



Marja Hokkanen

Derivatives and the European VAT System

Derivatives in the Context of
the Scope of Taxable Supplies

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55

Derivatives and the European VAT System

Why this book?

While certain types of derivatives (e.g. gold derivatives and certain options) are regulated under the EU VAT Directive (2006/112/EC), the lack of regulation in respect of derivatives in general has led to individual EU Member States treating derivatives very differently. This lack of regulation on an EU level brings uncertainty as to how these instruments should be treated, and the resulting inconsistencies and lack of guidance at a national level have effectively jeopardized any prospect of achieving neutrality and equality in treatment across the EU derivatives market.

The challenge of defining derivatives in the scope of the EU VAT system is not easy because of the diversity of derivatives. At the same time, the EU VAT system presents challenges in analysing derivatives in the context of legal tender, consideration or reciprocal supplies, to name a few, which have a special role in the world of derivatives.

This research aims to define the most common types of derivatives (i.e. commodity and financial options, futures, forwards and swaps) in terms of the EU VAT system and to bring clarity to the EU area regarding their VAT treatment on the basis of the VAT Directive, thereby attempting to give concrete answers as to how derivatives should be treated, with specific reference to the scope of the VAT system as defined under articles 1 and 2(1) of the VAT Directive. Another question to be answered is whether derivatives as financial instruments or contracts represent transactions in goods or services in VAT terms or whether the underlying transactions in goods and services should provide the sole focus for VAT. Also, the nature of derivatives as financial instruments raises question as to whether derivatives should also be entitled to the exemption afforded to financial and insurance services under article 135(1) of the VAT Directive. In addition to the supply of commodities, interesting questions regarding whether derivatives trading can be considered an economic activity as defined under article 9(1) of the VAT Directive are examined. Other pertinent questions raised concern what, if anything, constitutes consideration under a derivative, as well as when VAT becomes due, i.e. when the chargeable event takes place.

In addressing the research question, the doctrinal method is appropriate in bringing clarity to the definition of the scope of VAT as a key first step. The interpretation of articles 2(1)(a) and (c), 9(1) and 135(1) of the VAT Directive is crucial in this regard and effectively forms the basis for the research.

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Chapter 1

Introduction

1.1. Introduction

“Whether you love derivatives or hate them, you cannot ignore them!”¹ In giving this cautionary note, Hull suggests that even if one does not know too much about derivatives, they have an impact on everyone’s life, either directly or indirectly.

Derivatives are not a new phenomenon. The ancient Greeks traded olive oil futures under contracts, fixing the price of olive oil for a purchase sometime in the future.² In the 17th century, the selling price of tulips was also fixed in a similar fashion in the Netherlands.³ Both of these futures contracts fixed the sales price for the future, at which the right-holder agreed to buy a given quantity of olive oil or tulips, with the price being contractually binding with immediate effect. There are even stories about more ancient Babylonian kings selling instruments that permitted the holder of the instrument to call on the king to deliver one mercenary soldier and two slaves for each instrument held when the payment of the price specified in the instrument was made. This type of contract is similar to today’s physically settled call options, as it permitted the buyer of the option to request delivery of an identified form of asset for the payment of the contractually specified price.⁴

The essence of these ancient contracts is similar to that of the derivative contracts in operation today, in that they enable the buyer to get an idea of the future market price of an underlying asset, thereby protecting himself against price changes by fixing the price in advance.⁵ The first organized futures exchange, the Dojima Rice Exchange, began its operation in 1710 in

1. J.C. Hull, *Options, Futures, and Other Derivatives* p. 1 (8th ed., Pearson Education Limited 2012.).

2. Aristotle, *The Politics*, vol. 2, p. 453 (Clarendon Press 1885); and D. Swann, *The Regulation of Derivatives* (Routledge 1995).

3. S. James, *The Law of Derivatives* p. 1 (LLP 1999).

4. See P.G. Zhang, *Barings Bankruptcy and Financial Derivatives* p. 31 (World Scientific Publishing Co Pte Ltd. 1995), in relation to futures contracts being created in Japan in the late 17th century.

5. A. Hudson, *The Law on Financial Derivatives* pp. 26-27 (5th ed., Sweet & Maxwell 2012).

Osaka, Japan,⁶ while in Chicago, the first exchange trading in grain futures was opened in 1848.⁷

While these early exchanges facilitated the trading of derivatives based on agricultural products, precious metals, energy products and currencies, today's modern equivalent increasingly facilitates trading in financial instruments.⁸ While historically used for hedging and risk management linked to the main business of the entrepreneur, as was the case with the ancient Greeks with olive oil and the Dutch with tulips, today's exchanges cater increasingly to the trading of financial assets for speculation or other objectives separate from the main business. One advantage of derivatives is that any profit made on the underlying asset may be gained without having physical possession of the asset itself.⁹

As businesses face increasing pressure to control costs, derivatives have taken on a more significant role, not only within the European Union, but across the global economy. As a result, companies and other operators are trading derivatives on a variety of regulated exchanges and on the over-the-counter (OTC) market, with money moving across borders from one operator to another on a worldwide basis.

It has been said that the financial markets are the brains of the economy.¹⁰ The derivatives market, as part of the financial market, has therefore had a significant impact on operators and EU Member States. In contrast to the primary instruments of financial products, which are associated with consumption, savings and fixed capital formation that create wealth (such as securities), derivatives are associated with the transfer of wealth between

6. Private ordering at the world's first futures exchange; see M.D. West, *Private Ordering at the World's First Futures Exchange*, 98 Michigan Law Review 8, pp. 2574-2615 (1999).

