demand specific rules which cannot be applied universally, or if they were applied would have been an unnecessary burden for other industries. For example, capital adequacy ratios are a concern in bank regulation, but not in corporate law. Second, to enforce the financial rule book it is necessary to prevent services from migrat-

[6] Denmark approximately 5 1/2 percent, Sweden approximately 4 per cent of GDP (Source: Authors' calculations from National Accounts).
[7] Kingdon, J, "Agendas, Alternatives and Public Policies" (1984).

ing outside the regulated industry. Consequently, financial regulation has established licensing requirements for the provision of the various business and services which can be deemed "financial". Notably financial licenses entail also negative definitions. For example, the Commercial Banks Act states that "[a] commercial bank must not carry on or participate as an unlimited liability partner or co-owner in wholesale and retail trade, manufacturing, shipping, insurance or other business activity except … all business and services which it is customary or natural for banks to transact." [8] Even if such definitions has not established Chinese Walls – as illustrated by the resilience of so-called "shadow banking" – financial market regulation and supervision defines those industries we are searching as the financial sector.

Table 1 Industries supervised by the Financial Supervisory Authority of Norway

Industry	VAT included
Banks	
Finance companies	
Mortgage companies	
E-money institutions	
Payment institutions	
Financial holding companies	
Insurance companies	
Pension funds	
Insurance intermediaries[1]	
Investment firms[2]	
Fund management companies	
Stock exchanges and other regulated markets	
Clearing houses and securities depositories	
Real estate agencies	X
Debt collection agencies and debt purchase businesses	X
Auditors and external accountants	X

X = Industry provides services (mostly) included in the VAT system.

(1) Agents are not licensed, but required to register by the FSA.

[8] Commercial Banks Act, Section 19.

(2) Firms or funds investing only own/members' money are not licensed.
Source: *Finanstilsynet* Annual Report 2011.

Why is a definition of financial institutions of interest concerning also taxation? Tax authorities usually avoid basing rules on a definition of sectors – with good reasons. When one sees sector definition in tax legislation it normally is for defining exemptions. However, financial and insurance institutions may be an exceptional case where sector definition can help removing an exemption – contrary to introducing it. Financial services and insurance are mostly exempt from VAT in Norway as in other countries, inter alia due to the technical difficulty of applying a credit-invoice VAT for these services. An alternative tax should ideally apply only to exempted services. A definition of the industries providing financial services and insurance could be helpful in this respect. Therefore, financial services regulation may come to use for defining the tax subjects. We return to the question of designing such a replacement in section 4.2.

Most industries supervised by the Financial Supervisory Authority of Norway (FSAN) are exempted VAT for a major share of their incomes. The industries supervised by the FSAN are listed in table 1. It is indicated whether the services provided by various industries are (mostly) included in the VAT system or not. As the table shows, the exemption from VAT includes services provided by banks, payment institutions, insurance companies, investment firms, stock exchanges, clearing houses, etc. In contrast, real estate brokerage, debt collection, accounting and auditing are services that elicit VAT. As mentioned, financial services law generally require that the firm is licensed for the provision of particular services and not engaged in other businesses. Consequently, separating the VAT encompassed firms from other industries under financial supervision that are mostly exempt, should be fairly straightforward.

Not all providers of financial services are licensed. In particular, bank regulation " … applies to all institutions which fund their activities by accepting deposits form an unrestricted range of depositors."[9] This implies certain investment firms and funds that invest money on behalf of their share-holders or members only, are not licensed. Therefore, they escape bank or investment firm licensing. Consequently, if the tax subjects are defined on the basis of financial institutions licenses a number of investment firms and funds would escape also the financial tax. This may or may not be a problem concerning taxation of the financial sector – depending on the purpose of the tax one foresees.

Increasingly, financial services are provided by conglomerates, often combining banking, securities and insurance services. Conglomerates are licensed both as financial holding companies

[9] Commercial Banks Act, Section 1.

and subsidiaries or branches providing separate services. Even though the same restrictions on diversification apply to subsidiaries and branches as to independent companies, the growth of conglomerates may challenge possible tax rules based on licensing as bank, non-life insurance company, etc.

2.3 Tax system and reforms in Norway

The 1992 reform of corporate and capital income taxation established broad tax bases with few exemptions. A main ambition was to achieve more neutral capital taxation than before. The statutory corporate tax rate was reduced from 50.8 per cent to 28 per cent – while the number of items that could be deducted in the tax base or tax payable where substantially reduced. The expert group that outlined the reform – the *Aarbakke* Group – proposed to abolish *inter alia* deductions for expected losses and accounts receivable in general. According to the *Aarbakke* Group there is no tax-related need of special rules taking account of expected losses for banks, insurance companies and factoring (billing) companies in particular.[10] However, in the tax bill presenting the reform, the Ministry of Finance maintained deductions for expected losses for financial institutions and insurance companies. The Standing Committee on Finance endorsed the Ministry's conclusion.[11] Except this question of accounting treatment for expected losses, financial institutions were not considered in particular neither by the expert group outlining the reform nor, subsequently, by the Ministry of Finance. Corporate taxation has remained broadly unchanged since the 1992 reform.[12]

Taxation of services has been a recurring question since VAT was introduced in 1970. Initially VAT included only goods and specified services, but compared to the former turnover tax the number of taxed services – with an eye on the EEC VAT regulation[13] – was increased considerably. Financial services and insurance were not listed as taxable, and consequently did not elicit VAT. Delineation of the tax area, including the implicit exemption of financial services and insurance, was broadly in line with VAT as applied in various EC countries, Denmark and Sweden[14]. Even though an official committee was established already in 1987 to propose a general VAT, this was not introduced be-fore 1 July 2001.

The VAT reform of 2001 established general VAT liability for services, and only services explicitly listed in the VAT Act are exempted.[15] Among the listed exemptions are financial services and insurance. However, the 2001 widening of the tax area was not without consequences for the financial services industry. Not included in the definition of financial services and insurance are a number of adjacent services – which became taxed – such as safe-deposit boxes, factoring (billing

[10] NOU 1989: 14 *Bedrifts- og kapitalbeskatningen – en skisse til reform*, 242.
[11] Innst. S. nr. 5 (1990–91) *Innstilling fra finanskomiteen om retningslinjer for reformer i bedrifts- og kapitalbeskatningen, og konsekvenser for personbeskatningen*, 42.
[12] The individual shareholder model introduced in 2006 affected mostly self-employed persons and small enterprises.
[13] Directive 67/227/EEC of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes (the Second VAT Directive).
[14] Iceland introduced VAT in 1990 and Finland in 1994.
[15] Act no. 66 of 19 June 1969 relating to Value Added Tax. Replaced by Act no. 58 of 19 June 2009.

services) and debt collection. Another consequence of the 2001 reform is that certain non-financial services often supplied by financial institutions – notably managerial, legal, financial or technical assistance (consultancy) – which were formerly exempted became taxed, cf. section 3.2 for a detailed discussion.

Although the VAT exemption in Norwegian tax law is broadly similar to EU regulation, taxation of financial services and insurance is more limited than in many EU countries. First, EU tax law allows member states to levy VAT on certain financial services that are not obligatorily taxed. Management or safekeeping of securities is not exempted[16], and accordingly some member states impose VAT on fund management of securities. Norway includes securities management in the exemption of financial services. Second, and more importantly, EU tax law does not regulate alternatives to VAT. Many EU countries apply other taxation – explicitly or implicitly – as an alternative to VAT on insurance, and few countries also as an alternative to VAT on financial services. Insurance is exempted from VAT according to EU VAT regulations, but most EU countries apply excise duties on insurance premiums instead[17]. France and Denmark apply an additional payroll tax for VAT exempted industries, including the financial services and insurance industries. Also Iceland has an additional tax on wage costs in banks, finance companies and insurance companies. Norway does not have such additional taxation on VAT exempted industries – neither on wage costs nor insurance premiums.

