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In memory of

John King

(1944–2003)

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Preface

The papers in this volume address a set of issues that is probably among the most complex in the area of tax policy: the tax treatment of the primary institutions, products, and services that make up the financial sector—banks, insurance companies, securities companies, investment funds, pension funds, and derivatives. Getting this treatment right usually poses a significant challenge to policymakers, because the form of a financial transaction can be manipulated—without altering its economic substance—much more easily than that of a nonfinancial transaction (such as the sale of ordinary goods and services), thus rendering it easier to exploit tax loopholes. The consequent economic distortion could be costly. When it comes to taxing the financial sector, policy neutrality across different financial activities is key (unless, of course, non-neutrality is a policy objective), but ensuring it is a tall order.

Five of the six papers in this volume were originally prepared as background materials for a technical assistance mission of the IMF's Fiscal Affairs Department to China in September 2002 to discuss, at the authorities' request, various issues regarding the taxation of China's financial sector. The immediate impetus for the request was China's wide-ranging commitment to liberalizing its financial sector in connection with its accession to the World Trade Organization in 2001. The authorities were keen to assess the various policy implications of this commitment, one of the most important being the ability of China's tax system to cope with a sector on the verge of fundamental transformation.

It soon became clear, however, that the background papers commissioned on that occasion had a much broader appeal beyond the China context. Indeed, the papers do not address China-specific issues; they instead provide a concise overview of important concepts, issues, and country practices in financial sector taxation, covering both direct and indirect taxes, in a nontechnical and highly accessible manner. It is hoped that the publication of this volume will not only inform the interested reader of the relevant issues involved but also guide policymakers on the design of tax policy as applied to the financial sector.

I note with profound sadness the passing of my colleague and friend John King, who died in the summer of 2003 in a rock-climbing accident in his beloved country, Scotland. John will be dearly missed. This volume is being published in his memory.

Howell H. Zee
December 2003

1 Banks

John Isaac

Traditionally, the core functions of banking were to (1) accept money from, and collect checks for, customers; (2) honor checks for orders drawn on them by customers; (3) keep current accounts, or something of that kind, in which customers' debits and credits are entered; and, of course, (4) lend. Banks derived their income largely from the margin between the interest rates they paid on money deposited with them and the interest rates they charged on money lent by them.

Traditional definitions also made a distinction (sometimes borne out in practice) between ***retail*** banks, which typically provided basic banking facilities to a large number of usually small customers, and ***wholesale*** banks (including investment and merchant banks), which provided a wide range of services to a much smaller base of large customers, such as governments and multinational corporations. Some of the large international banks served both markets.

Modern banks derive much of their income from a wider range of financial services, usually offered on a fee basis, and deal in all kinds of financial instruments on their own account. They may handle general insurance, fund management, and even real estate agent business. They may also engage in (often through a subsidiary) activities such as finance leasing, securities trading, and venture capital. Similarly, insurance and other companies now undertake business traditionally regarded as the preserve of banks.

Against this background, modern tax practice tends not to attempt a comprehensive statutory definition of banking, but to treat as banking any business that is, in practice, treated as such by the central bank or other relevant regulatory authority. It tends to follow the accepted "best" accountancy treatment of

banking profits[1]—rather than to write separate and distinct tax rules. In doing so, it seeks to achieve consistent treatment on both sides of the profit and the loss account. However, there are important modifications and exceptions—notably in dealing with loss provisions and international issues (as further discussed below).

Major components of a bank's income and expenses (deductions against income) that go into the determination of its taxable profits are discussed first, followed by considerations of selected issues that are especially relevant for the banking sector.

Income

A bank's income falls broadly into three categories: (1) income derived from assets; (2) gains/losses derived from realization of assets; and (3) fees and charges.

Income Derived from Assets

Income derived from assets includes (1) interest on advances and on securities of all kinds (including securities held as trading stock and securities held for hedging or for capital reserve purposes); (2) discounts on government bills, trade bills, and other like instruments; and (3) dividends on shares, including shares held for trading purposes, as strategic investments, as part of a refinancing operation, and in subsidiary or other group companies.