7. J. Lauha, *OTC-johdannaiset ja Suomen oikeus*, Bank of Finland Discussion Paper 4/96 (14 Feb. 1996).

8. Financial instruments are also regarded to connote financial claims that can be traded on the financial market. See G. Visentini & M. Musolino, *The Financial System and Institutions*, in *Financial Services in Europe: An Introductory Overview* p. 19 (M. van Empel ed., Kluwer Law International 2008). International Financial Reporting Standard 9, which came into effect from the beginning of 2018, defines financial instruments as derivatives for accounting purposes.

9. Hudson, *supra* n. 5, at p. 32.

10. J.E. Stiglitz, *Federalism in Securities Regulation: An Economist's Perspective* p. 805 (University of San Francisco Law Review 2006). See also R. Knuutinen, *Muoto ja sisältö vero-oikeudessa – erityistarkastelussa rahoitus- ja sijoitusinstrumentit, Yliopistolainen väitöskirja* p. 5 (Suomen Lakimiesyhdistys 2009).

economic operators for different reasons, including hedging, arbitrage and the attainment of reductions in taxes or other costs.¹¹

The role of derivatives in today's financial markets¹² continues to expand year after year, despite the downturn following the recent economic recession. So-called "standardized derivatives" are traded on regulated exchanges, while "bespoke derivatives" are traded on the unregulated OTC¹³ market, with today's trading mainly being carried out electronically.¹⁴

It is notable that today's derivatives market is much bigger than the stock market when measured in terms of underlying assets,¹⁵ with the value of such assets underlying outstanding derivatives transactions with several times the value of the world's gross domestic product.¹⁶ While it is not possible to say exactly how much money is tied up in derivatives markets worldwide, an estimation made in 2010 put the figure at USD 12 trillion, which, in turn-controlled contracts that are connected to assets, have been valued at USD 1.2 quadrillion.¹⁷ In effect, this puts the notional value¹⁸ of the derivatives market at around 20 times the size of the world economy.

In 2015, based on information from the Bank for International Settlements, the notional amount globally outstanding on the OTC derivatives market covering foreign exchange contracts, interest rate and equity-linked contracts was estimated at USD 552,909 billion, with a gross market value of

11. A. Blundell-Wignall & P. Atkinson, *Global SIFIs, Derivatives and Financial Stability* pp. 3-6 (OECD 2011).

12. A "financial market" is defined as "a market where financial assets are exchanged i.e. traded". See F.J. Fabozzi & F. Modigliani, *Capital Markets: Institutions and Instruments* (4th ed., PHI Learning 2009); and P. Sebastianutti, *Capital Markets*, in *Financial Services in Europe: An Introductory Overview* p. 63 (van Empel ed., Wolters Kluwer 2008).

13. The over-the-counter (OTC) market involves trading in some other context than a formal exchange. Derivatives are traded, for example, through a dealer network as part of the OTC market.

14. These days, derivatives are mainly traded electronically. However, a small number of transactions are still traded on paper.

15. The underlying element of a derivative may be an asset, a basket of assets, an index or even another derivative, such that the cash flows of the (former) derivative depend on the value of this underlying element.

16. Hull, *supra* n. 1, at p. 1.

17. P. Cohan, *Big Risk: \$1.2 Quadrillion Derivatives Market Dwarfs World GDP*, Daily Finance (9 June 2010).

18. The "notional" value is the total value of a leveraged position's assets. This term is commonly used in the options, futures and currency markets instead of "nominal" or "face" value. The notional value of a financial instrument is the nominal or face amount that is used to calculate payments made on that instrument. The notional value or amount generally does not exchange hands and is thus referred to as notional. See Hull, *supra* n. 1, at pp. 548 and 811.

USD 15,521 billion. The equivalent figures for commodity contracts were estimated at USD 1,671 billion, with a gross market value of USD 237 billion. For credit default swaps, the figures were USD 14,596 billion, with a gross market value of USD 453 billion.¹⁹

While the regulation of derivatives has lagged far behind the development of these products, the economic crisis of 2008, which has been partly blamed on speculative activity on the world's derivatives market,²⁰ prompted a number of regulations targeting financial markets, including at an EU level. However, despite such measures, as well as the general reduction in the size of the market in recent years, derivatives continue to develop, promising even greater profits for practitioners and protection for their clients against a wide variety of financial risks.²¹

1.2. Derivatives and VAT

If derivatives are capable of destabilizing the world economy, they are too powerful a tool to be ignored in European VAT. Perhaps therein lies the very reason that their regulation for tax purposes (if it exists at all) remains weak and essentially stuck at the proposal level.²² That said, while certain types of derivatives, such as gold derivatives and certain options, are currently regulated under the EU VAT Directive,²³ the lack of regulation in respect of derivatives in general has led to individual EU Member States treating derivatives very differently, as will be shown later in section 4.3.²⁴ However, in July 1998, the Court of Justice of the European Union (ECJ) delivered

19. Bank for International Settlements, *Semiannual OTC derivatives statistics*, available at <http://www.bis.org/statistics/derstats.htm> (accessed 6 Apr. 2016).

20. See, for example, D.N. Shaviro, *Income Tax Reform Implications of the Financial Crisis*, in *Taxation and the Financial Crisis* pp. 184-185 (J.S. Alworth & G. Arachi eds., Oxford University Press 2012).

21. Hudson, *supra* n. 5, at p. 10; and *id.*

22. On top of the Commission proposals concerning VAT, the Commission has also introduced the Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final, Primary Sources IBFD, which includes regulations on derivatives. However, it seems that the “funeral” of the financial transaction tax proposal is ongoing, as was stated by the German Minister of Finance, Wolfgang Schäuble, at the beginning of the year 2016.

23. Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ L 347/1 (2006), Primary Sources IBFD [hereinafter VAT Directive].

24. The different interpretations might also have an impact on the European Union's own resources. This is especially the case with commodity derivatives, since, depending on the country, they may be out of scope, taxed or exempt, depending on the circumstances. See also J.J.B. Hickey, *VAT and the City: Banking, Finance and Insurance* p. 551 (7th ed., Walters Kluwer 2012).

its only finding to date regarding VAT and derivatives in a case concerning the First National Bank of Chicago.²⁵ This finding understandably plays a significant role in this research.

The VAT treatment of derivatives has important implications for companies and their cost structures, not only in respect of VAT collected on their supplies of goods and services, but, more importantly, with regard to their entitlement to recover VAT incurred on their business inputs, also referred to as “input VAT”. In this regard, a taxed²⁶ supply of most commodities carries an entitlement to a deduction of input VAT. The treatment of financial services as exempt supplies under the VAT Directive provides for deduction only in the case that input VAT is connected to supplies defined in article 169(c),²⁷ i.e. supplies made to third countries outside of the European Union.

In addition to the supply of commodities, interesting questions arise regarding whether derivative trading can be considered an economic activity as defined under the VAT Directive. Under current VAT rules, a taxable supply, which is a fundamental prerequisite for economic activity, cannot exist without a taxable person deemed to be acting as such in carrying out such activity. The question of whether traders in derivatives can be considered taxable persons making taxable supplies is, therefore, fundamental for this research.

Various commentaries signal the challenges presented in reconciling derivatives with the European VAT system and in answering the questions posed in this research. For example, in *Ines Zimmermann*, Advocate General Mazák stated:

Value added tax (VAT) was originally meant and introduced as a simple tax on the supply of goods and services. However, it is arguable that the VAT system and some of its rules have turned out rather complicated. Indeed, one judge

25. UK: ECJ, 14 July 1998, Case C-172/96, *Commissioners of Customs & Excise v. First National Bank of Chicago*, Case Law IBFD.

26. The definition of a “taxed supply” describes a supply that is within the scope of VAT as defined in art. 2 of the VAT Directive and are not exempt from VAT. The definition of a “taxable supply”, on the other hand, describes any supply within the scope of VAT, including those that are exempt. Similar concepts are also used elsewhere in VAT literature; see, e.g. B. Terra & J. Kajus, *Commentary – A Guide to the Recast VAT Directive* (1 July 2015), Global Topics IBFD.

27. Under art. 169(c) of the VAT Directive, a taxable person is entitled to deduct the input VAT if the goods and services are used for exempt financial services under art. 135(1) (a)-(f) and (i) the customer is established outside of the European Union; or (ii) the transactions relate directly to goods to be exported out of the European Union.

of the Court of Appeal (England and Wales) has, in that regard, observed that “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”.²⁸

The derivatives market, on the one hand, and the European VAT system, on the other, are two separate phenomena serving different purposes, even at the EU level, and reconciling them could present a challenge.

As an anonymous derivative trader declared: “It’s hard enough to get anyone to listen when you mention derivatives and when you combine them with commodities, people tend to want to run a mile.” A colleague specializing in the derivatives market continued: “[W]here do you run when someone wants to discuss the VAT treatment of derivatives?” In light of the increasing level of legislation targeting the financial sector and derivatives – both in the European Union and globally – the challenge is of marathon proportions, with no limit to this tendency evident to date.

Furthermore, Aarnio has stated that tax law is a citizen of two different worlds: tax law is part of justice per se, but its target and objects are economic.²⁹ Knuutinen refers to derivatives as entities serving economic markets, but ruled by law.³⁰ When regulating economic phenomena, such as derivatives, tax law not only needs to fulfill the criteria for strict legal certainty, as the ECJ has put it,³¹ but must be flexible enough to swiftly adjusting to continuous developments in the economic market.

It must also be recognized that the VAT Directive needs to be interpreted from its own perspective, taking into account its sole purpose of taxing economic activity.³² In its findings regarding the question of VAT-exempt supplies, of which financial services form a major part, the ECJ refers to

28. UK: House of Lords, 9 Oct. 2001, *Royal and Sun Alliance Insurance Group plc v. Her Majesty’s Commissioners of Customs and Excise*, [2001] STC 1476 (CA). See also DE: Opinion of Advocate General Mazák, 19 July 2012, Case C-174/11, *Finanzamt Steglitz v. Ines Zimmermann*, para. 1, Case Law IBFD.

29. A. Aarnio, *The Rational as Reasonable* pp. 235-236 (D. Reidel Publishing Company 1987).

30. Knuutinen, *supra* n. 10, at p. 2.

31. DK: ECJ, 15 Dec. 1987, Case 348/85, *Denmark v. Commission*, para. 19: “Furthermore, as the Court has decided on numerous occasions, Community legislation must be certain and its application must be foreseeable by those subject to it. That requirement of legal certainty must be observed all the more strictly in the case of rules liable to entail financial consequences, in order that those concerned may know precisely the extent of the obligations which they impose on them.”

