Addressing Tax Risks Involving Bank Losses

OECD

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Foreword

The role of banks in the global economy, as well as in the functioning of countries' tax systems, is of vital importance. As a result of the financial crisis, a large number of banks have sustained substantial losses. The scale of those losses, and the potential regulatory capital, profit and cash-flow benefits for banks able to convert them into cash, mean that revenue bodies must be alert to potential tax compliance risks as a result of aggressive tax planning involving losses.

This report, which deals with tax risks involving bank losses, was commissioned jointly by the Forum on Tax Administration (FTA) and the Aggressive Tax Planning (ATP) Steering Group of the Committee on Fiscal Affairs' and was led by HM Revenue and Customs and the OECD Secretariat.

This report reflects the experiences of 17 countries who participated in the study team: Australia, Austria, Canada, Denmark, France, Germany, Ireland, Italy, Mexico, the Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, the United Kingdom and the United States of America. South Africa also provided valuable input in the course of drafting the Report. The Study Team benefitted from the input of other members of the FTA and from consultations with the private sector.

The report builds on the earlier report by the FTA, *Building Transparent Tax Compliance by Banks* (2009), which contained a set of recommendations both for revenue bodies and banks. These were aimed at improving the transparency of banks' tax planning, providing better alignment between banks' internal governance and revenue bodies' risk assessment, and improving the effectiveness of international cooperation to counter aggressive tax planning.

The focus of the report is on real rather than artificial losses and it explores the different country approaches to giving tax relief to loss-making banks and to addressing tax risks involving banks' losses. These include the operation of the enhanced relationship with large businesses to support and provide early identification and resolution of claims, assessment of revenue and compliance risks, audit techniques, and detection and response strategies. Although the report deals primarily with the tax treatment of banks which have suffered overall losses, it also touches on issues which are relevant to write-downs and write-offs which may reduce a bank's profits. The report deals specifically with the banking sector, but similar issues may also arise in other sectors.

I would like to thank all of those who have assisted the Study Team in the completion of this report. I hope that it will be shared widely within revenue bodies among staff involved with the taxation of banks and other financial institutions, as well as within banks and their professional advisory firms.

Dave Hartnett
Vice-Chair, Forum on Tax Administration
and Lead Commissioner for the Study

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Executive Summary

The effects of the financial and economic crisis on bank profits worldwide has been phenomenal, with write-downs and losses of USD 1.3 trillion up to January 2010 specifically related to the financial crisis, and knock-on effects throughout the banking sector. Banks in countries participating in this study account for over 80% of global pre-tax losses of USD 400 billion in 2008, with the largest losses arising to banks headquartered in the US and UK, although other countries' banks suffered larger losses measured as a share of their home country GDP.

Reliable information on the likely extent and fiscal cost of banks' tax losses is not publicly available, but a very broad indication of the stock of realised and unrealised tax losses carried forward might be obtainable from deferred tax asset statements in banks' published accounts. For various reasons, deferred tax asset statements will not give a precise measure of tax losses, but on a rough calculation they suggest that the stock of realised and unrealised tax losses may be at least USD 700 billion, with a tax cost of some USD 230 billion, assuming they are relieved at an average tax rate of 33%. Deferred tax asset statements may provide useful information to supplement what is provided to revenue bodies by banks in their tax returns.

The extent of governments' tax exposure to banks' tax losses (and to potential tax planning involving losses) depends to a large extent on the likely availability of future bank profits against which these losses can be offset. There are indications that it may take some three to eight years for the overall stock of bank tax losses to be utilised, with some banks remaining in a loss position for many more years to come.

Country rules differ in the extent to which write-downs and losses on banks' loans and securities are recognised for tax purposes. There are also wide variations in country rules giving relief for overall tax losses. This gives rise to potential international tax planning opportunities.

Tax loss relief rules are complex, and differ from country to country, giving rise to further potential tax risks for both business and revenue bodies. Sideways loss relief is available in most countries, while others ring-fence loss relief to particular types of income or profits. Group taxation regimes of one kind or another are available in most participating countries, although cross-border group taxation regimes exist only in a small number of countries. Carry-over of losses (forward or backwards) is a feature of all tax systems, though there are marked differences between countries. There are also different restrictions triggered by a change in the ownership and/or the activity of the loss-making company carrying over the loss, and the definitions of these terms also vary between countries. These restrictions may not apply in some countries on internal reorganisations, if there is no tax avoidance, or if there are specific exceptions to facilitate commercial rescue/restructuring plans. From a cross-border perspective, whether losses of foreign branches are relieved depends generally on whether a country relieves juridical double taxation by credit or exemption. Losses of foreign subsidiaries are generally not

deductible in the country of the parent company, though there are some exceptions. A number of countries rule out "double-dip" relief for losses.

Losses give rise to various tax risks from the perspective of banks, which for the most part relate to certainty. Many of the concerns in this regard expressed by banks relate to policy considerations in relation to the applicable tax rules: these are outside the scope of this report but are mentioned in the report for completeness. Banks expect to receive tax relief for commercial losses, including by appropriate loss carry-back. However, they are conscious of the restrictions in current rules and concerned about potential future uncertainty. They consider that rules restricting loss carry forward in case of change of ownership or activity might have unintended consequences in the context of post-crisis government interventions and could hamper beneficial restructuring. Banks would normally not expect revenue bodies to revisit valuations signed off by auditors and more generally would like tax to follow accounts write-off treatment. They also expect revenue bodies to apply domestic and international tax rules consistently to both profits and losses. Banks have a key non-tax interest in ensuring that they receive full tax relief for commercial losses, as tax losses can in some circumstances count towards regulatory capital available to support their business. There is some evidence of tax planning by banks primarily aimed at maximising recognition of tax losses for regulatory capital, rather than tax/cash flow purposes.

An enhanced relationship with revenue bodies may be helpful for banks in reaching early resolution of potential tax disputes involving losses, and can also directly benefit banks' commercial operations and recovery from the crisis.

Revenue bodies are concerned with ensuring the right amount of tax is paid at the right time, and will pay particular attention to the incentives which may affect that outcome one way or the other. As outlined in the *Building Transparent Tax Compliance by Banks* report, revenue bodies are concerned at the risk to tax systems posed by the extent that banks use (as well as facilitate and promote) aggressive tax planning schemes. These concerns apply in principle to tax planning involving losses in the same way as to tax planning involving profits. To some extent, there are factors which potentially mitigate this concern, at least in the short term. The value of tax losses to banks as a source of regulatory capital in many countries may in some cases reduce incentives for banks to seek to sell those losses to unrelated parties. Beyond that, a contraction of the structured finance activity in the wake of the crisis may have temporarily reduced opportunities for aggressive tax planning involving structured finance products. Even so, although at present there is no evidence of significant manipulation of the estimated USD 700 billion+ stock of tax losses, the scale of these losses, and the potential regulatory capital, profitability and cash-flow benefits for banks able to convert them to cash, mean that revenue bodies are alert to potential compliance risks in a number of areas.

Transfer pricing is a key risk area in international taxation in general and may trigger particular attention in the case of loss-making banks or loss-making affiliates within profit-making banking groups. Revenue bodies will be seeking consistency of banks' transfer pricing policies with the arm's length principle, in a loss-making context as well as in a profit-making one.

A further potential compliance risk involves transfer of losses/profits through reorganisations. Tax rules do not always provide for symmetrical treatment of profits/losses, particularly where that might encourage tax-driven distortions, and revenue bodies are alert to techniques to frustrate necessary restrictions, including techniques

which anticipate likely losses or which exploit Controlled Foreign Companies (CFC) rules to import losses.

The use of financial instruments as a means of transferring losses/profits is another potential area of concern. New avoidance devices are emerging as some loss-making banks are trying to maximise the use of their commercial losses for tax purposes

In some cases, in which banks can no longer take advantage of tax losses, they are instead seeking to pass the benefit of those on to investors.

Circumvention of loss carry-over rules is a further area of potential compliance risk. Country variations in loss relief rules may themselves create an incentive for tax planning and a number of attempted loss-refreshing schemes have been seen.

Many countries regard double or multiple claims for losses as particularly aggressive.

Revenue bodies have a number of tools to help manage these potential compliance risks, starting with encouraging responsible tax reporting through co-operation and dialogue. Rulings, clearances and disclosure rules play a dual information and compliance role. Audits will continue to play a key role in the detection, deterrence and prevention of aggressive tax loss planning supported by international exchange of information and cooperation between revenue bodies.

The report concludes that:

- losses represent a significant potential tax risk both for banks and revenue bodies.
- commercial awareness of the context of bank losses, and of tax and non-tax (e.g. regulatory) drivers is fundamental.
- the complexity of country loss, and loss relief, rules, and the potential opportunities for banks to exploit differences between country rules through aggressive tax planning, are themselves a source of tax risk.
- countries are currently applying a variety of tools to address the compliance risks in relation to bank losses.

The report recognises differences in the experiences of different countries in relation to the taxation of bank losses, as well as differences in administrative, legal, and cultural frameworks. Against that background, it makes recommendations in the following areas, which are for countries to consider in the light of their particular circumstances.

Recommendations for revenue bodies

To improve commercial awareness in order to better understand, assess and respond to tax risks, while facilitating sustainable business activity, revenue bodies should:

- work constructively with the banking sector and regulatory bodies to gain a shared understanding of the commercial context and the links between tax and regulatory reporting, building on the engagement which has underpinned this report. This could involve joint training, secondments, seminars and workshops, including on a multilateral basis where appropriate.

To encourage transparent tax compliance and improve detection of aggressive tax planning, revenue bodies should:

- encourage real-time engagement and open and transparent relationships between banks and revenue bodies.
- consider with regulatory bodies how the transparency of financial accounts in relation to provisions for tax exposures might be improved.
- consider the use of disclosure rules for aggressive tax planning involving losses.
- remain alert to and actively monitor potential compliance risks involving bank losses; in this regard, revenue bodies could use deferred tax asset statements as a tool for better understanding banks' incentives for tax planning involving losses.

To reduce tax risks arising from complexities and uncertainties in the operation or interaction of country rules, revenue bodies should:

- consider the adequacy of their guidance for banks on how national loss relief rules apply and, where possible, to offer real-time discussion and resolution of issues.
- bring to the attention of their government tax policy officials those situations which may potentially raise policy issues, and in particular those where the same tax loss is relieved in more than one country as a result of differences in tax treatment between jurisdictions, in order to determine whether steps should be taken to eliminate that arbitrage/mismatch opportunity.

To benefit fully from international and domestic co-operation, revenue bodies should:

- share intelligence and information on aggressive tax planning involving banks' losses, including through an international network of revenue body officials and by contributing to the OECD Aggressive Tax Planning (ATP) Directory non-taxpayer specific information on schemes involving tax losses, including on bank tax losses.
- share experience and best practices on how to identify and, where possible, address cases of multiple deduction of the same economic loss.
- take opportunities to work closely with national regulatory bodies in addressing aggressive planning to maximise the use of losses for tax purposes, including in cases where that tax planning is intended to produce non-tax, regulatory benefits.

To encourage earlier certainty, revenue bodies should:

- consider an enhanced relationship approach, where appropriate to a country's circumstances, based on the benefits to both taxpayers and revenue bodies; in this regard, revenue bodies should recognise the importance for banks' business activity in securing early certainty on the availability of tax losses within the applicable tax rules, and give appropriate priority to the resolution of potential disputes over tax losses.

Recommendations for banks

In the course of the study, participating countries also identified a number of good practice recommendations for banks. In order to reduce their tax risks involving losses, banks can contribute in the following ways:

- Banks have a key role in supporting a better commercial understanding of their business by revenue bodies, and could encourage that through dialogue, joint training, secondments, seminars and workshops.
- Banks should be open and transparent with revenue bodies in their planning involving tax losses, whether or not that is primarily tax or non-tax driven.
- Banks' boards should ensure appropriate corporate governance processes are in place around tax risk management, including resourcing internal audit activities, as a means to confirm that such policies are adhered to.
- Banks should highlight areas of uncertainty in the operation of current country loss recognition and loss relief rules, thus allowing revenue bodies and their tax policy officials to address that uncertainty in a timely manner.
- Consistent with the OECD "Report on Attribution of Profits to Permanent Establishments" and the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, banks are encouraged to support the way they have allocated tax losses to a particular jurisdiction with appropriate documentation, as this may reduce substantially the potential for disputes.
- In setting their business strategy, banks should consider the benefits of an enhanced relationship with revenue bodies including early certainty, reduced compliance costs, and reduced reputational risk.

Chapter 1. Setting the context for current levels of bank tax losses[1]

Abstract

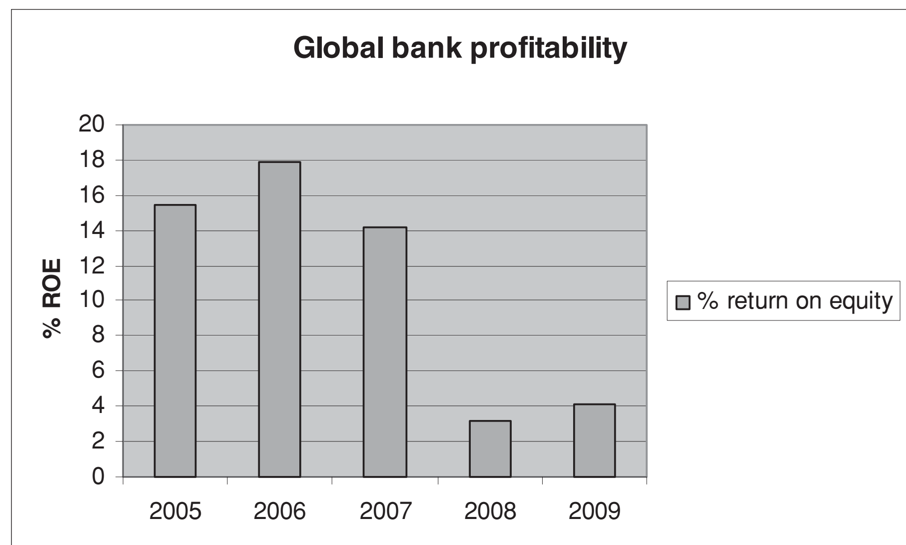
This chapter sets the context for current levels of bank tax losses, using data from a variety of publicly available sources. It briefly reviews the effect of the crisis on bank profits, the size and geographic distribution of banks' pre-tax commercial losses, and the relationship between banks and national revenue bodies.

The overall context

The effect of the crisis on bank profits worldwide has been phenomenal …

Banking is a global business, with over 10,000 banking institutions contributing up to 1.6% of world GDP, and holding around USD 100 trillion in assets.[2] Pre-tax profits of the top 1000 banks (ranked by their "Tier 1" regulatory capital) experienced phenomenal growth in the period before the crisis, and reached USD 786 billion in 2006, which overall represented a 23.4% return on their Tier 1 capital.[3] Industry-wide, returns on equity climbed to reach 17.9% in 2006.[4] The financial crisis which emerged in 2007 and took root in 2008 had a devastating impact on bank profits, putting profit growth into reverse in 2007 and causing returns to plummet, with industry-wide returns on equity falling to 3.2% in 2008 albeit with some recovery – to 4.1% – already evident in 2009 (see chart below).[5]

Figure 1.1 Global bank profitability



Source : Boston Consulting Group

Aggregate pre-tax profits of the top 1000 banks fell from USD 786 billion in 2006 and USD 780 billion in 2007 to USD 115 billion in 2008[6] Within that total, the top 25 banks by Tier 1 capital (17 of which are headquartered in 7 of the countries participating in this study) made an aggregate pre-tax loss of USD 32 billion. Stripping out the profits of the lower reaches of the top 25 means that the top 5 banks in the world, ranked by Tier 1 capital, had an aggregate pre-tax loss of USD 95.8 billion.

The largest commercial losses arose in those banks directly exposed to the collapse of the property market which was the immediate trigger for the financial crisis. These were banks involved as originators of sub-prime mortgages, as issuers of

Collateralized Debt Obligations (CDOs) linked to property assets, or as investors in asset-backed securities (despite the theoretical risk diversification benefits of securitisation), or any combination of the three. As illustrations of this,[7] 12 banks/brokers were issuers of over 70% of the worldwide CDOs issued in 2007. One of these subsequently went into bankruptcy, and 10 of the remainder accounted for 70% of the USD 162 billion net deferred tax assets accumulated by the 15 largest loss-making banks worldwide by the end of 2009. More generally, about 50% of the investment in worldwide asset-backed securities was held by banks or their conduits and Special Investment Vehicles (SIVs), with well over half of banks' crisis-related credit write-downs attributed to losses on such securities or CDOs of such securities.[8]

These large commercial losses can be regarded as the flip side of large profits made in the years prior to the crisis, with increased bank leverage combined with asset valuations which underpriced risk, producing exceptionally large returns on Tier 1 capital. A key source of such returns has been identified[9] as a regulatory arbitrage in which assets otherwise held on the bank's balance sheet were transferred to off-balance sheet conduits which required only a fraction – typically less than 20% – of the regulatory capital otherwise needed; and in which banks invested in the AAA-rated securities issued by these conduits, which also carried a significantly lower regulatory capital requirement than directly holding loans even though (while still performing) these securities typically yielded twice the spread of similarly rated corporate bonds and an apparently risk-free return over the cost of borrowing. A recent report gives the following further examples of upfront profits which relied on high levels of leverage and underpriced risk, and which subsequently gave rise to substantial losses.[10]

… with write-downs and losses led by the sub-prime collapse, and knock-on effects throughout the banking sector.

