



Derivatives and the European VAT System

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Subjects of Discussion

1. What are Derivatives in VAT terms?
 - *Derivatives and Contracts*
 - › A single contract or multiple contracts?
 - *Underlying Transactions*
 - › *Goods or services?*
 - *Derivatives as Financial Services*
1. Derivatives and Economic Activity
2. Comparison to Nordic Countries



Derivatives and VAT

Derivatives

1. Different types of derivatives
 1. Options
 1. Premium
 2. Swaption
 3. warrantty
 2. Forwards
 1. Futures
 3. Swaps
 1. Interest
 2. currency
2. Underlying
 1. Securities
 2. Goods
 3. Services
 4. Legal tender
 5. Derivatives
 6. Interest
 7. Index
3. Reasons of use
 1. Hedge
 2. Commodity trade
 3. Arbitration
 4. Speculation
4. Form/Substance
 1. Contract level
 2. Level of underlying
 1. Trasferred
 1. Allocated
 2. unallocated
 2. Net-off
5. Platform
 1. Exchange
 2. OTC
 1. Margins and other trading costs

VAT directive

1. Scope
 1. Derivatives as contracts
 2. Derivatives as commodities
2. Good or service?
 1. Definition of goods
 2. Definition of services
 1. Supply of currency , art. 135(1)(e)
 1. Definition of legal tender
 2. Securities, art. 135(1)(f)
 3. Betting and gambling, art. 135(1)(i)
 3. Supply
 1. Per contract/per transaction?
 1. Legs of swap
 2. Option/premium
 3. Contract as securities/premium
 4. Consideration
 1. Resiprocal transactions
 1. Currency swap
 2. Swaptions
 3. Derivativeforwards
5. Taxable person = economic activity
 - Exploitation of tangible or intangible property
 1. Acquisition of derivative
 1. Acquireing capital
 2. Investment
 3. Saving
 2. Holding-companies
 3. Different actors in the market
 1. Brokers
 2. Dealers
 3. Market makers
 4. Market members
 4. Incidental acquisitions
 5. Transferability of derivatives
 6. Transaction of the underlying
6. Black box

Derivatives from a VAT perspective

What is a derivative and why is it relevant for VAT?

Derivative dealer:

“It’s hard enough to get anyone listen when you mention derivatives, if you team them up with commodities, people tend to want to run a mile.”

Judge of the Court of Appeal of England and Wales:

“Beyond the everyday world ... lies the world of [VAT], a kind of fiscal theme park in which factual and legal realities are suspended or inverted.”

Subjects to be taken into account:

- The definitions of the VAT Directive to be interpreted from the basis of the VAT Directive itself.
- A unified interpretation has to be guaranteed between Member States.
- A strict interpretation of exempt services.
- Neutrality principle: Both in EU and the rest of the world

Derivatives from a VAT perspective

What is a derivative and why is it relevant for VAT?

- No unified definition can be found from regulation
- Multiple different interpretations of the definitions
 - › Interpretations may depend on
 - Legislature and its objectives
 - The point of view of the person making the evaluation e.g. educational background in law vs. economics



Schuyler K Henderson: Henderson on Derivatives (2003) :

*”A derivative is **first and foremost a contract between two parties**. There is no ”magic” to it, nor should it be presumed to be a separate ”thing” except to the extent a given legal system has expressly chosen to treat it as such for the particular purpose.”*

John C. Hull in Options, Futures, and Other Derivatives (2012):

*”A derivative can be defined as a **financial instrument** whose value depends on (or derives from) the value of other, more basic, underlying variable.”*

Derivatives from a VAT perspective

Derivatives in focus

Options

- An option creates a right to the buyer of an option to buy or sell a specified underlying asset at a given price at a specified time in the future.
 - › An option to buy the underlying asset is called a “call option”.
 - › An option to sell the underlying asset is called a “put option”.
- The buyer of the option is usually obliged to pay a fee when concluding the option contract called premium or option price of the option right.
- Products to be considered:
 - › Commodity options
 - › Financial options



Derivatives from a VAT perspective

Derivatives in focus

Forwards and Futures

- A buyer and a seller commit to buy or sell a specified underlying asset at a given price at a specified time in the future.
- Financial theorists consider them to be two opposite options.

