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# General Legal Report

*Axel Hilling*

## 1. Taxing the Financial Sector

### 1.1. Introduction

This general legal report deals with legal issues related to the taxation of financial undertakings within the Nordic countries. Because this report is based primarily on information presented in draft versions of the five national reports from the Nordic countries, some significant areas within the financial sector are not dealt with – the taxation of undertakings specifically involved in the risk capital business, for example. Besides the information in the national reports, some international literature has been used as reference material, because my goal is to position in a general context the various types of tax instruments which are presented in the national reports. Without this positioning, the presentation of the great variety of tax instruments and the legal issues related to them would likely be difficult to measure. In my choice of literature, I have favoured that which is or likely will be well-known in relevant contexts, and relevant materials from the International Monetary Fund (IMF), the G-20 and the European Union (EU).

This report comprises three chapters. In the first chapter – 1 Taxing the Financial Sector – I focus on general issues related to tax legislation in the five Nordic countries. Current international development (1.2) and variants of tax instrument targeting the financial sector (1.3) are presented in this section. The difference between a tax and a levy (1.4) and a relevant definition of the financial sector (1.5) are also discussed. The second chapter – 2 Taxation in the Nordic Countries – deals with the specific tax regulations presented in the national reports: 2.1 Levies on Financial Institutions, 2.2 VAT, 2.3 Corporate Income Tax, 2.4 Other Tax Instruments. Part 2 does not deal with *all* tax regulations presented in the national reports; rather it provides a selection based on their relevance in relation to the general legal issues presented in Part 1. In

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addition, this selection is made with the goal of presenting a fair view of relevant tax legislation in the five Nordic countries. The report concludes with some final remarks in the last chapter: 3 Final Remarks.

## **1.2. International Development**

The financial crisis of 2008 required many governments to provide extensive support to their financial sectors. To find efficient ways to recover the costs for these supports, the G-20 leaders asked the IMF to prepare a report for the 2010 meeting in Toronto, elaborating upon the question: *How could the financial sector make a fair and substantial contribution towards paying for any burden associated with government interventions to repair the banking system?*<sup>1</sup>

Based on two assumptions – that suggested measures should ensure that the financial sector meets the direct fiscal cost of any future governmental support, and that these measures render failures less likely and less damaging – the IMF suggested two forms of contributions from the financial sector: a Financial Stability Contribution (FSC) and a Financial Activity Tax (FAT). A FSC is a levy paid by a financial institution for the fiscal cost of any future government support to the sector, and the FAT is a tax levied on the sum of the profits and remuneration of financial institutions.

Although the G-20 leaders agreed that the financial sector should make a fair and substantial contribution towards payment for burdens associated with government interventions, they did not agree on the measures to be used.<sup>2</sup> In a meeting prior the G-20 summit in Toronto, however, the European Council decided that the EU should lead efforts to find a global approach for introducing systems for levies and taxes on financial institutions. In this context, the introduction of the Financial Transaction Tax (FTT) was explored.<sup>3</sup>

In September 2011, the EU's efforts resulted in a proposal for an FTT to be levied in the 27 member states of the EU.<sup>4</sup> During the ECOFIN Council meetings in the summer of 2012, however, it became evident that the member countries could not reach a unanimous decision about a common FTT. As of September 2012, therefore, the Commission received requests from 11 Member States asking it to submit a proposal for a Council Decision to authorise

1. IMF 2010.
2. G20 2010, Section 21.
3. European Council 2010, Section 17.
4. COM 2011 (594) final. See also COM 2010 (549) final.

enhanced co-operation on a common FTT.<sup>5</sup> This decision was approved in January 2013, and in February 2013 a proposal for a Directive on enhanced co-operation on a FTT among the 11 Member States was presented,<sup>6</sup> suggesting that the Member States within the enhanced co-operation should apply the provisions on the new FTT as of January 1, 2014.

### 1.3. Variations in Taxation of the Financial Sector

In its report to the 2010 G-20 Summit in Toronto, the IMF suggested two ways in which the financial sector could make a fair and substantial contribution to covering the cost of government intervention during the financial crises: an FSC, and an FAT. These two methods were supplemented by a third method, the FTT, in the enhanced co-operation among 11 EU Member States. These three methods come in several variations, and appear under different labels in the literature.<sup>7</sup>

The IMF group relevant instruments into two broad categories based upon the way they address different objectives for the regulation of the financial markets.<sup>8</sup> The first category includes levies on financial institutions – the FSC for example. These measures are generally aimed at preventing future failures among financial institutions by taxing leverage, which is seen as a major risk indicator and at covering the net fiscal cost of government support to the paying institutions. The second category covers all other tax instruments, such as FATs and FTTs. These taxes, which ensure a wider revenue contribution from the financial sector, are used to address adverse effects of financial-sector behaviour. FTTs target the gross proceeds, whereas FATs target the net proceeds that financial institutions generate through their business activities.<sup>9</sup> Variants of an FTT are a currency transaction tax (CTT), such as the Tobin Tax, the Swedish ‘Puppy Tax’ (*valpskatt*)<sup>10</sup> and the Danish Security Transaction Tax (STT) (*aktieomsætningsafgift*).<sup>11</sup> Iceland and Denmark have experiences with FAT, which, like the FTT, comes in several variations.<sup>12</sup> A broad-based FAT, like the Icelandic one, taxes the value added in the finan-

5. Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia.
6. COM (2012) 631 final/2 and COM (2013) 71 final.
7. See, for example, Larking, B. (2012).
8. IMF (2010) Section 18.
9. See Shaviro, D. (2012).
10. Abolished 1991.
11. Abolished 1999.
12. See IMF (2010) Sections 32-37 and Appendix 6.

cial sector and is therefore a potential solution to the perception of under-taxation of the financial sector, which is exempted from value-added taxes (VATs). More narrowly based types of FAT can be used to tax excess returns in the financial sector, such as bonuses.

