



FINANCIAL INSTITUTIONS AND INSTRUMENTS—TAX CHALLENGES AND SOLUTIONS

Background Paper for the International Tax Dialogue Conference¹

Beijing, October 2009

¹ * The paper has been prepared by staff of the IMF and OECD, with input from staff of the other organizations participating in the ITD. The views expressed here not official positions of any of these institutions, but rather are those of the individual authors. Comments are welcome, and should be addressed to the ITD secretariat via email (Rebecca.BREACH@oecd.org).

Contents

Page

| | |
|--|----|
| I. Scope, Objectives and Framework of the Conference | 1 |
| A. Taxing the Financial Sector—Why is it so Important?..... | 1 |
| B. Why is it so Challenging? | 2 |
| C. Neutrality—A Key Benchmark..... | 4 |
| D. The ITD Conference—Addressing the Challenges | 4 |
| II. Taxing Financial Instruments and Other Capital Income | 5 |
| A. The Financial Sector and the Taxation of Capital Income—Principle | 5 |
| B. The Financial Sector and the Taxation of Capital Income—Problems..... | 7 |
| C. Taxation and Corporate Finance <i>Session 14</i> | 10 |
| D. Innovative Financial Instruments <i>Session 4</i> | 11 |
| E. Dealing with Asymmetries in the Taxation of Capital Income..... | 13 |
| F. Islamic Finance <i>Session 7</i> | 16 |
| III. Taxing Financial Institutions | 17 |
| A. Banks <i>Session 5</i> | 18 |
| B. Insurance Companies <i>Session 6</i> | 21 |
| C. Collective Investment Vehicles <i>Session 11</i> | 22 |
| D. Private Equity and Hedge Funds <i>Session 9</i> | 26 |
| E. Sovereign Wealth Funds..... | 28 |
| IV. Taxing Financial Services and Transactions | 29 |
| A. The Value Added Tax <i>Session 10</i> | 29 |
| B. Financial Transactions Taxes <i>Session 12</i> | 32 |
| V. Administration | 33 |
| A. Financial Institutions Play Key Roles in Implementing the Wider Tax System | 33 |
| B. Controlling Financial Institutions in Developing Countries | 34 |
| C. Financial Institutions and Aggressive Tax Planning..... | 35 |
| D. Tax Policy Initiatives | 37 |
| E. Administrative Initiatives | 37 |
| F. International Exchange of Tax Information | 38 |
| VI. Issues for the Conference..... | 39 |
| Tables | |
| 1. Taxation of Investment Funds in Selected EU Countries..... | 23 |
| Boxes | |
| 1. Financial Equivalences—Put-Call Parity..... | 12 |

I. SCOPE, OBJECTIVES AND FRAMEWORK OF THE CONFERENCE

The conference will examine a key set of issues for financial sector tax policy and administration, which revolve around neutrality as a benchmark. What precisely does this mean? Is it always desirable? How can it be achieved? What are the current and prospective challenges for taxation of the financial sector, and how can they be addressed?

The financial sector encompasses banks, insurance companies, mortgage companies, investment and pension funds, stock brokerages, and a wide range of investment advisory services and other institutions, including informal lenders. Its core functions are to intermediate between, and share risk across, savers and borrowers, providing the credit and liquidity upon which business activity hinges. The effective and smooth operation of these functions is crucial not only for microeconomic efficiency and fairness, but also for long-term growth performance and—as has become all too clear over the past year and a half—for macroeconomic stability. The centrality of these functions has long lent the sector special importance. Even in normal economic times, the financial sector receives an exceptional degree of support from government in the form of central bank “lender of last resort” and other guarantees (implicit or explicit), and often in more subtle ways too. At the same time, it takes on a range of quasi-governmental functions, ranging from its central role in credit creation to more prosaic functions such as tax collection.

The 2009 Global Conference of the International Tax Dialogue is concerned with how the taxation of the financial services sector, and the payments and income generated within it, is best structured and implemented so as to best realize strong performance in terms of microeconomic efficiency, sustained growth and macroeconomic stability.

The issues are many. Should taxes bearing on financial markets and activities strive for the conventional objective of “neutrality” relative to what the situation would be in their absence? How exactly can such neutrality be achieved? Are there, on the other hand, non-tax distortions and inefficiencies that the tax system should seek to address by introducing deliberate non-neutralities, or should this be left to regulatory policy? Does financial innovation require a rethinking of the concepts and arrangements that underlie current tax practice? What are the emerging challenges—and opportunities—for tax administrators in dealing with the financial sector, and how can they be addressed?

This background paper sets out some of the key issues that arise in addressing these and other core questions in the taxation of the financial sector.

A. Taxing The Financial Sector—Why Is It So Important?

How financial activities are taxed is critical in several respects:

- There is considerable evidence that a well-functioning financial sector has a key role to play in fostering sustainable economic, social and political development—and

corresponding risk that ill-constructed tax systems can significantly impede the progress on all these fronts.

- There is substantial tax revenue at stake in the financial sector, both directly, in terms of tax on the income of the financial institutions themselves, and indirectly, through its role in collecting a broad range of withholding and transaction taxes. With responses to the financial crisis and looming demographic challenges in many countries implying severe fiscal pressures in the years to come, sheer revenue concerns are likely to come even more to the fore.
- The financial sector is a vital source of information for tax administration—virtually a modern tax handle to match the role played by customs border controls in the past. In developing countries in particular, dealing with the pervasive problem of informality is in large part a matter of fostering development of the financial sector.² The importance of the financial sector within the wider tax implementation context is likely to be brought into even sharper focus by recent work championed by the G-20 and building on the OECD work to promote and implement exchange of information and transparency.
- A lesson of the current crisis is that while taxation did not cause the deep failures of the financial system, it may well have exacerbated it: the tax bias towards the use of debt finance, aspects of the use of complex financial instruments (including their opacity) and the international spillovers arising from cross-border taxation of financial instruments and double taxation of foreign source income may well have proved more damaging than had previously been thought³--and the potential gains from reforming aspects of the tax treatment of financial instruments and institutions consequently larger than previously supposed.

Clearly, there is much at stake—for developing, emerging and developed countries alike—in seeking to get the taxation of the financial sector right.

B. Why Is It So Challenging?

The challenges in imposing taxation on the financial sector are correspondingly large—and indeed even deeper than might have been supposed even a year ago. These arise from elements that make the sector almost uniquely complex and subtle:

² See for instance Roger Gordon and Wei Lei (2005), “Tax structure in developing economies: many puzzles and a possible explanation,” mimeo, National Bureau of Economic Research Working Paper 11267.

³ For detailed discussion of the tax policy issues arising from the crisis, see IMF (2009) “Debt Bias and Other Distortions: Crisis-Related Issues in Tax Policy” (available at <http://www.imf.org/external/np/pp/eng/2009/061209.pdf>); Geoff Lloyd (2009) “Moving Beyond the Crisis: Strengthening Understanding of how Tax Policies Affect the Soundness of Financial Markets” (available at <http://www.itdweb.org/pages/Redirect.aspx?id=10953&type=doc&l=3>); and Joel Slemrod (2009) “Lessons for Tax Policy from the 2008-09 Economic Crisis” (mimeo, University of Michigan).

- There are considerable technical difficulties in taxing both income arising in the sector and the services it sells. These begin with the basic task of defining what constitutes "income," under varying circumstances, and include the characterization of that income for tax purposes, and continue through to the identification of the consumption of services it generates.
- The ease with which financial instruments can be created and transformed⁴ means that any tax rules applied in this sector are particularly susceptible to arbitrage and manipulation through the development and deployment of potentially complex instruments. This in turn has implications not only for tax revenue but for the efficiency of financial arrangements: does arbitrage ease the impact of arbitrary tax design, or does it jeopardize the stability of the wider financial system?
- Conceptually, market failures abound in the financial sector: problems of asymmetric information—borrowers knowing more of their prospects than lenders, financial institutions knowing more of their circumstances than do the government and regulators—are pervasive. Profound questions then arise as to whether the conventional prescription of ‘neutrality’—that taxation should interfere as little as possible with private decision-making—is appropriate, and as to the proper roles of tax and regulatory policies in addressing these failures, without which the financial sector might not even exist. The crisis, of course, makes these questions still more pressing.
- International spillovers arise throughout the financial sector. Even detecting them may be difficult, with further issues arising as to what forms of international coordination might be capable of dealing with them in a way that operates to all countries’ benefit.
- Some countries would also like to use the tax system to curb excessive speculation in the financial sector.
- The financial sector, indeed, has been at the cutting edge of globalization, and marked by rapid innovation. While this has been most evident in higher income countries, the impact is felt by all. Developing countries dealing with sophisticated multinationals—indeed often deriving much of their tax revenue from them—can be substantially affected by their use of hedging and other devices for risk-management: they need to understand their properties and implications, and perhaps avoid the mistakes that higher income countries have made in dealing with them.

⁴ For example, BIS data indicates that the total value of over the counter derivative securities in December 2008 stood at nearly 34 trillion U.S. dollars. These included foreign exchange, interest rate, equity-linked, and commodity contracts, and credit-default swaps. By comparison, total worldwide GDP for 2008 was \$61 trillion (IMF, World Economic Report, 2009).

C. Neutrality—A Key Benchmark

A ‘neutral’ tax system is one that leaves private decisions as they would be in the absence of taxation.⁵ In the present context, this would mean that the financial assets investors held and the institutional arrangements by which they held them would all be unaffected by the tax system. The importance of neutrality in evaluating tax systems is in placing the onus on policy makers to justify using the tax system in a way which distorts the operation of the market. There may in some cases be good reason to suppose that the markets do not in practice work perfectly: for example, non-tax factors such as limited liability create an inherent tendency toward excessive corporate leverage. While this can create a case for tax non-neutralities, there may be non-tax responses—regulatory capital requirements are generally seen as the appropriate response to dangers of excess leverage, for instance—that are better-suited to addressing such market failures. More generally, the nature of these potential inefficiencies is clearly less than fully understood. Care needs to be taken, in any case, that government interventions do not ultimately result in worsening matters.

The importance and usefulness of neutrality is thus not an absolute, but is rather a benchmark relative to which differential treatments may be identified and evaluated, providing a check on special pleading, inadvertent side effects and inequities. Of course, neutrality considerations in taxing the financial sector need to be tempered by distributional and other social concerns, as well as by the practicalities of administration and compliance—all of which may be quite country-specific.

D. The ITD Conference—Addressing the Challenges

The conference breaks down the detailed discussion of these questions into four areas, and this paper is organized correspondingly.⁶ Section II considers the appropriate taxation of financial instruments and the capital income they represent. Section III turns to the appropriate taxation of financial institutions—with the main focus being on taxing the income they generate. The appropriate taxation of financial sector services and transactions is considered in Section IV. Administration issues, challenges and opportunities are the topic of Section V. The paper does not aim to reach firm conclusions, but to raise issues for the conference: these are summarized in Section VI.

⁵ Apart, that is, from the effects from the transfer of resources out of the private sector that is inherent in any form of tax.

⁶ The focus is on issues that are unique to the sector, not on all that arise within it. The tax treatment of alternative forms of executive remuneration, for instance, looms large in the financial sector but, not being inherently unique to it, is not addressed.