Box 1.1. Common pre-crisis leveraged and profitable transactions which subsequently gave rise to substantial losses

Negative basis trades allow market imperfections to be exploited when the yield on a structured credit product exceeds the cost of funding it and buying credit risk insurance. In the years prior to the current crisis, banks funded the purchase of such assets and bought credit protection from monoline insurers. Because accounting treatment would regard the residual risks over the life of the transaction to be small, the excess spread could be booked as an upfront profit. Substantial losses were subsequently incurred as credit adjustments had to be made against monoline exposures.

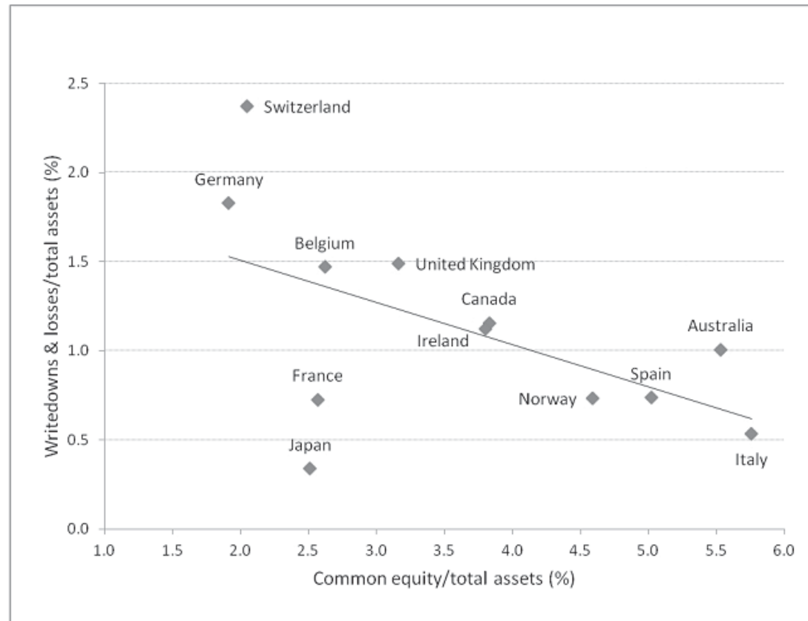
Leveraged super-senior (LSS) notes offer a yield enhancement by combining the yield on a highly rated structured credit product with the premium received from writing credit protection on a super-senior tranche for a multiple of this amount. By acting as an intermediary, the bank provides market access to investors for whom guidelines disallow selling credit protection. Accounting treatment of this transaction would permit the bank to record the credit spread between the protection it has sold and the protection it has bought from the investor via the LSS note as an upfront profit. While the loss to the investor is capped at the value

of the initial note investment, the bank is exposed to risks if losses on the credit protection sold exceed this amount. This type of transaction was common prior to the crisis, and generated material losses for banks.

Source : BIS (2009a)

The chart below demonstrates the relationship between the level of banks' write-offs and losses and their leverage, in terms of the ratio of total assets to common equity.

Figure 1.2 Common equity/total assets ("inverse leverage ratio") vs. write-downs & losses/total assets



The chart shows data only for selected countries where the data available is comparable.

Source : Blundell-Wignall, A., G. Wehringer and P. Slovik (2009)

The financial crisis brought huge credit losses on sub-prime lending and write-downs in asset backed securities, with some USD 1.3 trillion write-downs and losses disclosed by banks/brokers for the 3 years to January 2010.[11] The collapse of the sub-prime market led to the drying up of liquidity in the interbank market, and the near suspension of investment and corporate banking securitisation, structured finance and private equity activity, with the average cost of equity rising from 10.5% in 2005 to 15.6% in 2009.[12] The resulting global loss of confidence affected retail and commercial lending – the credit crunch – stoking an economic downturn which further contributed to banks' losses. Even the otherwise robust asset management and HNWI segments of banking activity suffered from the knock-on effects of the loss of confidence and worsening economy.

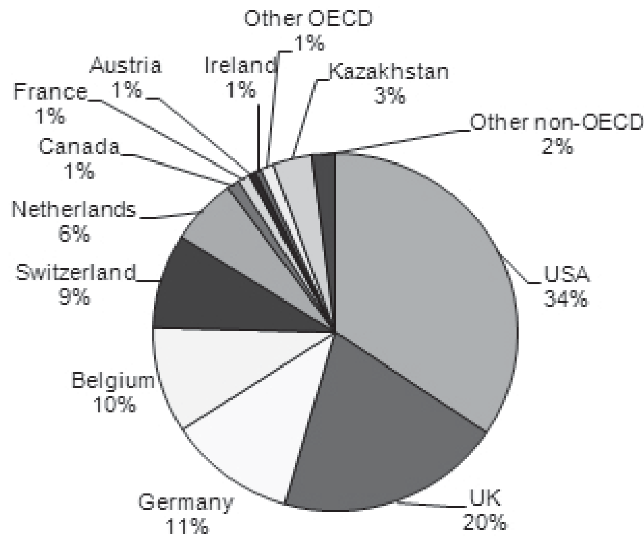
Size of banks' commercial (pre-tax) losses and distribution among participating countries

Banks in participating countries account for over 80% of global pre-tax losses …

Of the 4,500 banks worldwide monitored by The Banker (2009), 196 incurred pre-tax losses of USD 5m or more in 2008, totalling around USD 400 billion, or around 0.72% of global GDP. Of these 196 banks, 135 have their home country in one of the 17 countries participating in this report, and these 135 banks made pre-tax losses totalling around USD 332 billion, or around 1.1% of these banks' home country GDP.[13] The following charts show how the USD 400 billion total is distributed by the home country of the banks' ultimate parent, both in terms of the absolute amounts involved and expressed as a share of banks' home country GDP.

…. with the largest losses arising to banks from the US and UK, …

Figure 1.3 Distribution of banks' 2008 pre-tax losses by banks' home country

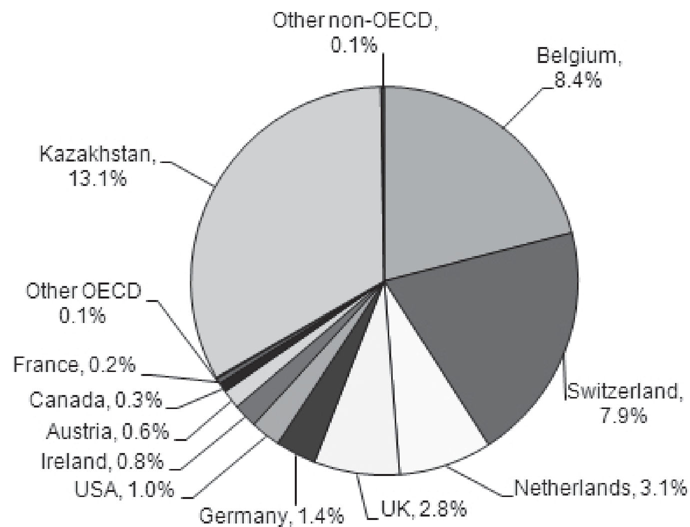


Note: all countries with a share of total losses lower than 1% are included in either "All other OECD" or "other non-OECD".

Source : The Banker Database

... though the distribution is very different in terms of losses as a share of the banks' home country GDP.

Figure 1.4 Distribution of banks' 2008 pre-tax losses as a share of their home country GDP



Source : The Banker Database

Governments' relations with banks

Governments have provided substantial support for the banking sector ...

Up to October 2009 governments provided or pledged potential support to the banking sector totalling USD 1.6 trillion in capital injections and facilities, USD 5.2 trillion in asset purchases, guarantees and facilities, and USD 4.6 trillion in debt guarantees and facilities, totalling around 21% of global GDP.[14]

... with some compensating measures now being introduced.

In addition to the recovery of support costs, some governments have imposed certain tax loss restrictions or increases in the taxation of the financial sector. For example, in **Ireland**, banks transferring "problem loans" to the National Asset Management Agency will experience restrictions on the use of losses for tax purposes; **Sweden** has introduced a stabilisation tax; the **United Kingdom** and **France** have announced levies on bonus payments in banks; and in the **United States** there has been a Presidential proposal to tax certain liabilities of large and systemically important financial institutions. Several countries, including **Germany, France** and the **United Kingdom**, are considering the introduction of a bank levy.

Banks are major contributors to general government revenues …

As major contributors to global GDP, banks are generally significant contributors to national tax revenues.[15] In the **United Kingdom**, the financial sector (excluding insurance) accounted for 22% of aggregate CIT liabilities accrued in 2006 and 23% in 2007. In **Ireland**, the financial services sector (excluding insurance) share of Corporate Income Tax (CIT) receipts was 21% in 2008 and 18% in 2009. The banks' CIT contribution in other countries

participating in this study is lower, ranging from around 1% in **Norway**, to around 16% in **Denmark.** In all countries the total tax contribution made by banks (including other taxes borne, such as irrecoverable VAT, employers' social security contributions and stamp duties, and taxes collected, such as payroll taxes and withholding taxes) will be greater than the CIT paid in isolation.[16]

… and their tax contribution, and associated tax compliance risks, may justify an enhanced relationship with the national revenue body.

Because of the importance of their tax contribution, all countries participating in this report have dedicated large business taxpayer units, and most also have specialist bank sector units, in some cases within the large business unit. Consultation mechanisms are in place in most countries to inform the development of policy and administrative practice. Formal advance rulings are available in many countries as part of the generally applicable tax administration system, and in the **United States** this extends to cover a wide variety of specified transparency and advance agreement mechanisms. In a smaller number of participating countries (**Australia**, **Ireland**, the **Netherlands**, **New Zealand**, **Switzerland**, and the **United Kingdom**) there is also ongoing dialogue with individual banks, and in some of these countries this specifically takes the form of risk-based, real-time working, and Board to Board level engagement.

Notes

1. This chapter gives a brief overview of the context for banks' post-crisis losses, using data assembled by the UK country co-ordinator from a variety of publicly available sources. It is not intended to give a definitive view of the causes of the financial and economic crisis or of banks' tax losses.

2. Source: IFSL, 2010

3. Source: The Banker, 2007

4. Source: Boston Consulting Group, 2010

5. Source: Boston Consulting Group, 2010

6. Source: The Banker, 2009

7. This information is drawn from p. 69 and p. 97 of Acharya V. and M. Richardson (2009) and published financial statements.

8. Source: Data on credit-related write-downs, to 26 January 2009, assembled by Creditflux Ltd from published accounts. Total bank write-downs analysed are USD 404 billion, of which USD 74 billion are from RMBSs and USD 157 billion from CDOs of ABSs, together making up 57% of the total;

USD 47 billion (12%) are from corporate credit; and USD 125 billion (31%) are from unknown or undisclosed sources.

9. More detail on these returns can be found in Acharya V. and M. Richardson, (2009), Chapter 2, “How Banks Played the Leverage Game”.

10. Source: BIS, 2009a

11. Source: Bloomberg data provided to the OECD Secretariat.

12. Source: Boston Consulting Group, 2010

13. It should be recognized that the 2008 picture relating to the scale and allocation of losses may not be indicative for subsequent periods.

14. Source: Blundell-Wignall, A., G. Wehringer and P. Slovik, 2009

15. Source: participating countries’ data.

16. See for example PWC (2010).

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Chapter 2. Potential scale/fiscal cost of banks' tax losses

Abstract

This chapter assesses the likely extent and fiscal cost of banks' tax losses, drawing on information in banks' published accounts, while making clear that these can only provide a broad indication rather than a precise measure of banks' tax losses.

Relationship between pre-tax losses, total write-downs/credit losses, and tax losses

Reliable information on the likely extent and fiscal cost of banks' tax losses is not publicly available …

A starting point for estimating overall bank tax losses is the amount of (pre-tax) losses reported in banks' publicly available accounts. As discussed in the previous chapter, data is available showing that 196 banks had pre-tax losses totalling around USD 400 billion in 2008[1]. It is not surprising that this figure is significantly lower than total reported write-downs and credit losses (around USD 1.3 trillion)[2] since accounts (pre-tax) losses are the combined result of adding together the results of loss-making and profitable activities carried out by banks, such that gross losses may be netted against profit from other activities.

In any case, the amount of banks' tax losses can differ from their overall (pre-tax) accounting losses as a result of significant differences in some countries between the accounting and the tax treatment of write-downs and credit losses, which mean that a write-down or credit loss recognised in the bank's accounts may not be recognised for tax purposes. The most common example of this difference is in relation to loan loss provisions, which in some countries are not deductible for tax purposes until the loss is actually realised.

The value to a bank (or the fiscal cost to the government) of tax losses will also depend on the conditions for relief for that loss being met. That itself depends in part on the detailed tax rules applicable in each country, including the extent to which profits and losses of each company within a banking group can be offset against each other in the same way as they are in calculating profits or losses in consolidated accounts. It may also depend on the future profitability of the bank, since in most cases, tax loss relief is given by offsetting the loss against future taxable profits.

Chapter 3 and Annex A contain further discussion of some of the key elements and country differences in the tax rules relating to recognition of accounting losses and to relief for overall tax losses. Broadly speaking, tax rules are in some respects more restrictive than accounting rules both in the recognition of write-downs and credit losses and in the circumstances in which losses can be offset against other profits within a banking group. As a consequence, the amount of tax losses available would normally be expected to be less than the amount of consolidated pre-tax losses, even though at any given point in time the stock of unrelieved tax losses may well be greater than consolidated pre-tax losses, as a result of some netting of results within consolidated accounts which is not available to the bank for tax purposes. Tax planning opportunities – covered in more detail in chapter 5 – may however result in banks receiving greater value for tax losses than would result from a simple offset between

profits and losses in consolidated group accounts.

Actual claims for tax losses, taking into account all these factors, are reflected in tax returns made to revenue bodies, and there is commonly a period of several months, at least, between the end of the accounting year and the time a tax return is filed, and in many cases also further delay before the precise amount of a tax loss is determined, *e.g.* following any audit or enquiries which the revenue body makes into the bank's tax return. Like all taxpayer information, these returns are made to revenue bodies on a confidential basis, and are rarely – if ever – made public by banks, in part because of the commercial sensitivity of the detailed information contained in their tax returns. Where countries publish aggregated details of tax losses, these are generally on a historical basis, and so do not help to quantify the scale of recent tax losses likely to be claimed by banks.

… but a very broad indication of the stock of realised and unrealised tax losses carried forward might be obtainable from "deferred tax asset statements" in banks' published accounts.

In line with international accounting standards, company accounts record as deferred tax entries the future tax consequences of events which have been recognised in the financial statements, based on the applicable tax laws and rates, and (in the case of deferred tax assets) subject to the judgement of the firm's management and auditors as to whether those consequences will be realised or not. Deferred tax entries therefore include amounts in respect of unused tax losses or excess tax credits carried forward, to the extent that future taxable differences or profits are expected, against which those losses or credits can be utilised. In some countries, the full gross value of deferred tax assets is identified, with a separate offsetting valuation allowance for amounts not expected to be realised (*e.g.* as a result of tax losses expiring unused), whereas in other countries only the net amount is identified. Deferred tax entries also include timing differences between provisions or expenses recognised for accounting purposes and those recognised for tax purposes – *e.g.* a write-down or expense, which is recognised for accounting purposes but not yet for tax purposes, gives rise to a deferred tax asset. Deferred tax assets may in some circumstances count towards banks' regulatory capital (see also Chapter 4 in this respect).

The overall tax loss position of a group as reflected in its published accounts can accordingly be reconstructed (broadly) as follows:

Box 2.1. Reconstructing the overall tax loss position of a corporate group

Net realised and unrealised tax loss for the year	A negative figure of current income taxes in profit or loss represents the tax repayment for the current and previous years expected as a result of tax losses realised in the current year. A negative figure of deferred income taxes in profit or loss represents the further reduction in future taxes (including any addition to losses carried forward) expected as a result of current year transactions, to the extent this has not already been recognised in current income taxes. This includes realised but unrelievable tax losses of the year, as well as tax losses which will be realised in later years as a result of accounting write-downs recognised in the current year.
Accumulated unused realised and unrealised losses carried forward (including unrelieved tax loss for the year)	Deferred tax assets in the balance sheet will include the future tax value of accumulated unused realised losses carried forward, based on the value of the losses expected to be utilised, or with a separate valuation allowance reducing the gross value of the losses and other tax benefits to the value expected to be utilised. Deferred tax assets in the balance sheet will also include future reductions in tax as a consequence of accounting entries (e.g. recognised but unrealised losses or expenses) to the extent these are not already recognised in the current income taxes charged to profit or loss.

For various reasons, deferred tax asset statements will not give a precise measure of tax losses …

In practice, accounting entries give rise to deferred tax liabilities as well as deferred tax assets; a number of categories of deferred tax asset or liability relate to temporary differences between tax and accounting recognition of income and expenditure (such as timing differences in relation to deferred compensation or leasing) rather than to losses; some entries are purely in terms of tax (*e.g.* tax credits) as opposed to representing the tax consequences, at the appropriate tax rate, of an accounting loss or write-down; the level of detail shown in published accounts may vary so that it is not easy to identify the tax loss element (even at the consolidated level shown in published accounts) with any precision; there are differences in accounting standards between countries in relation to the recognition of deferred tax assets and liabilities.