3 Present taxation of the financial sector

3.1 Corporate income

Taxation of wages and profits in the financial services and insurance industries is considered ac-cording to ordinary tax rules.[18] There is no additional taxation of income in these industries, ordinary tax rates apply, and there are no exemptions for financial institutions or insurance companies in particular. Notably interest earnings are taxed as ordinary income, and interest expenses are fully deductible for financial institutions as well as other taxpayers. Table 2 shows income and tax data for 2010 and 2011 for manufacturing, wholesale and retail trade, and financial and insurance activities. Economic activity in Norway was relatively normal these years, not deviating much

[16] Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, Art. 135(1)(f).
[17] Often at higher effective taxation than would follow from including insurance in the VAT system, what is explained in section 5.
[18] Certain special rules apply to financial institutions and insurance companies. In particular, financial institutions are allowed to deduct provisions for future losses, contingent on generally accepted accounting principles (Taxation Act, Section 14-5) – while other industries can deduct only realised losses. Insurance companies are allowed to deduct provisions for future compensations (Taxation Act, Section 4-52). Such rules can be seen a consequence of the special nature of the financial and insurance industries, and are not discussed in this article.

from trend growth. However, comparing taxable incomes in 2010 and 2011 one sees they fluctuated considerably in the financial services industries[19], and seemingly uncorrelated to value added. If considering taxable income as a proxy for taxing value added – more precisely the part of value added ascribed to remuneration of capital – such uncorrelated fluctuations could be a concern.

Table 2 Income and tax data for certain industries. NOK mill.

	Manufacturing		Wholesale and retail trade		Financial and insurance activities	
	2010	2011	2010	2011	2010	2011
Value added	179,091	189,854	181,634	187,653	101,344	101,473
Compensation of employees	123,504	128,297	135,033	143,109	39,555	42,343
Taxable income	32,444	42,912	40,178	44,648	59,870	34,551
Wealth tax	21	15	43	38	207	214
Income tax	9,084	12,015	11,249	12,514	16,763	9,671
Other taxes[1]	213	216	6	10	0	0
Tax credits[2]	613	550	88	86	110	183
Total assessed taxes	8,705	11,696	11,209	12,476	16,860	9,703

1) Hydropower rent tax, etc.

2) Credit for tax paid to foreign country, R&D tax credit, etc.

Source: Statistics Norway, National accounts and Tax statistics.

The statutory corporate income tax rate of 28 per cent applies to financial institutions in line with other industries inside the ordinary tax regime[20]. Since other taxes paid from corporate income – such as wealth tax[21] – are of marginal importance, and possible tax credits limited, assessed taxes as share of taxable income is near 28 per cent in the financial sector as well as in other comparable industries. Income tax rates adjusted for other taxes and tax credits are shown in table 3. The adjusted tax rate is somewhat lower in manufacturing than in wholesale and retail trade or financial and insurance activities due to R&D tax credits in particular.

[19] Even though banks increased margins on interests and currency transactions, profits decreased due to losses on loans and securities in 2011.

[20] Petroleum companies are taxed 78 per cent and hydro-power plants 58 per cent due to extra taxes on resource rent, while shipping companies can opt for tonnage tax instead of income tax.

[21] Limited companies are exempted wealth tax.

Table 3 Assessed taxes as per cent of taxable income and value added

	Manufacturing		Wholesale and retail trade		Financial and insurance activities	
	2010	2011	2010	2011	2010	2011
Taxable income	26.8	27.3	27.9	27.9	28.2	28.1
Value added	4.9	6.2	6.2	6.6	16.6	9.6

Source: Authors' calculations based on Statistics Norway, National Accounts and Tax Statistics.

Corporate tax claims a larger share of value added in the financial sector than in other industries since the profit share is higher. The statutory rate in Norway of 28 per cent was considered internationally low when introduced in 1992, but increasingly appears relatively high as other countries have been reducing corporate tax rates. Income tax as share of value added is considerably higher in the financial services industries than in manufacturing or wholesale and retail trade, even though assessed taxes amount to approximately the same share of taxable income. In an average year, each of these industries generates taxable incomes of about the same size, around NOK 40 billion. Out of this tax base corporations pay approximately NOK 10 billion in taxes. However, corporate taxes amount to as much as 10–20 per cent of value added in the financial services industries, compared to around 5 per cent of value added in other industries without a resource rent. Distribution of compensation to labour and to capital respectively in value added explains the difference. Consequently, a relatively high corporate tax rate in Norway implies considerable taxation of value added in the financial sector.

3.2 Value added

Exemption of financial service does not imply that value added is not taxed at all. A firm supplying financial services or insurance cannot reclaim (most) VAT embedded in the price of purchases. Such input VAT will be less than VAT on outputs – but **is** not necessarily less than potential revenue from taxing all value added in the financial and insurance industries. Output tax is creditable by VAT-registered customers, and net VAT would be less than input VAT from companies providing services mostly for businesses. Whether the financial sector is under-taxed of over-taxed is decided by the distribution between business customers and non-registered customers such as house-holds, non-profitable organisations and the public sector.

How much VAT does the financial services industry actually pay through input taxation? Non-creditable VAT is not reported in tax accounts, so there are no exact data available on such "hid-

den" tax contributions. Based on input-output tables in National Accounts, Statistics Norway has estimated input VAT paid by financial and insurance activities. The estimates based on National Accounts indicate that VAT on inputs to financial institutions and insurance companies amounted to approximately NOK 4 billion in 2010 – around 2 per cent of total VAT revenue. The figure is uncertain since the input-output tables are based on aggregate sectors and products that do not allow a complete simulation of the VAT system. Moreover, the calculation is based on the assumption that all input tax is non-creditable. Financial institutions also supply some services that are taxed today[22], and correspondingly reclaim part of input VAT. All together the estimate of input VAT is probably on the high side. Nevertheless, the result indicates that financial institutions contribute substantially to state revenue also through the VAT system.

How does input VAT compare to what the financial sector hypothetically "should have paid?" Not only is estimates of input VAT uncertain but there is little consensus on how a tax base equivalent to a hypothetical VAT on financial services should be estimated. Value added as presented in national accounts plus estimated input VAT may be considered a maximum reference for a potential tax base[23], and ascribing 45 per cent to non-taxable customers, one finds a hypothetical VAT of approximately NOK 12 billion on output of financial services and insurance at the ordinary rate of 25 per cent[24]. Based on this back-of-the-envelope calculation estimated input VAT amounts to around a third of a hypothetical, full taxation of value added in the financial services and insurance industries. This rough estimate suggests the advantage of the exemption for the financial and insurance industries amounts to approximately NOK 8 billion, equivalent to 0.3 per cent of GDP. Studies of EU countries have found an advantage around 0.15 per cent of GDP, but based on VAT exemption for core banking alone[25]. Considering the relative size of core banking to the total financial services and insurance sector these estimates seem close.