Besides the three specific types of ‘financial taxes’: bank levies, FTTs and FATs, there are two additional tax instruments which are relevant for organisations acting within the financial sector: Corporate Income Tax (CIT) and VAT. Apart from certain exceptions, organisations involved in business activities in the financial sector are subject to CIT. When it comes to VAT, however, the EU’s VAT Directive includes exemptions for financial transactions and insurances.<sup>13</sup> These exemptions have also been implemented in the VAT regulations in the two European Free Trade Association (EFTA) States of Norway and Iceland.

#### **1.4. What is the Difference between a Tax and a Levy?**

In its report to the G-20 leaders, the IMF distinguishes between taxes and levies based on how the given objectives are to be realised with the two types of instruments.<sup>14</sup> The terminology does not correspond to the way taxes are distinguished from levies in a general legal context, in which a tax is a compulsory contribution from individuals to the State, in order to finance public assets. Other than through taxes, public assets may be financed by levies from those who use the assets – a municipality levy for pre-school usage, for example. Thus, although both taxes and levies are used to finance public assets, they differ in the sense that levies finance assets that are used by the payer of the levy, whereas this is not necessarily the case for taxes. It follows from this distinction between taxes and levies that proceeds from taxes go directly into general government revenues, whereas proceeds from levies are collected in earmarked funds. In the IMF report, however, it is evident that some States – the USA, for example – has proposed levies on financial institutions in which proceeds from the levies would go to the general government revenues.<sup>15</sup> It seems impossible to distinguish between a tax and a levy, apparently, in a way that holds true in every situation. This uncertainty seems not only to appear in comparisons between the differential use of the two concepts in different jurisdictions; it appears also to be an issue within single jurisdictions.

The Nordic countries distinguish between taxes and levies based on the general concept presented here. Thus, a tax is a contribution to general gov-

13. See Section 2.2.

14. IMF (2010) Section 18.

15. IMF (2010) Section 19.

ernment revenues, whereas a levy is a payment for a specific asset provided by the public to the person paying. If a person within a specific group is providing a contribution to the public, in return for the public providing assets to that specific group, however, it is not clear if that contribution is a tax or a levy. It appears that contributions of this type would be classified as a tax in Sweden, as the payer of a levy must be the one that actually benefits from the public assets financed by that contribution. In accordance with this definition, the Swedish 'Stability fee' is a tax rather than a levy/fee, something that illustrates the national confusion in the use of the two concepts. The Finnish Constitutional Law Committee (*Grundlagsutskott*) distinguishes between a tax and a levy based on the value of public assets provided in return for the tax/levy. In order to constitute a levy, the value of the public asset must correspond to the contribution of the payer. If the value of the contribution clearly diverges, in either way, from the value of the public asset, therefore, the contribution is considered a tax. In Iceland, an issue has been raised about whether a contribution from a credit institution to the Debtors Ombudsman could actually be classified as a levy, given that this Ombudsman represents only individuals. The credit institution could not benefit directly from the contribution, therefore, and it was argued that it was to be classified as a tax instead, which, in this case, would be in conflict with the Icelandic constitution.

It appears that all Nordic countries adhere to a general principle by which the real difference between a tax and a levy is that a tax is an obligatory contribution to public assets, whereas a levy is an obligatory contribution to certain public assets which the payer intends to use – a town's water and sewer system, for example. The non-optional characteristic of a tax and the lack of a distinct reciprocal performance of the tax collector means that the paying of taxes to the State could well be described as the State sequestering the individual's property. This level of interference in individual privacy must generally be approved in the constitution of the State, more specifically in a principle of legality.<sup>16</sup> The principle of legality requires that a State does not have the right to charge taxes unless it is explicitly stated in a legal act approved by the Parliament. Still, constitutions may differ in the extent to which they allow the legislature to delegate tax-law-making authority. The Nordic countries seem to have a common approach to this matter, one that involves no delegation of the tax-law-making authority.

16. For example, see Vanistendael, F. (1996) pp. 16-19.

From what has been presented so far in this report, it is evident that taxes and levies are instruments used by States to collect funding for public goods and to provide either incentives or obstacles to certain activities within its jurisdiction. Private actors may also use these instruments to achieve similar goals, however. An example of such a situation is the excess order charge, which has been collected by the Oslo Stock Exchange since September 2012. The only real difference between this charge and a tax/levy is that its legality is stated in a contract between the Stock Exchange and its clients rather than in legislation decided upon by the Norwegian Parliament. This contractual basis, as opposed to a constitutional basis, means that the applicability of the charge is limited to the contractors, and the revenue accrues to the Stock Exchange.<sup>17</sup> For a potential payer of the charge, however, these differences are of limited relevance, although they may be decisive factors in determining if such a charge is possible to deduct from taxable income (see Section 2.3.4).

### **1.5. Defining the Financial Sector**

Because the financial crisis of 2008 forced many governments to undertake costly measures to support the maintenance of the functions on the financial markets, it is easy to understand the goal of requiring the general actors on these markets – the financial sector – to make a ‘fair and substantial contribution’ to cover these costs. Nor is it difficult to understand that regulatory bodies on both the national and EU level are interested in taking measures to reduce the possibility of future financial crises. Such measures are naturally directed at the actors in the financial markets – the financial sector. The wide variety of functions on the financial markets means, however, that there are also a wide variety of actors in these markets. Consequently, regulatory measures aimed at securing well-functioning financial markets must, in many cases, target groups of actors more specific than the general financial sector. In most cases, therefore, the term ‘financial sector’ is not used in the regulations on taxes and levies in the Nordic countries, and is therefore of limited interest from a legal point of view.