Nevertheless, the balance sheet figure of net deferred tax assets might be taken as a broad proxy of what a bank believes is the stock of future tax benefits, including unrelieved tax losses carried forward, that the bank thinks it probable it can utilise. "Tax losses" in this context includes both realised tax losses (*e.g.* net operating losses of a bank which are fully recognised for tax purposes) and unrealised tax losses (*e.g.* deferred tax assets of a bank which result from accounting write-downs or credit losses for which a tax deduction may not be permitted until the asset is wholly written off in a subsequent year). In either case, depending on the loss carry forward rules in the country concerned, these tax losses will only be

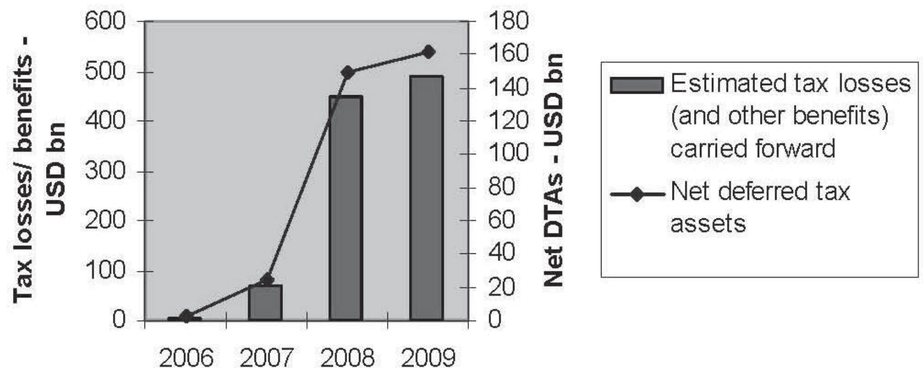
utilised in the future if there is a profit in a subsequent year: that might either be a reversal of an accounting write-down or credit loss (which would have the effect of absorbing an unrealised tax loss) or a net operating profit against which a net operating loss carried forward can be offset.

An estimate of the overall stock of bank tax losses carried forward

.. but on a rough calculation, deferred tax asset statements suggest that the stock of realised and unrealised tax losses may be at least USD 700 billion, with a fiscal cost of some USD 230 billion.

The following chart examines those 15 banking/broker groups with the largest write-downs and credit losses to January 2010, accounting for write-downs and losses totalling USD 876 billion (67% of the USD 1.3 trillion referred to in chapter 1)[3]. Taking the broad brush measure of net deferred tax assets in their (or their current parent company's) 2009 accounts as a proxy for overall realised and unrealised tax losses and other tax benefits carried forward, the chart compares the level of reported write-downs with this implied stock of tax benefits carried forward. The fact that the trend in this chart is almost precisely the inverse of the trend in bank profitability (see chart on page 9) suggests that these levels of net deferred tax assets can in fact be taken as a broad proxy not just of all future tax benefits (including temporary timing differences which are not related to write-downs or credit losses), but also, more narrowly, of the stock of banks' realised and unrealised tax losses carried forward, and potentially available to be offset against future taxable profits.[4]

Figure 2.1 Growth in estimated tax losses (and other tax benefits) carried forward for the 15 bank groups with the largest recent write-downs/ losses



Source : Bloomberg and published financial statements

Overall implied tax losses carried forward for this group of companies is USD 489 billion, which – if representative across the banking companies reporting total financial crisis related losses of

USD 1.3 trillion – would suggest an overall stock of tax losses carried forward for the banking sector as a whole involving financial crisis-related write-downs and credit losses of some USD 700 billion, with a fiscal cost of some USD 230 billion if eventually relieved at an average tax rate of 33%.[5] This USD 700 billion estimate is broadly consistent with the data available showing pre-tax losses of some USD 400 billion in 2008 alone (The Banker, 2009). However it will not include further losses which, under the applicable accounting rules, may not yet have been recognised for accounting purposes to the end of 2009, nor losses from the wider credit crunch/economic downturn which are not directly related to financial crisis-related write-downs and credit losses.

Deferred tax assets statements may also provide useful bank-specific information for revenue bodies.

For the reasons highlighted above, an overall estimate of tax losses based on deferred tax asset statements must be interpreted with care. Deferred tax asset statements do however provide valuable insights to corporate groups' overall tax position in a publicly available form, and estimates of likely tax losses based on deferred tax asset statements can provide useful context for revenue bodies' discussions with banks on their tax loss position.

Indications of future profits against which losses can be offset by carry forward

Indications of future bank profits suggest it may take three to eight years for the aggregate stock of losses to be utilised.

Information about the future is (inevitably) even more elusive than information about current and past periods. However, there are a number of current indicators of banks' future profitability, including their own latest in-year financial reports, future profits (and Earnings per Share) projections, and movements in bank share prices and Price-Earnings (P-E) ratios.

Earnings per share projections[6] for the 15 bank groups included in the chart above imply profits in 2010 at around 20% of 2006 pre-tax profits.[7] Without further increases in profitability in future years, this would take banks some eight years to utilise the estimated (realised and unrealised) tax losses carried forward.

The share price for these 15 bank groups stands, on average,[8] at around 50% of its pre-crisis, January 2007, level. This implies that – over the typical investor's time horizon – future profits are expected to be around 50% of pre-crisis levels. At that level, it would take banks some three years to utilise realised and unrealised tax losses carried forward.

The average[9] projected P-E ratio for these 15 bank groups is around 20:1. This is broadly in line with current all market P-E ratios, significantly below the >25:1 average P-E ratios in the pre-crisis period.[10] This too suggests that banks' profits are expected to show strong, but not spectacular, growth compared with current levels.

… with considerable uncertainty on the position of individual banking groups.

Overall, the picture from these various indicators is that it is likely to be at least three and possibly eight years before the aggregate current stock of bank losses is substantially eliminated.

This aggregate picture will nevertheless mask considerable variation in the position of individual banking groups and there is considerable uncertainty over how banks' future profits (or losses) might evolve.

Notes

1. Source: The Banker, 2009

2. Source: Bloomberg data.

3. Source: Bloomberg data.

4. In the case of a realised tax loss carried forward, the tax value of the loss carried forward simply offsets tax due on taxable profits in future years. In the case of an unrealised tax loss carried forward, there will have been an accounting loss in Year 1 not matched by a tax loss. The value of the unrealised tax loss carried forward can be subsequently realised in (say) Year 2 in one of two ways. Either the write-down giving rise to the unrealised tax loss carried forward from Year 1 might be reversed, which will give rise to an accounting profit in Year 2 which will not be taxable. Or there could be an event which triggers the realisation of the previously unrealised tax loss – e.g., a write-off. In either case, the existence of a realised or unrealised tax loss carried forward will reduce the tax due on future accounting profits to the extent that the relevant country's tax rules allow this kind of loss carry-forward offset.

5. Calculations derived from The Banker database (www.thebankerdatabase.com). This is calculated by taking the write-downs from Bloomberg data for this group of companies (USD 876 billion) as a fraction of the total overall USD 1.3tr write-down figure, and grossing up the implied losses of USD 489 billion by that fraction, thus USD 489 billion x USD 1300 billion/USD 876 billion = USD 726 billion, and this is rounded down to USD 700 billion.

6. Source: Bloomberg company data available from www.bloomberg.com/markets, consulted on 26 or 29 March 2010.

7. EPS figures imply 2010 profits for these banks of USD 61 billion compared with publicly reported pre-tax profits for the same banks, and those they have subsequently acquired, of USD 273 billion.

8. Average weighted by current market capitalisation. Source: derived from Bloomberg company data (www.bloomberg.com/markets).

9. As above.

10. See Historical table of S&P 500 P-E ratios available at www.multpl.com.

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Chapter 3. Summary of country rules in relation to taxation of bank losses

Abstract

This chapter summarises relevant country tax rules relating to bank losses. These include rules for how losses are recognised for tax purposes as well as rules for how tax relief may be given in respect of such losses. The rules are complex, and differ from country to country, and the chapter aims to summarise the key elements under a number of themes, including the tax treatment of the write-down of loans and securities, rules for offsetting tax losses against other income of the same company, rules for offsetting tax losses within a group of related companies, rules for the carry-over of unrelieved tax losses, rules for the treatment of foreign losses and restrictions on tax relief for a loss being given more than once.

Overview of relevant tax rules

Although commercial accounts are generally the starting point for the recognition of bank losses, tax and accounting rules are only rarely completely aligned.

This section of the report summarises the main features of participating countries' tax rules that are relevant for understanding both the main issues for banks (see chapter 4) and the tax compliance concerns of revenue bodies (see chapter 5). A more detailed overview of the relevant rules in the participating countries is included in Annex A. Neither this section, nor Annex A, is intended to be exhaustive.

The relevant rules can be categorised as, first, those relating to the recognition, for tax purposes, of losses on loans or securities and, second, those relating to the relief of overall losses incurred in a taxable period. It is also important to mention that, although a tendency is emerging of aligning accounting and tax treatment of losses and loans around IAS/IFRS principles, only in very few countries are the two treatments completely aligned.

Country tax treatment of banks' write-downs and write-offs of loans and securities

Country rules differ in the extent to which write-downs or write-offs of loans are tax deductible.

With certain limitations, most participating countries allow the deduction for tax purposes of write-downs on loans. For a write-down to be allowed as a deduction for tax purposes, some countries require that the loss in value of the loan must be certain. In others, appropriately calculated impairment losses recognised in the accounts are allowed for tax purposes, but not general bad debt provisions. In many countries, restrictions may apply to the write-down of intra-group loans. As regards write-offs, in the majority of the participating countries, this is allowed only when the loan is considered "bad" and the creditor has exhausted all legal means for its recovery. The tax treatment of write-downs and write-offs may also depend on the classification of an asset for accounting purposes, *e.g.* as held for trading or non-trading purposes.

For other securities, an accruals, mark-to-market, or realisation basis of taxation may apply.

In the case of other securities, many countries either allow or require banks to use mark-to-market or fair value accounting. However, for most countries where income/capital distinctions are maintained for financial instruments, if a security falls into the category of "capital assets", its decrease in value would not be recognised for tax purposes until the asset is disposed of ("realisation basis"), whereas a write-down on an accrual basis might be possible under the accounting rules. On the other hand, if a security is classified as a "current asset", provisions and losses are generally deductible on an accrual basis.

Country loss relief provisions

There are wide variations in country rules giving relief for overall tax losses.

If a bank's overall results for a taxable period represent a loss, the bank will generally seek to obtain tax relief for that loss by offsetting the loss against other taxable profits. The extent to which such relief is available – whether against the bank's own profits of the same, previous, or later periods, or against the profits of other related companies – differs markedly from country to country. The following country rules may be particularly relevant for purposes of identifying significant tax risks: (i) Sideways loss relief; (ii) Group taxation regimes; (iii) Carry-over of losses; (iv) Losses of a foreign permanent establishment (PE); (v) Losses of a foreign subsidiary, and (vi) Restrictions on dual use of losses.

Sideways loss relief

Sideways loss relief is available in many countries

In many participating countries a company's losses from one taxable activity can reduce its taxable income from other taxable activities for the same taxable period (with in some cases the balance available to reduce taxable income from other taxable activities in past or future taxable periods too). The reason for this is that generally in these countries income derived by a company is considered to be business income irrespective of its character. These countries generally treat capital gains as ordinary income and therefore capital losses can offset ordinary income. However, even in these countries, capital losses on the disposal of shares and other participations which qualify for the participation exemption regime are in some cases not deductible for tax purposes, or only deductible to a certain extent.

… while some have so-called schedular systems of taxation.

A number of countries have instead so-called schedular systems of taxation, according to which income and gains are divided into different categories based on their source. This generally means that losses can be offset only against income from the same income source, thus preventing sideways loss relief, although in some countries which otherwise operate a schedular system, corporate trading losses are available to be offset, sideways, against total corporate profits of the same, and in some cases a previous, year. In addition, since different categories of financial transactions such as payments of interest and dividends may be close substitutes in the hands of a financial institution, generally applicable tax differences between these categories of financial transaction may be set aside for the financial sector.

Generally speaking, domestic law restrictions on sideways loss reliefs tend not to affect the transfer of losses between an investment banking and retail banking arm of a single banking company, which would typically be regarded at any one time as carrying out a single banking activity for tax purposes, even though

the nature and mix of that activity might change over time, with possible consequences for loss carry-forward rules.

Group taxation regimes

National group taxation regimes

Group taxation regimes of one kind or another are available in most participating countries.

There are various types of group taxation regimes in participating countries. Some countries have group consolidation regimes under which profits and losses of companies belonging to the same group are aggregated and taxed on a consolidated basis. Others have group or consortium reliefs, under which losses may be surrendered among companies belonging to the same group. Others have systems of intra-group transfers of income, under which profitable companies may transfer income to loss-making companies belonging to the same group. And others have no group taxation regime at all. The various group taxation regimes are generally optional, and the qualifying requirements for group consolidation differ markedly between countries. These differences include minimum shareholding requirements, minimum holding periods, whether or not a PE of a non-resident company may act as head entity of the group, duration of a consolidation election, whether the election is on an "all-in" basis or not, and the method of consolidation.

There are special rules for loss offsets when companies join a group.

In view of its particular relevance to restructuring activity in the banking sector in response to the crisis, it is worth highlighting that there are special measures governing entitlement to group taxation treatment which apply in relation to losses of companies joining a group. These rules may be particularly relevant in the context of potential loss-trafficking and more generally in relation to the use of tax losses by entities other than those which incurred them.

Cross-border group taxation regimes

Cross-border group taxation regimes exist only in a small number of countries.

A small number of countries provide also for cross-border group taxation regimes, and here too the rules vary between those countries. There are differences in whether a non-resident company may act as the head of a consolidated group, whether the taxpayer may choose which entities should be included in the consolidated group, whether consolidation is limited to the parent's share of the profits of foreign entities, and whether or not pre-consolidation losses are ring-fenced in the company that incurred them.

Carry-over of losses

Carry-over of losses (forward or

Carry-forward of losses is a feature of all countries participating in this report, with time-limitations (where applicable) ranging

backwards) is a feature of all tax systems, though there are marked differences between countries.

between 5 and 20 years in some participating countries. Loss carry-back is allowed only in a few countries, and – where allowed – it is generally limited to between one and three years, although some countries have relaxed these limits, at least temporarily, in response to the financial crisis. Some countries additionally provide for quantitative limitations on the deduction of losses carried back or forward.

There are also different restrictions triggered by a change in the ownership and/or the activity of the loss-making company …

Most countries covered in this Report restrict the ability to carry losses back or forward when there is a change of ownership and/or of activity (and in some cases these restrictions apply also to unrealised, or "built-in" losses). Again the rules vary significantly from country to country, with key differences relating to what constitutes a "change of ownership" and/or a "change in activity" for the purpose of carry over rules. This may be particularly relevant in the context of recent bank takeovers in which there has been a change in the relative mix of activity (*e.g.* investment banking, retail banking, asset management, *etc.*) of the acquired bank.

… but there may be exceptions to these restrictions.

Country rules provide for exceptions to the restrictions on the carry-over of losses for a number of different reasons. Some countries provide for an exception in the case of internal reorganisations, or where the taxpayer demonstrates that the change of ownership and/or of activity is not made for tax avoidance purposes. Other countries provide for an exception for certain non tax-driven considerations, such as the maintenance of the workforce of the loss-making company or of the investments made or to be made in the following years (this might protect the carry-over of losses if the transfer takes place as part of a restructuring plan in order to rescue a loss-making company).

Some countries, in an effort to provide support to banks and other companies in the wake of the financial and economic crisis, have provided through guidance or legislation that government contributions shall not have the effect of causing a change in ownership for the purpose of certain statutory loss restrictions after an ownership change.

Losses of a foreign permanent establishment

Whether losses of foreign branches are relieved generally depends on whether a country relieves juridical double taxation by credit or exemption.

The tax treatment of losses incurred through foreign PEs is generally linked to the method through which double taxation is relieved.

Countries which relieve double taxation through the ordinary foreign tax credit method generally take into account profits and losses derived through a foreign PE in the determination of the taxable income of resident companies.

For some countries which apply the exemption method, both foreign profits and losses are exempt, such that foreign losses do

not reduce the taxable base of a resident taxpayer. In others, although foreign profits are exempt from tax, foreign losses do reduce the taxable base of resident taxpayers. In these countries, it is however provided that foreign losses which have been deducted in the residence State are recaptured in future years, *e.g.* when the foreign PE derives profits or when the foreign PE is alienated or converted into a subsidiary.

Losses of a foreign subsidiary

Losses of foreign subsidiaries are generally not deductible in the country of the parent company, though there are some exceptions.

As a general rule, losses of a foreign subsidiary are not taken into account in the State of residence of the parent company. Where a cross-border group consolidation regime is available, losses of a foreign subsidiary may be taken into consideration insofar as an election for the application of the regime has been made. In addition, some EEA countries expressly allow for the deduction of losses incurred by a foreign subsidiary resident elsewhere in the EEA if such losses cannot be offset anywhere else.

Profits or losses of a foreign entity may be passed through or otherwise recognised by the owner of a foreign entity if in the country of the owner the foreign entity is treated as a disregarded entity, partnership, or other flow-through entity.

Where Controlled Foreign Companies (CFC) or similar rules are in force, the question arises as to whether losses incurred by the foreign entity can be deducted at the level of the resident shareholder. In some countries, losses of the controlled foreign company are directly attributed to the resident shareholder; others do not attribute losses of the controlled foreign entity to the resident shareholder; while others allow for the carry-forward of such losses when determining the income of the foreign entity for CFC purposes.

Restrictions on the dual use of losses

A number of countries rule out "double-dip" relief for losses.

An increasing number of countries provide that, in certain specific cases, if losses incurred by a resident entity are also deductible under the rules of another country, the losses will not be deductible in the first mentioned country. In other words, the rules are aimed at preventing relief being given twice for the same loss.

Chapter 4. Main issues for banks in relation to tax losses

Abstract

This chapter identifies the main issues for banks in relation to tax losses. It highlights a number of issues raised by banks over current country tax rules relating to bank losses and underlines the importance to banks of their regulators' treatment of tax losses. The chapter also touches on how an enhanced relationship with national revenue bodies can bring specific benefits to banks in relation to the tax treatment of losses.