II. TAXING FINANCIAL INSTRUMENTS AND OTHER CAPITAL INCOME

A. The Financial Sector and the Taxation of Capital Income—Principle

A large part of what the financial system does is to channel capital income from the users of funds to the suppliers of funds, so that the questions at the heart of the conference are intimately connected with the taxation of capital income. There are, importantly, genuine questions as to whether capital income ought to be taxed at all. These though are usually unrelated to the financial system: theoretical arguments that taxing capital income is inappropriate⁷ would apply even if capital income did not take the form of financial claims but, quite literally, came in the form of the fruit growing on trees purchased by past investments. The view one takes on these deeper questions will affect some of the issues we are concerned with (such as those relating to capital income arising from the sector's own service-providing role and tax withholding roles). We simply take it that one part of the reason for being interested in the tax treatment of the financial sector is because of an interest in taxing—or, indeed, in not taxing—capital income.⁸

With that in mind, the rest of this section introduces core concepts and challenges relating to the role of financial institutions and instruments in taxing capital income.

What is capital income?

Capital income is the return on an asset—interest paid on a bank deposit, for example, or capital gains on shares in a company. It can include several types of return – a pure *time value of money* return (also known as the *risk-free* or *safe* return) representing compensation for deferring the use of the funds invested in an asset; a *risk premium* return to compensate the investor for bearing whatever degree of risk the asset entails; and the income over and above the risk-adjusted return generated by the *use* of an asset, commonly known as *economic rents*, *extra-normal returns* or *inframarginal returns*.

Some capital income is easy to identify, but much is not. Interest on bonds and bank deposits, dividends from shares of public companies and rents from the ownership of a house, for example, are all easily recognizable forms of capital income. However, an important component of capital income can be represented by changes in asset values, and valuations are often based on judgment and convention rather than arms-length prices. Moreover, labor and capital income cannot be separated easily in many circumstances, particularly in the case of closely held firms: colorful jargon like “sweat equity” is sometimes used to refer to the

⁷ Because, for instance, it implies huge distortions to the price of future consumption relative to current consumption.

⁸ Thus we do not enter into the debate as to which of either income or consumption should be taxed (the latter being achieved not necessarily only by indirect taxation but, potentially, with explicit progressivity by either exempting capital income or allowing a deduction for saving). The issues addressed in the conference and paper would not all disappear under the consumption tax route, though they would take a somewhat different form.

capital invested in a company represented by the efforts of entrepreneurs in a venture. How capital income is defined also depends on contractual arrangements required by financial intermediaries and financial markets, which are evolving over time. Their complexity can give rise to problems of definition, especially in the case of derivative instruments and contingent contracts, where gross payment flows between counterparties often do not solely represent the returns on capital.

The role of the corporate tax

Corporate taxation has a critical role in taxing capital income. It acts as a means of withholding against personal capital income of domestic and foreign shareholders, and also provides a backstop to the taxation of labor income, particularly in the case of closely held firms. A key issue here is the difficulty of taxing capital gains on an accruals basis—that is when they arise—at the personal level: if, as is almost invariably the case in practice, capital gains are taxed only on a realization basis—that is, when the asset is sold—then income that is retained and reinvested in the corporate sector can be sheltered from personal tax until it is taken out by either selling shares or taking dividends. Taxing corporate income as it is earned is a way of bringing this income into the tax system at the appropriate time.

To act as a withholding device against domestic shareholders, the base for the corporate tax should be only retained earnings, excluding both interest payments and dividends (since these can readily be taxed at the personal level), with a system of credit for shareholders when they take their income out of the corporation. But of course dividend payments are frequently not deductible, or not deductible in full, by corporations, unlike interest payments. (See Section II B). Tax rules for cross-border transactions, and the interactions between national tax systems, also complicate the use of the tax as a withholding device against foreign shareholders.

A corporate level tax may also be a particularly convenient way of levying a tax on economic rents arising in the corporate sector, the attractive feature of such a tax being that—since rents are by definition payments in excess of the minimum required by the investor—they can be taxed without causing any distortion. International considerations matter here again, however. To the extent that the source of the rents is not specific to a particular location—access to a particular mineral deposit, for instance, or to a protected local market—a tax on economic rents levied by one country may simply drive investments to other jurisdictions offering a lower rate of tax. For a small open economy, there is indeed a fairly robust theoretical argument that no source-based tax should be levied,⁹ though the practical importance of this is muted by, for instance, the backstop role of the corporate tax mentioned

⁹ With perfect international capital mobility, a small open economy faces a perfectly elastic supply of capital from abroad, so the burden of a source based capital tax will be fully shifted onto workers and other immobile domestic factors via an outflow of capital which drives up the pre-tax return. In this process, the productivity of the domestic immobile factors will fall due to a lower capital intensity of production. To avoid this drop in productivity, it is more efficient to tax the immobile factors directly rather than indirectly via the capital tax. Note that this argument for a zero *source*-based tax on investment is distinct from the argument referred to above for a zero *–residence*-based tax on saving.

above, and the availability of foreign tax credits for investors from countries applying worldwide taxation.

Most corporate taxes serve this rent-extraction role only imperfectly, however, since they exclude interest from tax but not the normal return to equity finance. Alternative forms of corporate tax can be envisaged—and have been applied in a few countries—that would seek to tax only rents, routes to this end being to allow a deduction for a normal return to equity (the ‘Allowance for Corporate Equity’, or ACE, system) or allowing immediate expensing of investment but no financial deductions (‘cash-flow’ taxes). These also serve to mitigate the pro-debt bias implied by most corporate taxes.

Risk-taking

The tax treatment of capital income can affect risk-taking by investors, but the effects are complex. In theory, if tax systems provided full offsets for losses, governments would share in both the upside (through taxation of gains) and downside (through full deduction of losses) of risky projects, and so reduce risk for investors.¹⁰ In practice, however, non-linearities in the tax system, such as limited loss offsets, may actually discourage risky investment, which is one reason why some countries impose lower levels of tax on capital gains tax than on income.

B. The Financial Sector and the Taxation of Capital Income—Problems

In practice, tax systems are far from neutral in their treatment of capital income—and are often extremely complex. Financial income is not subject to a uniform treatment (rates, base etc.) under most income tax systems. The assorted provisions that coexist side by side are often the result of accident, a piecemeal approach or the pursuit of political and social objectives. The international dimension of finance has also added to the differential treatment of instruments. The ensuing asymmetries have opened up numerous arbitrage possibilities that potentially endanger tax revenues. In the absence of satisfactory overarching solutions a patchwork of complex norms and regulations has been set up to protect the tax base. The following paragraphs outline some of the more common asymmetries seen in practice.

Realization

For practical reasons, tax systems are largely based on the measurement of income at the time of realization—generally through a market transaction. A realization-based system leads to reductions in the tax burden on some forms of capital income because taxpayers can defer the sale of appreciated assets and hence the payment of taxes (and, conversely, accelerate the sale of loss-carrying assets). Deferral can result in two types of behavioral response. First, as

¹⁰ Investors can scale up their holdings to offset the implicit “equity” participation of the government and attain their desired pre-tax portfolio, leaving them exactly the same net capital income as in the absence of tax. In this case, the capital income tax would apply in effect only to economic rents and the riskless (“normal”) return to capital.

just described, it distorts decisions on when assets are sold, creating potential lock-in or acceleration effects. The second potentially more harmful effect is that deferral may promote activities that are tax-favoured over equally productive activities that are taxed on a current basis. Where capital appreciation takes the form of *ex-ante* definable income the tax system can be adjusted to offset the benefits of deferral, and thus to eliminate the distortion. The solution found for original issue discount bonds, for example, is to distribute tax over time on the basis of the yield to maturity, which is known at the time of issue of the security. This is more difficult in situations where future returns are uncertain.

Uncertainty—capital versus ordinary income taxation

Tax systems generally distinguish between *ex-ante* definable income flows and contracts whose final value is contingent on some uncertainty which will be resolved only over time. This differentiation is often based on the historic legal (but non-economic) distinction between ‘ordinary’ capital income, which is considered to be the fruit resulting from the use of a capital asset, and capital gains and losses, which result from the sale or exchange of capital assets. In some instances, this asymmetry is compounded because the treatment of gains and losses may differ according to whether they have occurred on assets or liabilities, are an income or expense item, or depending upon the type of taxpayer—individual, financial institution, corporation or institutional investor. These distinctions between capital and ordinary income become untenable when derivatives allow a nominally contingent claim to be created from what are basically certain cash flows.

Non-uniformity

The tax systems of most countries subdivide transactions into particular categories which then are subject to specific provisions, resulting in non-uniform characterization of transactions. For example, typically dividends and interest are subject to different tax regimes. Their tax treatment in turn differs from that of other generic forms of payment between third parties. In many jurisdictions it has been debated whether cash flows exchanged under swap arrangements should be treated as interest. Since derivatives and other financial instruments allow easy modification of the external attributes of financial arrangements—transforming dividends into interest payments, for example, through the lending of shares—these distinctions have become increasingly arbitrary.

Non-linearities

Imperfect loss carry-forward and backward provisions, different marginal tax rates according to the characterisation of assets and liabilities and asymmetries of treatment for similar transactions across different types of market participant and jurisdictions produce kinks and non-linearities in tax schedules. Such non-linearities lead to incentives for tax planning and the trading of tax positions.

Tax arbitrage

‘Tax arbitrage’ generally refers to the earning of a relatively high after-tax rate of return through tax-favored instruments, strategies or organizational forms, while financing this using a low-tax source. For example, a high tax bracket investor can borrow from a tax-exempt lender, with the result that the borrower deducts the interest cost while the lender is not taxed on the receipt of the interest. As a result of these behaviors, for any specific investor, the tax system is not neutral. This can lead to imperfections in the workings of capital markets and undesired distortions in the allocation of resources. Tax arbitrage can potentially eliminate tax, or even result in tax rates being negative. The globalisation of finance has expanded the opportunity for arbitrage by facilitating the exploitation of differences in tax treatments across jurisdictions. Transactions may be structured to place at least one end in a low- or no-tax jurisdiction. cursory evidence, such as the growth of business channeled through offshore tax havens, suggests that arbitrage activity and revenue loss can be significant and may be growing. There is as yet little empirical evidence to quantify the extent of revenue loss resulting from the imperfections of the tax systems and aggressive avoidance behavior by taxpayers, although recent work done at the OECD on aggressive tax planning and offshore non-compliance suggest it is large and growing. Although taxation was not at the root of the ongoing financial and economic crisis, tax arbitrage may have exacerbated global imbalances in some regions by creating distortions in the composition of banks’ portfolios, and/or by shaping the debt structure of multinational financial institutions, by affecting subsidiary/parent firm location decisions, or by making foreign lending more attractive than domestic.

Inflation

The correct calculation of capital income hinges on its accurate measurement in real (inflation corrected) terms. Inflation alters the tax base by (a) reducing the real value of deductions based on historical cost for depreciation and materials (b) reducing the real burden (for debtors) and value (for creditors) of debt repayment and (c) distorting the computation of capital gains. With an unindexed tax system, inflation reduces the real after-tax return of taxable assets.¹¹ Assuming a given pre-tax real rate of return and that the inflation rate is fully reflected in nominal interest rates, higher rates of inflation will result in higher effective tax rates for a given statutory rate of tax. By contrast, with leverage and preferred taxation of capital income, inflation can lead to negative tax rates. Indexing the taxation of capital income has been attempted in several countries, but it is difficult to have a fully inflation-proof tax system. Many problems have been encountered with indexation, particularly where inflation indexed securities and unindexed securities co-exist side by side.

¹¹ For example, suppose a bond pays 8 percent interest of which 4 percent represents a real return and 4 percent represents inflation. At a 25 percent tax rate, the after-tax nominal return is reduced to 6 percent, or a 2 percent real after-tax return. The 25 percent statutory tax rate becomes a 50 percent effective tax rate on the real return.