Products to be considered:

- › Commodity forwards and futures
- › Financial forwards and futures

Swaps

- Two counterparties agree to exchange cash flows or deliver commodities at predetermined dates over a given period of time.
- Financial theorists consider them two opposite forward contracts or even similar forwards in succession or portfolios of forward and option contracts.
 - › Interest or currency
 - › CDS



Derivatives from a VAT perspective

The differences between a derivative and a sales contract



- E.g. a commodity forward: X commits to buy 1000 barrels of oil at the price of \$ 5000 in three months, on February 22.
- Presented answers:
 - › “A derivative includes some exotic factor, such as the payment of the contract price in a third currency”
 - › “Depends on whether the risk is being secured or if the sale price is being confirmed”
 - › “Derivatives carry a risk related to variables that cannot be forecast”
- *Spot contract / Derivative*
 - › Which is which - depends on the respective Member State
 - › Spot T+2 and Derivatives T+7<

Derivatives from a VAT perspective

The differences between a derivative and a contract

- A and B have concluded a contract, where A is obligated to clear the snow during a specified period of time at the contractual price. B is obligated to pay the contractual price for the service.
- A does not know if the price paid will fully cover his costs as this depends on the amount of snow falling during the winter.
- A's risk as a seller is linked to future weather conditions.
- The risk for B is clearly that he will be penalized should there be no snow.
- It is said that derivatives carry a risk related to variables that cannot be forecast.
- Risks exist for both parties to an agreement.
- Risk cannot be estimated in advance.
 - › Risk element is not solely confined to derivative contracts but is also a feature of other contracts and agreements.



Derivatives from a VAT perspective

A single contract or multiple contracts?

An agreement based on a payment made over 30 instalments to a gardener contracted to fell 30 trees.

Two ways to consider the agreement:

- i. as a single agreement, which is discharged only when all 30 specified trees have been cut down and the final instalment has been paid.*
 - ii. as a series of 30 separate obligations/agreements to pay an amount to the gardener, each payment being a consideration for a particular tree the gardener worked on that day.*
- Completed only when the last payment is made or if each of the separate payments relate to a separate contract resulting in existence of 30 separate contracts in the trees case outlined.
 - Hudson considers a swap as constituting a bundle of contracts or agreements
 - “no reason to regard unrelated transactions as constituting a single contract, even if not in line with ISDA.”*

Example by Alastair Hudson



Derivatives from a VAT perspective

A single contract or multiple contracts?

ISDA Master Agreement

- The most commonly used standard agreement on OTC market.
- The master agreement together with all of the attached documents (schedule, confirmation, definition booklets and credit support documentation) entered into between the parties constitute a single agreement.
- Does it matter in VAT terms how many contracts/agreements exist?
- Does it matter how many transactions exist?
 - › Option right– premium paid: Article 9 of the Implementing Regulation
 - › Exchange contract or currency swap?
 - › Transfer of a contract itself
 - If transferred for consideration, are the definition of any specific supply fulfilled?