32. See NL: ECJ, 26 Mar. 1987, Case C-235/85, *Commission of the European Communities v. Kingdom of the Netherlands*, para. 18, Case Law IBFD. The VAT Directive establishes a

such supplies as constituting independent concepts of EU law, which must be placed in the general context of the common system of VAT introduced by the Directive.³³ This suggests that in order to clarify the scope of a certain phrase or concept in the VAT Directive, it cannot be determined solely on the basis of interpretation exclusively based on the legislative text; reference must also be made to the context in which the phrase occurs and consideration given to the structure of the VAT Directive itself.³⁴ However, it should be pointed out that the ECJ has itself “borrowed” (or at least utilized) definitions set out in other EU legislation when providing its interpretation of the VAT Directive.³⁵

It will be seen that while the VAT system views derivatives from a different perspective than that of the financial markets, this does not mean that the VAT system exists in isolation or in a vacuum without recognizing the existence of economic phenomena and other legislation. VAT was introduced to tax economic activity, and the starting point should therefore not be to change the reality of that economic activity, nor to artificially redefine derivatives in order to fit them within the scope of the VAT system. Derivatives, as they currently exist, must therefore be analysed in the context of the EU VAT Directive as currently comprehended. In performing that analysis, the study is cognisant of the treatment of derivatives under other bodies of legislation, including those governing the derivatives market and the wider financial services market. The approaches adopted in such areas, including in the definition of derivatives, may provide useful perspectives for the treatment of derivatives under the VAT Directive.

common system of VAT based, inter alia, on a uniform definition of taxable transactions. See, in particular, DE: ECJ, 26 June 2003, Case C-305/01, *Finanzamt Gross-Gerau v. MKG-Kraftfahrzeuge Factoring GmbH*, para. 38, Case Law IBFD.

33. “As has been stated in connection with the examination of the term ‘economic activities’, the ... Directive is characterized by its general scope and by the fact that all exemptions must be expressly provided for and precisely defined.” See *Commission v. Netherlands* (C-235/85), at para. 19.

34. See DK: ECJ, 13 July 1989, Case C-173/88, *Skatteministeriet v. Morten Henriksen*, para. 11, Case Law IBFD, where the Court of Justice of the European Union analysed different translations of the VAT Directive and found that “[i]n view of those differences, the scope of the contested phrase cannot be determined exclusively on the basis of an interpretation of its terms. In order to determine its meaning, recourse must therefore be had to the context in which it occurs and to the structure of the [...] VAT Directive”. The same approach applies to the interpretation of the VAT Directive in other circumstances.

35. See, for example, cases concerning investment funds, such as UK: ECJ, 4 May 2006, Case C-169/04, *Abbey National plc (with Inscape Investments Ltd as Joined Party) v Commissioners of Customs and Excise*, Case Law IBFD.

1.3. Purpose of the study

The aim of this research is to define derivatives in terms of the European VAT system and to bring clarity to the EU area regarding their VAT treatment. The starting point for the study is the current VAT Directive, the primary purpose being to give concrete answers as to how derivatives should be treated, with specific reference to the scope of the VAT system as defined under the Directive.³⁶ At present, the distinct lack of regulation at the EU level brings uncertainty as to how these instruments should be treated, and the resulting inconsistencies and lack of guidance at the national level has effectively jeopardized any prospect of achieving neutral and equal of treatment across the EU derivatives market. Despite these deficits, it is important to note that this research has no interest in challenging the VAT system as it is currently legislated, although the study will propose amendments to particular articles, if necessary.

A number of fundamental questions arise in relation to how derivatives should be understood and defined under the VAT Directive. These questions include (i) whether the VAT system itself effectively succeeds in excluding derivatives from its scope; (ii) whether derivatives traders effectively act as taxable persons under the VAT system; (iii) whether derivatives represent transactions in goods or services in VAT terms; and (iv) whether the underlying transactions in goods and services should be the sole focus of VAT. Other pertinent questions concern (i) what, if anything, constitutes consideration under a derivative; and (ii) when VAT becomes due, i.e. when the chargeable event takes place.

In answering these questions, three articles of the VAT Directive are of particular interest, including (i) article 1, defining the principles underpinning the VAT system; (ii) article 2, defining the scope of the VAT system; and (iii) article 9, defining economic activity and the taxable person. The articles defining goods and services in the VAT system also play a key role in the study. Regarding services, particular attention is paid to the treatment of services sharing certain characteristics with derivatives and that are dealt with specifically under the VAT Directive.

36. See also R. de la Feria & B. Lockwood, *Opting for Opting in? An Evaluation of the European Commission's Proposals for Reforming VAT on Financial Services*, Warwick Economics Research Paper Series, Working Paper No. 927 (2010), available at http://www2.warwick.ac.uk/fac/soc/economics/research/workingpapers/2010/twerp_927.pdf (accessed 9 Apr. 2016).

In addition, the nature of derivatives as financial instruments raises questions as to whether derivatives should also be entitled to the exemption afforded to financial and insurance services in general under the VAT Directive. Derivatives, not only as contracts, but also as financial instruments, will therefore be assessed against the scope of the VAT Directive, with particular reference to these exemptions. In this regard, a comparison will be drawn between certain derivatives and financial and insurance services when determining whether at least some categories of derivatives should also be regarded as exempt supplies under VAT.

Services of particular interest here include (i) dealing in credit guarantees or any other security for money under article 135(1)(c); (ii) transactions concerning payments, transfers, debts, cheques and other negotiable³⁷ instruments under article 135(1)(d); (iii) currency services under article 135(1)(e); (iv) transactions in securities under article 135(1)(f);³⁸ and (v) gambling services under article 135(1)(i). In addition, insurance services provided for under article 135(1)(a) also merit examination.

While interesting questions arise in respect of various services associated with the derivatives market, in order to keep the study within reasonable and recommended limits, a line has to be drawn somewhere. As a result, the pricing of derivatives, their valuation or how the risk inherent to derivatives should be managed are of no interest in this study, the focus being on the VAT treatment of derivative contracts and transactions involving their underlying assets. While fortunately not focal in the research, the author readily admits that any otherwise deeper analysis of these entities would present a formidable challenge.