For ***interest,*** the normal rule is to tax it on an accrual basis. That is, interest is recognized in the accounting period in which it is earned, rather than in the period in which it is received. Exceptionally, interest may be taxed on a mark-to-market basis (see below)—notably, when a security is held as part of a bank's trading activity that is normally valued on a "dirty" basis (that is, the value of the security quoted at any time includes any accrued interest, without distinguishing it separately).

Similarly, ***discounts and premiums*** are also normally taxed on an accrual basis.

Under a normal corporation income tax (CIT), ***dividends*** paid by a resident company out of taxed profits are not charged again to the CIT in the hands of another resident company. However, some tax laws make an exception when (as in the case of many banks) shares are held as part of a company's trading stock—so that any gain or fall in the value of the share is taken into the company's

[1]That is, where accounting rules are well developed and consistent with good international practice (for example, *International Accounting Standards 2002* (London: International Accounting Standards Board, 2002)).

profit or loss account. In these cases, the dividend on such a share is taxed as income.

Gains/Losses Derived from Realization of Assets

In general, assets of a bank comprise fixed assets (for example, premises, plant and machinery, and shares in subsidiaries[2]) and current assets (for example, advances and loans, funds that the bank needs to maintain and invest to enable it to meet possible demands for payment, and assets held for trading purposes).

Gains and losses on ***fixed assets*** are generally recognized for tax on realization, essentially in the same way as gains or losses realized on their investments by other businesses under normal CIT provisions.

The general treatment of bad or doubtful debts on ***advances and loans*** is discussed in more detail below. Losses may also be realized in the particular cases of novation (substituting a new loan for an old loan), assignment (commonly, selling a debt for collection by another institution), swaps (exchanges of loans), and securitization (the transfer of a bundle of loans to another company—possibly specially set up for that purpose—which wraps them up within the envelope of a security and, in turn, may provide collateral for loans). Such losses are, in principle, recognized currently for tax. As a matter of practice, however, questions can arise as to whether a swap or securitization (or other transaction) has been undertaken at fair arm's-length value, especially if the transaction is between connected parties.

Gains or losses on ***assets needed to meet potential demands on a bank's funds*** are commonly recognized for tax on accountancy principles. Increasingly, modern practice is to mark to market, that is, to recognize a gain or a loss by reference to the amount at which, at the balance sheet date, the instrument could be exchanged in an arm's-length transaction between informed and willing parties.[3]

In modern practice, gains or losses on ***assets held for trading purposes*** are in general similarly marked to market.[4] Where, alternatively, the authorities accept accrual accounting, the carrying value at the end of the period will be cost, subject to adjustment for the difference between cost and ultimate redemption proceeds, as recognized in the accounts in accordance with the approved accounting method. There may be special cases, such as shares acquired by the bank

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[2]In this context, this means shares intended to be held for the long term. Shares held by a bank that intends to sell them later for a profit are not regarded as fixed capital, even if the bank holds 50 percent or more of a company's share capital.

[3]In practice, marking to market may properly be calculated in a host of different ways. The underlying objective remains to arrive at a reasonable approximation of a fair market value. For a quoted security in a liquid market, this may appropriately be the midpoint between the bid and offer rates.

[4]See also the treatment of derivatives and other off-balance-sheet items on pp. 10–12.

as part of a management buyout or as part of its venture capital operations, where gains or losses may be recognized for tax on realization.

In the cases of ***stock lending*** and ***sale and repurchase agreements (REPOs),*** the tax practice is to follow the substance of the transaction. The fee for stock lending is recognized for tax (see below). Technical legal sales and repurchases in REPOs are not recognized as such for tax, but profits/losses on such transactions are recognized as taxable income.

Fees and Other Income

Banks commonly earn fees and other income from a range of activities, including (1) traditional retail current banking services (such as checking facilities, credit cards, travelers' checks, and money transmission); (2) comparable capital services (such as safe custody, portfolio management, trustee, and tax advice); (3) capital market services for corporate clients (such as merger and take-over support, underwriting, and foreign exchange support); (4) credit references and guarantees; and (5) debt factoring (the breaking down of a large debt issue into smaller issues).