C. Taxation and Corporate Finance *Session 14*

The debt-equity decision

The distinction between debt and equity draws on the historic legal division between creditor interests (bonds and other interest obligations) and ownership interests (shareholders). The extent to which these debt/equity distinctions matter from an economic standpoint in company decisions is the subject of a longstanding controversy. *In the absence of tax factors*, economists have generally taken the view that the legal distinctions between debt and equity are irrelevant to firm valuation and the cost of capital. Famously, the Modigliani-Miller theorem (and later extensions) established conditions under which a company's decision in respect of real investments is independent of its financial decisions. Changes in debt/equity ratios merely represent a change in the sharing arrangement of a given return and risk profile between creditors and shareholders. In other words, a portfolio consisting of a little risky equity and a lot of safe debt should have the same value as a second portfolio with a lot of less risky equity and a little safe debt, if the underlying total risk of each of the two portfolios is comparable.

For tax purposes, however, interest payments are generally deductible in computing corporate profits, and dividends on equity are not:¹² financial decisions then cease to be irrelevant. The taxation of a company financed wholly through debt would thus be equivalent to that of a business in unincorporated form.¹³ Debt can be seen as a way of eliminating double taxation in the corporate form—a way of achieving an “integration” of the corporate and personal tax systems.

In the absence of personal taxes on equity income—as for tax-exempt investors, including for example pension and sovereign wealth funds—debt would clearly be tax-favored. If taxes on equity income are high enough, the preference could be reversed.¹⁴ While there is little

¹² For every \$1 of interest paid, bondholder gets $\$(1-t_p)$ (where t_p is the rate of personal tax on the interest payment). For every \$1 of interest not paid, the company can provide shareholders with $\$(1-t_c)$ (where t_c is the rate of tax on corporate profits) of which they take home $\$(1-t_e)$ (where t_e is some composite of the tax on either dividends or capital gains). So, the net benefit of \$1 of interest is $(1-t_p) - (1-t_c)(1-t_e)$. For example, if $t_p = 40$ percent, $t_c = 35$ percent and $t_e = 20$ percent, then the net benefit from debt is 8 percent. Importantly, the tax benefit to debt is greater the lower the marginal tax rate faced by the investor on interest: in this example if the recipient of interest were tax exempt the net benefit from debt would be 48 percent. For brevity this argument ignores the distinction between equity finance in the form of retaining earnings and subscribing to new equity: on this, see footnote 14 below.

¹³ If the marginal tax rate on debt is equal to that on other investments.

¹⁴ Under the traditional view of dividend payments on equity ownership, this difference between debt and equity would affect the cost of capital. Since the late 1970s, however, some economists have argued that the additional, personal-level tax on dividend income has little or no effect on the cost of capital, because marginal investment is financed primarily through retained earnings rather than new investments from outside the

evidence on this, the scale and activism of exempt investors, and opportunities for the deferral of personal taxation, suggest that debt will in many cases be tax-preferred.

Most recent econometric studies find that taxation does have a small but significant effect on firms' financial policy and capital structure. This is so in various studies covering different regions and using differing methodologies. Empirical evidence on the debt-equity ratios of subsidiaries of multinationals has yielded particularly strong results. One issue which is not fully addressed by this literature is the extent to which leverage has changed over time, and why. This is important for assessing the extent to which *tax* factors or rather other exogenous factors – such as the growth of capital markets or globalization-- have affected leverage. One might have expected, for instance, that the decline in statutory tax rates in recent years would have reduced the tax incentive to use debt.

Nonetheless, companies appear to be far from exploiting fully interest deductibility to reduce their expected tax liability to nil. This is partly due to the non-tax costs of debt,¹⁵ including the costs associated with financial distress. A number of features of the tax system may also attenuate in practice the incentive to leverage associated with the tax deductibility of interest. These include differences in the value of a corporate tax deduction (for example between profitable and loss-making firms), differences in the taxation of individuals (including differences from investing through institutions or investment vehicles rather than directly), the definition of the tax base and the possibility of alternative means of reducing taxable corporate income (i.e. the existence of so-called non-debt tax shields), and explicit restrictions on the deductibility of interest (such as thin capitalisation rules).

The incentives to leverage a company when financed by investors located in other jurisdictions may be much higher. Shifting of revenue from one jurisdiction to another can lead potentially to the absence of any taxation.

A sharp distinction between equity and debt is in any event often misleading. Debt and equity encompass a continuum of different types of claims that mix elements of each. The dividing line between different types of claim has become increasingly tenuous as the widespread use of contingent claims and the growth of so-called hybrid financial instruments have blurred the distinction between equity and debt.

D. Innovative Financial Instruments *Session 4*

The use of innovative financial transactions and instruments has expanded in recent years, primarily due to the need for greater risk management by businesses and financial investors

corporation, and a dividend tax reduces both the implicit cost of retaining income (in dividend income currently forgone) and the return from retaining income (in future dividend income). Taxing dividends thus has no effect on the cost of retention finance, but does increase that of new equity finance.

¹⁵ And presumably also partly due to constraints in issuing hybrid instruments which qualify as debt for tax purposes and function as equity.

which has spurred the development of sophisticated instruments tailored to meet such demands.

A broad group of innovative financial instruments, referred to as "derivative" contracts, call for specified cash flows to be made between the counterparties over time. Unlike traditional debt and equity securities, these instruments generally do not involve a return on an initial investment. Rather, derivative contracts are constructed and priced by reference to values "derived" from an underlying index, commodity, or other item, and their value fluctuates with the market movement of that referenced item. The basic building blocks of derivative instruments can be combined in any number of ways as specified by the counterparties. In particular, derivative contracts can separate each of the discrete economic attributes of a particular position or recombine them into new forms. Significantly, they can also be constructed to replicate any specified set of economic attributes (including those of debt or equity instruments) in a variety of forms (as shown in Box 1). Traditional patterns of investment have also been expanded through securities lending and repurchase agreements. These arrangements permit the owner to transfer title or possession of underlying securities, while retaining the economic attributes of the position.

Derivative instruments and other innovative financial transactions serve legitimate business and investment purposes. The holder can use such products either to take a position carrying specifically defined opportunities for profit and loss, or to offset (i.e., "hedge") the inherent risks of other investments or business activities. This ability to shift, substitute, or transform risks through the use of financial products is an essential tool of modern business and investment.

Box 1. Financial Equivalences—Put-Call Parity

The "put-call parity" theorem shows a fundamental relationship between debt, stock, and options to purchase or sell such stock. It provides a stark illustration of how innovative instruments can be used to construct positions that have different form but are economically equivalent.

Assume that Investor 1 holds a zero coupon bond that matures at date T and has a face value of $\$X$, and a call option to purchase a share of stock on date T at an exercise price of $\$X$. Investor 2, on the other hand, purchases a share of stock at its current value, and also buys a put option which allows her to sell the stock on date T at an exercise price of $\$X$. Put-call parity states that the two investors have economically equivalent positions. That is:

$$\text{Debt } (\$X) + \text{Call Option } (\$X) = \text{Stock} + \text{Put Option } (\$X)$$

(This simplified form ignores the offsetting effects of dividends paid on the stock, as well as transaction costs.) To see this, consider the alternatives for each investor as of date T . Investor 1 holds debt that will return $\$X$ on date T ; he will then have the choice of keeping $\$X$ in cash or using the cash to exercise the call, thus acquiring stock. Clearly, Investor 1 will exercise the call only if the stock is worth more than $\$X$ at date T . Thus, the investment participates in any appreciation of Stock, but is protected from a drop in its value below $\$X$.

Similarly, Investor 2 holds the stock and the right to sell the stock to another party for at least $\$X$; thus she will also participate in any appreciation of the stock above $\$X$, but due to the put rights, the investment will not drop below $\$X$. Accordingly, the two positions are equivalent.

These economic equivalencies can be used to replicate synthetic forms of each of the other financial instruments.

While playing a critical role in risk management, innovative financial instruments also present a number of serious challenges for income tax systems. The traditional income tax categorizations of character, source, and the timing and amount of income are difficult to maintain given the emergence of instruments that can mirror economic attributes of investments in any number of diverse forms. Similarly, the fundamental distinctions in most income tax systems between debt and equity are muddled by instruments providing for returns and risks that are economically equivalent to the financial attributes of debt and equity investments, or any "hybrid" combination of those attributes. "Ownership" of an instrument is also difficult to determine in contracts that replicate, shift or eliminate some or all of the returns and risks of an investment, or under securities lending and repurchase arrangements that transfer legal title but retain economic attributes of an investment.

Tax systems are challenged by two broad and sometimes competing concerns: (a) removing artificial tax barriers to effective risk management strategies; and (b) limiting the opportunities for tax arbitrage. This raises the more general issue of whether reductions in transaction costs associated with financial innovation, and more generally deregulation, have increased the significance of long-standing non-uniformities in the tax system and undermined net revenues. In other words, have tax systems in the past worked as well (or badly) as they have only because non-tax factors caused risk not to be able to be fully hedged, and transactions to be costly? Is this underpinning now under threat?

E. Dealing With Asymmetries In The Taxation Of Capital Income

New tax rules designed to meet these challenges must address—or at least be assessed relative to—the overall tax policy objectives of neutrality and equity, in order both to promote the efficiency of financial markets and to protect the revenue base. This must be accomplished with appropriate attention to the goals of certainty and administrability.

In the light of the challenges and tax law asymmetries described above, countries have applied a range of approaches (or combinations of those) in recent years. These include adopting elements of: (a) elimination of differential treatment through the adoption of transactional analysis; (b) taxation on the basis of accruals; (c) the application of specific formulas; (d) anti-avoidance provisions.

Transactional analysis

The transactional (or so-called "independent instrument" approach) consists in examining each innovative transaction and attempting to achieve substantive consistency in treatment with other known transactions. This independent instrument approach maintains the artificial

differences in the character of income flows which are at the origin of the distortions mentioned in the previous section; each transaction is defined and treated separately before aggregating the overall liability. This approach overlooks the similarities between cash flows, forces taxpayers to define the purpose for which each transaction has been undertaken, and largely ignores overarching financial strategies or methods of managing overall risk exposures. In addition, since there is no unique definition of income the distinction between various types of categories also entails increasingly complex legislation meant, on the one hand, to pigeonhole each new instrument into the specific categories defined by the tax code and, on the other, to establish anti-avoidance provisions.

A typical form of this transactional analysis is the *bifurcation* approach. Often cited is the example of a convertible bond which carries the right of conversion into shares at a specified price. Economically, the instrument consists of a discount bond and an equity option. Adopting bifurcation, each component could be taxed separately according to the provisions for each of these instruments. Bifurcation has the attractive feature that it would permit the individual transaction approach (if it were viewed as worth maintaining) to be applied in a wide range of circumstances once the various categories of each transaction have been identified. In practice, it runs into a number of problems of implementation. First, as already mentioned the system is indeterminate: there are always a number of different ways of subdividing a transaction into component parts. Second, the valuation of the segments may not always be possible if prices for the individual components or comparable instruments are not available. Finally, there may be synergies between the individual components so that the sum of the parts is greater (or less!) than the value of the whole.

Another such approach entails the *aggregation* of various individual transactions. Several countries have adopted "hedge accounting," under which the tax treatment follows economic substance in reflecting a deemed single aggregate transaction, where that is appropriate, rather than the result of looking at each actual component of that wider whole in isolation. A simple example of such a hedge or aggregate transaction is that consisting of a long position in a portfolio of shares against which a futures contract has been sold: the decline in value of the portfolio would be offset by the increase in the value of the position in futures. However where tax systems have moved towards hedge accounting, this has tended to be only on a selective basis, which of itself has introduced new non-linearities.