The constitutional characteristic of a tax (see Section 1.4) requires it to be of a general nature – that it must affect equal tax subjects equally. This characteristic of a tax makes it possible to distinguish between a tax and expropriation directed towards a certain person or group of persons. Consequently, an obligatory contribution to the public assets from a narrowly defined group of contributors – a certain type of actors in the financial market, for example – is

17. This charge is presented in more detail in Section 2.4.4 on Stamp Duties.

not necessarily a tax. Under certain conditions, it can be argued that such obligatory contributions represent more of an expropriation, the legality of which can be questioned.

The general character of a tax means that the same types of taxes are paid by tax subjects in different markets. The CIT in the Nordic countries, for example, is paid by companies within the financial sector and the construction industry, for example. If a certain group of these tax subjects – certain tax subjects within the financial sector, for example – had to pay an additional tax, such as an FTT, it could be argued from the EU's point of view that the FTT would be in conflict with the Treaty on the Function of the European Union (TFEU), specifically Article 107 on state aid. In this context, state aid constitutes selective tax benefits that distort competition and affect intra-EU trade incompatible with the internal market.<sup>18</sup> It is possible, however, for the European Commission to approve selective tax benefits in situations in which these benefits serve certain EU-sanctioned objectives.<sup>19</sup> If they are not approved, however, they must be withdrawn with retroactive effect.

A selective tax benefit, in conflict with the TFEU, is a tax benefit that places certain economic operators – certain companies – in a better position than their competitors. Consequently, a tax that covers an entire sector, such as the financial sector, does not interfere with the competition on the relevant markets, and is therefore not in conflict with the TFEU. It is likely that the proposed FTT in 11 EU Member States has a broad enough scope in order for it not to be circumvented, and thus constitute an unlawful tax benefit.<sup>20</sup> In case the implementation and enforcement of the FTT differ among Member States in a way that makes the FTT less burdensome in one Member State than other States that have implemented the same Directive, however, a state aid situation could exist.<sup>21</sup>

The concept of state aid differs somewhat in situations in which the relevant tax legislation is a result of the implementation of an EU Directive or the result of a State acting within its sovereignty to tax within its jurisdiction. State aid falls foul of Article 107 of TFEU only in the latter case, as a regulation based on an EU Directive is a result of a Member State complying with Community Law.<sup>22</sup> Thus, if EU or EFTA Member States take independent action to tax certain actors in the financial markets or the financial sector, the

18. See, for example, Rossi-Maccanico, Esq., P. (2013) p. 40.

19. Article 108 TFEU.

20. Chapter II, COM (2013) 71 final. See also Luja, R. (2012).

21. See, for example, Luja, R. (2012) p. 146-147.

22. For relevant case law, see Footnote 5 in Luja, R. (2012) p. 145.



issue of state aid must be carefully considered. Such tax legislation would possibly be in conflict with the TFEU in any situation in which economic operators in comparable situations are taxed differently, and the taxation therefore distorts competition among these types of operators.

## 2. Taxation in the Nordic Countries

### 2.1. Levies on Financial Institutions

#### 2.1.1. Levies in the Nordic Countries

As noted in Section 1.4, there is no consensus on a legal definition of a levy or a tax. From the national reports, it follows that different terminology is used for similar taxes/levies, which, in the IMF report, are commonly referred to as levies on financial institutions, and defined as:

*Levies on financial institutions: charged on financial institutions to cover the net fiscal cost of direct public support to financial institutions and help reduce excessive risk-taking.*<sup>23</sup>

In the aftermath of the financial crisis of 2008, three Nordic countries have introduced such levies. As of 2009, Swedish credit institutions must pay a stability fee; as of 2011, Icelandic banks must pay a bank tax; and, as of 2013, Finnish deposit banks must pay a bank tax. In addition, the Norwegian deposit insurance fee was made continuous as of 2013. This fee was not designed only to safeguard bank deposits, but also to make banks increase their core capital above the regulated minimum of 4 %, which makes the fee similar to a bank levy. Denmark has no regulations for taxes/levies equivalent to levies on financial institutions.

There are some general differences between the Swedish and Icelandic levies on the one hand, and the Finnish levy on the other hand. First, the Finnish levy is based on the asset side of the tax subject's balance sheet, whereas the Swedish and Icelandic levies are based on the passive side – like most equivalent levies in other jurisdictions. The Finnish base for the levy is generally much narrower than the Swedish and Icelandic levies. As a result, the rate of the levy is much higher in Finland (0,125 %) than in Sweden (0,036 %) and Iceland (0,041 %). Second, the Finnish levy is temporarily in force only between 2013 and 2015, whereas the Swedish and Icelandic levies are in force until further notice. The Norwegian levy is, like the Swedish and the Icelandic ones, based on the liability side and taxes 0,05 % of the total li-

23. IMF (2010) Section 18.

abilities. Depending on the core capital ratio of the tax subject, however, the rate is adjusted so that undercapitalised banks pay a higher rate, and banks with more core capital pay a lower rate, but never less than 0,0325 %.