In analysing derivatives purely as phenomena within the context of the VAT Directive (and, thereby, the European VAT system),³⁹ other areas of law, such as contract law,⁴⁰ financial market law and law on accounting standards

37. “Negotiable” means (i) capable of being negotiated; or (ii) transferable by delivery, with or without endorsement, with the title passing to the transferee.

38. It is noteworthy that art. 9 of the Implementing Regulation firmly signals the role of certain derivatives as securities in art. 135(1)(f) of the VAT Directive.

39. Knuutinen talks about trialism of tax law, other legislation and economics. See Knuutinen, *supra* n. 10, at pp. 64-67.

40. About studies on European contract law in general, see A. Hartkamp et al., *Towards a European Civil Code* (3rd ed., Kluwer Law International 2004); R. Sacco, *Formation of Contracts*, in *Towards a European Civil Code* pp. 483-492 (4th ed., A. Hartkamp et al. eds., Kluwer Law International 2011); J.H.M. van Erp, *The Pre-contractual Stage*, in *Towards a European Civil Code* pp. 493-513 (4th ed., A. Hartkamp et al. eds., Kluwer Law International 2011); J. Cartwright, *Defects of Consent in Contract Law*, in *Towards a European Civil Code* pp. 535-554 (4th ed., A. Hartkamp et al. eds., Kluwer Law

– which, inter alia, define these instruments – come into focus. Here, the question of why existing definitions of derivatives should not be borrowed per se for use under VAT arises. As already explained throughout this chapter, the answer lies in the necessarily different contexts and requirements being addressed in other areas of law. These definitions are, nevertheless, consulted in identifying approaches that may be of use in this research.

According to Warren Buffett, “[t]he range of derivatives contracts is limited only by the imagination of man (or sometimes, so it seems, mad men)”.⁴¹ As a result, the range of derivatives in use today is such that it is not possible or feasible to consider all types of derivatives in this research. In this regard, it is necessary to first understand the fundamental principles of derivatives, and to this end, the research focuses on the more basic or standard derivative contracts, such as options, forwards, futures and swaps, often referred to as “plain vanilla” derivatives, rather than the more exotic varieties involving, for example, weather metrics, indexes and so on. However, while plain vanilla derivatives are the main focus of the work, some more exceptional derivatives are utilized in highlighting specific questions and challenges associated with the European VAT system. The examples presented include derivatives traded on the OTC market and, to a lesser extent, on designated exchanges. These examples were chosen with a view to illustrate some interesting outcomes in relation to VAT. The OTC market plays a strong role in the study, as the derivatives on the OTC market give the operators more room for manoeuvre and, therefore, also create questions that may not occur in the context of exchange-traded derivatives. Both commodity and financial derivatives are discussed, including those settled in cash or by physical delivery.

It is clear that no single definition can cover all derivatives. It is also clear that similar derivatives are treated differently, depending on the country and the body of legislation involved. The role of derivatives as securities is a good example.

International 2011); H.L. MacQueen, *Illegality and Immorality in Contracts: Towards European Principles*, in *Towards a European Civil Code* pp. 555-570 (4th ed., A. Hartkamp et al. eds., Kluwer Law International 2011).; T. Wilhelmsson, *Standard Form Conditions*, in *Towards a European Civil Code* pp. 571-586 (4th ed., A. Hartkamp et al. eds., Kluwer Law International 2011); and C.-W. Canaris & H.C. Grigoleit, *Interpretation of Contracts*, in *Towards a European Civil Code* pp. 587-618 (4th ed., A. Hartkamp et al. eds., Kluwer Law International 2011).

41. See W. Buffett, *2002 Annual Report* p. 13 (Berkshire Hathaway Inc. 2003), available at <http://www.berkshirehathaway.com/2002ar/2002ar.pdf> (accessed 28 Oct. 2014).

Some specific instruments are excluded from the scope of the study, namely warrants and certain other derivative-type instruments often regarded as securities.⁴² Regarding warrants, while they resemble options,⁴³ they are negotiable documents that entitle the holder to convert them into shares.⁴⁴ The difference between warrants and shares is that a warrant per se is not a document bestowing that right, but requiring conversion into shares as securities. Other derivative-type instruments regarded as securities include certificates, which resemble warrants, but have the substantive difference of the price change in certificates following directly from price changes in the underlying asset.^{45,46}

While the parties to a derivative contract may encounter a variety of essentially peripheral charges levied by operators, e.g. exchanges, brokers and hedging companies, this study, as already mentioned, focuses on derivatives per se and the inherent transactions and dedicated payments central to their trading. The role of the various operators on the derivatives market is not of particular interest to the study, except of those trading in derivatives as taxable persons.⁴⁷

1.4. State of research

The research topic was recommended by the author's fellow academics with a view to address the lack of research on derivatives in the context of the European system of VAT. The author is aware of some studies on

42. See E. Parker, *Equity Derivatives: Documenting and Understanding Equity Derivative Products* pp. 7-20 (Globe Business Publishing Ltd 2009).

43. This is why warrants are also called "options with long maturity".

44. See L. Gullifer (ed.), *Goode on Legal Problems of Credit and Security* p. 230 (4th ed., Sweet & Maxwell 2012).

45. Parker, *supra* n. 42, at pp. 19-20. These instruments are also regarded as securities in the EU Council tax working group document, Presidency compromise text 14965/11 FISC 123 for the Implementing Regulation, art. 9(1)(c).

