European Commission

Taxation of the financial sector

Executive Summary

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This study, prepared for the European Commission's Directorate-General for Taxation and Customs Union (DG TAXUD), examines the tax framework for the financial sector. The purpose of the study is to (i) collect, analyse and present evidence of the existing problems with the current tax framework, (ii) provide insight on policy objectives and future considerations which could address these problems, and (iii) assess and compare the likely impacts of these considerations.

The tax framework is assessed in terms of its two main components, namely:

- The EU VAT framework for the financial sector, which is characterised by the exemptions laid down in Article 135(1)(a)-(g) of the VAT Directive. This framework, in place since the introduction of the EU VAT system in 1977, was historically justified on technical grounds related to the difficulty of defining the tax base on services priced in terms of interest-rate spread and other implicit charges.
- Outside the VAT framework, Member States sovereignly apply a variety of sectoral taxes. These include taxes on the sale of certain products, such as insurance premium taxes (IPTs) and stamp duties, financial transaction taxes (FTTs), financial institution levies, payroll taxes on salaries in the financial sector, additional corporate income tax (CIT), and so-called windfall taxes targeting exceptional profits.

The study also considers the **interaction of taxation with the specific prudential framework** applied to the financial sector.

Problems identified

First, due to the VAT exemption, providers of financial services do not have the right of deduction. This in turn means that many of the sector's input purchases are taxed, resulting in a tax burden that does not appear on invoices and therefore is commonly referred to as 'hidden' VAT. This results in tax-driven distortions rendering outsourced or centralised inputs more expensive than in-house production. As a result, the VAT exemption affects business structures and supply-chain decisions, even when these are not economically efficient.

The study finds that these distortions are becoming more important over time. Financial institutions increasingly rely on outsourced and digitally delivered specialist services, especially in areas such as payments, asset management, claims processing and fintech solutions. The exemption therefore creates a stronger and more widespread tax penalty on innovative, specialised value chains than in the past.

Second, the overall framework is uncertain, complex and fragmented. The VAT exemption for financial services relies on definitions that are often difficult to apply to modern business models. Divergence across Member States is especially acute in the treatment of **insurance-related services, fund and asset management, custody services, certain derivatives, payment value chains and some crypto-asset activities**. There are also major differences in structural VAT rules, including the availability of the option to tax, VAT grouping, cost-sharing arrangements and proportional deduction methods. This situation is further compounded by a patchwork of national sectoral taxes. The study identified 92 sectoral tax measures across the EU. Together, they increase fragmentation and complexity, especially for firms operating cross-border.

Consequences of the problems

The exemption creates economic distortions and strong incentives to produce services in-house or within domestic VAT groups rather than purchasing them externally or cross-border. This reduces VAT neutrality, limits outsourcing, discourages specialisation and may slow down innovation and productivity improvements. The effective VAT burden is uneven, with an average effective VAT rate on B2C financial services of 6.5% and the hidden VAT burden on B2B and B2G transactions estimated at 4.5%.

The study also identifies important fiscal impacts. The overall VAT liability associated with the financial sector is estimated at EUR 72.4 billion in 2023, but most of this is hidden VAT on inputs rather than VAT on final consumption. Of the total, only EUR 12.2 billion was attributable to final consumption, while EUR 54 billion stemmed from irrecoverable VAT on inputs used by the financial sector. This means 83.1% of VAT liability linked to financial services is hidden, compared with 33.5% for the economy overall. The VAT policy gap attributable to the exemption is estimated at EUR 52.2 billion in 2023, equivalent to

4.4% of total VAT revenue. This reflects forgone VAT revenue due to the exemption structure. At the same time, Member States collect around EUR 82 billion through sectoral taxes, of which around EUR 54 billion comes from IPTs alone.

The tax framework also imposes compliance burdens. Administrative costs for VAT compliance in the financial sector are estimated at around EUR 1.3 billion annually, with a further EUR 870 million for compliance with sectoral taxes. While these costs are generally small relative to turnover for large firms, they are important in absolute terms and widely considered by stakeholders in excess of the administrative costs of standard VAT treatment applied to other sectors, while also being felt more prominently among smaller providers of financial services. The rules on proportional deduction are identified as the most burdensome feature of the VAT framework. It is worth stressing the study finds little evidence that the financial sector is a major source of VAT fraud or evasion. Detected VAT irregularities were very low on average, and most compliance concerns relate to deduction methods and classification issues rather than deliberate fraud.

Policy considerations and their likely impacts

Several policy considerations were developed to address the problems, grouped into three broad building blocks.