### 2.1.2. Potential Juridical Double Taxation

The scope of the regulations establishing the three levies cover residents in these three countries. The Icelandic bank levy also covers foreign banks conducting their business activities in Iceland through a permanent establishment. The comprehensive tax liability of the Icelandic bank levy includes a risk for international juridical double taxation – when a Swedish or Finnish bank has a branch established in Iceland, for example. It is uncertain if this potential double taxation could be eliminated. Foreign bank levies seem not to be defined as a foreign tax according to the Swedish Tax Credit Act,<sup>24</sup> for example; nor does it seem that bank levies are among the taxes dealt with in applicable tax treaties. Furthermore, because of variations in bank levies (compare, for example, the Finnish and Icelandic levies), it could be argued that although a tax subject may pay bank levies in more than one jurisdiction, it would not constitute juridical double taxation, because the bases for the levies differ. The potential risk for juridical double taxation on bank levies becomes even larger because several other jurisdictions apply different principles to establish the tax liability on bank levies. In the Netherlands, for example, the ‘taxing right’ for bank levies is based upon a principle which gives primary taxing rights to the state of residence for the parent company of a banking group.<sup>25</sup> Consequently, if a Dutch banking group includes subsidiaries established in Sweden, Finland or Iceland, juridical double taxation may arise. As a result of the increased risk of juridical double taxation on bank levies, some countries have recently concluded so-called Bank Levy Agreements: the *Convention between the United Kingdom of Great Britain and Northern Ireland and the Federal Republic of Germany for the avoidance of double charging of bank levies*, for example, which was concluded on 7 December 2011. For the elimination of double-charging bank levies, several provisions are used in the convention.

#### Article 7

##### Elimination of Double Charging

- (1) Bank levy shall be determined in the case of the Federal Republic of Germany as follows:

24. *Lag (1986:468) om avräkning av utländsk skatt.*

25. van der Lans (2012), p. 117-118.

- a) The United Kingdom bank levy on an institution resident in the Federal Republic of Germany that is a subsidiary of a United Kingdom resident member of a relevant group shall, unless the parent of the relevant group is resident in the Federal Republic of Germany, be allowed as a credit against the German bank levy;
  - b) A United Kingdom bank with a permanent establishment situated in the Federal Republic of Germany shall be exempted from the German bank levy.
- (2) *Subject to the provisions of the law of the United Kingdom regarding the allowance as a credit against the United Kingdom bank levy of a bank levy payable in a territory outside the United Kingdom (which shall not affect the general principle hereof):*
- a) The German bank levy on an entity resident in the United Kingdom that is a subsidiary of a German resident member of a group shall, unless the parent of the group is resident in the United Kingdom, be allowed as a credit against the United Kingdom bank levy;
  - b) For an institution which is a resident of the Federal Republic of Germany with a permanent establishment situated in the United Kingdom, the credit shall take into account the German bank levy to be determined by reference to the relevant liabilities and derivatives attributable to the permanent establishment.

None of the Nordic countries have equivalent Bank Levy Agreements.

### *2.1.3. Deductibility on Taxable Income*

In Section 2.3, it is observed that financial institutions resident in any of the Nordic countries are obliged to pay income tax in that country. In case the financial institution is also subject to paying a levy dealt with in this section, it is vital to establish if it is possible to deduct the cost of the levy for income tax purposes. A general principle in income taxation is that only expenses related to the taxable activities of a tax subject shall reduce the taxable income.<sup>26</sup> In that way, only the net income is taxed. If the expense is some type of penalty charge, however, it is generally not deductible, as tax systems normally deny deductions that are illegal or inconsistent with public policy.<sup>27</sup>

Whether or not it is possible to deduct taxes against a tax subject's taxable income generally depends on whether the tax reduces the income or not. Consequently, taxes cannot reduce the income base upon which it is levied. Although it can be argued that the income tax paid reduces a tax subject's ability to pay taxes, it is not possible to deduct income tax from taxable income. Taxes and levies that are levied on tax bases other than income are generally possible to deduct against taxable income, however, because it would otherwise run contrary to the ability to pay principle.

26. See, for example, Ault, H.J. and Arnold, B.J. (2010) p. 249.

27. See, for example, Ault, H.J. and Arnold, B.J. (2010) p. 288.

It follows from this presentation that the deductibility of bank levies can be argued from at least three positions. First, it can be argued that a bank levy is an expense related to the business of the tax subject – an insurance premium, essentially – and that it should therefore be possible to deduct a bank levy against the tax subject’s income, in accordance with general principles. Second, it can be argued that because the bank levy is levied on a tax base other than the tax subject’s income, the bank levy must be deductible based on the general equality principle, including net income taxation. Third, it can be argued that a bank levy is a charge for the collective excessive risk-taking of the financial sector. As that risk-taking has been shown to be inconsistent with public policy, the bank levy can not be deducted against taxable income.

There seems to be no common approach to this issue among the Nordic countries. In Finland, the national bank levy can not be deducted from the tax subject’s taxable income, which it can be deducted from in Sweden. Whether or not foreign bank levies paid by Icelandic, Norwegian or Danish tax subjects are possible to deduct against taxable income is uncertain, and must be established on the basis of general principles.

## 2.2. VAT

Value Added Tax (VAT) is an indirect consumption tax, targeting the value added in the production of goods and services. Unlike such direct taxation as CIT, VAT systems among the EU Member States are harmonised, by way of the VAT Directive: Council Directive 2006/112/EC (based on the Sixth VAT Directive: Council Directive 77/388/EEC). The VAT legislation in the two Nordic non-EU Member States are also based on the VAT Directive.

The EU’s VAT system contains exemptions for financial and insurance services.<sup>28</sup> The exemption is based on the nature of the transaction, and not on the character of the subject providing the transaction (supply). One reason for this exception has been the difficulty of establishing the taxable base of a financial service: the amount for which the VAT that should be calculated. The problem does not cover the services based on fee as much as services for which the remuneration is based, for example, on an interest rate or value of a security. On the other hand, the exemption of financial services creates a hidden tax burden to clients of the suppliers, as the banks and other service providers are not entitled to deduct the input VAT (VAT on the input supplies). The input VAT encumbers the prices of the financial services and, therefore, is usually paid by the clients of banks – a “hidden VAT”. Tax on financial

28. Article 135(1) VAT Directive.

services could reduce the costs of taxable persons buying financial services, as they could deduct the input VAT on financial services. In such situations, consumers were required to carry the VAT burden on financial services themselves, however, as the VAT would be included in the interest rates on household loans (and VAT would, in these cases, be a final cost for the household). Thus, consumers had to pay VAT on borrowed capital used for consumption – as in the purchase of a car, for example – a situation that required them to be taxed twice: First on the borrowed capital and again on the purchase.