The general rule for both commercial accounting and tax purposes is that such fees are recognized when earned and receivable. However, when, for example, a fee is paid for advance or overdraft facilities or for a guarantee extending over a period of years, the fee may be spread forward on a time-apportioned basis.

Deductions Against Income

While many expenses incurred by a bank are similar to those incurred by any other nonfinancial enterprise and, therefore, do not raise special tax issues, two categories of a bank's deductions against its income—interest payable and bad debts—pose unique challenges to a tax system. They are discussed separately below.

Interest Payable

In the ordinary course of business, interest payable by a bank is tax deductible on an accrual basis. The exceptions relate to a variety of special cases where the purported interest may be thought to have some or all of the characteristics of a dividend on a bank's share capital. For example, when interest is payable at a higher than normal commercial rate, or the amount of interest depends on the borrowing company's business outcomes, many tax administrations disallow (not only for banks but for companies generally) the interest payment;[5] the

[5]Alternatively, in the case of excessive interest payments, they may disallow only the excess over a normal commercial rate.

disallowed payment may be taxed in the same way as a dividend or distribution of profits. A disallowance may also apply in the special case of "limited-recourse" or "nonrecourse" loans (where the lending bank does not have the right to recover all of the loan interest and capital from the borrower's assets). A special case is interest on a bank's core share capital (that is, securities corresponding with the definitions of Tier 1, 2, and 3 capital as recognized by the Bank for International Settlements (BIS)). Interest on this capital is not, in principle, tax deductible.[6] This may be seen as a special instance of the general problem of thin capitalization, where (what on normal commercial principles may be regarded as) the taxpayer's core share capital is instead controlled by the bank's regulator.[7]

Bad Debts

The tax treatment of impaired debts—that is, debts that are judged likely to be irrecoverable, either in full or in part—is of particular importance for banks.[8]

The broad principles for the principal of loans are pretty standard. Tax relief is given—in some cases with limitations and restrictions—for ***specific*** provisions for bad debts. There is a clawback, or recovery, of relief if subsequently the debt is repaid or the provision for impaired debts is found to be excessive. The result is comparable whether advances are accounted for on an accrual basis or on a mark-to-market basis. Tax relief is less generally given—and commonly subject to special limitations—for ***general*** provisions.[9]

Under best practice, unpaid interest on impaired debts is credited to a loan suspense account (thus bypassing the calculation of profit and loss) or otherwise

[6]To avoid this restriction, banks in a number of countries have devised complex arrangements involving offshore special purpose vehicles to create securities that rank as Tier 1 capital for regulatory purposes but give rise to interest that is tax deductible. The BIS guideline is that not more than 15 percent of Tier 1 capital may take this form.

[7]Foreign bank branches can pose difficult technical problems. Some countries require the formal allotment of capital to a branch—in which case the treatment parallels that of a subsidiary. Even when the domestic banking legislation does not require that, the guidelines of the Organization for Economic Cooperation and Development (OECD) authorize the tax authorities to treat an appropriate part of the payment by a branch of a foreign bank to its head office as remuneration for the use of equity capital, if that is what it does represent. The test is one of substance, rather than form, by reference to the facts of the case.

[8]See Emil M. Sunley, "Corporate Income Tax Treatment of Loan-Loss Reserves," in *Taxation of Financial Intermediation: Theory and Practice for Emerging Economies,* ed. by Patrick Honohan (Washington: World Bank, and New York: Oxford University Press, 2003), for a general review of issues.

[9]In broad terms, a specific provision relates to a specific debt or bundle of debts where an actual problem has been identified. A general provision relates to debts generally, where no actual problem has been identified, but a bank makes provisions against a possible problem in the future.

excluded from taxable profit.[10] Again, any such interest subsequently received is brought back to tax.

Practice varies significantly in details, however, from country to country as to how tax relief is actually given to bad debts, as shown in Tables 1.1 and 1.2. There are, broadly speaking, three different approaches.