The first building block consists of modernising and simplifying the current VAT rules while keeping the exemption in place. Two main approaches are considered. The first is to **modernise the definitions of financial services**, particularly in areas where legal uncertainty or divergent national treatment is most pronounced, such as derivatives, custody, payment value chains, insurance intermediation and crypto-asset services. The second is to **simplify and harmonise the rules on proportional deduction**, either by clarifying the default methods or by introducing fixed deduction rates, including possible optional or super-deduction approaches. The more incremental measures in the first building block would mainly **improve legal certainty and reduce administrative complexity but would only partially address the underlying distortions**. Updating the definitions could reduce uncertainty in key areas, while simplification of the proportional deduction rules could lower compliance costs. However, unless deduction rates are significantly increased, hidden VAT and the related distortions would remain largely in place.

The second building block focuses on reducing hidden VAT while retaining the exemption. This includes expanding or reforming VAT grouping and re-establishing cost-sharing arrangements for the sector, as well as making the option to tax available in all Member States. Different versions of the option to tax are considered, including narrow or broad scope and entity-wide or transaction-by-transaction application. Extending VAT grouping to all Member States would produce some gains, but cross-border VAT grouping or a broader use of cost-sharing arrangements would have much larger effects by reducing hidden VAT on intra-group and cross-border supplies. Likewise, a broad, transaction-by-transaction option to tax would significantly reduce hidden VAT where business customers can deduct VAT, although it would also reduce government VAT revenues and increase administrative complexity.

The third building block consists of more fundamental reforms. One set of approaches would remove the VAT exemption either for all financial services or only for fee-based services, while services remunerated in the form of interest rates and other implicit charges (e.g., consumer loans) would remain exempt. Different VAT rate choices are considered, including standard rates and revenue-neutral rates, and some variants would remove sectoral taxes to avoid double taxation. Another approach is to introduce a Financial Activities Tax (FAT) for all financial services, while zero-rating financial services for VAT purposes and removing sectoral taxes. The study finds that taxing financial services with VAT is practically feasible, especially for fee-based services, and would remove many of the current distortions and legal uncertainty. This is evidenced by the nine EU Member States allowing providers the option of applying VAT to (certain) financial services, as well as the approaches of 10 of the 15 third countries examined for the study, which apply VAT to at least parts of the sector. However, taxing interest-based services remains possible but the methods for doing so entail challenges that would need to be weighed carefully. A partial removal of the VAT exemption limited to fee-based services is therefore presented as a more workable compromise.

The expected impacts on sales of (i.e., demand for) financial services, tax revenues and macroeconomic effects of the reforms under the third building block vary according to their design. Applying standard VAT while removing sectoral taxes tends to moderately increase sales but reduce government revenues, since the elimination of hidden VAT and sectoral taxes more than outweigh the

introduction of VAT on outputs. Applying standard VAT while keeping sectoral taxes reduce sales and increase revenues. Revenue-neutral variants have near-zero aggregate effects on sales and revenues. In all cases, the macroeconomic impacts are generally modest once revenues are recycled into the economy.

The Financial Activities Tax (FAT) would improve coherence and reduce some complexity but would not fully restore VAT neutrality because the FAT is not a transaction-based tax and would leave some distortions in business-to-business chains. Its main attraction is simplicity and improvements to fiscal neutrality, but it would represent a major structural change and would only partly solve the market distortions caused by the current framework. Overall, each type of reform entails different costs and benefits that would need to be weighed carefully ahead of any policy initiative.

Overall conclusion

The study concludes that the original technical rationale for the VAT exemption no longer remains fully valid. In combination with divergent national sectoral taxes, the current tax framework causes distortions, complexity, legal uncertainty and fragmentation. These problems are becoming more serious as the sector digitalises and value chains become more specialised. While taxation is not the only or main barrier to integration, the current framework is not aligned with broader EU policy priorities such as the Savings and Investment Union Strategy, which aims to facilitate cross-border financial services and capital allocation. Incremental reforms could improve the framework by ameliorating legal certainty and reducing to some extent hidden VAT. The most effective way to address the root causes would be a more fundamental reform of the VAT exemption and its interaction with sectoral taxes. The study therefore concludes that such a reform would be, in several forms, practically feasible, while recognising that any final decision will depend on political choices about the trade-off and relative priorities. This is because the impacts of the policy considerations assessed differ substantially in terms of the level of simplicity and tax neutrality achieved, fiscal burdens on the financial sector, business customers and households, and wider impacts on the economy.

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