Accruals taxation

One of the conditions for the consistent treatment of financial instruments is that capital gains and losses must be taxed at the same rate as other sources of revenue or expense. In practice this means that capital gains should be taxed on an accrual basis, via the marking to market of positions. Full accrual and marking-to-market would be the cleanest approach and that which most closely approximates the true rate of return on a portfolio over a particular period. Marking to market has been increasingly adopted for accounting purposes for those financial market participants that frequently turn over their portfolios.

However, marking to market for tax purposes suffers from three distinct problems: (a) not all market participants—especially households—can accurately or conveniently mark to market their position; (b) non-traded assets (or instruments which are traded infrequently) are not easy to mark to market if prices of comparable assets are not available; (c) taxation of unrealised gains may pose cash flow problems that may require borrowing or forced liquidation at the time of tax payment—a legitimate concern if this interferes with the efficiency with which the underlying assets are used. Some of these problems can in part be solved. The marking to market of positions held by households should not be difficult, at least for regularly traded assets, if intermediaries can produce accounts on this basis. Similarly, accrued gains (losses) can be carried forward, held in tax suspension and charged a market rate of interest reflecting the deferral of tax liability, and liquidated either when actual realisations take place or at discrete time intervals. Similarly, to avoid problem (c), tax on accrued income of illiquid instruments may be recognised at a particular period and carried forward at a market rate of interest until the position is sold. Various options could be given for the timing of tax payment which would guaranty neutrality.

There are problems with this approach, however. The financial crisis has highlighted the problem of valuation in the presence of illiquidity. Movements in bid-offer rates during the course of the past year have shown, at times even for government bonds of major EU countries, that liquidity premia can be substantial and extremely volatile.

Full marking-to-market will not be possible for a number of taxpayers and will be imperfect for assets which are not traded frequently.¹⁶ In the light of these problems and given that accrual accounting has increasingly been adopted for a number of transactions, the issues become (a) which type of adjustment to a pure realisation system is preferable in order to avoid deferral and selectivity in the timing of gains and losses; (b) where to draw the line for accrual accounting; (c) how to integrate the taxation of instruments subject to accrual accounting with that of other transactions valued on an adjusted realisation basis. These issues are particularly relevant for the taxation of financial institutions (see Section III).

Formulaic solutions

Even when capital gains are not observed as they accrue but only when realized, the objective of taxing capital gains and losses at the same rate as other sources of revenue or expense can be theoretically achieved by taking account retroactively of past tax accruals. An approximation of the economic effects of accruals taxation may be achieved through some form of retrospective averaging formula or via the imputation of interest to take account of the time value of money gained via the deferral of taxation of accrued gains until realisation. The choice between these methods boils down to practical questions of measurement and of the different information requirements necessary for implementing these mechanisms.

¹⁶ As would be the case not only for some financial assts but also for many non-financial ones, such as works of art.

Anti-avoidance provisions

In recent years, governments have stepped up their effort to curtail the perceived increase in avoidance strategies pursued aggressively by both corporations and individuals¹⁷. This has acted as a backstop protection against the effects of certain asymmetries in the tax system, including, principally, protecting against the resulting loss of tax revenues. For example, the United States and many other countries have longstanding judicial decisions that prohibit ‘sham transactions’, mandate a business purpose, provide that a transaction be taxed in accordance with its substance rather than its form. There are also some regulatory provisions that allow government wide discretion to reformulate transactions. More recently new disclosure requirements for corporate “tax shelters” have been enacted in order to discourage taxpayers from entering into questionable transactions and to give the government earlier notice of such transactions. There are similar measures in other countries too, suggesting that an alternative (or supplementary) response to the problems highlighted above would be to grant more authority to tax administrators to disregard tax-motivated transactions.

F. Islamic Finance Session 7

Islamic finance refers to a system of banking or other financial activity that is consistent with the principles of Islamic law (*Sharia*). The basic principle of Islamic banking is the sharing of profit and loss, and the prohibition of *riba* (usury). The volume of Islamic banking has increased substantially in recent years.

Islamic financial transactions use a variety of techniques instead of loaning money at interest. For example, instead of lending a client money to purchase an item, a bank might buy the item itself from the seller, and re-sell it to the client for one or more deferred payments which include a mark-up. Similarly, in place of a home loan, the bank and the homeowner may form a partnership, both providing part of the capital to purchase the property. The partnership then rents out the property to the home buyer and charges rent, while the home buyer gradually accumulates equity and eventually complete ownership. A profit-sharing arrangement may also be used to provide capital to a business (and the arrangement may be securitized by issuing securities that pay a return based on the borrower’s profitability instead of paying interest). Another technique for providing capital to businesses is for the bank to engage in an equipment lease (i.e., a finance lease). Finally, instead of bank deposits which pay interest, Islamic banks may attract deposits by paying a return to depositors that is linked to the bank’s profitability.

A widely accepted tax policy goal is that the tax system should not impede Islamic financial transactions. Achieving this may require various adjustments to tax rules, depending upon the details of a country's tax system. Whether or not a conventional tax system is able to cope with Islamic finance transactions without a need for specific legislation will depend broadly on the extent to which it follows the economic substance or the legal form of transactions: the

¹⁷ See, for example, the publications “Engaging with High Net Worth Individuals” OECD September 2009 and Building Transparent Tax Compliance by Banks, OECD June 2009.

closer the alignment of conventional tax rules with economic substance, the less adjustment is likely to be needed for Islamic finance transactions. The U.K. is an example of a country which has needed to introduce--and has done so--significant changes to overcome obstacles for Islamic finance within its general tax system. These are couched in terms of 'alternative finance arrangements', rather than expressly in terms of Islamic finance, but address certain types of transactions widely used in Islamic finance. For example, the rules ensure that something which is equivalent, in substance, to the return on an investment of money at interest is treated for tax purposes in the same way as interest. Similarly, the rules disapply anti-avoidance measures to the extent that they would have an unintended impact on Islamic transactions while leaving equivalent conventional transactions unaffected.

Cross-border Islamic financial transactions may raise questions under tax treaties, which may have been negotiated at a time when such transactions were not frequent. Depending on the terms of the treaty, and the specific transaction at issue, there may be difficulties in applying the treaty so as to achieve a level playing field between Islamic and conventional transactions.

III. TAXING FINANCIAL INSTITUTIONS

Financial markets and institutions play a fundamental role in the economy by matching borrowers and lenders, evaluating borrowers, facilitating risk spreading, providing liquidity and making available a wide range of safekeeping and payment related services. This fundamental role is accompanied by a complex regulatory and accounting framework that sets out rules of behavior as well as standards for the calculation of income and risk.

Though there are important overlaps, the objectives of tax policy must be recognized as distinct from those of regulatory and accounting practices. Tax policy with respect to financial institutions is appropriately charged with raising revenue without creating excessive distortions. Elimination of non-tax distortions to financial decisions is a task generally thought to be best left to regulatory policy. Clearly, though, there are monitoring and compliance advantages in applying common definitions and concepts for tax and accounting purposes. There have been substantive discussions of the possible corporate governance advantages in closely aligning the measurement of tax and book profits. And in some cases where tax policy conflicts with desirable regulatory objectives or policies, it may be appropriate to realign tax policy to support these objectives—an example of this is the potential obstacle which loss carry forward restrictions in some countries presented to desirable bank restructuring and mergers in the wake of the current crisis. Nevertheless, the ideal tax base is not necessarily the most accurate measure of income. There could, for instance, be advantages in allowing full expensing of investment for tax purposes, although this would not most accurately measure income for accounting purposes. Similarly, even if marking to market were deemed inappropriate for financial accounting purposes, a strong tax rationale for doing so would remain, in order to avoid distortions.

A number of special issues arise in the taxation of banks and insurance companies. These largely reflect the fact that the “outputs” of financial intermediaries, while easy to identify in theory, can be difficult to measure in practice. The product is typically a complex bundle of services that cannot be easily disentangled. Moreover, some specific types of transactions are unique to financial intermediaries. And, not least, banks and insurance companies loom large in most economies both in terms of asset size and income produced. As such they both provide a very visible target for raising revenue, and also, importantly, operate as remitters of tax for third parties.

A. Banks *Session 5*

Banks¹⁸ are a special form of financial intermediary¹⁹. Although many of the specific features of banking—such as monitoring and evaluating borrowers, providing liquidity, and combining lending and liquidity provision—are carried out by other types of financial intermediaries and through the capital markets, bank lending is indeed special, providing a service that is not easily replicated elsewhere. Banks are unique in that interest income and expenses represent the core of their cash flows; their depreciation allowances for fixed assets are relatively minimal; and the need to value their complex financial transactions (such as activities in the foreign exchange markets, trading in securities and operations in derivative products) is recurrent. Banks are not simply intermediaries, but in many cases also engage in transactions on their own behalf. Banks' and securities companies' valuation of assets and liabilities depends on whether assets and liabilities are held in trading or investment portfolios. If they are held in trading portfolios they are typically marked-to-market; whereas if they are in investment portfolios, they may be subject to accruals accounting.

By the nature of their business, financial institutions are typically highly leveraged, although this is subject to regulation designed to ensure banks' solvency within a competitive environment through sufficient capitalization. Banks face qualitatively the same tax considerations in balancing equity and debt finance (the latter including deposits) as do non-financial corporations. By reducing the perceived probability of default, however, the implicit or explicit guarantee of deposits enables banks in particular to sustain particularly high debt-equity ratios. Indeed the effect of such guarantees in encouraging leverage is one rationale for capital adequacy rules.

The effect of capital adequacy rules, combined with the mobility of financial capital, may encourage banks to prefer to be organized as a network of branches rather than subsidiaries, with internal trading books. This can raise uncertainty over the location of profit for tax purposes.

¹⁸ For further discussion of the tax treatment of banks, see John Isaac (2004), “Banks,” in Howell Zee (ed) *Taxing the Financial Sector* (IMF: Washington D,C).

¹⁹ Building Transparent Tax Compliance by Banks, OECD June 2009.

Tax and regulatory arbitrage are often linked in the case of banks. “Hybrid” financing instruments—instruments functioning as debt for tax purposes but as equity for regulatory and rating agency purposes—have been used to reduce the cost of equity capital. Banks have been very significant users of hybrids as a means to bolster their capital requirements while still obtaining deductions for interest on this capital. The high profitability of financial institutions in recent years—accounting for 25 percent or more of the corporate tax base in some OECD countries—is likely to have made debt more attractive for them than for many non-financial corporations, since the low probability of “tax exhaustion” it implies means that banks are subject to a relatively high effective rate of corporate income tax.

There are many tax asymmetries which can produce distortions in the composition of banks' portfolios. When banks acquire tax-exempt securities, a portion of their interest expenses may be allocated under applicable tax laws to these purchases (and made non-deductible) in order to prevent arbitrage. Such arbitrage problems existed in Italy prior to changes made in the tax code in 1986, which made government bonds there taxable. In countries without such preventive provisions—such as Peru—arbitrage problems continue to exist. And, while helpful, such preventive tax provisions generally work imperfectly. In the United States, for example, in spite of such allocation of interest expenses banks, at least until reforms in 1986, found municipal bonds and other tax-exempt securities to be tax-favored.