Introduction

Many of the issues raised by banks in relation to tax losses relate to policy considerations rather than to the operation of the applicable tax rules themselves. Such tax policy concerns are outside the scope of this report, but are included here for completeness.

Obtaining tax relief for commercial losses

Banks expect to receive tax relief for commercial losses ...

Where a government taxes commercial profits, it will normally give tax relief for commercial losses. As explained in the previous chapter, this is unlikely to be on an entirely symmetrical basis (*i.e.* all governments set a limit on the amount of loss they are prepared to relieve by immediate offset or repayment, such as by reference to the profits taxed in the same and related entities in the same, previous or later years, or by reference to the location of the loss). Governments also apply additional restrictions to loss offsets on grounds of affordability, administrability, and to discourage tax-driven distortions. Banks are concerned that restrictions on loss offsets may mean that – over time – profits of temporarily loss-making banks are taxed at higher effective rates than profits of consistently profitable banks.

… including by appropriate loss carry-back.

Some banks have highlighted restrictions on loss carry-back rules as a particular constraint on utilising the economic loss incurred, particularly when they may be loss-making for a number of years in the future.

They are conscious of the restrictions in current rules …

Other banks have highlighted particular restrictions or inflexibilities in current loss relief rules, such as the fundamental terms of group relief rules, or requirements that elections for group treatment be irrevocable or extremely long, as constraints on receiving full loss relief.

… and concerned about potential future uncertainty.

In the current climate of government deficits, banks are concerned that a tightening of the rules applicable to loss utilisation may have a direct adverse financial and regulatory impact on banking groups which currently have Deferred Tax Assets (DTAs) in their accounts. Ideally, banks would wish to have certainty over the future tax treatment of past and current losses as they reassess their business plans following the recent turmoil. The degree of certainty over that is likely to affect banks' appetite for aggressive tax planning.

Some banks are concerned that revenue body audit procedures may mean that they do not have certainty about the amount of losses available to be used in the future, even though the loss-

making year has already been audited by the revenue body.

They consider that rules restricting loss carry forward in case of change of ownership or activity may have unintended consequences in the current climate and could hamper beneficial restructuring.

Some banks have concerns over the application of restrictions to carry over of losses in the case of change of ownership/activity or in certain cases of government financial support. They consider that many changes of ownership/activity which are currently undertaken or being considered are not made for avoidance purposes but for valid commercial reasons. These include changes of ownership triggered by the government taking a stake in the financial institution. They therefore consider that denying loss carry over in these cases may not be in line with the policy which is assumed to underlie the rules (preventing tax avoidance and loss trafficking) and may also hamper restructuring which would benefit recovery.

Banks also suggest that better guidance from the revenue body, for example setting out the circumstances in which commercial restructurings could proceed without triggering the loss relief restrictions, might be helpful in giving greater certainty.

Recognition of profit or loss in particular entities

Banks would normally not expect revenue bodies to revisit valuations signed off by auditors.

Some banks have expressed concern over the extent to which tax authorities may engage in review of the valuations of assets already made by auditors and regulators (*e.g.* insisting on valuations at a different point in the bid-offer spread from that used for accounts purposes). They consider that accounts valuations should be applied also for tax purposes, particularly in relation to assets that are very difficult to value. More fundamentally, some banks are concerned that tax policy in relation to the recognition of loan write-offs is in many cases more restrictive than accounting rules.

They also expect revenue bodies to apply domestic and international tax rules consistently to both profits and losses.

Some banks are concerned that countries may take an aggressive stance on losses allocated to their jurisdiction with the result that a significant part of a genuine commercial loss could not be allocated anywhere and hence could not be claimed by the taxpayer. They consider that a consistent application of the arm's length principle as included in the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD, 2010) and in the "authorised OECD approach" to attribute profits to PEs (AOA) is necessary, such that revenue bodies should apply the same approach for profits and losses. Some banks have suggested that the question of the arm's length amount of interest which a branch of a foreign bank should be able to deduct for tax purposes, on the basis of the equity allocation ("free capital") of that branch, may have a bearing on the losses properly attributable to the branch.

Relationship between tax and regulatory relevance of bank losses

Many banks have a key regulatory capital incentive to ensure that they receive tax relief for commercial losses …

Banks consider of particular relevance the issue of the regulatory treatment of deferred tax assets (whether constituted by loss carry-forward or book losses which are as yet unrealised for tax purposes).

Bank regulators require banks to hold a certain amount of non-repayable capital as a cushion against losses, so as to give protection to depositors, bank customers and bank counterparties. The purest and strongest form of capital is common stock, or equity, but regulators accept other forms, such as retained earnings, or preferred stock, in some circumstances. In most countries, a deferred tax asset may have the effect of increasing regulatory capital, to the extent that this represents cash due to the company from the government (or a reduction in tax otherwise due), provided there is the prospect of loss relief being given to trigger this cash-flow. Compared with raising new equity in the market (assuming that is possible at all in a time of crisis), recognition of deferred tax assets as regulatory capital is inexpensive: there is no carrying cost for deferred tax assets and – subject to rules limiting the amount of deferred tax assets which can be recognised (for example US regulators apply a limit of 10% of Tier 1 capital and a one year utilisation horizon) – these are valued at 100% of their face value, *i.e.* the amount of the loss multiplied by the tax rate at which relief is expected, with no discounting for the deferred realisation.

This means that each USD 100 million of a tax loss, if potentially relievable at 33%, could give rise to a deferred tax asset of USD 33m, and if this qualifies as regulatory capital, with an assumed minimum capital to assets ratio of 5%, could support lending/assets of up to USD 660 million, depending on the risk weighting of the lending/assets concerned. Putting this another way, tax losses might potentially be levered by a factor of 7 as a means of taking on further profitable activity, without the cost of taking on new equity or other regulatory capital. As a result, the regulatory capital recognition of tax losses is generally seen by banks as more important than the cash-flow benefit of accelerating loss offset.

In December 2009 the Basel Committee on Banking Supervision put forward proposals to strengthen bank capital adequacy, emphasising common equity as the principal component of Tier 1 capital (BIS, 2009b). Following consultations, these proposals were amended in July 2010. The proposals, as amended and which are likely to be adopted on a phased basis, place strict limits on the amount of deferred tax assets that can count as regulatory capital.

… and there is some evidence of tax planning by banks primarily aimed at maximising the value of tax losses for regulatory capital, rather than tax/cash-flow, purposes.

Regulatory rules expressly recognise that banks may engage in tax planning to maximise the extent to which tax losses will in fact reduce tax liabilities and therefore the extent to which they can be recognised for regulatory capital purposes. Typical tax planning, for this purpose, includes the acceleration of income, disclaimers of tax deductions or depreciation allowances, and corporate mergers or restructurings so as to provide a stream of profits against which losses can be offset. Even though the primary motive for such planning may be to enhance regulatory capital cover, revenue bodies will want to be satisfied that the steps taken are in compliance with the relevant tax rules. Tax planning may also include a decision not to close down an otherwise unviable activity on the grounds that utilisation of the loss carry forward may make the activity profitable on an after tax basis.

To the extent that tax losses are recognised for regulatory capital purposes, banks may have less of an incentive to engage in loss-trafficking outside the banking group to get value from their accumulated losses carried forward. However, not all tax losses will qualify in full as regulatory capital, and in that case regulatory capital, profitability and cash-flow considerations may all act as incentives for banks to seek to convert accumulated losses into cash. Alternatively, banks may engage in planning to allocate losses within the banking group to the jurisdictions where their value is higher or to maximise the value of losses in anticipation of the change in capital adequacy rules discussed above. The scope for such tax planning is covered more fully in Chapter 5.

The box below summarises how a bank might value its tax losses.

Box 4.1 Valuing bank tax losses

The potential value of tax losses can be realised by banks in a number of ways, and banks, like all taxpayers, will for good commercial reasons seek to maximise this value. A bank actively managing its tax will ascribe a notional monetary value to the losses, which can be used when assessing its options. This value is likely to take into account a wide range of factors, including the following:

- The carrying value under applicable accounting rules of any deferred tax asset on the group balance sheet, and the availability of such an asset to be reflected in the bank's capital base. The value of capital is such that only if deferred tax assets are no longer able to count towards regulatory capital will other options be considered.
- Profit forecasts and estimates as to how long it would take for losses to be fully set against taxable profits in the absence of planning. The present value of losses reduces if the expected time needed to realise their value increases.
- Opportunities to utilise losses within the group.
- Opportunities to convert tax losses into pre-tax earnings, by entering into tax planning structures which are aimed at transferring the value of its losses to third parties in return for immediate fee income. The fees achievable from these structures depend on a number of factors, including risk allocation between participants. They will also depend on the perceived "market price" for losses, which will take into account the demand for this type of planning from corporate groups with tax capacity, and the supply of tax losses available.
- The availability of planning opportunities to shelter tax on future profits without the use of losses. If a low cost alternative to tax losses as a means of sheltering taxable profits is available, the value of the losses to a third party corporate group (and therefore to the bank) will be reduced.

In broad terms, as the quantum of a bank's losses goes up, the profits needed to fully absorb the losses increase; it becomes less likely that the full value of the losses will be recognised as a deferred tax asset and be able to fully qualify as regulatory capital. In these cases, the marginal value of each additional unit of loss reduces, and planning opportunities that involve selling losses in return for a fee may become more attractive.

Relevance of an enhanced relationship

An enhanced relationship may be helpful in reaching early resolution of potential tax disputes involving losses and can also directly benefit banks' commercial operations and recovery from the crisis.

Commercial losses are by their nature a signal of commercial distress, and early resolution of a claim for tax losses can be crucial in securing cash-flow benefits, including through repayment or offset of tax otherwise payable.

Early certainty over the revenue body's attitude to a claim for tax losses can also make a substantial difference to a bank's cost of capital. Certain banks have indicated that revenue body support – in real time – for tax loss claims has directly influenced regulators in accepting tax losses as available to contribute to regulatory capital. Without this, the banks would have needed to issue new capital, repay borrowings, and/or reduce their lending activity and this may have affected their recovery strategy.

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Chapter 5. Compliance/tax risk issues for revenue bodies in relation to bank tax losses

Abstract

This chapter identifies the main compliance and tax risk issues for revenue bodies in relation to bank tax losses. It first gives an overview of the tax risks involving bank tax losses, and the incentives which give rise to those risks. It then describes the key tax risks in some detail, including a number of illustrative examples. Tax risks covered include risks relating to non arm's-length transfer pricing, corporate reorganisations, financial instruments, and the possible circumvention of loss recognition and relief rules.

Overview of the tax risks involving bank losses, and the incentives which give rise to those risks

Revenue bodies are concerned with ensuring that the right amount of tax is paid at the right time ...

The role of revenue bodies is to help ensure that the right amount of tax is paid at the right time. This involves helping banks to get the relief for tax losses due under the law, through applying the tax rules in a proper and fair manner. It also involves identifying – and dealing with – risks that banks may seek to secure more value from their tax losses than is due. Although the report deals with real economic losses incurred in the banking industry, revenue bodies remain alert to aggressive tax planning schemes aimed at generating artificial losses.

As outlined in the *Building Transparent Tax Compliance by Banks* (OECD, 2009a) report, revenue bodies are concerned at the risk to tax systems posed by the extent that banks use (as well as facilitate and promote) aggressive tax planning schemes, and these concerns apply in principle to tax planning involving losses in the same way as to tax planning involving profits. To some extent – as set out below - there are factors which potentially mitigate this concern, at least in the short term, and a contraction of the structured finance activity in the wake of the crisis may have temporarily reduced opportunities for aggressive tax planning involving structured finance products. Even so, although at present there is no evidence of significant manipulation of the estimated USD 700 billion+ stock of tax losses, the scale of these losses, and the potential regulatory capital, profitability and cash-flow benefits for banks able to convert them to cash, mean that revenue bodies are alert to potential compliance risks in a number of areas.

… and will pay particular attention to the incentives which may affect that outcome one way or the other.

The extent of those risks depends on the incentives and opportunities banks may have to engage – or not to engage – in tax planning to increase the relief due. These are the subject of this chapter. The relevant incentives and opportunities will differ in their significance from bank to bank, but in brief:

- Banks in many countries have sustained substantial commercial losses, in many cases from activity in relatively high-tax countries, rather than in low-tax jurisdictions. For those countries where real-time working with taxpayers is the norm, revenue bodies have the opportunity to discuss this commercial context with banks in some detail, as a basis for understanding potential tax risks.
- Several loss-making banks are projecting a return to profit either in 2010 or soon thereafter, and will be content to carry forward recent losses – to the extent these cannot be carried back to recover taxes paid in profitable years – to

set off against these early future profits. Other banks had substantial tax losses carried forward even before the crisis.

- Banks are central to all economies, and should have a strong interest in being, and being seen to be, compliant with tax rules. This is particularly the case in those countries in which governments have provided substantial support to the banking sector in crisis, where public tolerance of tax avoidance by banks is likely to be very low, and even more so where governments have taken a direct stake in the ownership of banks. More generally, the enhanced relationship with banks (and other) taxpayers in some countries is bearing results in the form of a reduction in aggressive tax planning activity, with opportunities for revenue bodies to better focus their attention on taxpayers who are less transparent or otherwise pose greater compliance/tax risks.

- Many otherwise potentially attractive tax planning techniques are ruled out by loss restrictions or anti-avoidance measures applicable in the countries concerned. Awareness on the part of revenue bodies of likely tax planning (through international cooperation, disclosure rules or otherwise) will further reduce opportunities for maximising loss relief through aggressive tax planning.

- To the extent that a bank may be able to include tax losses in its regulatory capital, this considerably increases the value of that asset to the banking group, and will reduce incentives for the bank to gain value from the loss by transferring it outside the group. Even where tax losses exceed what a regulator will recognise as Tier 1 capital, to the extent it can be recognised as a deferred tax asset for accounting purposes, the future value of a tax loss carried forward will form part of a bank's profits for its own reporting purposes (*i.e.* it will contribute to its overall Return On Equity), and that value is accounted for on a cash, rather than Net Present Value (NPV) basis, providing an accounting (even if not a cash-flow) incentive for the bank to retain tax losses within the group as long as there is a likelihood of relief being given at some point in the future.

On the other hand:

- There are incentives for banks to seek to increase loss relief due in order to reduce costs and improve cash-flow, particularly as they rebuild profitability following the crisis, though to an extent this is no different from any tax planning in good or bad times.

- Tax planning by some banks may also be driven by a desire to remain competitive in relation to other banks.

- Tax planning techniques for companies with accumulated losses, or for profitable companies in a position to benefit from widespread losses elsewhere in the sector, may however be quite different from the tax planning techniques which would normally be used in good times. For example, the fact that many banking groups are simultaneously in a tax loss position may offer unusual opportunities for back-to-back arrangements with unrelated competitors to maximise the loss relief of each party. Differences between the rules for loss relief – described in chapter 3 and annex A – will also increase incentives for tax planning which secures tax relief in the country with the most favourable rules. Relative incentives to have taxable income allocated to a relatively high or low tax jurisdiction are also clearly reversed in a period of losses compared with a period of profits.

- The fungibility of financial sector transactions, and the differences in national taxation of traditional as well as innovative financial products, gives banks tax planning opportunities to maximise relief for losses.

- The current availability of deferred tax assets (including realised and unrealised tax losses) as a source of regulatory capital increases the incentives on banks to maximise and accelerate the likelihood of tax relief for their commercial losses within the banking group, and to plan around restrictions on tax loss carry-overs or non arm's length transfer pricing which might frustrate that (although, as mentioned earlier, it may reduce incentives for loss trafficking outside of the banking group). The incentive to accelerate relief is particularly stark given the Basel Committee on Banking Supervision's consultative proposals to limit recognition of deferred tax assets as an element of acceptable Tier 1 capital[1]. And to the extent that tax losses do not qualify as regulatory capital, banks' requirements for alternative sources of regulatory capital may increase incentives for banks to seek to convert those losses into cash, including by seeking to sell the value of those losses to unrelated parties.

- A feeling that governments "ought" to give relief for commercial tax losses in a way which is broadly symmetrical with taxation of profits may encourage banks to engage in tax planning to secure that broad result, treating country restrictions on loss carry-over as technicalities to be sidestepped rather than as a fundamental policy prohibition on loss relief. Widespread tax planning to create "artificial" tax losses in profitable years only reinforces revenue bodies' concerns that banks will plan at least as determinedly to utilise real,

commercial, losses.

- The risk to a revenue body from planning with respect to bank tax losses is not restricted to the banking sector. Planning techniques used to realise value from bank tax losses are likely to include arrangements with profitable groups outside the financial sector, reducing tax revenues from other industries.

Revenue bodies have compliance concerns specific to bank tax losses, in a number of areas.

In the light of the above considerations, revenue bodies from participating countries have identified a number of potential risk areas in relation to the taxation consequences of banks' commercial losses. Potential risk areas identified include: (i) transfer of losses/profits through non arm's-length transactions, (ii) transfer of losses/profits through reorganisation, (iii) transfer of losses/profits through financial instruments, (iv) circumvention of loss carry over rules, (v) circumvention of loss relief rules, (vi) multiple deduction of the same economic loss. These are described below in further detail, including a number of illustrative examples.

Non arm's-length transfer pricing

Transfer pricing is a key risk area …

Transfer pricing is a key risk area in international taxation, both in profit-making and loss-making contexts. Specific transfer pricing challenges may arise in the case of loss-making banking groups and of loss-making affiliates within profit-making banking groups.