The hidden VAT is an asymmetry in the VAT system and essentially a hindering measure for financial undertakings to outsource activities and/or to make intra-group transactions. To limit the effects of this asymmetry, the VAT Directive allows group registration schemes – VAT groups – which makes it possible for closely related companies to be treated as a single taxable person for VAT purposes.<sup>29</sup> A VAT group is registered in one country, and the question arises as how to treat companies that are concurrently registered as part of a VAT group in other countries through fixed establishments. An additional legal question arises: Is it possible for Member States to limit the use of VAT groups to specific sectors? In Finland and Sweden, the use of VAT Groups is limited to companies within the financial and insurance sectors, a limitation that has been challenged by the Commission and was eventually settled by the European Court of Justice on April 25, 2013.<sup>30</sup> In opposition to the opinion of the Advocate General, the ECJ found that the Commission had not convincingly shown that it was in conflict with Article 11 of the VAT Directive to limit the allowance of group registration schemes to companies within the financial and insurance sectors.

Other legal issues related to VAT include the definitions of goods and services that are exempt from VAT. The European Commission has recognised that the definitions on exempt services, introduced in 1977, are sometimes difficult to apply to transactions that take place in today's banking industry.<sup>31</sup> This development eventually leads to different interpretations of the implemented VAT Directive in the EU Member States. Whether or not improvements in the definitions applied to financial services, as proposed by the Commission, will lead to amendments of the VAT Directive is yet to be seen.

29. Article 11 VAT Directive.

30. Commission v. Sweden, C-480/10, Commission v. Finland, C-74/11.

31. COM (2007) 746 and 747 final.

## 2.3. Corporate Income Tax

### 2.3.1. Introduction

CIT systems in the Nordic countries follow the same general principles, and are generally applicable to tax subjects in the financial sector. In broad terms, these tax systems can be described as classic income tax systems – involving economic double taxation – with a flat rate tax between 20 % and 28 %, on the tax subject's net income.<sup>32</sup> The net income of a tax subject in the financial sector is, in principle, the net proceeds from its business activities and its investments. Although the proceeds from these two types of activities are taxed at the same rate, there are generally timing differences in the recognition of income, depending on the classification of the activity resulting in income. Consequently, a critical juridical matter in the corporate income taxation of financial undertakings is to distinguish between the subject's business activity and its investment activities. Furthermore, several undertakings in the financial sector manage the assets of its underwriters, fund companies and life insurance companies, for example. Income from such assets must – for reasons of economic neutrality – not be taxed differently if the managerial function was conducted directly by the beneficial owner of the assets: the investor. It is necessary, therefore, to separate the tax subject's income from the tax subject's assets, and income from assets that are managed by the tax subject, but eventually belong to its underwriters. Besides these two classification issues, a third specific income tax issue related to the financial sector is whether it is possible to deduct sector-specific charges and fees against taxable income. In the following sections, these three issues are discussed in greater detail.

### 2.3.2. Classification of Income

For tax subjects within the financial sector, the classification of income as business income or investment income eventually comes down to whether or not the financial assets and liabilities are used in the business or for purposes of asset management. In broad terms, a business is an independent commercial activity undertaken for profit.<sup>33</sup> If the trading of financial instruments is such an activity, therefore, surplus from the trading of these financial instruments is classified as business income. Income and expenses from financial instruments that are not within the tradable stock of financial instruments are classified as investment income. Whether or not a financial instrument is

32. Iceland 20 %, Sweden 22 %, Finland 24,5 %, Denmark 25 %, Norway 28 %. As part of the recent tax reform, the corporate tax rate in Denmark will be gradually lowered from 25 % to 22 % in 2016.

33. See Burns, L. and Krever, R. (1996) p. 598.

within a tax subject's trading stock, gains or losses from the disposal of such an instrument is recognised at realisation. Unrealised gains or losses, however, are recognised only in regard to financial instruments classified as trading stock. For this reason, the classification of income from the trade of financial instruments is vital. The Nordic countries apply similar approaches in the classification of financial instruments as trading stock or investment assets, generally focussing on whether or not the trade with financial instruments is included in the relevant business concept. Because trade with a financial instrument is most often within the normal business of a financial institution, there seems to be a strong assumption that unless explicitly stated otherwise, financial instruments held by a financial institution are part of that institution's trading stock.

In situations in which the financial instruments of a tax subject include shares, there are other classification issues to consider. For income tax purposes, shares in the possession of a legal person are generally classified as either portfolio investments or substantial holdings. A substantial holding is a holding in a company in which the business is considered related to the business of the tax subject – the holding of a subsidiary for example. For that reason, in order to eliminate unwanted double taxation at a corporate level, dividends and capital gains from substantial holdings are tax exempt. On the other hand, dividends and capital gains from portfolio investments are generally taxed as business income, as those shares are normally part of the tax subject's trading stock, providing business income. As members of the EU or the European Economic Area (EEA), the natural point of departure for the Nordic countries in the classification of shares as substantial holdings or not is the Parent–Subsidiary Directive, which sets the limit at 10 % of the capital.<sup>34</sup> Thus, a general rule is that a holding of at least 10 % of the capital in a company is considered a substantial holding for income tax purposes. There are some differences in the scope of this concept within the Nordic countries, however.