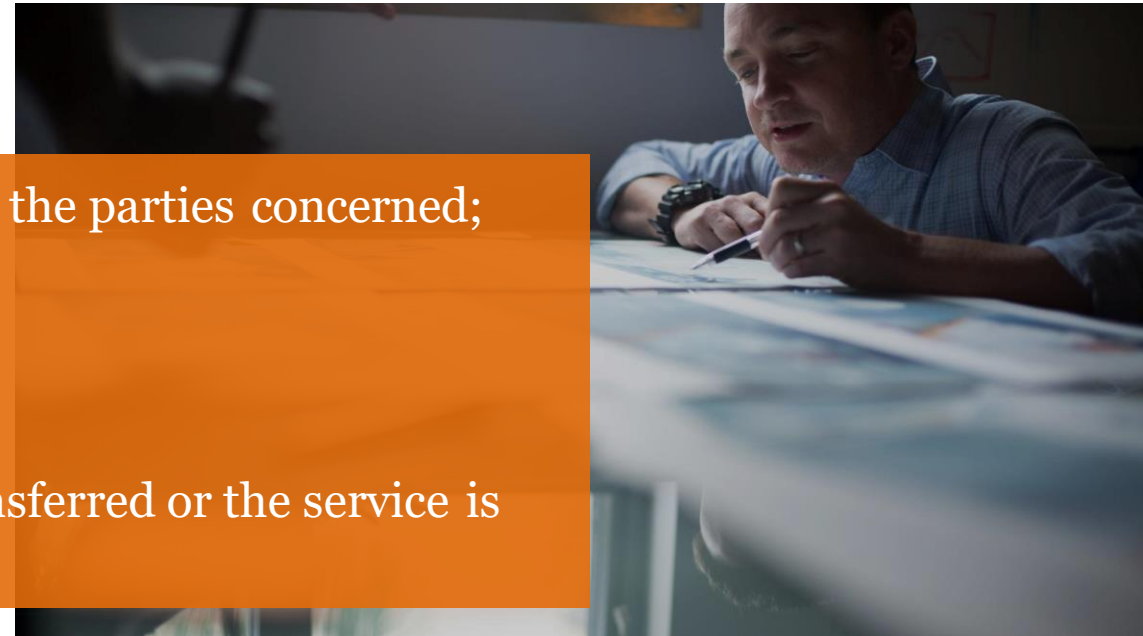


Derivatives from a VAT perspective

A single contract or multiple contracts?

From the VAT perspective the questions of particular interest include:

- i. The nature of the obligations the contract creates for the parties concerned;
- ii. the mechanism for fulfilling the contract;
- iii. the reasons payments are made under the contract;
- iv. the timing of these payments; and
- v. the point at which title to the underlying asset is transferred or the service is supplied to the buyer.



Derivatives from a VAT perspective

Underlying transactions

- According to Article 2(1) of the VAT Directive (2006/112/EC) the supply of goods and services are subject to VAT if transferred for consideration by a taxable person acting as such.
- Article 14: A supply of goods refers to the transfer of the right to dispose of tangible property as owner.
- Article 25: A supply of services refers to any transaction which does not constitute a supply of goods.



Derivatives from a VAT perspective

Goods or services?

ECJ C-172/96 First National Bank of Chicago

- Transactions between parties for the purchase by one party of an agreed amount in one currency against the sale by it to the other party of an agreed amount in another currency constitute supplies of services.
 - › Consisted of currency spot and forward transactions
 - › As currency is deemed a valid instrument of payment, it was therefore not regarded as a tangible property but a supply of a service
 - › ECJ: the underlying asset is relevant in determining whether the supply in question is one of goods or services



Derivatives from a VAT perspective

Goods or services?

- Does the type of settlement play any role?
 - › What is meant by “must be/can be physically settled”?
- Allocated/unallocated goods.
 - › Unallocated goods: becomes the bank's property
 - Regarded as a supply of a service or goods as in UK?
 - Holder of the account does not have title to the gold but a right to request the delivery under a separate contract
 - No physical transfer of the underlying commodity
 - Consideration for allocated or unallocated commodities is paid when the commodities are received as a deposit.
 - Could the consideration paid be regarded as a prepayment in Article 65? Possible problem to identify the object of the transaction



Derivatives from a VAT perspective

Insurance?

Article 135(1)(a) of the VAT Directive:
Member States shall exempt insurance and reinsurance transactions, including related services performed by insurance brokers and insurance agents.



Credit Default Swap

- Credit derivative or insurance?
 - › Could the payments made by the buyer of the CDS be regarded as an insurance premium?
 - › A CDS may refer to a specified loan or bond obligation of a reference entity
 - › Companies authorised to conduct such activity
 - › Do you need an personal interest to be insured?
 - › CDS breaches the “no-profit” criterion in comparison to an insurance contract

Regarding derivatives as insurance would expand the scope of insurance

Derivatives from a VAT perspective

Securities?