Revenue bodies will want to verify the consistency with the arm's length principle of the remuneration of cross-border transactions that a taxpayer conducts with foreign affiliates,[2] and/or of the profit allocation to a permanent establishment of a foreign bank.[3] General guidance on how to apply the arm's length principle to subsidiaries of banks can be found in the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD, 2010). Specific guidance can be found in Part III of the "Report on the Attribution of Profits to Permanent Establishments" (OECD, 2008), which specifically deals with the global trading of financial instruments between associated enterprises. Guidance on how to apply the arm's length principle to permanent establishments of banks and of enterprises engaged in the global trading of financial instruments is found in Parts II and III of the "Report on the Attribution of Profits to Permanent Establishments".

Under the arm's length principle, the remuneration of a subsidiary or profit allocation to a branch that is part of a multinational banking group has to reflect the functions performed, taking into account the risks assumed and the assets used by it. In the banking sector, the allocation of risks within a group has a very important and distinct role in profit/loss allocation and revenue

bodies are monitoring whether losses are allocated where the risks related to them belong.

Guidance on the application of the arm's length principle to risk allocation and risk transfers can be found in chapter IX of the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD, 2010) and in the "Report on the Attribution of Profits to Permanent Establishments".[4]

... and revenue bodies will be seeking consistency in banks' transfer pricing policies.

Banks will be reviewing their transfer pricing policies in the light of recent trading results and changes in their trading pattern introduced as part of their post-crisis recovery plans. For example, issues may arise when compensation is used as a factor to allocate the reward for performing one or more "people" functions between different locations, where an activity that is the subject of a profit split method results in a trading loss in any year. This is because the correlation between bonus compensation and losses may be less clear than the correlation between bonus compensation and profits. In such circumstances a careful analysis of the enterprise's compensation policy for loss years and the reasons for a particular loss would be needed to construct a sensible methodology based on a proper analysis of the facts and circumstances of the particular case. As noted in the "Report on the Attribution of Profits to Permanent Establishments", any solution that taxpayers adopt for dealing with losses should be consistent with the arrangements that would have been made, up front, by independent enterprises. In particular, a profit split model that is consistent with the ex ante risk of losses should not be altered simply because of an ex post realisation of losses.[5]

Where revenue bodies enjoy an enhanced relationship with banks, early discussions can take place to ensure that transfer pricing policies remain consistent with the arm's length principle. Particular attention will be devoted by revenue bodies to the consistency of the transfer pricing policy of banks with the business models adopted over time. In the years before the financial crisis, some banks were managing large financial assets through foreign subsidiaries located in low-tax jurisdictions. Due to the crisis, large losses have materialised in relation to these financial assets, over and above the losses which have been sustained in relatively high-tax jurisdictions. Revenue bodies are concerned that in some cases these loss-making financial assets may be allocated to relatively high-tax jurisdictions, through non arm's length transactions or dealings. Revenue bodies' Competent Authorities seek to ensure through Mutual Agreement Procedures (MAPs) that the arm's length principle is applied consistently across international boundaries.

Particular transfer pricing risk areas include non arm's-length guarantee and loan

The application of the arm's length principle is critical to ensure that transfer (mis-)pricing is not used to artificially transfer losses to profitable entities within the banking group, or to countries whose loss relief rules are relatively more generous. Transfer pricing risks can potentially arise from the misallocation

arrangements within banking groups.

of income or expenses within a multinational banking group, or from the over-pricing or under-pricing of transactions (*e.g.* head office charges or royalties). Transfer pricing concerns have also been identified in some participating countries in relation to financial transactions, for example non arm's length prices for guarantee fees and related party interest rates.

The Australian Taxation Office has issued Taxpayer Alerts dealing with some of these issues. For example, TA 2008/18 describes arrangements where a foreign resident entity has a branch in Australia which has assessable income for the relevant income year. The foreign resident entity has (a) accumulated losses, (b) assets with embedded, but not yet realised, losses or (c) a liability to pay a third party (the "third party liability"). The foreign resident entity arranges to inappropriately attribute to the Australian branch: (a) some or all of the losses from foreign operations, (b) loss assets at an inflated price (*i.e.* by not properly accounting for the decrease in value arising from the embedded losses when it is attributed to the Australian branch), or (c) the third party liability without attributing to the branch adequate compensation for the value of the liability assumed by the branch. As a result of the arrangements, greater deductions for losses are sought in Australia by the Australian branch or subsidiary.

Another issue also arises with split hedges – *i.e.* where a company in country A holds a hedging instrument for the benefit of the group as a whole in relation to an asset or liability of an associated company in country B. Such split hedges are common in international banking groups, and the transfer pricing analysis would have to examine the situation where, as a result of a hedging strategy, losses can be recognised for tax purposes in a jurisdiction other than that in which the gain from an offsetting position is recognised. As noted in the "Report on the Attribution of Profits to Permanent Establishments",[6] this raises difficult issues where the split hedges occur between associated enterprises and will be the subject of future work. In the meantime, general guidance on transactions which purport to transfer risk from one associated enterprise to another can be found in chapter IX of the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD, 2010). Particular problems also arise where financial institutions use "net" hedging strategies so that it is almost impossible to trace the gain or loss from any particular transaction to the offsetting gain or loss on the customer transaction it hedges.

Many countries have specific documentation requirements in their legislation, whereby taxpayers may be required to explain their transfer pricing policy and to provide the appropriate documentation supporting their position.

Corporate reorganisations

A further compliance risk involves transfer of losses/profits through reorganisations.

Corporate reorganisations (mergers, acquisitions, divisions, transfer of assets, transfer of corporate residence, *etc.*) are generally made for sound business and economic reasons, and have an important role to play in ensuring the banking sector recovers from the crisis. This includes reorganisations to consolidate risk handling at the bank's head office location, or to isolate the type of "toxic" assets which triggered the crisis. However, in some cases corporate reorganisations may be used inappropriately to transfer profits or losses between different locations and allow an unintended use of losses. The issue is relevant both before losses materialise and after they have materialised. Loss-making companies can be acquired simply for the purpose of using the tax loss they carry with them. This is not allowed under most countries' rules, which impose various restrictions to the carry-over of losses.

Tax rules do not always provide for symmetrical treatment of profits/losses, particularly where that might encourage tax-driven distortions …

Chapter 3 and Annex A of this report show that most countries have rules which restrict the use of losses in cases of changes of ownership and/or activity, although some contain exceptions for internal reorganisations. These rules limit the tax revenue costs of loss relief, though may also in some cases be directed specifically at counteracting abusive practices where losses are trafficked and loss-making companies are acquired primarily for tax purposes. This helps to prevent tax-driven distortion of economic decisions. The same applies to most countries' rules on tax consolidation or group taxation, which act to deter tax-driven mergers and acquisitions by ring-fencing losses within the entities (or group of jointly-owned entities) which incurred them.

… and revenue bodies are alert to techniques designed to frustrate necessary restrictions …

Revenue bodies (in particular those where real time working is the norm) are already examining the tax consequences of changes of ownership and reorganisations to ensure that the rules are being complied with. Techniques which have been seen and raise concerns from the perspective of revenue bodies are for example the acquisition of a loss-making company for the only purpose of merging it or including it in the tax group with profit-making companies, therefore reducing the profits of other group companies by the losses of the acquired company.

Another example seen in practice is as follows: at the end of year 1 Company X acquires all shares in company Y. Before the sale of the shares, the inventory and personnel of company Y have been transferred to an associated company. The only remaining item is tax losses amounting to *e.g.* 500. The sale price of the shares has been agreed to 8% of the losses reported until year end, thus 40. In year 2, company Y receives 500 from company X in the form of a group contribution. The group contribution is treated as taxable income at the level of company Y (and is used against its tax losses) and as deductible at the level of company X. In year 3,

company Y pays 500 as tax-exempt dividends to company X. Thereafter, company Y is liquidated. The result of the transactions, assuming a tax rate of 28%, is that company X obtains a net benefit equal to 100, equal to the tax value of the contribution made (28 % of 500=140) minus the price paid for the shares (40).

In addition, other examples have been seen in practice where the taxpayer has tried to circumvent the tax treatment of capital gains/losses through corporate reorganisations. For example, in one country, capital gains on shares in EEA countries are exempt (and therefore capital losses are not deductible), and the technique consists in transferring the corporate residence of a loss-making company to a non-EEA country in order to benefit from the deduction of the capital loss on the planned alienation of its shares. The transfer of the corporate residence took place purely on paper, without any change in the underlying economic substance.

… including techniques which anticipate likely losses or which exploit CFC rules to import losses.

In other cases, revenue bodies have noticed an increase in the acquisition of loss-making companies towards year end, before losses materialise for tax purposes. This may be due to the fact that restrictions on the carry-over of losses or on different forms of group taxation regime rarely apply in relation to parts of a tax period. Some participating countries have noticed that trading of bank losses within a tax year has recently increased. This involves the acquisition before the end of a taxable period of a company that has "built in" (latent) losses. Where there are no rules limiting deductions for losses incurred during the fiscal year in which the change of ownership occurs, the acquiring company can then make use of the available group taxation regime to offset the acquired company's losses against the profits of other group companies.

Revenue bodies have also encountered cases where, in the course of corporate reorganisations, banking entities with loss-making activities have been allocated highly mobile income (such as income from financing or licensing of intangibles) so as to be able to offset their losses against the related income, despite the fact that they were not carrying out the economic activity giving rise to this income.

One example seen in practice is as follows: a company which is part of a banking group (the Group) and resident in one Country (Country A) has large losses due to the financial crisis. The Group conducted an internal restructuring in order to utilise the losses in Country A. This involved a transfer of group companies in Country B to a group company in Country C. The Country C company financed its acquisition of the Country B companies through an intra-group loan advanced by the Country A company, which can in this way offset its tax losses against the interest received on the loan. Conversely, the Country C group company deducts the interest it pays from its taxable income.

Finally, where CFC rules provide for the allocation of both profits and losses to a resident shareholder, reorganisations can

also be used to bring a loss-making foreign entity within the scope of the rules in order to import losses into the home country. Although no specific scheme has yet been seen in participating countries in this respect, revenue bodies will carefully monitor these situations.

Revenue bodies will expect taxpayers to be able to explain the commercial reasons underlying such corporate reorganisations and to maintain appropriate documentation in that respect.

Financial instruments

Use of financial instruments to transfer losses/profits is a particular concern …

The use of financial instruments for the purpose of shifting profits or losses among different taxpayers is also a concern for revenue bodies. The issue is relevant both before losses materialise and after they have materialised. The use of complex financial instruments or schemes involving more than one jurisdiction poses challenges to the revenue bodies, particularly in terms of being able to obtain all the relevant information. In this respect, international cooperation among revenue bodies plays a key role in ensuring that the underlying business reasons for transactions and their effects in the different jurisdictions involved are well understood.

… and a number of instances of this have been identified.

Potential risks which have been identified in this area are the use of call/put options to transfer profits or losses, the purported transfer of risks through swaps, other derivatives, and debt waivers. These instruments may be used to transfer losses to entities or branches within a group for the simple reason that there is tax capacity in that entity or branch jurisdiction. In other cases, the instruments may be used to transfer profits, *e.g.* by accelerating the production of income, to an entity with loss-making activities so as to be able to fully use the loss incurred.

Some countries have identified back-to-back transactions that are primarily or exclusively motivated by the willingness to transfer or optimise the use of tax losses. Depending on the country's legislation, such schemes may fall under general anti-abuse rules or principles and will be challenged by the relevant revenue bodies. In some countries, they may also fall under the domestic transfer pricing rules, even though the parties to the transaction may be formally independent from each other.

For example, one scheme seen in practice is as follows: Bank A is resident in high-tax Country A. Bank B is resident in high-tax Country B. Both banks operate in Country C (a low-tax jurisdiction) through subsidiaries, respectively Sub Bank A (belonging to the Bank A group) and Sub Bank B (belonging to the Bank B group). Both subsidiaries manage large loss-making financial assets. Sub Bank A and Bank B enter into a financial derivative contract (a credit default or an equity swap depending on the underlying assets) which transfers the Sub Bank A's

exposure in respect of its financial assets to Bank B. At the same time, Sub Bank B and Bank A enter into a similar financial derivative which transfers the Sub Bank B's exposure in respect of its financial assets to Bank A. Finally, Bank A and Bank B enter into a similar financial derivative which effectively neutralises, on a group consolidated basis, the transfer of the risks between Bank A Group and Bank B Group. In other words, the transaction does not modify the consolidated exposure in respect of the financial assets that the two banking Groups had before the transaction, while at the same time losses are allocated for tax purposes in the high-tax jurisdictions (Country A and Country B).

Another arrangement identified involves a group of related companies entering into offsetting long and short positions in index-linked securities which could result in the transfer of unusable tax losses incurred in one jurisdiction to a related profitable party in another jurisdiction. Although the movement in the underlying index cannot be predicted with certainty, the terms of the arrangement are that – at worst – the group emerges in a neutral (no gain/no loss) after-tax position, whereas if the index moves within the bounds of market expectations, gains will arise in the loss-making company (and be used against the losses carried forward), while losses will arise in the profitable company (where they will reduce the tax payable on that company's other profits).

Some avoidance devices involve banks capitalising on their tax exhaustion and undermining the investor tax base.

There may also be cases where instruments which are in economic terms a loan or deposit to the bank are instead structured in a way that they qualify as shares giving rise to dividends. In such cases, reflecting the bank's lack of tax capacity, the return on the instrument is not tax deductible for the bank, but – in comparison with interest – benefits from a favourable tax treatment in the hands of the recipient, and this can be priced into the terms of the investment to the benefit of both the bank and the investor.

More generally, revenue bodies are alert to new tax planning techniques involving financial instruments which take advantage of the tax exhaustion of banks, as opposed to the (more traditional) techniques designed to shield profits from taxation. They will expect taxpayers to be able to demonstrate the commercial reasons underlying transactions involving financial instruments and to fully disclose the relevant details of the transactions.

Circumvention of loss carry-over rules

Circumvention of losses carry-over rules is a further area of compliance risk.

Circumvention of the rules on loss carry-over is another area of potential concern for revenue bodies. The issue is generally relevant after losses have materialised and may take different forms, some of which have already been mentioned above, such as the transfer of profits through non-arm's length transactions or financial instruments. The possibility of carrying back or forward losses against income of other group companies may also be a

source of concern and has been mentioned above in relation to reorganisations.

Tax planning techniques in this area which are applied to crystallised or realised losses may also in principle be used to circumvent restrictions on the carry-over of unrealised/latent losses.

Country variations in loss relief rules may themselves create an incentive for tax planning…

As indicated in chapter 3, loss carry-forward is provided in all participating countries, while loss carry-back is allowed only in a few countries. Countries allowing loss carry-back may therefore attract tax planning aimed at releasing tax paid by companies reporting profits in previous years. Similarly, countries which provide for short loss carry-forward expiry dates may be particularly exposed to tax planning aimed at acceleration of loss utilisation or loss refreshing, while other countries may be particularly exposed to planning aimed at loss importation.

… and a number of attempted loss-refreshing schemes have been seen.

Examples of attempted loss-refreshing schemes which have been identified in some of the participating countries include a bank's transfer of its perpetual loan obligation to a subsidiary at a value below its nominal amount, for which it claims to realise profits against which it can set off its expiring losses, in return for a potential future loss in the subsidiary.

Similarly, income acceleration schemes have been seen whereby a bank claims to sell its future income from clients (goodwill) to a subsidiary, realising income against which it can set off its expiring losses while the subsidiary is allowed to depreciate the asset (goodwill) in future years.

Circumvention of loss recognition and relief rules

A further compliance risk involves manipulation of the loan/securities loss recognition rules for banks.

There is also concern regarding possible manipulation of bank loss recognition rules from a purely domestic tax planning perspective. This includes for example the opportunities due to the different tax treatment of loans and securities, which in some instances are taxed on a realisation basis and in others on an accrual basis, as banks are potentially able to control when they recognise a loss by deferring sales or bringing forward sales as needed.

Circumvention of country rules ring-fencing different types of losses are also a potential risk area

In some countries different items of income are treated differently for tax purposes and profits/losses from each type cannot be offset against each other. There is a risk that taxpayers try to circumvent these rules in order to obtain upfront relief for their losses.

Similarly, in many countries capital losses on shares qualifying for a participation exemption regime are not deductible for tax purposes. Taxpayers may therefore attempt to circumvent these rules in order to have capital gains falling within the scope of the participation exemption regime and capital losses falling instead

outside of such a regime and therefore being fully deductible for tax purposes.

Multiple deduction of the same economic loss

Double or multiple dip claims for losses are regarded as particularly aggressive.

An area of potential concern for revenue bodies is the multiple deduction of what economically is the same loss, generally through the use of hybrid mismatch arrangements. In other words, differences in countries' tax systems may facilitate aggressive tax planning through the use of hybrid financial instruments, hybrid entities, and dual resident companies.

An increasing number of countries have rules dealing with schemes whose aim is to exploit the arbitrage possibilities due to the existence of differences in the applicable tax rules. In some cases these rules are based on a linking principle, according to which the domestic tax treatment is linked to the tax treatment in the foreign country, therefore preventing *e.g.* the deduction in more than one country of what is economically the same loss.

Notes

1. Source: BIS, 2009.For more information see also http://www.bis.org/press/p100726.htm.

2. For treaty situations, see Article 9 of the OECD *Model Tax Convention on Income and on Capital 2010.*
3. For treaty situations, see Article 7 of the OECD *Model Tax Convention on Income and on Capital 2010.*
4. See in particular paragraphs 9-12, 18-23, and 174-192 of Part II (dealing with banks); and paragraphs 91-105, 211-230, and 260-271 of Part III of the Report (dealing with enterprises engaged in the global trading of financial instruments).
5. See paragraph 191 of Part III of the Report.
6. See paragraph 138 of Part III of the Report.