Interest income received by banks on foreign loans is subject to special rules, which in some instances increase the profitability of such lending. In general, withholding taxes are levied on a gross interest basis in borrowing countries whereas income taxes are normally imposed on the net income of banks in lending countries. Since the foreign tax credit available to the lender can exceed the net interest margin, foreign lending can be more attractive than domestic business.²⁰

Financial traders are subject to tax on all their financial income (on a mark-to-market basis) at regular income rates, and can use losses on this financial income against other forms of income. In principle, financial trading income is viewed to arise largely as compensation for work effort, similar to employment income and other forms of business income. On the other hand, financial portfolio income is treated on the presumption that taxpayers are not engaged primarily in financial trading. Typically, income arising from sales of portfolio assets will be treated more favorably for purposes of tax, which in part offsets the disadvantage of losses from such activity being ring-fenced.

The tax treatment of loan losses is a central tax policy issue for banks given the importance of loans in bank assets and the correspondingly large potential for bad debts. Losses are an inevitable cost that banks incur in providing credit and are recognized as an expense for

²⁰ In recent years, however, this favorable tax rule has been clawed back in at least the United Kingdom and the United States.

financial, regulatory and tax purposes. The principal issues surrounding the treatment of loan losses concern the timing and manner in which expenses are recognized. These may differ depending on the different objectives pursued by auditors, regulators and the tax authorities. Three constraints affect the level of provisioning and the amounts of write-offs which a bank may make. Supervisors are concerned to see that banks follow a prudent and responsible approach to making provisions. For this purpose they allow general reserves, which have not been earmarked, to be included in bank capital and have generally excluded provisions for specific loans from such calculations. Tax law and administrative practice set out guidelines as to what deductions are allowed against profits, which differ from those requirements. Finally, under applicable securities or corporate law, what banks are required to disclose as doubtful loans on their balance sheets may be different still.

One of the problems in understanding provisioning and its possible effects is that each of these various types of valuation may differ markedly from country to country, and even within a single country. There are broadly two approaches. The so-called *charge-off method* recognizes a tax deduction only when loans become worthless. Countries which follow this approach are the United States, Australia, Korea, Malaysia and the Philippines. The tax authorities in most other countries tend to allow *specific provisions* but this treatment differs widely in terms of the degree of conformity with financial accounting for loan losses, the required evidence regarding the deterioration in asset values, and in some instances the maximum amount of loan-losses allowed in a single year. Among the most generous countries from this standpoint are France, Germany and the Netherlands. Finally, a few countries (for example, Germany and Singapore) also allow deduction for tax purposes of *general provisions*, calculated as a percentage of qualifying loans, subject to limitations.

Provisioning rules can have several effects on the international activities of banks of different nationalities and the allocation of banks' assets across financial centers. Banks may decide to allocate their loans to centers where provisioning is most generous. Generous provisioning policy can be an implicit subsidy to banking relative to other forms of financial intermediation and can affect interest rates charged on differing forms of financing. Generous provisioning may allow certain financial institutions to shield a sizeable part of their income from tax and thereby obtain a competitive advantage. Second, where accounting and fiscal definitions of income do not broadly coincide, banks may be unwilling to set aside an appropriate level of provisions unless the tax authorities permit tax deductibility. This may have significant implications for financial stability. Early recognition of expected losses through provisioning helps to contain excessive expansion of credit and risk-taking in booms, and provides better buffering of losses in the downturn. The costs of financial instability caused by inadequate provisioning should therefore be weighed against the revenue costs of allowing tax deductibility. Finally, different tax provisioning policies can affect the character of risk-taking by banks and the distribution of their profits over time. In those countries where tax provisioning for doubtful debts is limited, there is an incentive for banks to realize losses outright, through sales of their loans in secondary markets or by establishing losses through specially authorized loan sales. Such sales can be economically inefficient, given that secondary loan markets are typically illiquid. By contrast, the possibility of tax

deductions for provisions has encouraged banks in some countries to allocate large amounts of their capital to developing country assets, possibly inhibiting the disposal of their assets on the secondary market for country loans.

The financial crisis has brought a number of tax issues affecting bank losses to the fore. The sheer scale of losses (made up of both credit losses and trading losses) makes tax relief for losses a significant issue both for banks and for governments' tax revenues. Banks will be seeking to monetize the value of potential tax relief for losses, and there may be tax compliance risks from attempts to shift the character or location of losses to permit them to be deducted. On the other hand, governments may wish to ensure that these restrictions do not hamper restructuring and consolidation of the banking sector, as it positions itself to emerge from the crisis.

Proposals for procyclical provisioning, forcefully made in the wake of the crisis, may also raise longer term issues for tax policy. Should such provisioning be fostered by corresponding tax deductions? This would be a significant departure for countries following the usual practice of not allowing deductions for general provisions.

B. Insurance Companies²¹ *Session 6*

Many life insurance policies combine savings features with those of pure insurance. The pure insurance component is the protection against the economic loss caused by premature death. The savings portion takes the form of interest-earning reserves accumulated out of premium payments. At any time, the pure insurance protection afforded by the policy is the difference between the face value of the policy and the accumulated reserves. A one-year term policy involves no saving element, whereas a policy promising to return a fixed amount after a specific time period may be mainly a savings instrument. As development proceeds, the latter type of policies tends to grow in importance, resembling similar types of liability by other financial intermediaries, such as term deposits.

In most countries life insurance benefits are subject to some form of special tax treatment. First, premium payments are given special treatment under the income tax, in some instances being exempted up to some ceiling. Second, similar to the case of bank loan losses, property and casualty and life insurance companies are normally required to hold reserves to meet expected future payments to policyholders. For tax purposes, the deduction of additions to such reserves can lead to a mismatching of the income relative to expenses incurred to earn such income. Insurance company reserves, which have a built-up component reflecting the income earned on these savings, should therefore be subject to tax—otherwise life insurance would be favored relative to other (taxable) savings instruments. However, it is difficult to separate reserves into components held for contingency and savings purposes. At best, the built-up income must be estimated by, for example, multiplying the reserve by an interest rate such as a treasury bill that would be “riskless;” the balance of the fund is exactly

²¹ Further discussion is in Robin Oliver (2004) “Insurance companies,” in Zee op. cit.

intended to cover benefits to compensate insureds for risks. Third, income earned by insurance companies is often subject to a lower level of tax than that of other taxpayers, or exempted. Fourth, payout on maturity or surrender of a policy after a defined period is also often subject to a low tax rate or to exemption.

The taxation of life insurance products poses many difficulties because of the impossibility of attributing income and capital gains directly to policyholders. Taxpayers subject to high rates of tax are therefore able to benefit in many countries from the ability to roll up income within such funds at lower marginal rates than would apply to direct savings. These problems are amplified by the possibility of cross-border investment.

C. Collective Investment Vehicles *Session 11*

Investment funds

Collective investment vehicles (CIVs)²² are entities which allow for the pooling of assets by individual investors, and the sharing of costs of investment. Differing legal requirements, and the diversity of investment objectives pursued by different types of CIV, have led to the creation of organizational forms that differ quite widely amongst themselves and for which the tax treatment is also diverse.

Mutual funds (or investment funds or trusts) account for a substantial and increasing portion of the world's portfolio investments. They allow small and medium-sized investors to invest their savings in the market, offering them the advantages of financial expertise, economies of scale for such items as market research, portfolio management, and trading activity, and the opportunity to diversify and pool investments.

The taxation of investment vehicles aims to balance various objectives. First, given their potential social advantages one overriding objective is not to hamper or prevent their development. Second, tax rules generally aim to achieve "neutrality", i.e., to devise tax rules that are comparable to those that would apply if the investment were carried out directly by the ultimate investor. A final objective is to adopt tax rules that can be easily administered and enforced.

A major difficulty in designing a tax regime for investment funds and their investors is the number of different combinations of components that policymakers need to consider in applying the principle of "transparency". If funds are really "look-through" investment vehicles, for tax purposes, individuals should be indifferent between a direct purchase of the underlying assets and the acquisition of the same investments through a fund. But as a result of the varying forms of taxation of capital income otherwise applicable to direct investments, this has resulted in vast differences across countries in the treatment of investment funds; See Table 1.

²² See Collective Investment Vehicles Study, OECD January 2009.

Table 1: Taxation of Investment Funds in Selected EU Countries

| | Fund Type | Wealth Tax | Income Tax | Withholding tax on fund revenues | Enforcement/ international agreements |
|---------|---|---|---|--|--|
| Austria | Open ended funds | NO | Pass-Through Prototype on interests and dividends Separate Tax (5%) on equity realized gains of the fund | NO: interest and capital gains YES: dividends | NO |
| Belgium | 1. Fonds communs de placement à nombre variable de parts (FCPV) 2. SICAV | FCPV: NO SICAV: 0,06% of assets value (annual) | Funds: Pass-Through Prototype SICAV: corporate Tax on a narrow base | Funds: YES SICAV: NO | Funds: NO SICAV: YES |
| Denmark | Open ended fund: 1. that may issue certificates: a. distribution funds b. accumulation funds 2. that are prohibited from issuing certificates (account based funds) | NO | Funds of type. a and 2: Pass-Through Prototype Funds of type 1.b: Corporate Tax | NO: interest and capital gains YES: dividends | To be defined in each case |
| Finland | Open ended funds | NO | Pass-Through Prototype | NO | YES |
| France | 1.Fonds communs de placement (FCP) 2. SICAV | NO | Pass-Through Prototype | NO (except for foreign income) | Funds: NO (unless different specific agreements) SICAV: YES |
| Germany | Open ended funds | NO | Pass-Through Prototype | NO | NO (unless different specific agreements) |
| Greece | 1. Investment Funds 2. Investment Companies | YES 0,3% of assets value (annual) | Exemption: tax (0.3%) on gains from derivatives only | NO: interest and capital gains YES: dividends | Funds: NO Investment Companies: YES |
| Italy | 1. Mutual Funds 2. SICAV | NO | Annual tax on net operating earnings. No tax credit on dividends foreign source income | NO (except for some specific cases) | NO |

| | | | | | |
|----------------|--|---|---|--|--|
| Luxembourg | 1. Fonds communs de placement (FCP) 2. SICAV/F | YES: 0,01%-0,05% of AUM at establishment (annual fixed rate) | Pass-Through Prototype | NO | NO (except for some specific cases) |
| Netherlands | 1. Investment Funds 2. Investment Companies | NO | Funds: Pass-Through Prototype Investment companies: Corporate Tax (with zero tax rate for distribution schemes) | NO: interest and capital gains YES: dividends | Funds e Investment Companies (subject to corporate tax): YES |
| Portugal | Open ended funds | NO | Proportional tax, applied with withholding at source on interest and dividends; annual self-liquidation for capital gains | YES | YES |
| United Kingdom | 1. Authorized Unit Trusts (AUTs) 2. Open Ended Investment Companies (OEICs) | NO | Corporate Tax on a narrow base. The tax income includes only interest and foreign source income, while domestic source dividends, capital and derivative gains are excluded. Bond distribution funds can deduct interest payments (Pass-Through Prototype) | YES: interest on bank deposits NO: dividends, foreign incomes and interest coming from government bonds and onshore corporate bonds | YES |
| Spain | 1. Listed Investment Companies 2. Authorized Investment Funds | NO | Corporate Tax on a narrow base. No tax credit on dividends. | YES (but most of the funds invest in non taxable securities, for example government bonds) | YES |
| Sweden | 1. Open ended funds 2. Investment Companies | NO | Corporate Tax. Annual flat rate tax on equity capital gains. Incomes are deductible. | NO | YES |

Source: Sanelli et al (2001), KPMG

Pension funds

Ensuring that individuals have adequate provision for their old age, including through the use of private pension plans, has long been a major policy objective in higher income countries, and is increasingly a concern in developing countries too. Typically, countries have chosen to provide preferential treatment—relative to the normal income tax treatment—for such savings. While practice varies, most OECD countries in effect provide consumption tax treatment by combining three elements:

- Contributions by individuals to approved private pension schemes are deductible from those individuals' taxable income, with contributions paid by employers deductible in calculating taxable business profits (both commonly up to some ceiling), and not taxed as a benefit at the level of the employee;
- Income earned by approved pension funds from their investments is exempt from tax;
- Pensions paid out are most commonly taxed as employment income, although these too (and/or lump sum payments made on retirement) are sometimes given special tax relief.