Expanding the credit-invoice VAT to fees and commissions on financial services would not reduce the favourable tax treatment of financial services if all input VAT became creditable. Paradoxically, simply including financial and insurance services in the present VAT system would reduce revenue – not increase it. According to the estimates by Statistics Norway above, reclaimed input VAT would reduce revenue more than the introduction of VAT on fees and commissions would contribute to revenue. However, the estimates do not take into account a hypothetical VAT

[22] Safe-deposit boxes, and managerial, legal, financial or technical assistance (consultancy).
[23] National Accounts probably overestimate value added of financial services *inter alia* because net interest incomes of equity transactions are included in income. Moreover, time value of money, which represents a cost for maturity transforming institutions, is not considered in National Accounts, and consequently appears as income.
[24] Roughly calculated as follows: Value added + input VAT (NOK 100 billion + NOK 4 billion) * share of value added from non-taxable entities (0.45) * tax rate (0.25) ≈ NOK 12 billion.
[25] European Commission (2011) "Is the financial sector under-taxed? Empirical part", *Impact Assessment Accompanying the document Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC*, SEC(2011) 1102 final Vol. 6.

on insurance premiums, which is discussed in section 5. Moreover, allowing all input VAT to be credited while only a part of incomes arrives from direct payments, may be considered too generous[26], and crediting on a pro rata basis appropriate. Nevertheless, the large share of income from margins on interests, currency transactions, etc. implies the credit-invoice method is not applicable for taxing value added from a considerable part of the financial services industries.

The VAT exemption distorts relative prices and therefore provides inefficiencies in the economy. On average financial services become cheaper compared to goods and VAT included services, which leads to over-consumption of financial services and excessive expansion of the financial sector as discussed above. However, businesses are over-charged for financial services since embedded VAT (in inputs of financial institutions) is non-recoverable, while households are under-charged since there is no output VAT added to the margin on financial services they consume. The cost of financial services for VAT-registered businesses is higher than it should have been while households receive cheaper financial services than they would in a neutral tax system. In addition, the exemption provides incentives for inefficient in-house production in financial institutions. Outsourcing of auxiliary services from a financial institution, e.g. data processing or cleaning, incurs VAT on the service. The exemption implies in-house production will be profitable for a bank until an extra cost of 25 per cent on the service. There is also a distortion of industry structure since in-house production of auxiliary services can be more easily arranged by large than smaller companies.

3.3 VAT exemption of financial services

3.3.1 Legal basis

The VAT exemption for financial services and insurance is to some extent based on the Sixth VAT Directive[27], and follows the same casuistic approach. The exemption has the following wording[28]:

"The supply or brokering of financial services shall be exempt from the Act, including:

a) the supply of insurance services.

b) the supply of financial services, but not finance leasing.

c) the processing of payment orders.

[26] Generous input tax credits appear to be accepted by tax authorities in many European countries, cf. Huizinga, H, (2002), "Financial Services – VAT in Europe?" *Economic Policy* 17 (2002) 501, 509.
[27] Council Directive 77/388/EEC
[28] VAT Act 19 June 2009 nr. 58, section 3-6.

d) the supply of legal tender.

e) the supply of financial instruments, etc.

f) the management of securities funds.

g) the management of investment companies."

One should notice that services relating to managerial, legal, financial or technical assistance are not exempted, even though such services are often provided by financial institutions.

The exempt transactions are defined according to the nature of the services provided, and not ac-cording to the entities providing or receiving the services. For example, the supply of credit management services is subject to VAT whether provided by a bank or a subcontractor to the bank. In certain cases a financial service may contain elements of additional services that would be liable to VAT when seen in isolation. Such elements are not always taxed. If the associated service is directly connected to, and subordinate to, the main financial service, it may, upon evaluation, be exempted. For example, corporate finance services may include additional services that by nature are taxable, but are allowed to be included in the exemption.

Interpretation and application of the VAT exemptions is facilitated by and where relevant based upon other legislation. Tax authorities consider uniformity with EU VAT law in particular, and emphasise – as in EU VAT regulation – that the exemption for financial services must be interpreted narrowly. In parallel, definitions of the various financial services are seen in the context of legislation concerning financial markets, i.e. harmonised with the definitions that are made for financial regulatory purposes. Definitions from financial market regulation provide guidance, as a starting point, for determining VAT treatment.

The tax status of services is considered separately for each business activity. A subcontractor who provides a service which is liable to VAT must therefore ensure that VAT is added, even if the service forms a necessary part of an exempt service at a later stage in the supply chain. Services provided by a subcontractor may, however, be regarded as financial services in themselves, and thus exempt from VAT. For a subcontractor's service to be covered by the exemption, the service must be separate from, but essential and specific to, an exempt financial service. A decisive factor in such an evaluation is whether the subcontractor is independently responsible for the specific and essential components of the exempt financial transaction.

Case law and administrative practice have uncovered relatively few areas of ambiguity or conflicting interpretations during the 12 years the current VAT regulations concerning the financial services exemption have been practiced. On the other hand, the cases that have been encountered

are complex and to a certain degree unresolved. Noteworthy in this respect is application of the exemption for mediation of financial services, in particular regarding loan and insurance mediation, where case law and administrative practice show on-going disagreement between the tax authorities and the financial and insurance sector. The question concerns whether tax authorities' practice is harmonised with EU regulation and case law. The industry claims the position of the Norwegian tax authorities is based on a too narrow interpretation of the exemption, and is untenable taking into account decisions on this matter in the European Court of Justice (ECJ) [29]. Current status shows support for the tax authorities' view in the lower courts, and partly in the Supreme Court by its decision of 22 December 2009 in Sundal Collier Holding ASA and Carnegie ASA.

3.3.2 Definition of exempted services

Financing services (but not financial leasing)

The exemption applies to charges for loans, financial guarantees, advances, credit card services, credit facilities, clearing and settlement-services, in short – core banking business. Conversely, financial leasing, debt collection and factoring are taxable supplies.

Processing of payment orders

In addition to the execution of traditional payment orders, usually performed banks, the exemption also covers services from clearing houses, data processing facilities, etc. which provide transmission or collection of transactions, provided they have independent responsibility for a given stage in the payment transfer. Mobile payment (e.g. payment via SMS) is classed as a technical or administrative service, and not considered as processing of payment orders. There is currently a court case pending regarding this exemption, where the payment services in question are considered in relation to ECJ decisions[30].

Supply of legal tender

The exemption applies to valid means of payment and brokerage services during such supply.

Supply of financial instruments, etc.

[29] CSC (C-235/00), and Volker Ludwig (C-453/05).
[30] SDC case (C-2/95), and SWIFT case (C-540/09).

The exemption applies to financial instruments and brokerage services during such supply. Financial instruments are defined as shares, bonds and other negotiable securities, units in securities funds, money market instruments, forward rate agreements, interest and currency swaps, etc. The exemption also includes options on the purchase and sale of such instruments. Examples of other excluded activities are the active management of an investor's portfolio, underwriting services for share issues, and clearing. Supply relating to a company's interests that are not shares – i.e. general partnership and limited partnership – and commodity derivatives are also exempt from VAT.

The management of securities funds

The exemption is based on statutory definitions in financial markets legislation.[31]

Management of investment companies

Investment companies are similar to securities funds, but there is no statutory definition. The term "investment companies" is, however, broader than "securities funds" as defined by financial market legislation, and applies to e.g. private equity funds and venture capital funds.

Supply of insurance services (and insurance mediation)

There is no statutory definition of insurance in Norwegian VAT regulation. Norwegian and EU regulation of the insurance sector provides guidance of the extent of the exemption. An approximate definition is a transfer of risk against payment, i.e. the insurer undertakes an obligation to pay, or provide services, if specified events occur[32].

"Insurance mediation", on the other hand, is defined with basis in Directive 2002/92/EC on insurance mediation, as implemented in Norwegian legislation in Act of 9 December 2002 on insurance mediation: "Insurance means the activities of introducing, proposing or carrying out other work preparatory to the conclusion of contracts of insurance, or of concluding such contracts, or of assisting in the administration and performance of such contracts, in particular in the event of a claim."