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Chapter 6. Tools available to revenue bodies to address compliance risks in relation to bank tax losses

Abstract

This chapter summarises the tools available to revenue bodies to address compliance risks in relation to bank tax losses. It assesses the benefit of encouraging responsible tax reporting through co-operation and dialogue, the role of rulings, clearances and disclosure rules, and the role of audits, supported by international exchange of information and co-operation between revenue bodies and between revenue and regulatory authorities.

Tools available to revenue bodies to address compliance risks

Revenue bodies have a number of tools to help manage these compliance risks, starting with encouraging responsible tax reporting through co-operation and dialogue.

Revenue bodies have a range of tools to identify and address the main compliance risks in the area of bank losses. Tools and strategies used by revenue bodies have to operate within the context of the applicable tax system. Policy and legislative choices are for policy-makers, not for revenue bodies, and this report makes no recommendations in relation to tax policy matters. Since some tax policy choices can have an impact on compliance risks, this chapter describes some of the choices that have been made, with a specific focus on tax losses.

First and foremost, revenue bodies seek to encourage responsible tax reporting and to discourage aggressive tax planning on the part of banks (and other taxpayers) and many engage in close and real time co-operative engagement with banks in order to achieve that. Initiatives aimed at establishing a fruitful and effective dialogue with the taxpayer are considered to be very useful in addressing the main compliance issues from the perspective of the revenue bodies, and these also carry important benefits for the taxpayer in terms of the greater certainty which comes from real time working with the tax authority. Even where a dispute will be resolved through litigation, dialogue can help to clarify the positions taken by each party, and to reduce the costs to each party of the dispute being unnecessarily protracted. These approaches may form part of "enhanced relationship" initiatives.

Some countries (including the **United Kingdom** and **South Africa**) have a Code of Conduct for banks under which banks are expected to refrain from entering into or promoting transactions that are outside the "spirit" of the law.

Real time intelligence gathering on industry developments, the use of questionnaires, taxpayer alerts, hiring experts and related staff training, are also relevant: they ensure that dialogue between the tax authority and banks is on a "commercially aware" footing and that revenue bodies are suitably attuned to sector specific compliance risks. Revenue bodies can gain significant insights from the information to be found in the public financial statements of commercial banks and from the disclosure banks make for regulatory purposes. Although information concerning the tax consequences of transactions is sometimes difficult to ascertain from a simple analysis of the financial statements, these will contain useful information for purposes of understanding the commercial context as well as the tax risk appetite of taxpayers.

Rulings, clearances and disclosure rules play a dual information and

Requests for rulings and clearances from revenue bodies also play an important role in gathering relevant information about banks' intentions and risk appetite as regards the use of losses for tax purposes. Rulings are intended to give taxpayers certainty

compliance role.

about the relevant tax treatment of a planned transaction, and this is an important tool for an effective and sustainable relationship. At the same time, this allows revenue bodies to better understand the current trends in the industry and assess the risks posed by them. Evidence from some countries shows that when major banks were given a negative indicative view on a planned transaction, they have not implemented it.

Since the lack of timely information is widely considered to be an obstacle for a fair and proper enforcement of the applicable rules, several countries have introduced or are in the process of introducing disclosure rules. These rules also serve as an early-warning system and may put aggressive tax planners on notice that the revenue body will want to analyse certain transactions in detail. In many cases, disclosure rules and rulings requests have also given revenue bodies sufficient intelligence to be able to pass legislation which removed the scope for a particular aggressive tax planning scheme. This can be beneficial even to the bank concerned, in that it restores a level playing field between those who might otherwise have adopted the scheme and those not choosing or unable to do so.

Audits will continue to play a key role in the detection, deterrence and prevention of aggressive tax loss planning…

For all countries, audits constitute an important tool to detect aggressive tax planning behaviour, and are clearly a key backstop to real time dialogue and intervention. Audits include both on-site visits to the taxpayer concerned and automated audits of relevant data, by analysing tax behaviours using the information contained in databases and systems managed and operated by the relevant revenue body. Those countries which rely mainly on audit techniques may however find difficulties in obtaining real time data, since audits necessarily look at past tax periods. The time lag between the tax audit and the date when an aggressive tax planning scheme was put in place is regarded by some revenue bodies as a barrier to an effective response to such planning. This has caused some countries to explore other means for early detection of aggressive tax planning such as disclosure rules and enhanced relationship initiatives.

… supported by international exchange of information and co-operation between revenue bodies.

International cooperation among revenue bodies is particularly relevant in order to fully understand the details of taxpayers' behaviour, particularly in the area of complex financial instruments involving multiple countries. A number of participating countries are engaged in enhanced information exchange arrangements such as the Joint International Tax Shelter Information Centre (JITSIC), created in 2004, which seeks to identify and curb abusive tax avoidance transactions, including those involving banks. Joint audits may also play a useful role in this respect since they allow revenue bodies to obtain relevant information in an efficient manner (concurrently with this report, the FTA has also issued a report containing practical guidance on how revenue bodies can collaborate to conduct a joint audit).

Co-operation with regulatory bodies may also play a key role.

Cooperation between revenue bodies and local regulators may also be an effective tool, since banks are required to continuously monitor their own risks, including their tax risks. The experience in certain participating countries shows that this cooperation may be extremely fruitful. For example, during 2009 there were informal consultations between the **Netherlands** Tax and Customs Administration and the Netherlands banking regulator (DNB) to explore the possibility of more intensive co-operation. In its "2010 Monitoring Themes", the Netherlands banking regulator states that banks should apply not only the letter but also the spirit of the law. In this context aggressive tax planning is mentioned as undesirable behaviour which can feed public distrust of the integrity of financial institutions.

Chapter 7. Conclusions and recommendations

Abstract

This chapter sets out the key conclusions of the report and makes a number of recommendations for both revenue bodies and banks.

Summary of report

This report set out to identify and address tax risks involving banks' losses. In order to do that, it has summarised the commercial context for the recent level of bank losses, used publicly available sources to give an indication of the scale of tax losses involved, and has given a high level overview of the country rules under which losses are recognised and relieved. It has then summarised potential areas of risk and concern both for banks and revenue bodies, and identified the range of tools which revenue bodies have to mitigate those risks.

A recurrent theme throughout the report, as with the FTA previous study Building Transparent Tax Compliance by Banks, is the potential mutual benefit of transparency and dialogue between banks and revenue bodies in understanding the commercial issues involved and in addressing tax risks within that commercial context. The key conclusions from this study are:

1. **Losses represent a significant tax risk both for banks and revenue bodies.** For banks, the key risk relates to the uncertainty over the availability of loss relief for commercial losses. Such uncertainty carries tangible costs, in terms of (i) providing for possible future tax liabilities, (ii) the cash-flow impact in relation to tax previously paid on profits, and (iii) tax compliance costs. The biggest potential cost for many banks relates to the status of tax losses for regulatory capital purposes. For revenue bodies, despite the value to banks of retaining tax losses for their own use, significant potential tax risks remain. Key areas of concern include potential compliance risks involving transfer pricing, corporate reorganisations, financial instruments, and other techniques used to circumvent national restrictions on loss relief. Opportunities for multiple deductions of the same economic loss are also a key area of concern.
2. **Commercial awareness of the context of bank losses, and of tax and non-tax (*e.g.* regulatory) drivers of tax planning is fundamental.** The critical importance of the regulatory capital status of tax losses is a key driver of tax planning involving losses. The commercial context is however also key to the application of national tax rules determining the allocation of profits and losses between related companies and limiting loss offset in the case of certain business reorganisations or changes of activity.
3. **The complexity of country loss, and loss relief, rules, and the potential opportunities for banks to exploit differences between country rules through aggressive tax planning, are themselves a potential source of tax**

risk. Revenue bodies need to understand and address areas of uncertainty in the application of their own country's rules, as well as being alert to interactions between their own country rules and those of other countries.

4. **Countries are currently applying a variety of tools to address potential compliance risks in relation to bank losses.** These tools include real time dialogue and transparent working relationships between banks and revenue bodies, industry-wide information gathering and transaction-specific assistance (including through rulings and clearance processes) and disclosure rules, together with traditional audits and on-site visits. International co-operation between revenue bodies, *e.g.* through exchange of information for tax purposes, and between revenue bodies and regulators, has had a positive impact on addressing tax risks involving losses.

Recommendations

The report recognises differences in the experiences of different countries in relation to the taxation of bank losses, as well as differences in administrative, legal, and cultural frameworks. Against that background, it makes recommendations in the following areas, which are for countries to consider in the light of their particular circumstances:

Recommendations for revenue bodies

To improve commercial awareness in order to better understand, assess and respond to tax risks, while facilitating sustainable business activity, revenue bodies should:

- work constructively with the banking sector and regulatory bodies to gain a shared understanding of the commercial context and the links between tax and regulatory reporting, building on the engagement which has underpinned this report. This could involve joint training, secondments, seminars and workshops, including on a multilateral basis where appropriate.

To encourage transparent tax compliance and improve detection of aggressive tax planning, revenue bodies should:

- encourage real-time engagement and open and transparent relationships between banks and revenue bodies.
- consider with regulatory bodies how the transparency of financial accounts in relation to provisions for tax exposures might be improved.
- consider the use of disclosure rules for aggressive tax planning involving losses.

- remain alert to and actively monitor potential compliance risks involving bank losses; in this regard, revenue bodies could use deferred tax asset statements as a tool for better understanding banks' incentives for tax planning involving losses.

To reduce tax risks arising from complexities and uncertainties in the operation or interaction of country rules, revenue bodies should:

- consider the adequacy of their guidance for banks on how national loss relief rules apply and, where possible, to offer real-time discussion and resolution of issues.
- bring to the attention of their government tax policy officials those situations which may potentially raise policy issues, and in particular those where the same tax loss is relieved in more than one country as a result of differences in tax treatment between jurisdictions, in order to determine whether steps should be taken to eliminate that arbitrage/mismatch opportunity.

To benefit fully from international and domestic co-operation, revenue bodies should:

- share intelligence and information on aggressive tax planning involving banks' losses, including through an international network of revenue body officials and by contributing to the OECD ATP Directory non-taxpayer specific information on schemes involving tax losses, including on bank tax losses.
- share experience and best practices on how to identify and, where possible, address cases of multiple deduction of the same economic loss.
- take opportunities to work closely with national regulatory bodies in addressing aggressive planning to maximise the use of losses for tax purposes, including in cases where that tax planning is intended to produce non-tax, regulatory, benefits.

To encourage earlier certainty, revenue bodies should:

- consider an enhanced relationship approach, where appropriate to a country's circumstances, based on the benefits to both taxpayers and revenue bodies; in this regard, revenue bodies should recognise the importance for banks' business activity in securing early certainty on the availability of tax losses within the applicable tax rules,

and give appropriate priority to the resolution of potential disputes over tax losses.

Recommendations for banks

In the course of the study, participating countries also identified a number of good practice recommendations for banks. In order to reduce their tax risks involving losses, banks can contribute in the following ways:

- banks have a key role in supporting a better commercial understanding of their business by revenue bodies, and could encourage that through dialogue, joint training, secondments, seminars and workshops.
- banks should be open and transparent with revenue bodies in their planning involving tax losses, whether or not that is primarily tax or non-tax driven.
- banks' boards should ensure appropriate corporate governance processes are in place around tax risk management, including resourcing internal audit activities, as a means to confirm that such policies are adhered to.
- banks should highlight areas of uncertainty in the operation of current country loss recognition and loss relief rules, thus allowing revenue bodies and their tax policy officials to address that uncertainty in a timely manner.
- consistent with the OECD Report on Attribution of Profits to Permanent Establishments and the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, banks are encouraged to support the way they have allocated tax losses to a particular jurisdiction with appropriate documentation, as this may reduce substantially the potential for disputes.
- in setting their business strategy, banks should consider the benefits of an enhanced relationship with revenue bodies including early certainty, reduced compliance costs, and reduced reputational risk.

Annex A. Country rules in relation to taxation of bank losses

Overview of relevant tax rules

Although commercial accounts are generally the starting point for the recognition of bank losses, tax and accounting rules are only rarely completely aligned.

This section of the report summarises the main features of the relevant rules in the countries which contributed to the drafting of the report. It is not intended to be exhaustive but simply to give an overview of relevant rules in relation to the tax treatment of losses for the purpose of assessing where tax risks may arise both for business and for revenue bodies. The relevant rules can be categorised as, first, those relating to the recognition, for tax purposes, of losses on loans or securities and, second, those relating to the relief of overall losses incurred in a taxable period.

Although a tendency is emerging of aligning accounting and tax treatment of losses and loans around IAS/IFRS principles, only in very few countries (such as **Norway** and **Switzerland**) are the two treatments completely aligned.

Since 1996 the **United Kingdom** has had corporate debt rules in which the intention is, broadly, to follow accountancy practice in recognising profits and expenditure, and to move away from the revenue/capital divide by taxing all credits and debits from loan relationships as income. Since 2002, it has also had derivative contract rules in which all profits from a company's derivative contracts are charged as income. In **Australia** new provisions (TOFA rules) have recently been enacted, aimed at eliminating the distinction between revenue and capital treatment of financial arrangements and at reducing differences between the accounting and the tax treatment.

Country tax treatment of banks' write-downs and write-offs of loans and securities

Country rules differ in the extent to which write-downs of loans are tax deductible.

Of particular significance to banking is that the creation or acquisition of a financial asset such as a loan or a security leads to the assumption of different types of risk (credit risk, market risk, operational risk, *etc.*) and these risks have to be taken into account when valuing the assets for tax purposes.

With certain limitations, most participating countries allow the deduction for tax purposes of credit write-downs on loans. For a write-down to be allowed as a deduction for tax purposes, some countries require that the loss in value of the loan must be certain (**Australia** and **Norway,** although Norway allows financial institutions a tax deduction for loan losses more generally if these

are recognised under accounting principles); in **Italy** quantitative limitations are provided; in **Spain** temporal limitations apply; in **Denmark**, **Sweden** and **Switzerland** write-downs for tax purposes are allowed only insofar the bank has also done so for accounting purposes. In **Austria** and the **United Kingdom**, appropriately calculated impairment losses recognised in the accounts are allowed for tax purposes, but not general bad debt provisions. In many countries, restrictions may apply to the write-down of intra-group loans.

Write-offs of loans are generally limited to when the loan is proved to be "bad".

In the majority of the participating countries, a write-off of the loan is allowed only when the loan considered "bad" and the creditor has exhausted all legal means for its recovery. This is the case in **Australia** (under the default method and subject to the application of restrictions dealing with continuity of ownership and same business test), **Italy**, **New Zealand** (where restrictions for intra-group loans also apply) and **Norway**.

Many countries allow either an accruals or mark-to-market basis of valuation for other securities, although some categories of security at least remain subject to a realisation basis of taxation.

In the case of other securities, many countries either allow or require banks to use mark-to-market or fair value accounting. However, for countries where income/capital distinctions are maintained for financial instruments, if a security falls into the category of "capital assets" its decrease in value would not be recognised for tax purposes until the asset is disposed, whereas a write-down on an accrual basis might be possible under the accounting rules. On the other hand, if a security is classified as a current asset, provisions and losses are generally deductible on an accrual basis. This difference in classification is not recognised in **Norway** and, for tax purposes, losses on securities are generally only recognised on disposal.

Country loss relief provisions

There are wide variations in country rules giving relief for overall tax losses.

Tax losses for banks can arise because of different reasons. Losses arising from the recent financial crisis are primarily due to borrowers defaulting on their obligation. If a bank's overall results for a taxable period represent a loss, it will generally seek to obtain tax relief for that loss by offsetting the loss against other taxable profits. The extent to which such relief is available – whether against the bank's own profits of the same, previous, or later periods, or against the profits of other related companies – differs markedly from country to country. The following paragraphs cover specifically the following rules: (i) Sideways loss relief; (ii) Group taxation regimes; (iii) Carry-over of losses; (iv) Losses of a foreign PE; (v) Losses of a foreign subsidiary, and (vi) Restrictions on dual use of losses.

Sideways loss relief

Sideways loss relief is available in many countries …

In many countries corporate tax systems are built on a net income principle, so that losses from one taxable activity can reduce the taxable income from the taxpayer's other taxable activities. The reason for this is that generally in these countries income derived by a company is considered to be of the same type irrespective of its source. These countries generally treat capital gains as ordinary income and therefore capital losses can offset ordinary income. However, even in these countries, in some cases capital losses on the disposal of shares and other participations which qualify for the participation exemption regime are not deductible for tax purposes (**France**, **Germany**, **Italy**, the **Netherlands**, **Norway**, **Sweden**) or only deductible to a certain extent (**Denmark** and **Mexico**). No restriction on the deductibility of capital losses on shares and other participations is provided for in **Spain** and **Switzerland**. The same is true for **Austria**, where the loss has, however, to be apportioned over a period of seven years.

… while some have so-called schedular systems of taxation.

A number of countries have instead so-called schedular systems of taxation, according to which income and gains are divided in different categories based on their source. This is generally the case in **Australia**, **Canada**, **Ireland**, and the **United Kingdom**. In most of these countries, losses can be offset only against income from the same income source, thus preventing sideways loss relief. For example, non-trading losses can only be set off against profits from the same kind of activity and not against trading profits. However in the **United Kingdom** and **Ireland** corporate trading losses are available to be offset, sideways, against total corporate profits.

In view of the particular fungibility of financial transactions, a generally applicable schedular system may be qualified for these transactions, or for the financial sector generally. On this basis, for example, the **United Kingdom** has "shares as debt" legislation which provides that returns on financial instruments designed to produce what is economically an interest-like return are taxed as income even if those are in a form which for tax purposes would otherwise give rise to a capital gain or a "tax nothing".