This standard tax regime for pensions (frequently referred to as “EET”—exempt-exempt-taxed) treats individuals' savings through private pension funds more favourably than most direct forms of savings (return on investment), which would in the absence of special rules under an income tax be treated as “TTE” (saved from after tax income, return on savings currently taxed, and untaxed on withdrawal).²³ This difference likely distorts savings choices, and is indeed designed to provide an incentive for individuals to provide for their old age, when it is coupled with provisions penalizing withdrawal of savings prior to retirement. How effective such provisions are in encouraging genuinely ‘new’ saving—rather than a reshuffling of assets from taxable to non-taxable form—has been a matter of controversy, with a quite widespread view that only 25–40 percent of saving in these forms is additional.

What is clear, however, is that many countries on the verge of establishing significant private pension provision have yet to establish coherent tax regimes for their treatment. There are cases, for instance, in which rules provide ‘EEE’ treatment—even more generous than the standard above, and an effective subsidy to retirement savings.

REITs

Recent years have seen the growth of vehicles for collective investments in real estate. In Europe these vehicles have until recently tended to take the form of specialized companies or

²³ In effect, it provides consumption tax treatment (on a registered asset basis).

closed-end funds, whereas in the United States the preferred form of organisation is the Real Estate Investment Trust (REIT), a form of corporation subject to special tax rules. These entities, however organised, hold, manage and maintain real estate for investment purposes and receive most of their earnings from rental income or trading in real estate. If all of the earnings are attributed to beneficiaries or shareholders, the REIT avoids an entity level tax. REITs have spread to a number of countries in recent years, including Japan, France, and the United Kingdom.

Structuring property investment vehicles raises a number of issues from a tax standpoint. How is neutrality achieved between direct holdings of property and indirect investments through a pooled investment vehicle? Should the vehicle itself be taxed or is pass-through treatment most appropriate? How are the investment activities carried out by the vehicle “ring-fenced” from other business activities which would ordinarily be subject to corporate tax? What is the appropriate level of withholding taxes that should be applied to foreign investors? These questions need to be answered by any country intending to establish pooled property investment market.

D. Private Equity and Hedge Funds *Session 9*

Private equity

Broadly speaking, the term ‘private equity’ refers to all forms of equity or quasi-equity financing that is not obtained through organized stock exchanges. Private equity (PE) funds are used generically to refer to two types of investment fund: early stage or venture capital (VC) funds and later stage or restructuring (expansion capital, leveraged buyouts, buy-ins, public to private) funds. VC funds invest in start-up companies with the hope of a public offering of shares in the successful venture at sometime in the future. Later-stage funds purchase existing companies with the hope of restructuring the businesses and selling them at a profit. Most later-stage fund acquisitions involve private, rather than publicly listed, firms.

Private equity and venture capital funds established themselves in the United States in the 1960s but have spread rapidly elsewhere. In the past few decades they have grown in terms of value, number of transactions and geographic reach, had a pronounced impact on investment and employment in certain sectors, and attracted a widening investor base particularly among savings institutions. Although mature industries such as chemicals, machinery and retailing still provide popular buyout targets, the fraction of LBOs undertaken in high-growth, “high-tech” sectors such as computers and biotech has been growing significantly in the past decade. Given the size and scope of private equity funds it is not surprising that they have been at the centre of a multifaceted debate surrounding their influence on the governance of companies and the time horizon of investments, their impact on the innovative activity of firms, their effects on employment—and their tax treatment. Many such funds are now held offshore.

The structuring of PE and VC funds in various countries is driven in large measure by various tax factors. The first is the tax treatment of investments by the fund and of the proceeds from those investments received by various categories of investors. Attention has focused, in particular, on their placement of substantial debt in acquired later-stage companies—in some cases eliminating corporate tax liability for several years. They are often seen, in this respect, as providing a leading exemplar of the tax bias towards debt finance, perhaps not only in the firms they acquire but also in those that fear they might be acquired. The second issue, which may be in part related to the first, concerns the tax treatment of the sponsors or managers of the fund in respect of ongoing management fees but most importantly (and controversially) of “carried interest.” Thirdly, there a number of cross-border tax issues regarding the tax treatment of the operations of management companies operating outside their home jurisdictions, of foreign investors in domestic funds and funds investing outside of their domestic jurisdiction. Finally, PE and VC funds raise a number of potential VAT related issues in certain jurisdictions.

One of the crucial issues surrounding private equity is whether it deserves special tax treatment relative to other forms of collective investment. The reason for such special treatment would be (it is argued) its close connection with entrepreneurship. The tax treatment of investors in private equity funds depends on the structure of funds allowed in various jurisdictions. In many countries, private equity funds are tax transparent; in others the vehicles used have corporate status and normal or preferential corporate tax rates apply.

Managers of PE and VC funds receive two types of compensation – a management fee, which is treated as ordinary income, and “carried interest,” a form of partnership “profits interest,” which retains its underlying character as received by the partnership – whether ordinary income, capital gains or dividend – when distributed to the managing partner. Disposal of a partnership profits interest generally receives capital gain treatment. A feature of U.S. partnership tax law since the 1950s, profits interests—which are usually granted to managing partners in exchange for their labor contribution (although fund sponsors typically contribute some capital as well)—were enacted to encourage entrepreneurship. When they were used principally in operating partnerships (which generate mostly ordinary income), this tax treatment remained uncontroversial. However, the recent explosion of private equity and hedge funds, which generate substantial capital gain income, coupled with the divergence between income and capital gains tax rates, highlighted the potential distortions of the tax break. In the US, for example, the tax rates (15 percent) are substantially lower than the rates on ordinary income (35 percent). A similar reduced rate capital gains tax (18 percent) also applies in the U.K.

The tax treatment of “carried interest” has come under attack in recent years, and there have been various proposals to have carried interest re-characterized as ordinary income. The focus of discussion has concerned the nature of activity carried out by fund managers, the impact on tax revenues of such arrangements and the behavioural responses that would result from such changes in tax treatment. For instance, if one took the view that some part of

carried interest received by managing partners ought to be charged as labor income, other partners would in theory be entitled to deduct a corresponding amount in calculating any tax they paid on their partnership interest. The discussion of carried interest highlights two key problems in taxing capital income: the distortions to behaviour induced by differences in tax rates and the difficulty of distinguishing labour from capital income. In this as other areas incentives to income shifting are perhaps inevitable and certainly give rise to complexity.

Private equity funds are faced with a further potential tax problem because of their reliance on local 'advisors' when managing investee companies in other countries. As these advisors are based in the local country, providing the necessary support to the management of the investee company, it could be argued that they are creating a 'permanent establishment' for the fund by the local tax authorities—to which all of the fund profits are attributed for tax purposes (although the fund is usually structured to avoid this). For PE and VC funds in several jurisdictions there are also uncertainties over whether the services provided by management companies are liable to VAT.

Hedge Funds

Like private equity, hedge fund activity ballooned over the past two decades, with global assets under management rising from roughly \$7 billion in 1990 to about \$2 trillion in 2007, before dropping sharply as a result of the global financial crisis. And like private equity, many hedge funds are held offshore. There is a wide variety of hedge fund investment styles, from global macro to equity and credit arbitrage to commodities trading; most, however, share certain common traits. In contrast to private equity funds, hedge funds tend to invest in relatively liquid securities and derivatives over the short- to medium-term, and frequently use leverage to enhance returns.

Hedge funds do not raise the same tax issues as private equity in respect of leveraged buy outs, but the remuneration issues are essentially the same: the typical fee structure comprises a percentage of assets (typically two percent), which is ordinary income (deduction) to the profits partner (partnership), plus a carried interest (typically 20 percent). However, because hedge funds typically generate fewer long-term capital gains and dividends than private equity funds—about 20 percent of income versus 50 percent or more—treating carried interest as ordinary income would have less of an impact on hedge funds than private equity funds.

E. Sovereign Wealth Funds

A sovereign wealth fund (SWF) is a government-owned, actively managed investment fund constituted from foreign exchange earnings. Generally established by countries with large commodity or manufacturing-based trade surpluses, SWFs have grown rapidly over the last two decades, from about \$500 billion in 1990 to roughly \$3 trillion in 2008, as a result of commodity price gains and global trade imbalances—relative to a total value of traded

securities (debt and equity) denominated in U.S. dollars of over \$50 trillion, this makes them significant participants in financial markets, though not huge ones.

SWFs are typically exempt from tax on their cross-border investment income, although the scope and mechanism of exemption differ from country to country. For example, SWFs are generally not taxed on their investments in the United States, provided those investments are passive (e.g., securities and bank deposits) and do not constitute commercial activities. Where SWF investment activities are not exempted (i.e., commercial activities and certain real property investments), they are taxed the same as foreign corporations. Foreign corporations are taxable on any income effectively connected with a U.S. trade or business, as well as fixed or determinable, annual or periodic (FDAP) income; the major exceptions to FDAP income are portfolio interest and capital gains. Depending on how a SWF is classified—as an “integral part” or “controlled entity” of a foreign government—participation in commercial activity anywhere in the world may disqualify it for treatment as a sovereign entity.

Australia, Canada and the United Kingdom also exempt SWF passive investment from taxation, generally on an administrative basis. Australia and Canada apply this treatment on a case-by-case basis. Broadly speaking, the impact of the growth of SWFs in such cases is to in effect increase the significance of tax exempt investors in the market, which increases the distortion associated with the coexistence of tax-exempt and taxable investors.

Not all countries follow the same treatment, however; Japan, while exempting foreign governments from taxation, does not extend this treatment to SWFs, but treats them like foreign corporations except as specified by bilateral tax treaties. Germany does not extend tax-exemption to foreign governments or SWFs, treating them the same as foreign corporations; however, Germany generally exempts foreign investors from taxation on interest and most capital gains. Switzerland also provides no exemption for foreign governments, except by tax treaty.

IV. TAXING FINANCIAL SERVICES AND TRANSACTIONS

A. The Value Added Tax *Session 10*

Taxation of financial services under a VAT presents both theoretical and operational problems.²⁴ It can be difficult to identify the tax base, so exemption without credit for related input tax has become a standard approach. From the theoretical standpoint, there is some debate on which financial services, if any, should ideally be taxed. It is generally agreed that, because a VAT should be levied only on final consumption and not intermediate inputs to

²⁴ See generally, IMF: Ebrill, Keen, Bodin, and Summers, *The Modern VAT*, chp. 8 (Washington 2001).

production, financial services purchased by VAT-registered businesses should not be taxed. While there has been some dispute on this issue, it is now also widely accepted that purchases of financial services by final consumers should be taxed.²⁵

The question is how to achieve this. For services provided by financial institutions and charged for by means of an explicit fee, such as safe deposit boxes and management fees, there is no particular conceptual problem as the base is identifiable. Many jurisdictions impose VAT on financial services compensated through these explicit fees. Input credits for firms providing both exempt financial services and non-exempt fee-based services must therefore be allocated between the two. Market and regulatory pressure for greater pricing transparency has resulted in more financial products being compensated through explicit fees, potentially broadening the scope for taxation under the VAT. However, in some cases the differentiation between fee based and margin based services is not so straightforward. For example, in the EU, exemption often extends to specific fees, particularly where the institution's remuneration is a combination of fees and margins. This approach likely had its origins in concerns that exempting one and taxing the other would encourage distortion when there is a degree of flexibility in structuring the overall price.