Managerial and technical services supplied in relation to insurance and mediation of insurance are not exempted, e.g. risk management and evaluations or claims appraisal.

[31] Act No 44 of 25 November 2011 regarding securities funds.
[32] Cf. EU case law (e.g. C-394/96 "CPP").

3.3.3 Inputs to financial services production

Embedded tax in purchases of goods and services as an input to VAT exempt production is not recoverable. While there is no exception to this principle in the Norwegian tax law, the EU VAT Directive allows recovery for export of financial services[33]. The Directive lays down the condition that the customer is established outside the EU, or that the services are directly related to goods to be exported out of the EU. Such zero-rating of exports of financial services appears to be common[34], and in this respect the VAT regulation in Norway is less generous than in other countries.

3.3.4 Cost-sharing

Related companies or limited liability partnerships can, if they meet certain criteria (requirements concerning ownership and co-operation between the entities), register as a single taxable entity – a VAT group. A VAT group is treated in the same way as a single taxable entity registered for VAT on its own. The registration is made in the name of the representative member. The representative member is responsible for completing and submitting a single VAT Return and making VAT payments or receiving VAT refunds on behalf of the group. However, all the members of the group remain jointly and individually liable for any VAT debts.

The attraction for a company joining a group is that it does not need to account for VAT on goods and services supplied to or received from other group members. VAT is liable only when goods or services leave from or arrive into the group as a whole. Therefore, membership of a cost-sharing group may reduce the administrative burdens of VAT compliance.

Cost-sharing is more attractive for companies supplying exempted services than those mostly inside the VAT system. Financial institution establishing cost-sharing can avoid input VAT on value added provided by subcontractors. Consequently cost-sharing reduces input VAT and removes much of the disincentive for out-sourcing by financial institutions that the VAT exemption creates.

3.3.5 Option to tax

The EU VAT Directive allows member states to introduce a system whereby companies are entitled to select VAT liability for specific financial activities. Some EU countries have introduced such options in their national VAT legislation for certain types of financial services. Norwegian VAT regulation does not offer an option to tax for any VAT exempted services.

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[33] Article 169.

[34] Keen, M, Krelove, R, and Norregaard, J, "The Financial Activities Tax" in Claessens, S, Keen, M, and Pazarbasiogiu, C (eds.) *Financial Sector Taxation: The IMF's Report to the G-20 and Background Material* (2010) 127.

3.4 Financial transaction taxes

3.4.1 Stamp duties

Certain financial transactions were formerly taxed through stamp duties. The stamp duty is one of the oldest tax forms, and originally applied to real estate transactions.[35] Over the years stamp duties were introduced for other transactions, and in particular financial transactions. Bills of exchange required a stamp duty from 1902, and insurance contracts, although with many exemptions, from 1915. Legislation establishing a stamp duty on share and bond transactions was passed in 1916. The rate was 1 per cent on the value in the contract note for shares, and 0.1 per cent for bonds. However, stamp duties on shares and bonds applied only to secondary transactions.

Stamp duties on financial transactions lasted until liberalisation of financial markets in the 1980s. Taxation of financial transaction became seen as hindering revitalisation of the stock exchange and supply of private equity to industry and trade. While most stamp duties on financial instruments were abolished in 1976, they remained for share transactions still some years.[36] Secondary transactions became untaxed from 1978, and issue offers – which had been included in the stamp duty only in 1976 – from 1984. Taxation of secondary share transactions was reintroduced in 1988, at a rate of 1 per cent of the market value, only to be abolished the year after. Volumes decreased during the year the tax was applied on share transactions, but one cannot conclude from this observation that the tax reduced trading.[37] The Black Monday crash on stock markets in October 1987 had lowered share prices both internationally and in Norway, and 1988 was marked by an economic downturn throughout the year. Since then, taxation of financial transactions has not been a topic in Norway – until recently.

3.4.2 Stock exchange charge on excess orders

Oslo Børs (Oslo Stock Exchange) started charging excess orders from September 2012. This should not be associated with charging transactions, since it is rather the opposite – charging non-transactions that distort the trading system. Furthermore, this is a measure decided by the stock

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[35] Statistics Norway, "Det norske skattesystemet 1967. The Norwegian System of Taxation 1967", SØS 20 (1968) 116–117.
[36] Statistics Norway, "Skatter og overføringer til private. Historisk oversikt over satser mv. Årene 1975–1994" Rapporter 94/71 (1994) 57–58.
[37] NOU 2011: 1 *Bedre rustet mot finanskriser*, 173.

exchange independently – and not a public tax[38]. Nevertheless, the stock exchange charge is an example of incentives-based charges that add empirical evidence to the debate on taxes as a means for influencing behaviour by actors in financial markets[39]. The charge is based on an Order to Executed Order Ratio (OEOR) of 70 to 1. Excess orders, based on monthly activity, incur a charge of NOK 0.05 per order.[40] The charging of excess orders is expected to reduce order activity that does not result in transactions. The purpose is to limit strain and upgrading needs for IT systems as well as bandwidth requirements for trading venues, brokers and investors. Moreover, traders have an extra incentive to improve algorithms which create many orders but rarely result in trades.

The approach taken by Oslo Børs differs from other stock exchanges implementing order to trade ratios, in that it tries to identify orders that improve market quality and liquidity, and keep these out-side the ratio. Orders that do not negatively impact the capacity of the trading infrastructure, inter alia orders that rest more than one second before being modified, and order amendments that improve price, volume or both, are not counted. So far no charge has been levied.[41] It turned out all participants who were above or near the OEOR, adjusted their order activity below the required limit before the charge came into effect. One reason for the perfect adjustment by market participants is that Oslo Børs communicated the OEOR to the markets well in advance of implementation. The results also show that behaviour in financial markets can adjust extremely fast when price signals changes – even at seemingly minuscule price incentives.

Application of a fee instead of regulation[42] provides valuable flexibility for both participants and the stock exchange. From time to time there may appear extraordinary situations when exceeding the OEOR would be neither irrational nor damaging to the market. In such situations collecting a fee afterward is a more appropriate sanction by the stock exchange than terminating orders, if at all possible, at the moment they were being placed.

3.5 Deposit insurance fee

Deposit insurance is financed by a fee paid by banks according to their guaranteed deposits and core capital. Revenue from the fee is allocated the Norwegian Banks' Guarantee Fund. Even though the Fund is an independent legal entity – governed by a board with five members elected

[38] France introduced a state tax on high frequency trading as one element of its financial transactions tax, which came into force on 1 August 2012.
[39] The modern debate on transaction taxes can be traced back to James Tobin's proposal in 1972 of a currency transaction tax.
[40] Oslo Børs press release 24.5.2012 "Oslo Børs to Implement Order to Executed Order Ratio"
[41] Interview with Jan Dankert Skagen (Oslo Børs) 27.2.2013.
[42] The European Commission is considering regulation of minimum resting times or transaction to order ratios, as part of the MiFID revision.

by the general meeting and one each from the Bank of Norway and the FSAN – the Fund's obligations and organisation as well as the deposit insurance fee are regulated by the Guarantee Schemes Act of 1996. Membership is obligatory for banks with head office in Norway, while branches of foreign banks operating in Norway have an option to become members.

Based on experiences of the early 1990s banking crisis, Norway established a deposit insurance system with a number of notable and innovative system stabilising features. Deposit insurance is extensive, the Fund's authority and obligations goes further than being a guarantor of deposits, and the fee structure provides some incentives to prudential banking behaviour. The Fund guarantees deposits of up to NOK 2 million (equivalent to approximately EUR 270,000) for each depositor in each member institution. Not only is the level of deposit guarantee higher[43] but the Fund has more extensive resolution powers than similar institutions in most other countries[44]. The Fund is allowed to protect also deposits that are not covered by the guarantee, and it can support banks in distress by equity infusion, liquidity support, loans or guarantees for loans – i.e. all types of intervention available to prevent defaults vis-à-vis singles institutions.