Group taxation regimes

National group taxation regimes

Group taxation regimes of one kind or another are available in all participating countries except Canada and Switzerland.

There are different group taxation regimes in participating countries. Domestic group consolidation regimes under which profits and losses of companies belonging to the same group are aggregated and taxed on a consolidated basis are available in **Australia**, **Austria**, **Denmark**, **France**, **Germany**, **Italy**, the **Netherlands**, **New Zealand**, **Spain**, and the **United States**. Group or consortium reliefs under which losses and other tax attributes may be surrendered among companies belonging to the same group are available in **Ireland**, **New Zealand**, and the **United Kingdom**. Systems of intra-group transfers of income under which profitable companies may transfer income to loss-making companies belonging to the same group are available in **Norway** and **Sweden**. Finally, **Canada, Mexico** (in the case of banks) and **Switzerland** do not provide for group taxation regimes.

The various regimes are optional in all countries, with the exception of **Denmark**, where it is generally mandatory. Other requirements for group consolidation regimes differ markedly between countries. These features include minimum shareholding requirements, minimum holding periods, whether or not a PE of a non-resident company may act as head entity of the group, duration of a consolidation election, whether the election is on an all-in basis or not, and the method of consolidation. These various features are summarised in the table below.

Table A.1. Summary of national group taxation regimes

Country	*Type of group taxation regime*	*Optional*	*Ownership*	*Local PE of non- resident as head entity*	*Minimum duration*	*All-in*[1]	*Degree of consolid-ation*	*Entity owning the losses*	*Use of losses when joining*[2]
Australia	Consolidation regime	Yes	100%	No	Irrevocable	Yes	Total	Head entity	Included[3]
Austria	Consolidation regime	Yes	>50%	Yes[4]	3 years	No	Total	Head entity	Ring-fenced
Canada	None	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Denmark	Consolidation regime	No	Control	Yes	N/A	Yes	Total	Loss-making company	Ring-fenced
France	Consolidation regime	Yes	95%	Yes	5 years	No	Total	Head entity	Ring-fenced
Germany	Consolidation regime	Yes	>50%	Yes	5 years	No	Total	Head entity	Ring-fenced
Ireland	Group and consortium relief	Yes	75%	N/A	N/A	N/A	N/A	Surrenderee company	Ring-fenced
Italy	Consolidation regime	Yes	>50%	Yes[5]	3 years	No	Total	Head entity	Ring-fenced
Mexico	Consolidation regime not applicable to banks	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Netherlands	Consolidation regime	Yes	95%	Yes[6]	None	No	Total	Head entity	Ring-fenced
New Zealand	Consolidation regime	Yes	100%	No	None	No	Total	Group	Included[7]
Norway	Intra-group transfer of income	Yes	90%	N/A	N/A	N/A	N/A	Receiving company	Included
Spain	Consolidation regime	Yes	75%	Yes	None	Yes	Total	Head entity[8]	Ring-fenced
Sweden	Intra-group transfer of income	Yes	90%	N/A	N/A	N/A	N/A	Receiving company	Included
Switzerland	None	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
United Kingdom	Group and consortium relief	Yes	75%	N/A	N/A	N/A	N/A	Receiving company	Ring-fenced
United States	Consolidation regime	Yes	80%	No	None	Yes	Total	Group	Ring-fenced[9]

There are special rules for loss offsets when companies join or leave a group.

In view of its particular relevance to restructuring activity in the banking sector in response to the crisis, it is worth setting out in more detail some of the measures applied by countries in relation to losses of companies joining a domestic group. These rules may be particularly relevant in the context of potential loss-trafficking and in more general terms in relation to the use of tax losses by entities other than those which incurred them. Losses incurred before a company joins a group consolidation regime are ring-fenced (and can therefore only be offset against the income of the entity which incurred them) in **Denmark**, **France**, **Germany**, **Italy**, the

Netherlands, Spain, and the **United States**. This also applies to the **United Kingdom**'s group or consortium relief regimes, with losses of a particular accounting period apportioned where appropriate on a time apportionment basis. Such losses can however be used to offset the group's income in **Australia, New Zealand, Norway and Sweden.**

Cross-border group taxation regimes

Cross-border group taxation regimes exist only in Austria, Denmark, France and Italy.

Austria, **Denmark**, **France**[10] and **Italy** provide for cross-border group taxation regimes, and the main features of these are summarised in the table below.

Austria and **Denmark** allow a non-resident company to act as the head of a consolidated group, provided that shareholdings in the consolidated subsidiaries are effectively connected to a PE in Austria or Denmark respectively. **France** and **Italy** allow only resident companies to act as head of a cross-border consolidated group. **Austria** allows the taxpayer to choose which entities should be included in the consolidated group, while **Denmark, France** and **Italy** provide for an all-in principle where any election for cross-border consolidation has to apply to all qualifying entities. Provided the minimum shareholding requirements are met, there is full consolidation in **Denmark**, while in the case of **Austria**, **France** and **Italy** this is in proportion to the parent's share of the profits of the foreign entities.

Pre-consolidation losses are ring-fenced in **France**, and can be utilised only against the income of the company that incurred them. In **Austria**, **Denmark** and **Italy**, pre-consolidation losses are completely disregarded for purposes of the consolidation regime. On termination of the regime, either overall or in relation to a foreign loss-making subsidiary, all four countries with cross-border group taxation regimes recapture foreign losses which were included in the total income of the consolidated group.

Table A.2. Summary of cross-border group taxation regimes

Country	Head entity	Owner-ship	All-in?	Term	Ruling	Determination of taxable income	Degree	Pre-consolidation losses	(Early) termination of the regime
Austria	Resident or PE of EEA company	>50%	No	3 years	No	Austrian	Proportional	Disregarded	Recapture of losses
Denmark	Resident or PE of non-resident company	Control	Yes	10 years	No	Danish	Full	Disregarded	Exit
France	Resident	50%	Yes	5 years	Yes	French	Proportional	Ring-fenced	Recapture of losses
Italy	Resident	>50%	Yes	5 years[11]	Yes	Italian	Proportional	Ring-fenced	Recapture of losses

Carry-over of losses

Carry-over of losses (forward or backwards) is a feature of all tax systems, though there are marked differences between countries.

Administrative and fiscal considerations, as well as the necessity of counteracting abuse, play a major role in designing the rules on the carry-over of losses. Generally, the basis for carry-over of losses is that the right to carry over losses lies with the company which has suffered the loss. In case of a change in the economic and/or legal identity of the company, the question arises whether the company maintains the rights to carry over its losses. Most countries limit this right when there has been a change of ownership and/or of activity in the company which suffered the losses. These restrictions are in some cases subject to exceptions under the applicable legislation.

Loss carry forward is provided in all the participating countries, while loss carry-back is only allowed in few countries. Some countries provide for quantitative limitations on the deduction of losses carried back or forward.

A summary of the main features of country rules on loss carry-overs is included in the following table.

Table A.3. Main features of country rules on loss carry-overs

Country	*Loss carry-back*	*Loss carry-forward*	*Restrictions*	*Exemptions*	*Rulings*
Australia	No	Indefinite	Change of ownership and activity	No	Yes
Austria	No	Indefinite[12]	Change of ownership and activity	Other (non-tax) considerations	No
Canada	3 years	20 years	Change of ownership	No	No
Denmark	No	Indefinite	Change of ownership and other criteria[13]	No	No
France	3 years	Indefinite	Change of activity	No	Yes
Germany[14]	1 year	Indefinite	Change of ownership	Other (non-tax) considerations	No
Ireland	1 year [15]	Indefinite	Change of ownership and activity	Internal reorganisations	No
Italy	No	5 years[16]	Change of ownership and activity	Other (non-tax) considerations	Yes, in some cases
Mexico	No	10 years	Change of ownership and activity,[17] mergers[18]	Inheritance, donation, internal reorganisation, merger and split off that are not considered alienations for tax purposes[19]	In case of internal reorganisations and mergers, sometimes it is necessary to obtain rulings.
Netherlands	1 year [20]	9 years	Change of ownership and activity[21]	Lack of tax avoidance motive	No
New Zealand	No	Indefinite	Change of ownership	Ownership tracing concessions Internal reorganisations[22]	No
Norway	No [23]	Indefinite	Change of ownership and other criteria	Lack of tax avoidance motive	No
Spain	No	15 years[24]	Change of ownership[25]	Internal reorganisations	No
Sweden	No	Indefinite	Change of ownership[26]	Internal reorganisations	Yes, in some cases
Switzerland	No [27]	7 years	Change of ownership and restart of activity	Financial Restructurings	No
United Kingdom	1 year [28]	Indefinite (against profits of the same trade)	Change of ownership and activity	Internal reorganisations	No
United States	2 years[29]	20 years	Change of ownership	No	No

Carry-back rules, where available, allow a company an early cash-flow benefit.

In view of its particular relevance to restructuring activity in the banking sector in response to the crisis, it is worth setting out in more detail some of the measures applied by countries in relation to carry over of losses. The following countries allow losses to be carried back within a certain timeframe, as a result of which a company will receive an early cash-flow benefit through repayment of tax already paid: **Canada** and **France** (3 years), the **United States** (2 years), **Germany**, **Ireland**, the **Netherlands** and the **United Kingdom** (1 year). On the other hand, **Australia**, **Austria**, **Denmark**, **Italy**, **Mexico**, **New Zealand**, **Norway**, **Spain**, **Sweden**, and **Switzerland** do not allow the carry-back of losses.

In some countries, there have been changes in these rules triggered by the financial crisis. For example, the **United Kingdom** introduced a temporary extension of loss carry-back for 2 years, allowing a maximum of £50,000 per annum to be carried back up to 3 years. The **Netherlands** has introduced an optional 3-

year loss carry-back for losses incurred in 2009 and 2010, up to an amount of 10 million per year (any remaining losses can be carried forward for 6 years). Similarly, **Norway** has introduced temporary provisions which give companies the possibility to carry-back losses incurred in 2008 and 2009 for two years, up to an amount of NOK 20 million per year.

Carry forward provisions differ in relation to the length of carry-over and in some cases the amount which can be relieved in any year.

All participating countries allow losses to be carried forward against certain future profits. **Australia**, **Austria**, **Denmark**, **France**, **Germany**, **Ireland**, **New Zealand**, **Norway**, **Sweden** and the **United Kingdom** do not provide for any time limitation, allowing therefore losses to be carried forward potentially indefinitely. Other countries instead provide for a time limitation: **Canada** and the **United States** (20 years), **Spain** (15 years), **Mexico** (10 years), the **Netherlands** (9 years), **Switzerland** (7 years) and **Italy** (5 years). **Austria** limits the possibility of offsetting carried-forward losses to 75% of the income. In **Germany**, only 60% of profits in excess of 1m may be offset against carried forward losses. In the **United Kingdom** and **Ireland** losses can be carried forward only against profits of the same trade.

There are also different restrictions triggered by a change in the ownership and/or the activity of the loss-making company.

All countries covered in this Report restrict the ability to carry losses back or forward when there is a change of ownership and/or of activity. In **Denmark**, these restrictions do not apply in the case of financial enterprises, including banks. **France** provides for restrictions to losses carry-over in the case of a change of activity, whether or not there is a change in ownership. **Germany**, **New Zealand**, **Norway**, **Spain**, **Sweden** and the **United States** apply restrictions in the case of a change of ownership, while restrictions in **Australia**, **Austria**, **Canada**, **Ireland**, **France**, **Italy**, the **Netherlands**, **Mexico**, and the **United Kingdom** apply only if there is a change of both ownership and activity.

The definition of "change of ownership" varies between countries.

The determination of whether there has been a change of ownership for purposes of the relevant legislation varies from country to country. This applies for instance as regards the focus of the change, with some countries focusing on the share capital, others on voting rights or on both. Also the relevant percentage varies among different countries, ranging from *e.g.* 30% in the **Netherlands** to 75% in **Austria**. Finally, country rules also vary in relation to the time span over which the existence of a change is evaluated. Generally, the restrictions apply only when there is a change in the direct ownership of the loss-making company, thus carving out cases where there is only an indirect change in ownership. However, the rules applicable in **Australia**, **Germany, New Zealand**, the **Netherlands** and the **United States** also cover an indirect change of ownership.

The question of what is a "change of activity" gives rise to particular uncertainty, and also varies between countries.

The question of what constitutes a change of activity for the purpose of carry-over rules varies considerably from country to country, and it appears that by no means all forms of banking would be regarded as one activity for this purpose. This may be particularly relevant in the context of the recent bank takeovers in which there has been a change in the relative mix of activity (*e.g.* investment banking, retail banking, asset management activity) of the acquired bank.

In **France**, a change of actual activity or substantial change of corporate purpose can lead directly to a forfeiture of any loss carry forward. In **Australia,** if the change of ownership test fails, the losses carried forward may still be deductible if the company carries on the same business as it was carried on immediately prior to the change. The same business test (SBT) focuses on more than a change in activity of the loss company. It also incorporates a new business test and a new transactions test. In broad terms, the SBT requires: (i) the company to carry on the same business for the whole of the income year as it carried on immediately before the failure of the COT; (ii) the company must not, for the whole of the income year, derive assessable income from a business of a kind it did not carry on before the failure of COT; and (iii) the company must not, for the whole of the income year, derive assessable income from a transaction of a kind it had not entered into in the course of its business operations before the failure of COT. In **Austria,** if after a substantial change of ownership, the identity of the taxpayer changes, through a substantial change of the organisational and economical structure, then the loss carry forward is forfeited. In **Canada**, after an acquisition of control of a company, non-capital business losses can be carried forward and post-acquisition non-capital business losses can be carried back if the business is carried on with a reasonable expectation of profit throughout the year and only to the extent of income from the loss business or a similar business. In **Italy**, the loss carry-forward is forfeited if a change in the main business activity of the company occurs within the two years following or preceding the change of ownership. In **Mexico**, the loss carry forward can only offset profits from the same type of activity that generated the losses if the sum of the receipts derived during the last 3 years is less than the accumulated losses of the company. In the case of mergers, only the merging company can carry forward the losses it has at that moment, and only for purposes of using them against profits derived from the same trade that originated the losses. In the **United Kingdom,** if there is within a period of three years a change of ownership of a company and a major change in the nature or conduct of a trade, trading losses incurred by the company in an accounting period beginning before the change of ownership cannot be carried forward against any income or other profits of an accounting period ending after the change of ownership. The same applies if the trade has become small or negligible and there is considerable revival of the trade after a

change of ownership. A major change in the nature or conduct of a trade includes a major change in the type of property dealt in, or services or facilities provided, in the trade, or a major change in customers, outlets or markets of the trade. Similar rules exist in **Ireland**.

These restrictions may not apply in some countries on internal reorganisations, if there is no tax avoidance ...

Some countries provide for an exception to the restrictions on the use of losses in the case of internal reorganisations. Specifically, in **Mexico**, **Spain**, and **Sweden** the restrictions on the carry forward of losses do not apply for group intern restructurings. In **New Zealand** losses can be carried forward after an internal group restructure if continuity and commonality requirements are met. In the **United Kingdom** and in **Ireland**, if a trade is transferred to another company within a 75% ownership relationship, losses may be carried forward against profits of the successor company attributable to the same activities.

Some countries provide for an exception to the restrictions on the use of losses in the case where the taxpayer demonstrates that the change of ownership and/or of activity is not made for tax avoidance purposes. This is the case in **Norway.** In **Mexico**, there is an exception to the restriction regarding the change of ownership and activity (and not to one regarding mergers), in the case of inheritance, donation or an internal reorganisation, and merger or split off that are not considered alienations for tax purposes. An exception to the restriction is also provided for in the **Netherlands** in relation to certain changes in the level of trading, provided that most of the assets of the company are not passive investments.

… or if there are specific exceptions to facilitate commercial rescue/ restructuring plans.

Some countries provide for an exception to the restrictions on the use of losses for non-tax considerations, such as the maintenance of the work force of the loss-making company or the investments made or to be made in the following years. Specifically, in **Germany** the forfeiture does not apply if the transfer takes place in the course of a restructuring plan in order to rescue a loss-making company. Similar rules exist in **Italy** and **Austria**.

Losses of a foreign PE

Whether losses of foreign branches are relieved generally depends on whether a country relieves juridical double taxation by credit or exemption.

The tax treatment of losses incurred through foreign PEs is generally linked to the method through which double taxation is relieved. Countries which relieve double taxation through the ordinary foreign tax credit method generally take into account profits and losses derived through a foreign PE in the determination of the taxable income of resident companies. The countries covered in this Report which apply the credit method are: **Canada**, **Ireland**, **Italy**, **Mexico**, **New Zealand**, **Norway** (losses are not deductible if the exemption method applies to relieve on double taxation on PE income in the relevant tax treaty), **Spain**, **Sweden**, the **United Kingdom** and the **United States**. **Austria**,

Germany, and **Spain** also apply the credit method when the conditions for the application of the exemption system are not met or when the taxpayer has so elected.

Subject to certain conditions **Austria**, **Australia**, **Denmark, France**, **Germany**, the **Netherlands**, **Norway**, **Spain** and **Switzerland** generally apply the exemption method to relieve double taxation on foreign PE profits. The way in which the exemption method is applied varies. In **Australia**, **Denmark** (unless an international group consolidation regime applies), **France**, **Germany** and **Norway**, both foreign profits and losses are exempt and therefore foreign losses do not reduce the taxable base of a resident taxpayer. In **Austria**, the **Netherlands**, **Spain** and **Switzerland**, although foreign profits are exempt from tax, foreign losses do reduce the taxable base of resident taxpayers. In these countries, it is however provided that foreign losses which have been deducted in the residence State are recaptured in future years, *e.g.* when the foreign PE derives profits or when the foreign PE is alienated or converted into a subsidiary.