In Sweden, a substantial holding exists when a Swedish company holds shares which are not part of its trading stock, which are not traded on a regulated market, which corresponds to at least 10 % of the voting rights in the company, or is closely related in some other way to the holding company. Apparently, shares within a company's trading stock can generally not constitute a substantial holding. The only exception to this rule occurs when the holding is in a foreign company resident within the EU. In this situation, trad-

34. Council Directive 2011/96/EU.

ing stock of at least 10 % of the company's capital constitutes a substantial holding.

The Swedish exception is a general rule in Denmark. This means that the classification of a substantial holding does not relate to the classification of a share as part of the tax subject's trading stock or investment assets. Consequently, a (tax exempt) substantial holding – the shares in a subsidiary, for example – may be classified as trading stock and therefore taxed for unrealised gains or losses on an accrual basis. This type of taxation may be circumvented, however, if the increase in value is distributed to the parent company as tax-exempt dividends.

In Finland, dividends received by a company are generally tax exempt. If the dividends come from investment assets, however, or are paid from listed companies to non-listed companies, 75 % of those dividends constitute taxable income. This exception does not include dividends covered by the Parent–Subsidiary Directive, of course, but is applicable to all dividends paid by companies resident outside the EEA.

In summary, it is vital for undertakings in the financial sector to distinguish between income from business activities and income from investment activities. Furthermore, the tax exemption status of income from holdings in shares depends on whether or not that holding is considered substantial.

### 2.3.3. *Classification of Assets*

In previous sections, I argue that the income tax systems in the Nordic countries are classic income tax systems in which the payoff from a direct investment in a business activity is taxed twice: first, as business income at a corporate level and, second, as capital income at an individual level. If, however, an individual makes a direct investment in a corporation or equivalent tax subject (an investment fund for example), because that corporation is entitled to income from the holding of an attractive portfolio of financial instruments, the classic income tax system can not, for reason of equality, be applied without exceptions. This situation exists because the economic double taxation following the classic income tax system would be more burdensome than a situation in which the individual investor invests directly in the same attractive portfolio of financial instruments. In that situation, income from the portfolio would be subject to income tax only on capital income. Consequently, tax subjects offering attractive investments products – shares in investment funds and life insurances for example – would be potentially harmed if no modifications were made to the classic income tax system.

There are different ways within and between the Nordic countries to deal with this potential arbitrage situation. Swedish investment companies, for ex-



ample, are subject to income taxation only on interests and dividends, but are also allowed income deductions on these types of income when they are distributed to its owners. As a result, income from the holdings of an investment company may flow through this company to its owners without any tax consequences. In that way, unwanted economic double taxation is avoided. This special tax regime on investment companies makes it necessary to restrict their opportunity for group relief, which could be used to defer taxation or for unwanted tax planning.

In Denmark, an economic double taxation on indirect investments is avoided by excluding certain undertakings from income taxation. Thus, Danish pension funds and life insurance companies involved in pension funding the labour market are exempted from income taxation.

Although excluded from income taxation in one way or the other, investment undertakings are generally taxed on the return of their investments. The tax is often based upon a template income, based, in turn, upon the value of the tax subject's holdings. In order to treat investment undertakings equally, however, independent of place of residence, it is often necessary to make the individual investor, resident in the taxing state, subject to such a tax. Danish individuals investing in pension funds managed by a foreign or Danish insurance undertaking, for example, are taxed on the return of the funds. A similar tax regime is applicable to Swedish tax subjects that are investing in national or foreign investment funds.

#### 2.3.4. *Deduction of Expenses*

In Section 2.1.3 on bank levies, I argue that there are at least three ways to argue how bank levies are to be treated for income tax purposes: Arguments for the deduction of such a bank levy is generally based on the general equality principle focussing on net income taxation. On that basis, bank levies are deductible because they reduce the disposable income of tax subjects. If the tax levy is essentially a penalty charge, it does not matter, however, that the levy reduces the tax subject's income; a levy of this type is not deductible, because tax deductions on expenses that cover illegal activities or activities that are inconsistent with public policy are usually denied.

On these general bases, Sweden allows deductions on the national bank levy (*garantiavgift*), whereas Finland and Iceland do not. The different treatment among the Nordic countries raises the question of whether foreign bank levies are deductible or not. Is it possible for a Swedish bank to deduct an Icelandic bank levy as a business expense, for example, if it is attributable to its permanent establishment in Iceland? It is possible that the answer to that

question eventually depends on whether the bank levy is considered a tax or a penalty charge according to the Swedish income tax system.

Although it appears that deductions for bank levies that have been introduced in the aftermath of the financial crisis are treated differently within the Nordic countries, levies to safeguard the interest of individuals' investments are treated equally; they are usually deductible in all Nordic countries. In Finland, for example, mandatory payments to the Deposit Guarantee Fund (*inlåningsbanks garantiavgift*) and to the Government Guarantee Fund (*säkerhetsfondens garantiavgift*) are allowed as deductions from taxable income. Likewise, comparable payments are deductible in Norway, Sweden and Denmark. In the interests of its clients, Icelandic banks and other financial undertakings must make compulsory payments to the Depositors and Investors Guarantee Fund and to the Debtor's Ombudsman. Furthermore, financial undertakings pay a separate fee to finance the operation of the Icelandic Financial Supervisory Authority. These three payments can presumably be deducted from taxable income.

Finally, whether or not the charge for excess orders can be deducted, an issue of relevance for traders on the Oslo Stock Exchange, comes down to a simple question: Is it considered a business expense or a charge related to activities inconsistent with public policy?