The difficulties arise for margin trades—such as accepting a deposit and lending the proceeds. There is no problem in identifying the value added by the intermediary—the excess of the lending rate over the deposit rate. But it is not obvious how to allocate that margin between the two sides of the transaction, so as to ensure that the crediting mechanism works appropriately. And disclosure of even the aggregate margin on specific transactions can also be an issue for financial intermediaries. Business to business (B2B) transactions would presumably require a tax invoice so that the recipient could recover VAT.

The dominant treatment of such non-fee based financial services has for these reasons—notably in the EU—been to exempt them from VAT.²⁶ This means that financial institutions do not charge tax on their supply of exempt services and they are unable to recover tax on their purchase of taxable inputs.²⁷ Exemption therefore overtaxes business use of financial services—since some previously paid VAT will presumably be included in the price of the

²⁵ It should, however, be noted that since non-recoverable VAT incurred by financial and insurance institutions has become an established source of revenue for many counties, many of them resist change and may not find this view congenial.

²⁶ The EU “option to tax,” permits member countries to allow financial institutions to elect VAT taxation for particular products or customers, which has the potential to alleviate the overtaxation of business purchases (though without alleviating the problem of allocating value-added across transactions and customers). This is, however, not widely used and most EU tax administrations seem opposed to expanding its use.

²⁷ Thus, only the value added of the firm itself, and not that provided earlier in the chain of production, escapes the tax.

financial services—but undertaxes consumer purchases of financial services. For developed countries at least, the revenue cost of the latter is generally believed to outweigh the revenue gain from overtaxing the former although the lack of available data makes it difficult to conduct a rational analysis of this.

Exemption is problematic, however. Tax cascading promotes vertical integration of financial institutions—to avoid unrecoverable input taxes, financial firms produce more of their own inputs than would otherwise be efficient. Financial institutions subject to VAT exemption also face a competitive disadvantage as compared to financial institutions in countries without a VAT. The EU therefore zero rates financial transactions between the EU and non-EU countries, and allows for input tax recovery. As the EU does not zero-rate intra-Community transactions, however, as the internal EU market for financial services becomes more integrated EU member states which are net suppliers of financial services to other member states will benefit from this non-credited (and therefore retained) tax at the expense of the latter.

The European Commission has made comprehensive proposals for revising the current VAT treatment of financial and insurance services by redefining in detail the scope and character of the exempt services so as to ensure that the exemption better reflects the complexity and diversity of the modern industries, by conceptualizing an industry-specific exemption on cost-sharing arrangements and by extending the possibility to opt to tax²⁸. Countries outside the EU have developed other methods for addressing the problems of VAT taxation of margin-based financial services. Some developing countries, for example, charge VAT on gross interest receipts. At one level this might be rationalized as a device to prevent avoidance of the VAT—through the device of providing a service at minimal nominal cost but effectively charging an additional price in the form of interest. The risk of adopting this approach, however, is of overcharging for financial services—which can be a particular concern when development of the financial sector may be key to wider development goals. France levies an additional tax on payrolls of firms whose output is at least 90 percent exempt from VAT, which addresses the undertaxation of consumer services but exacerbates the overtaxation of business financial services. Israel levies an addition method VAT on payroll plus profits in the financial sector, which does not allow per transaction tax assessment and thus precludes business users from claiming VAT credit, resulting again in overtaxation. Singapore and Australia tax financial services compensated through fees and commissions, as well as permitting financial institutions to recover a fixed percentage of the VAT on their inputs for margin services.

²⁸ See http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/VAT_insurance/index_en.htm [COM(2007)746 and COM(2007)747]

There are theoretical ways in which the fundamental allocation problem can be solved. A comprehensive cash flow tax—treating all inflows to financial institutions (including of principal) as taxable sales, and outflows as creditable purchases—could accurately tax the value added embedded in financial services compensated through financial margins on a per-transaction basis. Ultimately, the tax would be equivalent in present value to the implicit value of services received by the household sector. The main objection to this method of taxation is the potentially large liquidity demands it would place on financial customers. One proposal to deal with this is by the use of “tax calculation accounts” (TCAs), which defer the tax on principal flows until reversed at maturity. Rather than charging borrowers an up-front tax on loan principal, the principal amount would be credited to a TCA, and the borrower would pay interest on that amount until the principal was repaid at maturity, substantially smoothing tax liabilities over time. A pilot study for financial sector taxation using TCAs was conducted by the EU, but it was not enacted due to over-complexity and implementation costs. Most importantly perhaps, the need for change was not sufficiently established at the time. An alternative that has been suggested is to zero-rate B2B financial transactions while subjecting business to consumer (B2C) transactions to a cash flow form of VAT. New Zealand has recently introduced this approach as part of a wider package of taxation reform.

B. Financial Transactions Taxes *Session 12*

Financial transaction taxes (FTTs)—meaning broadly those levied on the face value of some set of financial transactions—have been used in a numerous countries—many in Latin America, but also in countries ranging from the European OECD to developing nations. They are introduced for a variety of purposes: (i) to increase taxation of the financial sector, (ii) to reduce volatility of financial asset prices (including exchange rates, if applied to international currency transactions); (iii) as a convenient, effective, and quick way of increasing government revenue in general.²⁹ The feasibility of raising revenue from such taxes increases as there is greater use of centralized clearing and settlement of over-the-counter derivatives and currency contracts.

However, there are good reasons to be skeptical about whether such taxes can achieve these aims:

- Whether FTTs reduce volatility is by no means obvious: while they make some speculative trades uneconomical, movements would tend be larger when they take place. Unless set at prohibitive rates, FTTs would not prevent major capital flows in a crisis. The empirical evidence tends to confirm this ambiguity, some even suggesting

²⁹ FTTs have in some cases been introduced to circumvent secrecy rules preventing banks sharing information with tax authorities: but they are clearly not the best response to secrecy problems, and the argument in any event presumably calls for only miniscule tax rates.

that volatility increases with FTTs, as liquidity providers (market-makers) widen their spreads and stabilizing speculation is deterred.

- FTTs suffer a high risk of tax avoidance. First, it is often possible to design equivalent transactions that avoid the tax (e.g. contracts for difference in currencies). Second, unless taken up internationally, transactions simply migrate to other countries, as they are independent of the location of businesses and thereby particularly mobile.
- FTTs levied on centralized clearing systems might well increase systemic risk. The majority of global currency transactions are now cleared through CLS (Continuous Linked Settlement), so reducing counterparty risk. Imposing an FTT risks pushing transactions outside such systems.
- There is some evidence that FTTs are inefficient in that they tax intermediate transactions, and so distort production decisions. Moreover, they have the particular effect of discouraging use of the formal financial system—exactly the opposite, the evidence cited at the outset suggest, is needed to support development.

The incidence of these taxes—who actually bears the real reduction in private sector income they imply—is unclear (although likely to be borne by current owners of financial assets if values fell). There appears no good reason to believe, for instance, that, as is sometimes suggested, the burden would fall on higher-paid employees of financial institutions.

V. ADMINISTRATION

A. Financial Institutions Play Key Roles in Implementing the Wider Tax System

Financial institutions play a key role in implementing the tax system. They collect and remit details of tax payments, and in many countries, in collaboration with their respective revenue bodies, they enable electronic payment of taxes and refunds of overpaid taxes to be directly credited to taxpayers' accounts.

In many countries, financial institutions also have responsibilities in withholding tax regimes, in respect of payments of interest income made to non-resident taxpayers and sometimes resident taxpayers. For example, financial institutions in 22 of the 30 OECD countries are required to generally withhold tax on payments of interest income to resident taxpayers.³⁰ Further, in many countries they facilitate the detection of unreported income, by providing

³⁰ See page 176 of *Tax Administration in OECD and Selected non-OECD Countries: Comparative Information Series (2008)* (www.oecd.org/dataoecd/57/23/42012907.pdf).

certain information on third party income to revenue bodies for systematic matching with taxpayers' records. In the United States, for example, such third party matching provisions are credited to a great extent with the extremely low tax gap now associated with interest income. And in a few countries (e.g., Australia, Denmark, Finland, Netherlands, Norway and Sweden) this information is also used to assist with the preparation of pre-filled tax returns by the tax authorities.

Financial institutions are often required to execute levies or garnishments³¹ in respect of deposits held by them. These can arise in respect of unpaid tax debts. Financial institutions also assist with tax audit inquiries and tax fraud investigations in respect of specific taxpayers by providing access to financial records. Although not all countries' domestic laws permit such information to be obtained from banks, banking secrecy is increasingly being recognized as a potential obstacle to effective tax compliance.

Financial institutions play a major role worldwide in the battle against crime, including tax crimes, through cooperation with law enforcement and revenue bodies. For example, they track and report large cash transactions and suspicious transactions, and apply laws to combat fraud and money laundering.

B. Controlling Financial Institutions in Developing Countries

Incorporating the financial system into the wider tax structure in these ways can play an important role in achieving the wider developmental objective of combating the informality that is so pervasive in many lower income countries. A first step towards this, as well as towards ensuring that the institutions themselves are properly taxed, is establishing effective monitoring of financial institutions by the tax authorities. And a sound starting point for this is to strengthen administration of the largest taxpayers more generally, with financial institutions commonly prominent amongst them.³² This would typically involve implementing a large taxpayer office (LTO) structured around key industry segments,³³ including a dedicated unit to administer taxpayers in the finance/banking/insurance sector. Steps to be undertaken in establishing an effective LTO, and financial sector unit in particular, would include:

- Recruiting LTO staff of sufficiently high caliber to deal with complex tax issues and transactions related to the financial sector.

³¹ A garnishment prevents a third party holder (such as a bank) from allowing the dispersion or transfer of assets when it has been notified that money or property belonging to another has been seized under legal writ.

³² As a simplification—there are often relatively few of them—it is common for all financial institutions to be included in the LTO.

³³ See Katherine Baer, Olivier Benon and Juan Toro (2002), *Improving large Taxpayers' Compliance*, Occasional Paper No. 215 (IMF: Washington D.C.).

- Creating a professional atmosphere that discourages tax officials from corrupt practices.
- Developing financial sector industry knowledge, expertise, and ‘commercial awareness’ of LTO staff.
- Training LTO staff in areas of legal interpretation, audit methodology, and appeals case management.
- Developing a service strategy, whereby the LTO banking unit would provide a single point of access for banking sector inquiries, requests for rulings on technical issues, and so on.
- Developing a responsive audit strategy aimed at early detection of financial sector-related risks to the tax system.

C. Financial Institutions and Aggressive Tax Planning

This degree of exposure to the tax system inevitably leads to a substantial degree of interaction between financial institutions and revenue bodies. Among the issues which surface in this interaction are appropriate levels of service to the industry, the appropriate balance between the requirements of the tax system and the cost of compliance, and differing perspectives on interpretations of the tax code and on what constitutes acceptable tax strategies.