Losses of a foreign subsidiary

Losses of foreign subsidiaries are generally not deductible in the country of the parent company, though there are some exceptions.

As a general rule, losses of a foreign subsidiary are not taken into account in the State of residence of the parent company. Where an international group consolidation regime is available (**Austria**, **Denmark**, **France** and **Italy**), losses of a foreign subsidiary may be taken into consideration insofar as an election for the application of the regime has been made.

In the **United States,** profits or losses of a foreign entity may be passed through or otherwise recognised by the US owner of a foreign entity if in the US the foreign entity is treated as a disregarded entity, partnership, or other flow-through entity.

Where Controlled Foreign Companies (CFC) or similar rules are in force, the question arises as to whether losses incurred by the foreign entity can be deducted at the level of the resident shareholder. In **Spain**, losses of the controlled foreign company are directly attributed to the resident shareholder. On the other hand, **Canada**, **Germany**, **Mexico,** the **United Kingdom** and the **United States** do not attribute losses of the controlled foreign entity to the resident shareholder. **Australia**, **Denmark, France**, **Italy**, **Norway** and **Sweden**, although not directly attributing the losses of the controlled foreign company to the resident shareholder, allow for the carry-forward of such losses when determining the income of the foreign entity for CFC purposes. In **New Zealand,** a CFC loss may be offset only against CFC income (or foreign investment fund income calculated under the branch equivalent method) derived from the same country. Any additional CFC loss can be carried forward to a later year against income derived from the same country. The issue does not arise in **Austria**, the

Netherlands, **Ireland** and **Switzerland**, which have not enacted CFC rules.

Some countries (**Ireland**, **Sweden** and the **United Kingdom**) expressly allow for the deduction of losses incurred by a foreign subsidiary resident in an EEA country if such losses cannot be offset anywhere else.

Restrictions on the dual use of losses

A number of countries rule out double-dip relief for losses.

An increasing number of countries provide that, in certain specific cases, if losses incurred by a resident entity are also deductible under the rules of another country, the losses will not be deductible in the first mentioned country. In other words, the rules are aimed at preventing relief being given twice for the same loss. Countries which have these rules include: **Denmark**, **Germany**, **New Zealand**,[30] the **United States** and the **United Kingdom**.

Notes

1. This column deals with whether all qualifying entities in a group must be included in the consolidation regime.

2. This column deals with whether losses incurred by one entity before (i) the consolidation regime was in place, (ii) the conditions for intra-group transfers of income were met, or (iii) the conditions for group or consortium relief were met, can be offset against the results of other group entities.

3. Losses transferred to the group on election may only be offset against a fraction of the head entity's income and gains.

4. If the company is resident in the EEA.

5. If the company is resident in a tax treaty country.

6. If the company's legal form is comparable to a Dutch NV or BV and it is incorporated under the law of the Netherlands Antilles, Aruba, another EU Member State or a country with which the Netherlands has concluded a tax treaty containing a non-discrimination provision.

7. Subject to certain conditions, i.e. that continuity and commonality requirements are met.

8. With respect of entities leaving the group, unused carry-forward losses are reallocated to these entities according to their portion of losses

9. If acquisition of a joining member of the group constitutes an ownership change pursuant to section 382, then only the section 382 loss limitation rule would apply.

10. In practice banking groups have not made use of the French cross-border group taxation regime.

11. Three years for subsequent renewals.

12. A loss carry-forward can only offset 75% of income.

13. These rules do not apply to financial enterprises, including banks.

14. Monetary restrictions apply to the carry-back and to the carry-forward of losses.

15. If a trade is permanently discontinued the loss may be carried back against profits of the same trade for the previous 3 years.

16. Losses which occur in the first three years from the beginning of the business activity can be carried forward indefinitely.

17. After a change of control and of ownership activity, a loss carry-forward can only offset profits from the same type of activity that generated the losses if the sum of the receipts derived during the last 3 years is less than the accumulated losses of the company.

18. Where a merger is carried out, only the merging company can carry forward the losses it has at that moment, and only for purposes of using them against profits derived from the same trade that originated the losses.

19. These only apply in the case of change of ownership and activity not to the case of mergers.

20. Optional three year loss carry-back for losses from 2009 and 2010, for remaining losses a loss carryforward of six years is allowed.

21. Additional restrictions are applicable in the case of holding and group financing companies.

22. In New Zealand losses can be carried forward after an internal group restructure if continuity and commonality requirements are met.

23. In case of liquidation a two year loss carry-back is allowed. In addition, a temporary two year loss carry-back has been introduced for losses from 2008 and 2009.

24. For newly established companies, the 15-year carry-forward period commences as from the first tax year in which profits are made.

25. The amount of losses available for carry-forward is reduced reduced by the difference between the parent company´s basis in the shares and the selling price.

26. After an acquisition of control of a company, the loss carry-forward is deductible only up to 200% of the acquisition price and it is not possible to use the loss carry-forward of the acquired company through group contributions during the first 5 years after the change of ownership.

27. One canton (Thurgau) allows a one year loss carry-back for local taxes (§ 83 StG Thurgau).

28. If a trade is permanently discontinued certain losses may be carried back against profits of the same trade for the previous three years.

29. Generally two years but up to five years for 2008-2009 losses.

30. Although New Zealand does not have rules specifically preventing the dual use of losses, it has rules which state that an entity does not have the ability to offset tax losses in New Zealand if it is resident in New Zealand and treated as not being resident by virtue of a double tax agreement or liable to income tax in another country, through domicile, residence or place of incorporation.

Glossary of acronyms and technical terms

This glossary is intended to help readers to understand the context in which certain technical terms are used for purposes of this report. It does not intend to provide a legal definition of the different terms.

AAA-rated securities A security rated "AAA" has the highest rating assigned. This rating indicates extremely strong capacity to meet financial commitments.

Advance Ruling A written statement issued to a taxpayer by a revenue body that interprets and applies the tax law to a specific set of facts and is binding upon the revenue body.

ATP (Aggressive Tax Planning) Consistent with the OECD report *Building Transparent Tax Compliance by Banks* (2009), this refers to two areas of concern for revenue bodies:

- Planning involving a tax position that is tenable but has unintended and unexpected tax revenue consequences. Revenue bodies' concerns relate to the risk that tax legislation can be misused to achieve results which were not foreseen by the legislators. This is exacerbated by the often lengthy period between the time schemes are created and sold and the time revenue bodies discover them and remedial legislation is enacted.
- Taking a tax position that is favourable to the taxpayer without openly disclosing that there is uncertainty whether significant matters in the tax return accord with the law. Revenue bodies' concerns relate to the risk that taxpayers will not disclose their view on the uncertainty or risk taken in relation to grey areas of law (sometimes, revenue bodies would not even agree that the law is in doubt).

ATP Directory A secure OECD on-line platform for sharing non-taxpayer specific information on aggressive tax planning schemes, so as to improve the response time to emerging global tax risks, trends and patterns already identified and experienced by some revenue bodies, and to share experiences in dealing with them.

Audit All revenue bodies have processes to check the accuracy of tax returns and to allow them to obtain further information to verify the accuracy of items included. The means by which these processes are undertaken and the mechanisms and objectives of each country differ. Terms such as audit, examination, enquiry, control, intervention and investigation (although in some countries the term "investigation" is only used for criminal matters) are used by different countries. For the purposes of this report, the term "audit" describes all these processes.

AOA (Authorised OECD Approach) The OECD approach as contained in the 2008 Report on Attribution of Profits to Permanent Establishments

ABS (Asset-backed securities) An asset-backed security is a security whose value and income payments are derived from and collateralised (or "backed") by a specified pool of underlying assets. The pool of assets is typically a group of small and illiquid assets that are unable to be sold individually. Pooling the assets into financial instruments allows them to be sold to general investors, a process called securitisation, and allows the risk of

investing in the underlying assets to be diversified because each security will represent a fraction of the total value of the diverse pool of underlying assets.

Artificial loss Loss claimed for tax purposes, without the taxpayer incurring an economic loss.

Back-to-back arrangements Indirect lending arrangements under which funds are lent through an intermediary which enters into separate but symmetrical loan agreements with the lender on the one hand and the borrower on the other. May also describe more loose arrangements where, *e.g.* one party guarantees a loan made by an unrelated financial institution to another party. The ultimate lender and borrower are typically related parties, *e.g.* members of the same corporate group. Back-to-back loans may be used in order to circumvent, *e.g.* thin capitalisation rules, or as a treaty shopping device to obtain the benefit of more favourable withholding tax rates.

Call options Contract under which the holder of the option has the right but not the obligation to purchase securities or commodities, including foreign currencies, on or before a specified date for a specified exercise price. A call option may be privately entered between two parties, or in the case of publicly traded securities and commodities, may be purchased on an organised exchange.

Put option Contract under which the holder of the option has a right but not an obligation to sell assets such as securities or commodities, including foreign currencies, for a specified price during a specified period. A put option may be privately entered between two parties or, in the case of publicly traded securities and commodities, may be purchased on an organised exchange.

CDOs (Collateralised Debt Obligations) Collateralised debt obligations are a type of structured asset-backed security (ABS) whose value and payments are derived from a portfolio of fixed-income underlying assets.

CDS (Credit Default Swap) A Credit Default Swap (CDS) is a financial instrument used to transfer the credit risk of a reference entity (corporate or sovereign) from one party to another. In a standard CDS contract one party purchases credit protection from another party, to cover the loss of the face value of an asset following a credit event. A credit event is a legally defined event that typically includes bankruptcy, failure-to-pay and restructuring. This protection lasts until some specified maturity date. To pay for this protection, the protection buyer makes a regular stream of payments, known as the premium leg, to the protection seller. This sise of these premium payments is calculated from a quoted default swap spread which is paid on the face value of the protection. These payments are made until a credit event occurs or until maturity, whichever occurs first.

CFC (Controlled Foreign Companies) Companies outside a country's tax jurisdiction because they are non-resident, but which are controlled by a resident shareholder. CFC legislation is usually designed to combat the sheltering of profits or income of resident companies in CFCs resident in low- or no-tax jurisdictions by imposing a tax charge on the resident shareholder equivalent to all or part of the CFC's profits or income.

Compliance risk Risk that the correct amount of tax may not be paid to the Government.

Credit method A method of relieving international juridical double taxation under which, in general, a taxpayer's State of residence provides a credit for foreign tax paid with respect to income derived from (or capital situated) abroad. The credit is generally limited to the amount of domestic tax corresponding to the foreign income (or capital).

Debt waivers The forgiveness or waiver of a debt may give rise to tax consequences for the debtor and/or creditor. For example, it may be treated as giving rise to taxable income for the debtor or as an informal capital contribution by the creditor.

Double-dip A situation in which for example the same loss is deducted for tax purposes in more than one jurisdiction.

DTAs (Deferred Tax Assets) Deferred tax is an accounting concept (also known as future income taxes), involving a future tax liability or asset, resulting from temporary differences or timing differences between the accounting value of assets and liabilities and their value for tax purposes.

Enhanced relationship A collaborative, trust-based relationship between revenue bodies and taxpayers who abide by the law and go beyond statutory obligations to work together co-operatively. See also the 2008 Report Study into the Role of Tax Intermediaries.

EPS (Earnings per Share) The portion of a company's profit allocated to each outstanding share of common stock.

EEA (European Economic Area) Created by agreement between the European Union (EU) and the European Free Trade Association (EFTA), with effect from 1 January 1994. It allows EFTA States which are not members of the EU to participate in the EU Internal Market on the basis of their application of internal market relevant *acquis*.

Exemption method A method of relieving international juridical double taxation under which, in general, a taxpayer’s state of residence exempts from tax income derived from (or capital situated) abroad.

FTA (Forum on Tax Administration) The FTA was created in July 2002 by the OECD Committee on Fiscal Affairs (CFA) with the aim of promoting dialogue between tax administrations and of identifying good tax administration practices. Its members are the heads of tax administrations from OECD and non-OECD economies.

HNWI (High Net Worth Individual) Individuals at the top of the wealth or income scale. The term high net worth individuals is used broadly and thus includes both high wealth individuals and high income individuals.

Hybrid entity Entity that is characterised differently in two or more jurisdictions, for example, an entity that is treated as a partnership in one jurisdiction and as a corporation in another.

Hybrid instrument Any instrument classified differently under the tax laws of two or more countries.

IAS/IFRS (International Accounting Standards/International Financial Reporting Standards) IAS are a set of accounting standards issued by the IASB. The more recent standards are referred to as International Financial Reporting Standards (IFRS). The standards are applied on a voluntary basis, and are directed in the first place towards listed enterprises. Under an EU regulation, all listed EU companies must adopt these standards in their consolidated accounts from 2005.

JITSIC (Joint International Tax Shelter Information Centre) JITSIC is an initiative of various tax administrations designed to supplement their ongoing work in identifying and curbing perceived abusive tax avoidance transactions, arrangements, and schemes.

Loss trafficking Loss trafficking refers to a market in tax losses, for example where a profitable company purchases an unprofitable company with accumulated tax losses only for the purpose of carrying over the losses and setting them off against its own profits.

NPV (Net Present Value) The difference between the present value of cash inflows and the present value of cash outflows.

PE (Permanent Establishment) Term defined by Article 5 of the OECD *Model Tax Convention on Income and Capital* and used to determine when an enterprise resident in one Contracting State is regarded as participating in the economic life of the other Contracting State to such an extent that the business activities of the enterprise come within the taxing jurisdiction of that other State.

P-E (Price-Earnings) ratio The P-E ratio (price-to-earnings ratio) of a stock is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share.

Pre-tax profit/loss Profit/loss reported before (corporate) tax effects are considered**.**

Realised tax losses The amount of negative taxable profits/income/gains in respect of which a taxpayer has an established entitlement to potential tax relief in the relevant jurisdiction – subject to there being actual profits *etc*. against which the loss can be offset. See also unrealised tax losses.

Regulatory authorities Public authorities or government agencies which set and enforce standards in areas relevant for the banking sector, such as central banks, prudential regulators, and financial reporting regulators.

Regulatory capital Minimum level of capital to be held by banks to cover credit risk

Securitisation The process of issuing new negotiable instruments backed by cash-flow producing existing assets such as loans, mortgages, credit card debt or other assets.

SIVs (Special Investment Vehicles) A subsidiary company with an asset/liability structure and legal status that makes its obligations secure even if the parent company goes bankrupt.

Split hedge The situation where, as a result of an intra-group hedging strategy, losses can be recognised for tax purposes in a jurisdiction other than that in which the gain from an offsetting position is recognised.

Structured finance Broad term used to describe a sector of finance that was created to help transfer risk using complex legal and corporate entities.

Swaps Derivative financial instrument in which two parties agree to exchange payments calculated by reference to a notional principal amount. In the classic interest rate swap agreement two parties contract to exchange interest payments based on the same amount of indebtedness of the same maturity and with the same payment dates; one party provides fixed interest rate payments in return for variable rate payments from the other party and vice versa.

Tax Arbitrage The exploitation of asymmetries between the tax rules of either different countries or the same country to achieve a reduction in the overall level of tax payable.

Tax losses The amount of negative taxable profits/income/gains in respect of which a taxpayer is potentially entitled to tax relief in the relevant jurisdiction (with actual loss relief dependent on there being taxable profits, *etc*. against which the loss can be offset). The term encompasses both capital and revenue losses.

Tax risk The risk that the taxpayer will fail to comply with tax legislation in any of the jurisdictions in which it does business or (from the perspective of the taxpayer) the taxpayer's exposure to uncertainty over its tax liabilities

Tier 1 capital Regulatory capital is classified into different Tiers of capital, based broadly on the permanency of the capital invested. The most permanent capital is Tier 1 capital and consists of items such as paid-up ordinary shares, non-cumulative and non-redeemable preference shares, non-repayable share premiums, disclosed reserves and retained earnings. Tier 2 capital includes items such as subordinated debt instruments, long-dated debt, and certain reserves.

Transfer pricing The terms and conditions applying to transactions between associated enterprises.

TPG (Transfer Pricing Guidelines) The *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* provide guidance on the application of the "arm's length principle" for the valuation, for tax purposes, of cross-border transactions between associated enterprises.

Unrealised tax losses A future tax loss, not yet recognised or crystallised for tax purposes. For example, a tax loss may be recognised in some circumstances only when an asset is disposed of ("realisation basis"). In such circumstances, an asset whose value has fallen may be regarded by the company owning it as giving rise to an unrealised tax loss, which would be realised only at the point that the asset is sold.

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Addressing Tax Risks Involving Bank Losses

The financial and economic crisis had a devastating impact on bank profits, with loss-making banks reporting global commercial losses of around USD 400 billion in 2008. This level of commercial losses has brought tax risks for both banks and revenue bodies. These risks affect banks' profits, their capital base, and their level of certainty. For revenue bodies, the concern is that aggressive tax planning involving losses will further reduce already depleted tax revenues as a result of the crisis.

This comprehensive report:

- sets the market context for bank losses and provides an overview of the tax treatment of such losses in 17 OECD countries;
- describes the tax risks that arise in relation to bank losses from the perspective of both banks and revenue bodies;
- outlines the incentives that give rise to those risks, including incentives related to the regulatory capital treatment of accumulated tax losses accounted for as deferred tax assets;
- describes the tools revenue bodies have to manage these potential compliance risks; and

It concludes with recommendations for revenue bodies and for banks on how risks involving bank losses can best be managed and reduced.

Further reading

Building Transparent Tax Compliance by Banks (2009)

Engaging with High Net Worth Individuals on Tax Compliance (2009)

Study into the Role of Tax Intermediaries (2008)

The full text of this book is available on line via this link:
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