The fee structure provides financial incentives for banks to increase core capital above the regulated minimum of 4 per cent.[45] Membership of the Fund could create a moral hazard problem itself – when deposits are guaranteed by the Fund the individual bank could take on more risk than it would do otherwise. The fee has two elements. In addition to 0.1 per cent of total guaranteed deposits, banks must pay 0.05 per cent of total liabilities. This second element of the fee is adjusted according to capitalization of the bank. If Tier 1 capital is lower than 8 per cent, banks must pay an additional amount equal to a higher rate. Conversely, a bank with more core capital pays a lower rate but never less than 0.0325 per cent.[46] The adjustment according to core capital ratios makes the Norwegian deposit insurance fee parallel to stability fees or bank levies as introduced by some other countries after the 2008 financial crisis. Stability fees are generally calculated as a fixed percentage on the amount of liabilities that are not covered by core capital, while the Norwegian fee is an adjusted percentage of total liabilities. Expanding core capital would reduce the base on which a stability fee is calculated in other countries as well as the fee rate in the Norwegian system. Adjusting the base or the rate amounts to the same. However, differentiation of the fee may be insufficient to influence core capital significantly. Most Norwegian banks have capital ratios well above the regulated minimums, but this may have other causes than incentives provided by the fee. The

[43] EU countries guarantee EUR 100,000 or a similar amount, Directive 94/19/EC Art. 7(1a).

[44] More extensive compared to other European countries. The Federal Deposit Insurance Corporation in the US certainly has more extensive authority.

[45] Present Basel II rules. New Basel III rules will raise Tier 1 requirement to 6 per cent.

[46] The fee is raised by 4 times the number of percentage points by which Tier 1 capital falls short of 8 per cent, or reduced equivalently for Tier 1 capital above 8 per cent. For example 4 per cent Tier 1 capital implies a rate of 0.05 + (0.05 * 0.04 * 4) = 0.058. Relatively high Tier 1 capital of 12 per cent implies a rate of 0.05 – (0.05 * 0.04 * 4) = 0.042. Minimum rate is 0.0325 per cent (at Tier 1 capital 16.75 per cent and above).

authors are not aware of any studies that have estimated impacts of the differentiated fee on bank behaviour.

Until 2013 the deposit insurance fee was levied only when the Fund was not fully capitalised.[47] The Guarantee Fund's aggregate capital base shall at all times at least equal the sum of 1.5 per cent of aggregate guaranteed deposits with the members plus 0.5 per cent of the sum of the liabilities for those institutions which are members. A full contribution by the members would amount to approximately NOK 1.7 billion per year. However, as there have been few banks defaults or near defaults[48] ordinary members have not been paying fees a number of the last years[49]. Such on and off charging may have reduced the incentives effect of the fee differentiation. However, from 2013 the "ceiling" on the size of the Guarantee Fund has been removed, implying all members have to pay their fee continuously. The unlimited charging also allows the Fund to build up more capital during good times, so it will be better prepared to handle potential problems in larger banks, and problems affecting several banks at once.

4 Reviews of financial sector taxation

4.1 The Services VAT Committee (The *Storvik* Committee)

The *Storvik* Committee, which considered a general VAT on services, recommended maintaining the exemption for financial services and insurance. The Committee was established in 1985 to consider the VAT system and prepare improvements, and finalised its official report in May 1990. It recommended charging services in principle and exempting only explicitly listed services. This reversal from formerly taxing only listed services has been named *"speilvendingsprinsippet"* meaning the reversal principle. The attraction of the legal twist is that new services, or services unknown to the lawmaker, become taxed without amending the VAT law. The VAT reform of 1 July 2001 implemented the reversal principle and some of the Committee's proposals for expanding the tax base.

The Committee based its discussion of taxing financial services and insurance on the EC VAT regulations, and practice in other countries, as well as an assessment of the technical feasibility of applying the credit-invoice method to financial services. In particular, the Committee refers to Sweden, where a report of June 1989 on excise duties assessed inter alia taxation of financial services[50]. The Swedish committee argued for taxing the value added by financial and insurance activities in principle, but refrained from recommending such taxation with reference to on-going con-

[47] The moratorium applied only to ordinary members. New members had to pay continuously during an introductory period.
[48] Last payments and loans from the Fund were in 2008 (defaults of Glitnir Bank and Kaupthing Bank).
[49] Ordinary members did not pay the fee in 2005, 2006, 2007, 2011 and 2012.
[50] SOU 1989: 35 *Reformerad mervärdesskatt, betänkande av kommittén för indirekta skatter*.

siderations in the EC. The *Storvik* Committee noticed that the Swedish report described alternative methods of taxing value added, either taxing aggregate wages and profits (addition method) or margin incomes directly, but did not itself assess these alternatives to the ordinary credit-invoice method. Consequently the Committee concluded that a VAT is not practicable for taxing financial services and insurance. However, the Committee emphasises that its recommendation of maintaining the exemption for financial services is based principally on considerations of competitiveness and taxation in other countries.

A minority of two members argued a credit-invoice VAT should be charged on brokerage fees and commissions, and that the EC VAT law did not restrict this extension of the tax area.[51] However, the majority found management of securities should not be taxed differently than other financial ser-vices. Moreover, the Committee appears not to have scrutinised alternative taxation of value added in the financial sector in other countries, except the above Swedish study. The wage tax introduced in Denmark in 1990 is not mentioned in NOU 1990: 11. Neither is there any reference in the report to excise duties or turnover taxes on insurance premiums as applied, for example, in Finland. In this respect the *Storvik* Committee appears to have interpreted its mandate as assessment of the credit-invoice method narrowly, and not comprising alternative methods of taxing value added.

One should not forget the economic and political context in which the Committee presented its recommendations. This was the time of the most severe economic downturn in Norway after World War II, and an escalating banking crisis – hardly the best of times for proposing additional taxation of financial services. Exemption of financial services was included in the 2001 VAT Law in line with the Committee's proposal. However, the law bill stated that the exemption was preliminary. [52]

4.2 The Financial Crisis Committee

The Financial Crisis Committee was the first official committee in Norway to consider and propose tax measures for the financial services industry in particular.[53] The Committee was established by the Government in June 2009, and assigned the task of assessing origins and impacts of the international financial crisis, and to identify possible impacts and recommendations for Norwegian economic policy and financial market regulation. Even though the Committee was not explicitly asked to consider tax matters, it dealt quite extensively with taxation of financial services. However, the Financial Crisis Committee was not an expert committee on taxation. It discussed tax

[51] NOU 1990: 11, 211.
[52] Ot.prp. nr. 2 (2000–2001) *Om lov om endringer i lov 19. juni 1969 nr. 66 om merverdiavgift*, 124
[53] A committee that considered competitive conditions in the financial industries only spent a half page on taxation. NOU 2000: 9 *Konkurranseflater i finansnæringen*, 202–203.

matters in qualitative and general terms and did not substantiate its recommendations by quantitative or empirical examination of possible tax designs. The Committee qualified its recommendations on taxation as needing further assessment. The Committee presented its report in January 2011.