Article 135(1)(f) of the VAT Directive: Member States shall exempt transactions including negotiation but not management or safekeeping, in shares, interests in companies or associations, debentures and other securities, but excluding documents establishing title to goods, and the rights or securities.



According to Article 9 of the Council Implementing Regulation 282/2011:

The sale of an option, where such a sale is a transaction falling within the scope of point (f) of Article 135(1) of Directive 2006/112/EC, shall be a supply of services within the meaning of Article 24(1) of that Directive. That supply of services shall be distinct from the underlying transactions to which the services relate.

- Two separate supplies
- At least some options are regarded as securities in Article 135(1)(f)

Derivatives from a VAT perspective

Securities?

- Securities are defined differently depending on the context.
- Financial legislation in the EU does not define the requirements of the negotiable security from the private law perspective.
- Generally speaking, securities are
 1. tradable assets
 2. include different rights, including the right of ownership,
 3. which may be used only by having physical possession of the security as a document itself.



Derivatives from a VAT perspective

Securities?

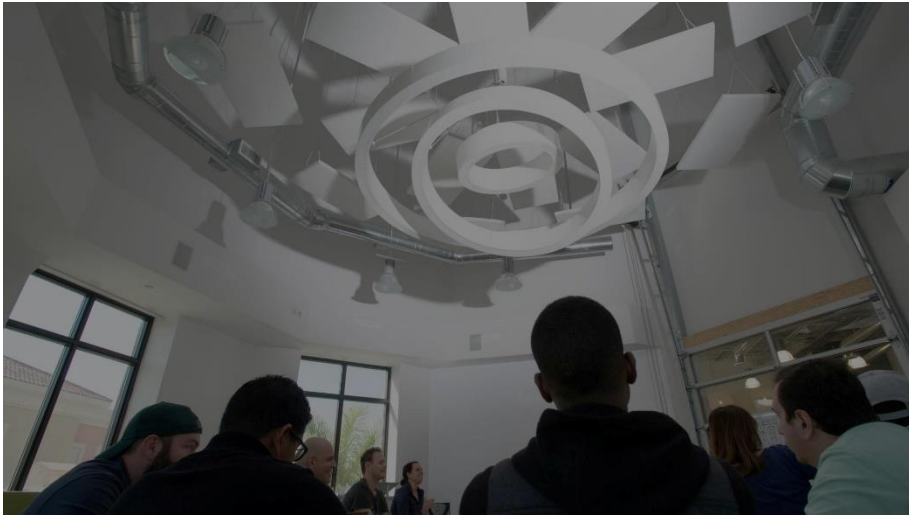
- Tradability i.e. the possibility to transfer securities without the permission of a contracting party is a core criterion also under Article 135(1)(f), as otherwise the exemption rule becomes redundant.
 - › All derivatives do not seem to fulfil the criterion in terms of Article 135(1)(f)
 - › Closing the position by entering to an opposite position would not fulfill the criterion
- CJEU: Acquiring securities should bestow a right of ownership over a company or similar, or a claim against that company, or any related right
 - › holding of a derivative does not *per se* give any title to any commodity or asset
- CJEU: Securities traded in the primary market are out of scope
 - › Can we talk about secondary market except for securitised derivatives?



Would we need a specific exemption for derivatives? Is it not enough to tax them in accordance with transactions of similar commodities or contracts?

Derivatives from a VAT perspective

Legal Tender



Article 135(1)(e): Member States shall exempt transactions, including negotiation, concerning currency, bank notes and coins used as legal tender, with the exception of collectors' items, that is to say, gold, silver or other metal coins or bank notes which are not normally used as legal tender or coins of numismatic interest.

Article 135(1)(e) a reasonable basis for exempting both cash settlements and settlement in foreign currency?