46. For warrants and other hybrid instruments, see also Hull, *supra* n. 1, at pp. 209-210. Regarding hybrid financial instruments of shares or securities in the Netherlands, see E. Jansen & E. van Kasteren, *Hybrid Financial Instruments*, 10 Derivs. & Fin. Instrums. 5, pp. 186-188 (2008), Journal Articles & Papers IBFD. For negotiable instruments, such as bonds, certificates and fund units, which have an embedded equity derivative element, see E. Parker, *Overview and introduction to equity derivatives*, in *Equity Derivatives: Documenting and Understanding Equity Derivative Products* pp. 9-10 (E. Parker ed., Globe Business Publishing Ltd 2009).

47. However, it may be noted, as discussed in ch. 9, that some subjective factors of the operators might play a role when defining whether the action is regarded as an economic activity on the basis of the VAT Directive.

the topic, including a master's thesis by Euser in 2010.⁴⁸ However, since it is written in Dutch, its use in the study has been limited. In addition, some papers discussing VAT and derivatives have been published, with an article by Englisch being of particular interest,⁴⁹ focusing on the VAT treatment of financial investments based on current EU law, highlighting the lack of clarity surrounding the treatment of investments in derivatives in the absence of an EU legislative framework. An article by van Kasteren and Heydari sets out the basis of taxation of derivatives from a European VAT perspective and seeks to highlight issues that should be considered by traders when seeking to ensure not only compliance with VAT legislation, but also cost effectiveness from a VAT perspective.⁵⁰

A number of scholars have published doctoral theses discussing VAT and financial services in general. In 2007, Henkow published his doctoral thesis entitled "Financial Activities in European VAT",⁵¹ which examined the scope and role of specific exempt financial services set out in article 135(1) (f) of the VAT Directive. His thesis briefly discussed certain derivatives and their role as exempt financial services. In 2010, Jepsen published his research on VAT and activities connected to securities.⁵² In his 2011 thesis, Bohn Jespersen focused on "Intermediation of Insurance and Financial Services in European VAT in 2011".⁵³ His work presents different cases of intermediation but does not focus on derivatives. Papis-Almansa published her doctoral thesis, "Insurance in European VAT - Current and Preferred Treatment in the Light of the New Zealand and Australian GST Systems", in 2016,⁵⁴ in which she made a profound analysis of insurance in terms of the European VAT system. Her thesis was a valuable source in terms of exempt insurance services as defined in article 135(1)(a) of the VAT Directive.

48. D. Euser, *Het BTW-risico van derivaten* (Wolters Kluwer 2010).

49. J. Englisch, *Financial Investments: European Union*, in *VAT and Financial Services* p. 257 (R. van Brederode & R. Krever eds., Springer 2017).

50. E. van Kasteren & S. Heydari, *European Union – Derivatives and VAT*, in 11 *Derivs. & Fin. Instrums.* 3 (2009), *Journal Articles & Papers IBFD*.

51. O. Henkow, *Financial Activities in European VAT: A Theoretical and Legal Research of the European VAT System and the Actual and Preferred Treatment of Financial Activities* (Lund University 2007).

52. A.S. Jepsen, *Moms og aktiviteter i forbindelse med værdipapirer* (Thomson Reuters 2010).

53. C.B. Jespersen, *Intermediation of Insurance and Financial Services in European VAT* (Kluwer Law International 2011).

54. M. Papis-Almansa, *Insurance in European VAT – On the Current and Preferred Treatment in the Light of the New Zealand and Australian GST Systems* (Lund University 2016).

A number of books on VAT and financial services discussing the state of play of taxation in respect of derivatives in EU Member States in particular were also examined. For example, Nilsson's survey of VAT on financial services in Sweden⁵⁵ and the work of Chesham deserve mention.⁵⁶ Hickey describes, in detail, the British VAT system in respect of derivatives.⁵⁷ This was of interest for the research, given that the United Kingdom boasts substantially more regulations in this regard than any other EU Member State. Van Brederode and Krever edited a book in 2017 that also includes the article by English mentioned above.⁵⁸

Several publications discussing financial services in general are also available. Articles on the taxation of financial services in general were consulted, including those of Poddar and English⁵⁹ and Zee and Schenk.⁶⁰ In 2006 and 2012, PricewaterhouseCoopers conducted studies on behalf of the EU Commission on the impact and state of play of VAT on financial and insurance services.⁶¹

An important source of information for the study was clearly the literature dedicated to derivatives per se. Useful sources in this regard include the work of Hull,⁶² Hudson,⁶³ Parker, Parker and Perzanowski and Denton.⁶⁴

The literature highlighted above represents only a small portion of the material consulted for the study, which included several articles, case law at the EU and national levels, as well as texts discussing VAT, on the one hand, and

55. U. Nilsson, *Moms för bank och finans* (Norstedts Juridik 2014).

56. M. Chesham, *VAT and Financial Services* (Spiramus Press Ltd 2012).

57. Hickey, *supra* n. 24.

58. R. van Brederode & R. Krever (eds.), *Financial Investments: European Union* (Springer 2017).

59. S. Poddar & M. English, *The Taxation of Financial Services under a Value-Added Tax: Applying the Cash-Flow Approach*, 50 National Tax Journal 1 (1997).

60. H.H. Zee & A. Schenk, *Financial Services and the Value-Added Tax*, in *Taxing the financial sector: concepts, issues, and practices* (H.H. Zee ed., International Monetary Fund 2004).