Regulation should still be the main instrument for assuring prudential institutions and protecting consumers in financial markets – but the Committee argues that taxes or fees could supplement regulation and supervision in a useful manner. The Committee points at a number of rationales for focusing more on taxation as a policy instrument. First, taxes are more flexible in not establishing quantitative targets or limits, but exercising a gradual reaction according to the degree of deviation from a norm. Second, certain problems left out by regulation could potentially be addressed by taxation. Even though capital adequacy requirements imply some costs on expansion for banks, existing regulation does not aim at controlling the size of the financial sector. Third, since regulation is to a considerable extent co-ordinated internationally while countries have broad discretion in tax matters, taxation could be implemented faster, independently and tailored national structures. On the other hand, the lack of international tax co-ordination could enhance concerns of competitiveness, and the Committee itself qualifies a number of its tax recommendations as requiring international co-operation.

In the Committee's view a stability fee should be imposed on Norwegian financial institutions. The tax base should be liabilities in excess of equity and guaranteed deposits. Expectations of government intervention to avoid default of financial institutions may cause excessive risk-taking and un-due expansion of the financial sector. Therefore, private costs of financial services are less than social costs – implying a rational for the government to raise the cost of financial services through taxation. The Committee finds the prospect of bank resolution constitutes an implicit government guarantee that goes further than deposit insurance, and consequently proposes a stability fee in addition to the existing deposit insurance fee. Nevertheless the Committee also recommends that the deposit insurance fee should not be deferred when the Fund is fully capitalised.[54] Obviously the Committee found the incentives mechanisms of the present fee – even if charged on a continuous basis – insufficient for compensating externalities of the implicit government guarantee. Revenues from the two fees should be used for different purposes – with the stability fee financing measures to prevent problems arising in financial institutions, and the insurance deposit fee for resolving defaults or near defaults.

Co-ordinated introduction of identical or similar taxes in several countries would be preferable ac-cording to the Committee. It argues additional taxes introduced in only one or few countries

[54] Continuous payment of the deposit insurance fee had been proposed by the Bank of Norway and the FSAN formerly.

could spur relocation of financial businesses to other countries. In particular, a tax on financial transactions could be evaded be moving trading venues to other jurisdictions. If the EU does not establish legislation on a common stability fees at a substantial level, the Committee recommends Norway should work towards a harmonized approach among the Nordic countries.

Furthermore, the Committee argues the VAT exemption implies cheaper financial services and, therefore, an expansion of the financial sector. At first sight, one might assume concerns of competitiveness should not explain an exemption of VAT. Conversely, the exemption implies in-puts are non-creditable, which increases the cost of producing for export markets as well as the domestic market. VAT is applied according to the destination principle. It is a tax on domestic final consumption treating national and foreign producers equally concerning both imports and exports. Imported products are charged VAT in line with domestic products while exports are VAT-exempted. How-ever, another rationale for the exemption is technical difficulties of designing a proper VAT on financial services. It is not possible to apply a credit-invoice VAT on margin in-comes such as interests and currency trade. When exempted, different rates in various countries, notably certain countries not having VAT or equivalent taxation, may distort competition between exempted, mobile services in various countries. Many financial services have the property that they can be produced and consumed at different geographical locations. For example, a company may borrow in a foreign bank as well as a domestic bank, shares may be listed abroad, etc.

The Committee recommended that the Norwegian authorities should examine the basis for – and the possible impacts of – an additional tax on financial institutions' wage payments and profits. This is in line with other proposals for a FAT, which has been put forward inter alia by the IMF.[55] By definition value added equals the sum of remuneration of capital and labour respectively. If taxing each transaction is inapplicable, the idea is to tax aggregate measures available from income tax accounts. The Committee found it unfortunate that services produced in an entire sector are ex-empted VAT, and considered an additional tax on profits and wages – if it is designed in an appro-priate manner – could assure that financial services are treated in line with other goods and ser-vices. In that way an additional tax could reduce distortions in consumption and industrial structure as well as providing significant state revenue. Similar tax designs and co-ordinated implementation in as many countries as possible would facilitate the implementation. The Committee referred in particular to the European Commission's assessment of a possible FAT.

5 Follow-up and on-going work

5.1 Introduction of continuous deposit insurance fee

[55] IMF, "A Fair and Substantial Contribution by the Financial Sector", Final Report (2010).

The deposit insurance fee, which formerly was paid by banks only when the Fund was under-funded, has been made continuous from 2013. The Ministry of Finance argues accumulation of reserves above the former requirements will prepare the Fund for handling potential problems in larger banks and more banks at the same time. Moreover, continuous payments will strengthen incentives for banks to increase core capital above the regulatory requirements.

Incentives and funding provided by the fee now appears broadly in line with stability fees or bank levies in some other European countries. Revenue of the deposit insurance fee in Norway is comparable to what the stability fees of UK[56] or Sweden[57] respectively if applied on Norwegian banks, would have generated[58]. Impacts of continuous payment of the deposit insurance fee are overlapping the rationales for a stability fee as presented by the Financial Crisis Committee. Accordingly the Ministry of Finance has decided not to assess a stability fee further.

[56] Applied on banks in Norway the basic allowances in the UK bank levy appear very high. Only without any basic allowance the revenues would be about similar.
[57] Including deposit insurance fee.
[58] Prop. 11 L (2012–2013) *Endringer i finanstilsynsloven, banksikringsloven og foretakspensjonsloven*, 25.

5.2 Practicing the current VAT exemption

Interpretation and application of the VAT exemption has been demanding, and a source of disputes between the financial services sector and the tax administration, concerning mediation of financial services in particular. One should note that the VAT exemption of financial services applies to both the mediation of a financial service as well as performance of the actual financial service. This includes services from intermediaries in various parts of the financial services industry, such as mutual fund and stock brokers, currency brokers and insurance brokers.

The term mediation in this regard should apply to the act of bringing parties together in an agreement only. Mediation must be distinguished from consulting, marketing and other taxable services. Hence, the services rating agencies and others who provide investment advice on an independent basis, unrelated to specific financial services, falls outside the scope of the exemption. Similarly, mediation unrelated to an exempt financial service is considered a taxable supply, for instance the services provided by real estate brokers. Furthermore, mediation must be distinguished from services of technical, professional or administrative nature, which are taxable services.

Interpretation of the term "mediation of financial services" has, on a case by case basis, been shown to be difficult, since the exemption is regarded on the basis of the nature of the service, and not the VAT status of the entity delivering the service. Many financial institutions typically offer complex packages of services, where mediation is just one component of a larger supply of services. The question of defining one or several supplies in relation to VAT, and the distinction between principal and ancillary services has proven to be a particularly complex issue.

The Ministry of Finance, in a statement of 15 June 2001, provided guidelines in these matters: “An exempt financial service may contain some elements of taxable ancillary services. One must make an assessment whether there are separate, principal services, or whether the taxable service merely is an ancillary, associated service that reasonably can be considered as an integral part of the principal exempt supply that makes both services exempt.” This is normally the case when the ancillary service is of a nature that commonly is provided alongside the principal financial service while the financial service still can be characterized as the principal service.

These guidelines have been applied in judicial and administrative practice. It is also to be noted that the VAT status of a service must be decided individually for each supplier. Consequently, a taxable service from a subcontractor may, in turn, be deemed an exempt service from the end suppliers as a consequence of the guidelines above – the taxable supply from the subcontractor may be considered an ancillary part of an exempt principal supply, and the whole supply is therefore considered an exempt service.

These issues have been a particularly evident in the area of corporate finance services. There is no legal definition of the term "corporate finance services", and these services usually contains a multitude of services (taxable and exempt), which in varying degree can be characterized as principal/ancillary services. Again, the Supreme Court decision of 22 December 2009 – Sundal Collier Holding ASA and Carnegie ASA, mentioned in section 3.2.1, provides illustration of the complexity of the matter, and shows that a case by case approach to the matter is necessary. One should note that the court states that the basic principles given in the Volker Ludwig case (C-453/05) are to applied in this area.