- Difficult to pinpoint which of the contracting parties is acting as the supplier in VAT terms.
 - › For example a currency swap
 - › Reciprocal transactions?
 - › The nature of the contract should not account
- If legal tender is treated both as a commodity and a method of payment, any purchaser should be regarded as a supplier of or service i.e. money.
 - › Needs to be strictly limited by interpretation to cases defined in Article 135(1)(e)
 - › Financial market: a derivative is an instrument or a contract entailing an obligation to pay or a contract of debt.

Derivatives from a VAT perspective

Gambling

Article 135(1)(i):

Member States shall exempt betting, lotteries and other forms of gambling, subject to the conditions and limitations laid down by each Member State



CJEU:

- Neutrality must not be compromised by differentiating the exemption in terms of the lawful or unlawful nature of the operation or provider of the game
- The legal form under which providers exercise their activities is irrelevant
- Differentiation may not be based on other taxes carried by the services
- Identical or similar from the point of view of “an average consumer”?
 - › Brain scanning problem

Derivatives from a VAT perspective

Gambling

Relatively fine line exists between these products, clarification from the legislator would be welcome.



- Gambling or betting are used solely for speculation.
 - › Use of derivatives include hedging and trading in commodities and other assets
- Derivatives have a commercial purpose, while gambling does not.
 - › Supporting real economy
- Gambling and betting as activity of private people
- Level of risk is clear and fixed in ordinary gambling
 - › More difficult to estimate risk in respect of derivatives

Derivatives from a VAT perspective

Economic Activity

Article 9 of the VAT Directive:

“Taxable person shall mean any person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity.”

“Any activity of producers, traders or persons supplying services, including mining and agricultural activities and activities of the professions, shall be regarded as ‘economic activity’.”

“The exploitation of tangible or intangible property for the purposes of obtaining income therefrom on a continuing basis shall in particular be regarded as an economic activity.”



Derivatives from a VAT perspective

Economic Activity

Article 174 of the VAT Directive: The deductible proportion shall be made up of a fraction comprising the following amounts:

- a) as numerator, the total amount, exclusive of VAT, of turnover per year attributable to transactions in respect of which VAT is deductible pursuant to Articles 168 and 169;
- b) as denominator, the total amount, exclusive of VAT, of turnover per year attributable to transactions included in the numerator and to transactions in respect of which VAT is not deductible.

By way of derogation from paragraph 1, the following amounts shall be excluded from the calculation of the deductible proportion:

- a) the amount of turnover attributable to supplies of capital goods used by the taxable person for the purposes of his business;
- b) the amount of *turnover attributable to incidental real estate and financial transactions*;
- c) the amount of *turnover attributable to the transactions specified in points (b) to (g) of Article 135(1) in so far as those transactions are incidental*.

Derivatives from a VAT perspective

Economic Activity

- More difficult to regard assets of a company not belonging to the economic activity of the company than assets acquired by a private person (C-306/94 *Régie Dauphinoise*)
- Sale of investment capital goods or current assets incorporated into business assets are objects of economic activity.
 - › On the balance sheet of the taxable person
- How about derivatives?
 - › Impact of case law of the securities

- In case of a financial institution or any other market operator as a speculator or a hedger, the income obtained represents the remuneration received as consideration for the activity carried out?
- Even though the nature of the economic activity should be analysed purely on an objective basis, subjective reasons for using derivatives might be significant in respect of the deductibility entitlements of a taxable person.
 - › CJEU: “The responsibilities of the Tax Authorities do not include evaluating why a taxable person has performed a transaction.”
 - › CJEU: The assessment of a performed transaction by an “average consumer”
 - Problem of brain scanning

Derivatives from a VAT perspective

Economic Activity

- The CJEU has defined activity as not being incidental if the activity is
 1. a direct,
 2. permanent and
 3. necessary extension of a taxable activity.



- The direct link to the main activity of the company is considered to be even stronger when the transactions concerned are carried out with a business or commercial purpose characterized by, in particular, the wish to maximize returns from capital invested.
 - > Normal business activity may be understood as supplies of current assets or capital goods in cases where these assets are sold
 - > Based on CJEU, may it be concluded that Article 174(2) mainly excludes supplies other than those of current assets from the pro rata calculation?