61. See PricewaterhouseCoopers, *Study to Increase the Understanding of the Economic Effects of the VAT Exemption for Financial and Insurance Services: Final Report to the European Commission* (2 Nov. 2006); and PricewaterhouseCoopers, *Review of Current Practices for Taxation of Financial Instruments, Profits and Remuneration of the Financial Sector*, European Commission Taxation Papers, Working Paper N.31-2012 (2012).

62. Hull, *supra* n. 1.

63. Hudson, *supra* n. 5.

64. E. Parker, *Credit Derivatives: Documenting and Understanding Credit Derivative Products* (Globe Business Publishing Ltd 2007); Parker, *supra* n. 42; E. Parker & M. Perzanowski (eds.), *Commodity Derivatives: Documenting and Understanding Commodity Derivative Products* (Globe Business Publishing Ltd 2010); and J. Denton (ed.), *Practical Derivatives: A Transactional Approach* (2nd ed., Globe Business Publishing Ltd 2010).

derivatives, on the other. The legal interaction between these two themes provides the focus of this study.

1.5. Methodology

While the research question posed must, obviously, be valid, the importance of choosing an appropriate methodology underpinning the study cannot be overemphasized, as the methodology effectively determines the value of the outcome. While addressing the same research question, different methodologies can lead to different outcomes.

In this study, the research question itself effectively identifies the options in terms of the methodology. Since the primary research question in this study asks how derivatives should be regarded under the current VAT Directive *de lege lata*, this effectively defines the possibilities regarding the methodology to be employed.⁶⁵ In addressing this research question, the author considers an approach based on the doctrinal analysis to be appropriate in bringing clarity to the definition of the scope of VAT as a key first step.⁶⁶ The interpretation of articles 2(1)(a) and (c), 9(1) and 135(1) of the VAT Directive are crucial in this regard and effectively forms the basis of the research.

However, given the need to deliver realistic outcomes, the method of interpretation is decisive. Literal, analogical or even systematic interpretations are difficult to apply in this study, since any interpretation of the definitions in the VAT Directive must take into account the role of the VAT system. In this regard, particular attention must be paid to ensuring compliance with the principle of neutrality underpinning the VAT system, as well as its role in delivering revenue into national exchequers while simultaneously protecting the integrity of the VAT system against often diverging political objectives.

Every exemption provided for in the VAT system simply serves to dilute its effectiveness as a consumption tax and can also add to its complexity. Therefore, the exemption of certain services (particularly, financial services)

65. About the methodology in tax law research, see M. Myrsky, *Basic Research in Tax Law* pp. 277-287 (Scandinavian Studies in Law 2003).

66. The doctrinal research method has been defined as “a synthesis of rules, principles, norms, interpretive guidelines and values” that “explains, makes coherent or justifies a segment of the law as part of a larger system of law”. In doctrinal research, the essential features of the legislation and case law are examined critically and then all the relevant elements are combined or synthesized to establish an arguably correct and complete statement of the law on the matter at hand. See T. Mann, *Australian Law Dictionary* p. 197 (Oxford University Press 2010).

from tax provided for under the VAT Directive must also be interpreted strictly, further reinforcing the need to adopt a restrictive interpretation approach in the research. Finally, in order to deliver realistic outcomes, the taxation of derivatives needs to be sufficiently clear in order to be administered both by tax authorities and taxable persons. If the result of the exercise positions derivatives within the scope of VAT but views them as being taxed in some situations and exempt in others, the taxation of these products must be achievable in practice. If it is not possible to implement such an outcome in practice, the research would serve little purpose, neither for the operator of the VAT system nor for the legislator, and the research methodology would – justifiably – be criticized.⁶⁷ In practice, this critical thinking may mean that the system needs to be as simple as possible in order for operators to freely use derivatives in their economic activities, but also in order to minimize difficulties in its administration. Quite separate from practical feasibility, it is important that any outcome complies with the current VAT Directive.

The essential features of the VAT Directive, such as the principle of neutrality, the rules of interpretation created by the ECJ, relevant case law and guidelines, as well as other sources of literature are examined, and the relevant elements are combined and synthesized to establish a baseline for the analysis of the phenomenon of derivatives.⁶⁸ These features underpinning the VAT system are introduced in chapter 2. Teleology, which, as a primary method of interpretation in the field of EU law, emphasizes the purpose and objectives of the VAT system, plays a strong interpretative role in this study. However, VAT, as a complex tax structure, taxing the real economy on every level of output and in every sector of the economy, forces the interpreter of the VAT system to apply a sort of systems thinking for the analysis. This is a holistic approach to analysis that focuses on analysing the functioning of the separate parts of the study for the functions of the derivatives market.

Historical and comparative jurisprudence play a minor role, mainly due to the lack of relevant material, but are kept in mind where such material exists. Because material about the legislation or case law in different EU Member States is very limited (if not completely absent), the author sent

67. It is said that applying the doctrinal method in conjunction with critical thinking to the legal framework is not a special method as such, but “more an attitude”. See T. Hutchinson, *Doctrinal research – Researching the jury*, in *Research methods in law* pp. 7-33 (D. Watkins & M. Burton, Routledge 2013); and P. Minkinen, *Critical legal “method” as attitude*, in *Research Methods in Law* pp. 119-138 (D. Watkins & M. Burtone eds., Routledge 2013).

68. Hutchinson, *id.*, at pp. 9-10.

a questionnaire to the VAT departments of PricewaterhouseCoopers in different EU Member States, as well as those in Norway and Switzerland. The idea was to get information from those who operate as VAT consultants of the companies trading with derivatives and who should know how derivatives are treated in practice. This is also because, based on the author's experience with the Council working party when dealing with the Commission proposal on VAT in respect of financial and insurance services in the years 2007-2011, even the legislators of the Member States did not have a very clear picture of the case law in their countries. It was also evident that only few countries had introduced any legislation or guidelines on derivatives.