The OECD *Banks and Tax Intermediaries* studies adopted a common definition of "aggressive tax planning" by identifying two areas of concern:^{34, 35}

- Planning involving a tax position that is arguably valid, but has unintended and unexpected tax revenue consequences relative to the legislative intent of the provision at issue;
- Taking a tax position that is favorable to the taxpayer without openly disclosing that there is significant uncertainty as to whether it accords with the law.

³⁴ The OECD Study into the *Role of Tax Intermediaries* (2008). This study recommended a follow up study on investment banking.

³⁵ *Building Transparent Tax Compliance by Banks* was a joint Australian Tax Office, HMRC (U.K.) and OECD Secretariat study. It took the view that while tax administration issues were not significant contributors to the financial crisis, the crisis had highlighted issues which have implications for revenue bodies.

Drawing on a number of sources including court decisions, general legal concepts, experience of general anti-avoidance provisions in a number of countries, and published revenue body guidance, the banks study identified a range of features which might indicate the presence of aggressive tax planning. Factors included transactions which have no commercial rationale, which have uncommercial terms, or have steps where the tax benefit is disproportionate to the other benefits in the transaction.

There is nevertheless still a gap between the perceptions of revenue bodies and those of many financial institutions about acceptable and unacceptable tax planning. Revenue bodies have long been concerned about tax compliance in the financial services industry, particularly in banking. The Tax Intermediaries study noted that banks provide aggressive tax planning for their clients and also for themselves through proprietary trading and inter-bank finance market transactions. It went on to signal a need ‘to improve understanding of the role banks play in designing and implementing aggressive tax planning and how this relates to their wider commercial activities’. The financial crisis also highlighted a number of issues with potential significance for tax compliance which needed to be examined. The *Banks* study identified a number of these issues, including the extent to which the complexity and limited transparency associated with many financial products clouded the issues for revenue bodies, and the potential impact on tax compliance of deficiencies in corporate governance and risk management strategies.

The most significant concerns of revenue bodies about aggressive tax planning by banks center on the use of complex structured financing transactions (CSFTs). This is the case whether these products are provided for clients (either corporate clients or wealthy individuals) or for the banks themselves where they engaged in proprietary trading or inter-bank finance market transactions. Both the *Tax Intermediaries study* and the *Banks study* pointed out the need for revenue bodies to be able to distinguish CSFTs that have a commercial (non-tax) purpose from those which are specifically designed for aggressive tax planning purposes. But revenue bodies’ concerns about banks’ use of CSFTs center precisely on their complexity and cross-jurisdictional impact. These financial products involve the use of financial instruments—e.g. loans, derivatives, repos—which attempt to exploit mismatches in tax treatment between different countries.

Aggressive tax planning in the financial services sector is not unique to banks, however. For example, in the insurance industry loan transactions may be disguised as reinsurance transactions in an attempt to avoid withholding tax and to shift income inappropriately to a foreign related company.

Revenue bodies across the world have responded to the threat to revenues posed by aggressive tax planning in the financial services and other business sectors. This response includes a range of administrative initiatives, sometimes underpinned by specific tax policy initiatives.

D. Tax Policy Initiatives

Statutory advance disclosure regimes have been introduced in a number of countries including the U.S. and the U.K.,³⁶ providing these revenue bodies with information sources needed to enable them to move quickly to challenge the bona fides of particular schemes, where necessary through the appeal process, or through recommending urgent amendments to legislation.

General anti-avoidance rules and ‘abuse of law’ principles are becoming more common, with the objective of disallowing the tax advantages of tax planning arrangements.

Particular penalty regimes which target the promoters of aggressive tax planning and effectively change the economics of aggressive tax planning have been introduced in some jurisdictions (e.g., Australia).

E. Administrative Initiatives

Some of the more radical changes in the approach to influencing the compliance of large business, including the financial services industry, have taken place through new administrative initiatives.³⁷ These have been aimed at improving compliance partly through building higher degrees of trust between revenue bodies and business including the financial services industry. Initiatives are being taken in a number of countries to promote new approaches to transparency by both sides. Financial institutions are being urged to share their tax planning strategies with revenue bodies, as far as practicable in real time, and some revenue bodies are putting in place structures to provide rulings or non-statutory guidance to these taxpayers, thus offering certainty in relation to the tax consequences of tax planning strategies.

Moves are being made to improve awareness of the needs of business in revenue bodies, by building in revenue bodies greater understanding of the business and products of financial institutions. In a number of countries this has involved a greater degree of specialisation in industry segments in financial services. Generally greater capability to deal with the financial services industry is being built in revenue bodies. This covers the spectrum of accounting, taxation, legal and industry issues associated with the industry and is also leading to a greater understanding of the distinction between business-driven and tax-driven decision making and products in the industry.

Enforcement with respect to the financial services industry is increasingly being made on the basis of more sophisticated tax risk analysis. This analysis is drawing on country and growing international experience of acceptable and unacceptable tax planning, with the

³⁶ The United States disclosure regime contains a total of 6 categories of reportable transactions. The United Kingdom regime requires promoters of direct taxes schemes to disclose schemes falling within certain criteria.

³⁷ These initiatives are detailed in a report by the OECD Forum on Tax Administration Task Group on Compliance Management of Large Business (2009).

degree of cooperation and transparency exhibited by particular taxpayers and their advisors increasingly influencing decisions about tax risk and about the prioritisation of enforcement resources.

In a number of countries, a new structured approach to the basic relationship between the revenue body, the financial institution and the tax intermediary is being implemented. Sometimes described as an "enhanced relationship," this is ideally characterised by openness, transparency and responsiveness on both sides. It normally involves board-level engagement by the financial institution with the revenue body, clear lines of communication and a joint approach to tax risk analysis potentially leading to lower risk ratings, less intrusive interventions and consequently lower compliance costs for the business. As part of this, there is a growing focus on how tax compliance can be positioned as a recognised good practice element in corporate governance, and integrated into corporate risk management systems. This would ensure that tax compliance and important tax risk issues are considered at board-level in financial institutions and other large corporate business. Revenue bodies are increasingly interested in adding scrutiny of financial institutions' corporate governance (including tax governance) to their tax risk assessment process.

F. International Exchange of Tax Information

Effective exchange of tax information between tax agencies in different countries is a critical part of enforcement of taxpayer obligations. Normally, such effective information exchange takes place under the terms of bilateral tax treaties, either general or specifically drafted to cover administrative issues including in particular information exchange. Unavailability of information exchange has long been recognized as a particularly important factor permitting the sheltering offshore of, especially, financial income, and the resulting growth in the use of tax havens. But exchange of information has been hampered both by a lack of transparency and strict secrecy rules applicable in some jurisdictions, on the one hand, and by a lack of capacity to produce required information in usable forms on the part of many countries, on the other. Unprecedented progress has been made on this issue, especially in the past year, in the wake of international incidents involving tax secrecy linked to taxpayer evasion and fraud in various jurisdictions. Steps now being undertaken through the expanded G-20-inspired Global Forum mechanism will have major implications for tax administration not only in OECD, emerging market and tax haven jurisdictions, but—importantly— in developing countries as well.

Nearly a decade ago, the OECD initiated the Global Forum on Transparency and Exchange of Information for Tax Purposes, in order to facilitate the development of internationally accepted standards of transparency and information exchange. In 2002, a model Agreement on Exchange of Information in Tax Matters was issued, and in 2005 standards on availability and reliability of accounting records were developed. Since then, the implementation of these standards has been reported on in the Global Forum annual assessment of progress in over 80

jurisdictions³⁸. The G-20 leaders agreed at the Washington 2008 and London 2009 summits that the work of the Global Forum should be considerably strengthened, by restructuring it and by expanding its membership to all jurisdictions covered in the 2009 assessment and to all G-20 members—that is, all 84 jurisdictions that have so far agreed to implement the standards of transparency and information exchange. On 1-2 September 2009 the Global Forum met in Mexico and agreed to reformulate the Forum, put in place a robust peer review, speed up the process negotiations and to engage with developing countries. All members will be reviewed under a new peer review process, covering first their legal standards in this area, and second—and more complicated—their implementation of these standards. Additionally, non-members will "where appropriate" also be subject to such reviews.

VI. ISSUES FOR THE CONFERENCE

The conference aims to examine and point the way towards suitable approaches to the wide range of key issues affecting taxation of the financial sector reviewed above.

The *context* is crucial, and will be the theme of the opening session. This will be an opportunity to take stock of changes leading to and resulting from recent financial sector developments, and an opportunity to address a number of questions which help to set the scene for the sessions to follow. What are the distinct features of the current financial landscape following the financial crisis? How has the crisis affected the activities of the financial sector and of investors? What changes are taking place in the regulatory and corporate governance environment? And what are the key implications of this new context for tax policy and administration?

Moving on to an overview of the *principles and concepts* in financial sector tax policy and administration, the conference will address the question of neutrality in taxing the financial sector. How important is neutrality—is it desirable, or are there ways in which tax policy and administration can help to address non-tax shortcomings in financial sector markets and regulation? What are the key elements of current financial sector taxation which depart from neutrality, and how significant are these in the light of financial sector developments? What would be involved in reducing or eliminating unwanted tax distortions? Are there practical improvements which could be made, and what are the obstacles to doing that?

The conference will also offer an overview of the *administrative challenge* in taxing the financial sector, and a series of perspectives on how that challenge is addressed. The global reach, scale and complexity of financial sector business, as well as the role of the financial

³⁸ See Tax Co-operation 2009: Towards a Level Playing Field - 2009 Assessment by the Global Forum on Transparency and Exchange of Information

sector in third party tax payments and information reporting, all add a special dimension to tax administration in this sector.

In a series of parallel panel sessions, the conference will also drill down into the *practical implications* of these challenges and pointers for reform in a number of areas of financial sector taxation.

Financial innovation has arguably rendered redundant a number of the borderlines on which tax systems traditionally rely. Has the time come to re-appraise those distinctions in certain areas, or as a whole, and is there a simpler, less distortionary, and more secure basis on which financial sector commercial profits can translate into financial sector tax revenues? What special issues arise for *banks* and for *insurance* companies? And what should be the fundamental approach to financial sector taxation, and leasing in particular, in regimes governed under rules of *Islamic Finance*?

Collective investment vehicles raise questions of neutrality between different forms of financial sector activity – how can neutrality between investments made through funds and those made directly be promoted? Similar issues are raised by the taxation of *private equity* and *hedge funds*, which also exemplify the challenge of a borderline between taxation of income from labor and income from capital.

There are particular challenges in applying a *VAT* to the financial sector. What should be the tax base, and what are the implications of the various models countries have adopted? Is the exemption model a suitable response? What has been the experience with *financial transaction taxes*, and how do these interact with taxation of capital income?

Non-neutrality in the cross-border taxation of financial instruments and its exploitation through *aggressive tax planning* raises further challenges for tax policy and administration. What might governments do to reduce the opportunities for such distortions and maintain the security of their tax revenues?

Underlying many of these challenges in specific areas of financial sector taxation are common—and more widely applicable—*differences in the tax treatment of income and capital gains, and of debt and equity*. How have countries approached the challenges thrown up by these differences, and what lessons might be learned for financial sector taxation in particular?

The conference is an opportunity to build a common understanding of the challenges in financial sector taxation, but, more than that, to point to suitable future directions for policy and administration. The primary responsibility for rebuilding the financial sector out of the current crisis lies with the sector itself, and its regulators. But tax policy makers and administrators have a responsibility too, to identify *how the global tax system can better*

support and promote a healthy financial environment. That will be theme of the final session of the conference.