

## **Reports and studies commissioned for the Commission**

### **THE TCA SYSTEM – A DETAILED DESCRIPTION EXECUTIVE SUMMARY**

The TCA system would be “truncated” in that only financial institutions would be required to calculate the tax, whereas all suppliers of taxable supplies must calculate VAT under the normal VAT system (unless specifically exempt). Since only financial institutions would be required to remit the tax, the definition of a financial institution is very important under the TCA system. Truncation of the TCA system would facilitate the zero-rating of transactions with registered customers, as well as transactions with non-residents and other financial institutions.

Consideration for financial services can take the form of explicit fees and commissions or an implicit charge in the form of margin. Under the TCA system, both margin services and explicit fees would be subject to tax. Since all financial services provided by financial institutions would be taxable under the TCA system, financial institutions would be allowed to claim full refund of VAT paid on all taxable purchases. Explicit fees would be taxed in the same manner as under the normal

#### **VAT system**

##### **Calculation of tax on loans and deposits**

Under the TCA system, the tax base for margin services would be computed over the term of the financial contract, whereas the tax base under the normal VAT system is the explicit price charged for the goods or services. It is paramount that there be a consistent means of measuring the margin over time which can be applied to all financial products. Margin services are measured by the tax calculation account (“TCA”) as the difference between the actual interest charged on a loan, or paid on a deposit, and the interest calculated on the loan or deposit using a proxy for a “pure” rate of interest which contains no charges for intermediation services or credit risk (referred to as the “indexing rate”).

Conceptually, the taxable margin so computed should be a measure of the intermediation services provided by the financial institution. Thus, the TCA allocates the total margin earned by the financial institution (being the difference between the interest rate charged on the loans and paid on the deposits) between the borrowers and depositors using the indexing rate as the benchmark. It is proposed that a short term inter-bank rate (either 1-month or 3-month rate) be used for the indexing rate. In EU countries, the inter-bank market rates come closest to riskless and serviceless interest rates. The selection of the appropriate indexing rate is discussed in Section 3-IV of this report.

By using the same indexing rate for all transactions of a given currency, regardless of the maturity or other risk characteristics of the transaction, the margin allocated to a particular borrower or depositor should vary across financial institutions only where the interest rate differs. Differences may arise due to competitive position of the financial institution or different fee structures of the financial institution. However, differences between the fees structures of financial institutions should impact the total VAT paid only where the total amount charged to the customers in the form of margin and fees is not the same. For fixed rate loans and deposits, the VAT computed by the TCA and remitted to the government each period would vary with the short-term indexing rate even though the interest rate on the contract is fixed. While the use of indexing rates which are matched to the maturity of the contract was considered, it was concluded that the use of such rates was not feasible.

The actual interest rate charged on loans (which would include any credit risk premium) would initially be included in the tax base and the financial institution would be allowed to claim tax credits for the bad debts when they occur. While allowing the financial institution to claim tax credits for bad debts on loans to registered customers would result in a net revenue loss to the government, the same situation arises under the current VAT system for non-financial services which allows a vendor to claim tax credits for bad debts even if the purchaser has claimed VAT refunds in respect of the unpaid consideration.