The administrative costs of deciding whether a particular service should be taxed or not, is a minor part of the negative impacts of the present system. Increasing the exempted area generally reduces tax revenue, and contributes to under-taxation that may encourage undue expansion of the financial sector. There is also the matter of influence on the corporate structures in the financial sector, where the VAT exemption provides incentives to in-house production instead of otherwise rational use of subcontracting and outsourcing. Group-registration may mitigate such distortions, but on the other hand encourage aggressive tax planning, especially in combination with cross border operations that may take advantage of different corporate taxation in various countries.

5.3 Assessment of a Financial Activities Tax

The recommendations of the Financial Crisis Committee, together with a summary of comments from a public review, were presented in the tax bill[59] on the state budget for 2012. Based on the recommendations and comments the Ministry of Finance announced it is evaluating the possibility of and impacts from a FAT as well as considering a stability fee. As a preliminary assessment the Ministry found introducing a FAT would be judicially and technically feasible.

The Ministry of Finance reported in more detail on its considerations in the 2013 tax bill on the state budget[60] than the preceding year. The assessment is two-pronged – examining both whether (some) financial services can be included in the VAT system, and whether a FAT is applicable (for the remaining financial services). The credit-invoice method appears not to be practicable for taxing (most) financial services – and that leaves a tax based on aggregate measures from income tax accounts as the most realistic approach for a major part of the sector.

When considering a FAT, a main concern of the Ministry is to integrate qualities of a credit-invoice VAT as far as possible. This ambition raises a number of challenges of both an economic and a judicial nature. First, a tax base representing value added in financial institutions should be defined in a manner that is applicable and controllable. Second, VAT-registered businesses should

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[59] Prop. 1 LS (2011–2012) *Skatter, avgifter og toll 2012*, 77–80.
[60] Prop. 1 LS (2012–2013) *Skatter, avgifter og toll 2013*, 215–217.

not be charged the FAT when purchasing financial services. Third, the destination principle should be applied also for a FAT. Neither of these requirements has a straightforward solution nor can be considered off-the-shelf tax designs.

Income tax accounts do not present value added directly, but could potentially be adjusted to represent a tax base for a FAT. By definition value added equals the sum of remuneration of labour and capital respectively. The part from remuneration of labour is simply wage costs of the firm. Adding the capital part is more complicated since profits as they appear in income tax accounts do not separate interest on customer transactions from interest on equity transactions. Net interests on equity transactions, including dividend payments, is a cost of capital and not value added of financial services, and should not be included in the tax base. Moreover, capital expenditures are amortized over the life of capital property in income tax accounts, while capital expenditures are deducted as they incur in a VAT system. In principle, profits as calculated for income tax purposes can be adjusted to a FAT with an allowance for corporate equity (ACE). A tax on the sum of wage costs and ACE adjusted profits is equivalent to a tax on value added.[61] Only four countries have introduced additional taxation to compensate the VAT exemption, and out of these only one taxes also profits substantially.[62]

Avoiding a FAT being charged on supplies to VAT-registered businesses requires an in-house deduction from the tax base, i.e. the financial institution charging and reporting FAT only on the value added deriving from non-registered customers. By the credit-invoice method charging VAT-registered customers is avoided by the customer crediting tax embedded in inputs. Conversely, a FAT embedded in net payments for financial services cannot be deducted by customers since the tax is calculated from accounts, and consequently not declared on invoices. Without other arrangements the tax would accumulate through intermediate products, so-called cascading, and would be paid by businesses as well as households. To avoid cascading a FAT would have to be imposed on supply to non-taxable customers only.

No country with a wage tax for the financial services industry has exempted sales to VAT-registered customers. However, some countries allow crediting of input VAT according to the share of inputs applied for servicing registered customers.[63] If a distinction between registered and non-registered customers can be applied to inputs, it should be possible also to divide value added between the two groups[64]. Possible solutions could be to establish different template shares for various types of financial institutions, or a self-declaration of share of value added belonging to VAT-

[61] Mirrlees Review, 2. Vol.: Tax by Design, 210.
[62] France, Denmark and Iceland have additional taxes on wages, while Israel taxes both wages and profits substantially (without ACE in profits).
[63] Singapore, New Zealand and Australia. See Schenk, A and Oldman, O, "Value Added Tax. A Comparative Approach" (2007) 331–334.
[64] Dividing input VAT is not necessary, since all embedded tax should be recovered (zero-rating).

registered or non-registered customers. However, such arrangements would entail a certain amount of discretion on part of the taxpayer that may discredit the system.

In principle exports of financial services could be considered according to the destination principle, while a FAT itself is not applicable for charging imports of financial services. Ex-ports could be exempted in line with incomes from VAT-registered domestic customers – parallel to treatment of exports in the VAT system. Technically this implies that input VAT is credited according to the share of value added generated by supplies to domestic VAT-registered customers plus customers abroad. Inputs for financial services supplied to customers abroad already are creditable in most countries with VAT or similar taxation. In contrast, charging imports with a FAT appear fundamentally impossible. Wages and profits are generated and taxed in the country of origin, and therefore escape a FAT in the destination country. In this respect applying a FAT is equal to ordinary income taxation of wages and profits. The VAT system is particular in taxing imports at the rates applied in the destination country. Whether a country could establish import charges to compensate a lower or no FAT in exporting countries, is a question for international trade law, which is not discussed in this article.

5.4 Could the VAT base be expanded?

The Ministry of Finance announced in the tax bill on the state budget for 2013 that it is assessing the feasibility of including direct payments, such as fees and commissions, in the ordinary VAT[65] as well as continuing the assessment of a FAT. Insurance services are exempted from VAT in Norway as well as in the EU. While introducing VAT on insurance is not an option for EU member states, Norway is not restricted by EU tax law in this matter, and could hypothetically include insurance in the VAT system. Therefore, it could be worthwhile considering whether it is feasible to include non-life insurance in the ordinary VAT.

Some countries that relatively recently introduced taxation similar to VAT provide examples for considering taxation of non-life insurance. In 1986 New Zealand introduced Goods and Services Tax (GST) with exemption of financial services and life insurance, but included non-life insurance in the tax area.[66] Australia introduced GST in 2000, and like New Zealand included non-life insurance.[67] Other countries that have include non-life insurance, are South Africa[68] and Singapore[69].

[65] Prop. 1 LS (2012–2013) *Skatter, avgifter og toll 2013*, 217.
[66] Schenk, A and Oldman, O, “Value Added Tax. A Comparative Approach” (2007) 343–355.
[67] Ibid, 355–356.
[68] Ibid, 343.
[69] Inland Revenue Authority of Singapore, “GST: The Insurance Industry” (2012).

The VAT exemption does not imply insurance is untaxed. VAT embedded in purchases of goods and services is not reclaimed by the insurance company, like in other industries providing exempted services. Moreover, replacement goods and services and repairs provided by compensations are included in the VAT system in line with other purchases of similar products. Consequently, non-life insurance is to a considerable extent taxed through VAT on its inputs – both replacements for damages claimed by policyholders and products consumed and invested in the insurance companies.

What remain untaxed are only the internal activities of the insurance company, which consist mainly of attracting customers, establishing risk-sharing financial arrangements and considering claims for losses and damages. A major part of the cash inflow to non-life insurance companies finances purchases of VAT included products, and only a minor part the value added by the insurance activity itself. Accordingly a tax on insurance premiums without deducting embedded tax – i.e. an excise duty – could represent a considerable over-taxation (depending on the rate) compared to applying VAT.