The questions sent to the countries can be found at the end of the book (*see* annex 1). As explained in chapter 4, the material obtained was very sparse and lacked detailed. As the information obtained was based on the inside information of the consultants, it may not be regarded as reliable enough as the basis for an academic comparative study. Indeed, it became clear that the lack of regulations across Member States ruled out the possibility of delivering a proper comparative legal study with this research.⁶⁹ This does not mean that the information does not have any value for the study. Even if the survey conducted for this research on the VAT status of derivatives in different European countries is not intended as a comparative legal study,⁷⁰ it is designed to provide information on current approaches to the taxation of derivatives in EU Member States, as well as in Norway and Switzerland.

Finally, one might ask why the study focused on analysing the treatment of derivatives based on the current VAT system but did not focus on providing answers as to how derivatives should be treated in the future. For the author, it was clear that before gaining resources to create a future VAT system for derivatives, one should know how the derivatives are or should be treated based on the legislation in force. Otherwise, there would be no basis for building something better and more functional in the current system. Before tackling the problems in the current system, one needs to know how the current system functions. After analysing derivatives *de lege lata*, the outcome of the study also serves future research of derivatives *de lege ferenda*. The principle outcome of the study is illustrated in the graphic at the end of the book in annex 2.

69. See PricewaterhouseCoopers, *Survey made for the study on request of Marja Hokkanen by PricewaterhouseCoopers Finland* (2016-2018).

70. Comparative legal studies have raised questions of the meaning and potential of such studies. *See*, for example, G. Samuel, *Comparative law and its methodology*, in *Research Methods in Law* pp. 100-118 (D. Watkins & M. Burton eds., Routledge 2013).

1.6. Structure of the study

The book has ten chapters, with chapters 1-4 forming the backdrop of the in-depth analysis carried out in chapters 5-9. Chapter 10 presents final remarks on the study.

Following the introductory chapter 1, which sets out the purpose, the state of research, the methodology and the content of the study, chapter 2 describes the principles underpinning the European VAT system. This covers the definition of VAT as a consumption tax, the scope of the European VAT system, the principle of neutrality and the influence of the exemption of supplies on the VAT system. Chapter 2 presents the current regulations relating to derivatives specifically identified in the VAT Directive and concentrates on the 2007 proposals of the European Commission to amend the tax treatment of insurance and financial services, including the treatment of derivatives.

Chapter 3 describes derivatives and the derivatives market. This is necessary for the specific part of the study in which derivatives and the market are examined in respect of the scope of European VAT, i.e. in the context of VAT as a legal tax system. Chapter 3 (i) discusses the function and purpose of derivatives; (ii) describes the different platforms on which derivatives are traded; (iii) discusses the most common types of derivatives, also giving examples; and (iv) explores the diversity of underlying assets. Chapter 3 also characterizes the different methods of executing the derivatives. Finally, the EU regulation of derivatives as part of financial services is outlined.

Chapter 4 outlines current VAT practices in certain European countries, with the UK approach being presented separately from that of EU Member States, as it is the most “developed” in respect of the regulation of derivatives under the VAT system. The discussion on the United Kingdom is based on literature and its tax authority’s guidelines. The discussion on the EU Member States is based on the survey conducted as part of this study.

Chapter 5 analyses derivatives as contracts and discusses whether the trading of such contracts can be considered a supply of goods or services as defined in the VAT system and, thus, subject to VAT. In this regard, chapter 5 discusses whether derivative contracts should, like other financial instruments, be regarded as objects of VAT per se or whether derivative contracts are, in effect, akin to any other contracts defining contractual relationships. Finally, chapter 5 discusses the VAT consequences of transferring derivative contracts.

Chapter 6 focuses on transactions made based on derivatives, specifically derivatives either leading to financial settlements or, in the case of commodity derivatives, resulting in the physical delivery of the underlying asset. Consecutive transactions, as well as the so-called “suspension mechanism” (“black box”) already operating in the United Kingdom, are discussed in the context of the potential simplification of the treatment of commodity derivatives. In addition, the treatment of margins and collaterals paid as deposits in the trading of derivatives is briefly discussed.

As evident from article 9 of the Implementing Regulation,⁷¹ the legislator regards at least some options as financial services in article 135(1)(f) of the VAT Directive. The Implementing Regulation, however leaves many questions unanswered regarding the specific nature of derivatives and their treatment as financial and insurance services under VAT. This issue is elaborated in chapter 7 when analysing certain derivatives connected with exempt financial services, as well as insurance services. Chapter 7 therefore concentrates on analysing whether certain derivatives or transactions based on these derivatives should be regarded as financial or insurance services under article 135(1)(a)-(f) of the VAT Directive.

In chapter 8, the issues arising in relation to the consideration paid for derivative-based supplies are examined. The questions of the taxable event and the chargeable event under VAT are also discussed briefly.

Chapter 9 concentrates on the definition of a “taxable person” in the scope of VAT. Only supplies of a taxable person made in the context of his economic activity as defined in articles 2(1) and 9(1) of the VAT Directive fall within the scope of VAT. Chapter 9 discusses the activity of traders in the derivatives market in the context of economic activity. Finally, chapter 10 presents final remarks on the study.

71. Council Implementing Regulation (EU) No 282/2011 of 15 March 2011 laying down implementing measures for Directive 2006/112/EC on the common system of value added tax, OJ L 77/1 (2011).

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