Derivatives from a VAT perspective

Economic Activity

Every activity needs to be analysed separately taking the totality of the business of the operator into account



How about:

- Hedging the airline business?
- Managing business liabilities or assets in the core business?
- The companies only business being the speculation on the derivatives?
 - › Designed solely to realise a profit
- Using arbitrage to maximise the revenue of the sales products?

Derivatives from a VAT perspective

VAT Treatment in Finland

Finnish VAT Act Section 42(2):

Dealing in securities means the sale and brokerage of shares and other corresponding interests, claims and derivative agreements, also when they are not made out in documentary form.

Questions:

- *Is it relevant why the trade is made?*
- *Is the nature of the derivatives at hand in the trade relevant?*
- *How about the method of settlement?*

Administrative Court of Appeal in Helsinki

Background: The parent company of a Group took care of derivatives trading on behalf of the whole Group and charged fees for this from the other Group companies. A question of their VAT treatment.

- Energy production and supply to Nordic power exchange or electricity companies.
- Production and supply of district heating and distribution gas to district heating companies.
- The Group's business activities relating to energy production were hedged by derivatives.
 - › No other trading aside from this
- “Does not sell derivatives” but has charged expenses from other Group companies -> VAT exempt intermediation in securities.
- The right to deduct was valid to the extent that hedging costs were deemed related to the supply of electricity.
 - › Relating to these costs, no right to deduct

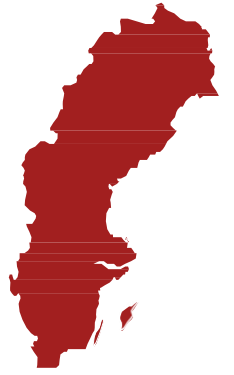


Derivatives from a VAT perspective

VAT Treatment in Sweden

Sweden

- General VAT treatment of derivatives is VAT exempt without credit.
- Not regulated as VAT exempt in national legislation.
 - › However, derivatives should fall under the exemption of "supply and intermediation of shares, other participations and receivables, whether represented by securities or not."
- Normally should be considered financial instruments and fall under the exemption, when settled financially or the underlying asset is a security / another financial asset.
- Swedish Tax Authorities have mentioned some examples of types of derivatives that are qualified as financial instruments.
 - › i.e. "Examples of other securities are standardized options and futures (derivatives) that are listed on a regulated securities market."
 - › However, should not be a requirement that the derivatives are standardized or subject to trade in a regulated market.



Derivatives from a VAT perspective

VAT Treatment in Denmark



Denmark

- Derivatives not regulated as VAT exempt in Danish legislation.
- VAT exemption based on (inter alia) Article 135 (1)(f) of the VAT Directive.

Derivatives

What is the underlying asset?

Synthetic (e.g. index), securities or currency?

Goods and similar

Contract requires cash settlement

The contract can only be fulfilled by "physical" settlement

Contract settlement method is optional

The contract includes a financial element

The elements constitute a single composite supply

The elements constitute two independent supplies

What is the primary element?

The supply of goods

The financial element

The supply of goods

The financial element

VAT exempt financial supply

VAT taxable supply

Further analysis required

Derivatives from a VAT perspective

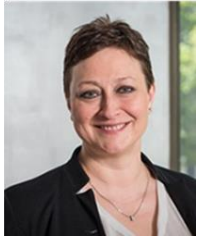
VAT Treatment in Norway

Norway

- General VAT treatment of derivatives is VAT exempt without credit.
- Defined as financial instruments according to the Norwegian VAT Act.
 - › Further defined in the Norwegian Securities Trading Act
- No relevance to what underlying asset is at hand as long as the derivative is deemed a financial instrument.
- Derivatives where the underlying object are goods:
 - › Always regarded as VAT exempt when traded in stock exchange or a similar authorized marketplace.
 - › If this is not the case, a further review of the "product" should be made.



Thank you!



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