In summary, it is not possible to systemise the deductibility for bank levies within the Nordic countries. The general income tax principles explain when deductions can or can not be made, depending on the type of levy. If the levy is not a penalty charge, it is likely deductible as a general business expense, in line with the general equality principle. Over the past few years, however, this principle has been challenged by large intra-group interest payments, which have been considered a general business expense in most jurisdictions. This consideration has resulted in a huge proportion of the tax base moving from Nordic countries to low-tax jurisdictions. Consequently, several of the Nordic countries have relatively new tax legislation limiting the opportunity to deduct intra-group interest payments. The contents of the various regulations will not be dealt with in this report, however, because it is not a typical issue for the financial sector.

## **2.4. Other Tax Instruments**

### *2.4.1. Introduction*

In the previous three sections, I have presented some of the legal issues related to the tax instruments, bank levies, VAT and CIT. Besides these tax instruments, several others – FTTs, FATs, and Stamp duties, for example – may potentially be used to impose taxes on the financial sector. All Nordic

countries have present or past experiences of these ‘special’ tax instruments. Following is a short overview of these experiences.

#### 2.4.2. *FTT*

As noted in Section 1.3, an FTT is a tax on the trade of financial instruments. At present, Finland is the only Nordic country with such a tax. All Nordic countries, however, have recent experience with Stamp Duties – a type of transaction tax (see Section 2.4.4). The Finnish tax is not related to the FTT which, it is suggested, is applicable among the EU Member States within the enhanced co-operation (see Section 1.2). Rather it is a different transaction tax, which generally focuses on the trading with non-listed securities and real property. The Finnish transfer tax was introduced in 1997 to replace a stamp duty, which had been levied on real property, securities and several other types of legal documents from the beginning of the twentieth century. The transfer tax on real property is 4 % of the purchase price and 1,6 % of the transfer price of securities. As of 2013, however, Finland’s transfer tax on securities, which entitles the right to govern real property, has been raised to 2 %. The definition of a security, as laid down in the Finnish Transfer Tax Act, essentially covers all equity-related financial instruments issued by non-listed companies, including general and limited partnerships and other corporate bodies resident in Finland. Subject to this tax are actors in the financial and/or real property market (not individuals) resident in Finland, with the exemption of non-business institutions of the Finnish State. Unlike the proposed EU-FTT, the Finnish transaction tax is not a round-trip tax – payable both by the transferee and the transferor – but payable only by the transferee of the security or real property. Because of the complex area covered – securities – and the large number of classification issues, the Finnish Transfer Tax Act was subject to several loopholes, which have been dealt with in new legislation as of 2013.

Both Denmark and Sweden have experience with FTTs. The Danish FTT, which was abolished in 1999, was 0,5 % of the market value of traded shares and similar securities, to be paid by the subject disposing of the shares. The person paying the FTT was not allowed to deduct it from the returns of the sell, but the tax could be considered as a deductible expense in relation to the net income of the person’s total returns from share trading. The two major reasons for abolishing the tax were to encourage trading on the Copenhagen Stock Exchange (CSE) and to make Denmark consistent with the other Nordic countries.

The Swedish FTT was introduced in 1984. The FTT – the puppy tax<sup>35</sup> – was a response to a public malaise about the high level of returns in the financial sector, and targeted trade in shares and derivatives which was conducted using Swedish brokerage services. The rates of this round trip tax was initially 0,5 % on shares and 1 % on share options – a total tax of 1 % and 2 % respectively. After several adjustments in scope and tax rates, the tax was abolished in December 1991. A major reason for ending the puppy tax was its severe effect on the Swedish financial market, for much of the trade in financial instruments ended up leaving the country. For this reason, in regard to tax instruments in the financial markets, the Swedish FTT has been referred to the ‘Swedish Horror Story’.<sup>36</sup>

#### 2.4.3. FAT

FAT is a tax on the sum of profits and remunerations of undertakings in the financial markets. It comes in several variations, three major types of which are presented in the IMF report.<sup>37</sup> Two of the Nordic countries – Denmark and Iceland – have variations of FAT.

The Danish FAT is better known as a *lønsafgift* and works as a substitute to VAT within such VAT-exempted areas as the financial sector (see Section 2.2). The FAT is levied on the sum of a financial institution’s total remunerations to employees, at a rate of 10,9 %, which will gradually be increased to 15,3 % in 2021. Like special taxes in general, the Danish FAT is deductible from the CIT base.

The Icelandic FAT, which came into force on 1 January 2012, is designed to tax the value added within the financial industry, in line with recommendations from the technical assistance group of the IMF. For this reason, it covers not only remuneration to employees (cp. Denmark) but also the excess profits of financial institutions. Specifically, financial institutions, with the exception of pension funds, official institutions and foreign branches must pay a special income tax of 6 % on their CIT base in excess of ISK 1 billion, and a special tax of 6,75 % of the total remuneration to their employees. The tax on remuneration is deductible against the income tax base, whereas the tax on excess return is not.

From a legal point of view, it is noteworthy that the material connection between tax accounting and financial accounting is non-existent in Iceland. As a result, there is significant room for accounting measures to avoid the ex-

35. A reference to the intentional payers of the tax – the finance puppies (*finansvalpar*).

36. See Larking, B. (2012) p. 41.

37. IMF (2010) pp. 66-70.

cess profit tax. To illustrate this discrepancy in the recognition of income, the three largest banks in Iceland reported a combined profit of ISK 23,2 billion before tax in their audited accounts in 2012, whereas the same banks reported a combined income tax base of ISK 9,4 billion.