Insurance companies receive income from both direct payments (premiums) of policyholders and financial investments on behalf of the customers – and while the premium part can be taxed through an ordinary VAT, the investment part would not be included in the tax base through the credit-invoice method[70]. Not all of premium incomes are paid out as compensations immediately, as a part is invested in financial assets. When the insurance companies stipulate the premium levels they consider expected compensations and also returns from the policyholders' funds that they have at their disposal. Returns on such investments partly finance compensations as well as premiums, and their profits should be included in the tax base to cover value added entirely. However, only returns exceeding the time value of money contribute to value added, and therefore a normal rate of return should be deducted. Taking this together, value added of insurance activities can be defined as follows:

Value added = Premium payments + financial incomes exceeding normal returns – compensations – inputs of goods and services

The credit-invoice method is more applicable to non-life insurance than to life insurance and financial services. A concern for applying a credit-invoice VAT to many financial services is the possibility of financial institutions shifting income from direct payments (fees, commissions, etc.) to

[70] A cash flow method of taxing transactions could in principle include value added on investments, see Barham, V, Poddar, S and Whalley, J, "The tax treatment of insurance under a consumption type, destination base VAT", *National Tax Journal* 40–2 (1987) 171–182.

margins on their services. Casualty and property insurance is financed mostly through current payments, and less through proceeds of funds. When financial incomes are not included in the tax base a considerable part of value added from non-life insurance would still be taxed. Leaving out investment incomes, the remaining parts of the equation above can be handled by the credit-invoice method, as explained below.

Another factor facilitating use of the credit-invoice method is that terms and financing of non-life insurance is of a short term character, in contrast to the long-term commitments of life insurance and many other financial services.[71] Terms and premiums of non-life policies may be changed at the main due date, usually every year, and customers are allowed to terminate contracts with one month's notice. Since non-life insurance is for a large part based on current funding with short-term commitments, introducing VAT should entail relatively modest transition problems for insurance companies.

In addition, some designs of a credit-invoice method are enabled by the insurance companies' transactions with VAT-registered businesses being separable from transactions with non-registered customers concerning both in-flows and out-flows. While a bank's financing is not included in the contract for a deposit or loan, premium payments and compensations are linked to each insurance policy. Consequently, the cash flows (except investment dispositions) of a non-life insurance company can be allocated to each customer in a transparent way.

Tax systems i New Zealand and Australia provide two different templates for including non-life insurance in a VAT system. As explained above, embedded tax in compensations should be deductible for supplies to registered claimants. If not value added would be tax both at the point of replacement or repair and at the point of paying a premium. In New Zealand insurance companies are allowed a deduction of embedded tax as if all compensations incurred tax, including claims by registered businesses. On the other hand, registered claimants are obliged to "charge" received compensations – equivalent to regarding the compensations as taxable supplies from claimants to insurance companies. Embedded tax in a replacement or repair is recoverable, so the business claimant will not pay any tax on damages. Compensations are "grossed up" by insurance companies so that claimants cover their costs fully. Conversely, Australia allows insurance companies to deduct embedded tax for compensations to non-registered claimants only. Consequently business claimants are not charged on compensations, and there is no need of tax rules applying to insurance "income" of registered businesses in particular. Registered claimants receive compensation exclusive of tax, and they procure replacements and repairs exclusive of tax.

[71] This difference may not be as conspicuous in Norway as in many other countries, since the share of fixed-interest deposits and lending is relatively small.

Various methods of reclaiming tax embedded in compensations raise different problems of calculation and compliance. Australia's method – reclaiming tax only for compensation of non-registered customers – requires the insurance company to differentiate between registered and non-registered customers. Tax deduction for compensation to corporations with split activities – i.e. partly taxed and partly exempted turnover – has to be scaled down pro rata. One should notice that the change from today is not that insurance companies have to separate registered and non-registered claimants – they already have to[72] – but that incorrect payment of the tax element to VAT-registered claimants will no longer come at a loss to the insurance company. While insurance companies today have self-interest in avoiding incorrect "gross up" of compensations, and therefore can be trusted to scrutinise the tax status of claimants thoroughly, they may become less alert when embedded tax becomes deductible. New Zealand's method eliminates the necessity of insurance companies splitting compensations for tax purposes, but may require more attention to compliance by VAT-registered claimants than Australia's approach. Businesses will have to add tax on received insurance "income" in their VAT/GST statements. It may not be intuitive for business claimants to "charge" VAT on received compensations as if it had been extra sales – based on promises that insurance companies have "grossed up" compensations sufficiently to cover ensuing VAT of the claimants.

Insurance of property or damages in other countries, or insurance purchased from abroad, can be considered mostly in line with exports and imports of other services – but there are some complicating elements of taxing insurance in particular. One question is recovery of the tax element in compensations. Compensation of damages in other countries would not incur a deduction since the premiums have not been taxed in the country of origin. Imports may be more complicated than handling exports when the company providing compensations is not registered for tax purposes in the destination country[73]. A possibility would be to allow voluntary registration for foreign insurance providers that operate without a local representative or agent.[74]

6 Conclusion – where are we today?

Taxation of the financial sector has developed mainly as a result of applying general rules to the sector in line with other taxpayers. Only at a few occasions have practicability of the general rules and impacts for the financial sector in particular been touched upon. The expert group that

[72] Compensations paid to non-registered customers includes VAT, and accordingly insurance companies set premiums to cover the cost of compensations including VAT for private policyholders. Conversely, VAT-registered businesses receive compensations from the insurance company exclusive of VAT since they can reclaim tax embedded in the price of replacement goods and services or repairs.

[73] Normally a foreign insurance provider would be registered through a subsidiary, branch or agent.

[74] The alternative of a lower premium tax rate for imported insurance (and no deduction for compensations) raises a number of awkward questions.

outlined the 1992 reform of corporate and capital taxation considered special rules for financial institutions concerning deduction of losses as unnecessary, but did not examine the question in detail. The VAT exemption of financial services was discussed first by the *Storvik* Committee. The Committee recommended maintaining the exemption for financial and insurance activities principally since no other country applied a VAT for these services. Not until examination of the recent international financial crisis did the question reappear sincerely. The Financial Crisis Committee argued for a FAT that could compensate the VAT exemption, but found implementation should be contingent on European or at least Nordic co-ordination.

A corporate income tax rate of 28 per cent with a broad tax base implies value added in the financial sector is taxed to a considerable extent today. This is due to a high share of capital remuneration in value added in the financial services and insurance industries compared to other industries without resource rent income. In addition value added is taxed through input VAT. A back-of-the-envelope calculation indicates input VAT amount to around a third of what a full taxation of value added should have realized. To emulate a tax on value added in the financial sector, alternatives to the credit-invoice VAT – due to the high share of remuneration of capital in value added – would have to include profits in the tax base. In addition, a tax on value added including profits could possibly provide counter cyclical incentives.

Consideration of financial sector taxation in Norway – when it has taken place – has been based on ambitious concepts. Implementing new tax concepts is challenging, but one should not overlook that a deposit insurance fee with incentives to raise core capital above regulatory requirements has been accomplished and recently made continuous. For compensating the VAT exemption of financial services, the alternatives being considered are expanding the ordinary credit-invoice method or introducing a FAT that emulates as many as possible of the properties of an ordinary VAT. In this respect the taxes that have been implemented in a few other countries as a VAT replacement – mostly payroll taxes – appear relatively far from the objective. It remains to see whether the on-going work in Norway on a comprehensive solution to the VAT exemption will come to a practicable and acceptable proposal.