#### 2.4.4. Stamp Duties

A stamp duty is substantially a transaction tax which often targets transactions on real property. Historically, trade in shares has often been covered by this kind of tax as well, making it a type of an FTT. A well-known example is the UK stamp duty in share transactions, which is still in force. Among the Nordic countries, however, the term ‘stamp duty’ not only covers taxes on the transfer of assets. In Sweden and Denmark, the same terminology is used for taxes which do not target the transfer of assets, but are levied on the basis of a specific activity – the issuance of shares in a corporation or the issuance of mortgage deeds, for example. The latter tax is far from a transaction tax, but is more similar to what is commonly known as an excise tax – a special tax on specific goods or services.

The Nordic countries have a mixed approach to the use of stamp duties. Finland abolished its stamp duty on shares and real property in 1996, replacing it with an FTT on the same types of transactions, but with a narrower scope (see Section 2.4.2). Iceland has a long tradition of levying stamp duties on transactions with certain types of goods, such as real property, ships and several financial instruments – securities contracts, loan contracts, debt and share issuance and insurance contracts, for example. The rates on the duty varies, but is normally about 1,5 % of the value traded or issued. In the aftermath of the financial crisis, the IMF and the EFTA Surveillance Authority has recommended that Iceland reduce the use of stamp duties, as it could harm competition in the financial market. An obligation for customers to pay stamp duty when changing credit institutions may be an unwanted obstacle in the financial market. Thus, the future for stamp duties in Iceland is uncertain.

Sweden, like Finland and Iceland, has a tradition of levying stamp duties on the transfer of real property and shares. The Swedish stamp duty on shares, however, in force between July 1984 and December 1994, did not focus on share transactions, but on the size of equity in Swedish limited corporations (*aktiebolag*). Denmark has experienced a similar duty – *kapitaltilførselsafgift* – which was in force until 1993. The obligation to pay the Swedish stamp duty occurred when a corporation’s equity was increased, in relation to initial registration or issuance of new shares for example. The duty was 2 % of the nominal value of the shares. The nature of this ‘stamp duty’ differs from what is normally considered a stamp duty – a transaction tax. Rather,

the Swedish stamp duty on shares was more similar to an excise (*punktskatt*); it was an excise on equity. The Swedish stamp duty on real property, however, does have the characteristics of a transfer tax and is levied at a rate of 1,5 % to individuals and 4,25 % to legal persons, based on the value of the traded property. Moreover, mortgage on real property (*pantbrev*) costs 2 % of the nominal amount of the mortgage. The mortgage deed is formerly attached to the underlying property, however, and can be transferred without additional costs to a subsequent owner of the property. The ‘stamp duty’ on a mortgage in real property is not a transaction tax, therefore, but more like an excise on mortgage in real property.

Norway has a history of extensive stamp duty regimes on real property and financial instruments. The liberalisation of financial markets in the 1980s changed the tradition, and stamp duties on financial instruments were, from that time forward, considered obstacles in the development of the stock markets and supply of risk capital to industry and trade. From the mid-1980s, therefore, stamp duties on financial instruments have not been on the agenda at the Norwegian Ministry of Finance. Yet at the Oslo Stock Exchange, the transaction tax instrument – of which a stamp duty is an example – is used to reduce order *activities that do not result in transactions*. As of September 2012, the Exchange has charged excess orders at a rate of 0,05 % of the order value. An excess order is defined in relation to a specific order ratio, but so far (as of February 27, 2013), no charge has been levied. In this context, it is worth mentioning that because this charge on excess orders is initiated and conducted by the Exchange, it is not to be considered a tax or a levy, as defined in Section 1.4. Rather, it is a charge on contractual basis between the Exchange and its brokers.

The Danish stamp duty is similar to Sweden’s present system, with a transfer tax on real property and an excise on mortgage in real property. These rules also cover transfers and mortgages in ships and aircrafts. These Danish rules, which came into force in 2000, previously levied a stamp duty on a much wider variety of Danish debt instruments than mortgage loans on real property, ships and aircraft. The elimination of those rules was driven by the fear that the stamp duty would make it more difficult for Danish credit institutions to compete with foreign market participants with products that were not subjected to a stamp duty.

### 3. Final Remarks

This general report highlights some of the legal issues related to taxation of the financial sector, and provides examples of these issues in relevant regulations in the Nordic countries. Following are five examples of the key legal issues discussed in this report, and relevant for the taxation of the financial sector. First, when a country intends to limit certain tax measures to a specific sector, like the financial sector, there will be a risk that the scope of these measures does not cover all undertakings in comparable situations. In that case, the tax measures may constitute an unlawful tax benefit and conflict with Article 107 TFEU on State aid. Second, tax instruments in the zone between a tax and a levy – a bank tax for example – may give rise to international juridical double taxation – double charging. Because of their untraditional nature, however, they are often outside the scope of bilateral and unilateral mechanisms to eliminate such double taxation: double taxation treaties for example. Third, based on the EU VAT Directive, VAT legislation in the Nordic countries contains exemptions for financial and insurance services. The rapid development of these services sometimes makes it difficult to apply the relatively old regulations to new kinds of services, which lead to legal uncertainty, and a different interpretation of the EU VAT Directive in EU Member States. Fourth, undertakings within the financial sector are generally subject to income taxation. Whether or not taxes and levies from such new tax instruments as bank levies are deductible from taxable income seems to depend on the general principles of the income tax system. The deductibility eventually comes down to whether the tax within the income tax system is considered a business expense or an expense to cover activities inconsistent with public policy. Fifth, specific tax instruments for the financial sector, FTT and FAT for example, are used, or have been used to some extent, in the past and in the present, in all Nordic countries. Legal questions related to these instruments follow the same pattern as for other direct or indirect tax instruments. Thus, legal issues to be considered in relation to a FAT differ little from the issues relevant to income tax legislation or legislation on bank levies. When introducing an FTT, then, it is probably a good idea to look first at the legal issues that relevant VAT legislation has put forward.

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