Commercial Accounts Approach

Countries with well-developed and well-observed accountancy rules base their tax treatment of bad debts on commercial accounting practice rather than on objective quantitative guidelines. Some allow both general and specific provisions for bad debts—in some cases, subject to an overall ceiling. More commonly, these countries may allow no general provision for potentially impaired debts but accept specific provisions for impaired debts, as shown in the commercial accounts. They may require that substantial debts be assessed individually; for large numbers of small debts (for example, in credit card operations), they may accept a formula as giving (in the light of experience) a reasonable calculation of the overall value of the specific impaired debts.

Regulatory Approach

Other countries look for greater certainty—or greater protection for the tax revenue against possibly overly cautious (and, inevitably, somewhat subjective) provisions for impaired debts. A common approach is to relate tax relief to the minimum provisions required (according to objective criteria) by the central bank or other regulatory authority.[11]

Within this group, however, details vary. Some countries give full relief for the loss provisions required by the regulatory authorities. Others argue (rightly) that the regulatory authorities are concerned, above all, about ensuring the stability of the banking system and therefore take a deliberately prudent view (that is, tending toward the pessimistic) of the risks of loan default. By contrast, the tax system seeks to distribute the tax burden fairly among taxpayers and is

[10] Technical issues may arise when interest is said to be "capitalized." Depending on the details of the transaction and the law of the country concerned, such interest may retain the quality of (unpaid) interest for both regulatory and tax purposes. Alternatively, some countries accept that there may be a notional receipt of interest, reinvested in an impaired new loan. In such cases, the regulatory authorities are commonly concerned to ensure that such devices are not used to conceal the fact that a loan has fallen into arrears. For tax purposes, however, if the bank claims a loss provision for the "reinvested" interest, the net outcome on the profit and loss account may be much the same as if the interest had been credited to a suspense account in the first instance.

[11] For example, a central bank may require banks to make provisions of x percent when loan service is more than n weeks overdue; y percent when loan service is more than $2n$ weeks overdue, and so forth.

therefore required to take, to the extent possible, a more neutral view of the risks of loan default. Tax legislation based on this view may exempt 100 percent of the regulatory provisions for proven bad debts from tax, but it commonly disallows any general provisions for unimpaired loans and may disallow provisions for loans only slightly in arrears (or may allow only a percentage of the regulatory provisions for debts considered to be impaired but not in the ultimate loss category).

Charge-Off Approach

A few countries allow provisions for bad debts only when creditors have exhausted all legal means of recovery and written off the debts as finally irrecoverable. However, best practice in modern tax legislation tends to regard this approach as too restrictive and as inhibiting the banks from adopting a prudent level of provisioning.[12]

Anti-Avoidance

Some tax legislation includes anti-avoidance provisions, possibly restricting relief for impaired debts where the debtor and creditor are connected. In such cases, there may be a special provision to preserve tax relief if the parties are deemed to be connected for tax purposes only because the bank has accepted a loan/equity swap in a company debt restructuring. There may be a similar protection when the parties are deemed connected only because the bank has acquired equity as part of its genuine venture capital operations.

A special case arises when, in a company debt restructuring, a creditor swaps a loan for equity (usually worth less than the original loan). When the bank intends to employ any such equity stock in its banking business—for example, it takes it into its loan portfolio—the tax treatment may be to view the loan as sold, and the equity stock is then treated for tax purposes in the same way as other such assets. When the bank accepts the equity stock only with a view to a subsequent orderly debt workout, the equity stock may be treated as an advance, at first at the carrying value of the original loan and, subsequently, at the estimated realization value if less than cost.

Recapitalization

When public funds are employed to write off the losses of a bank (or other business), any corresponding tax losses are also written off. Banks are not allowed to double dip—to off-load the commercial losses and to retain the tax losses to shelter any future commercial profits.

[12] To soften the cost of the transition from a charge-off approach to an accounting or regulatory approach, some countries have phased the reform over a period of years.

Table 1.1. Tax Deductibility of General and Specific Provisions for Bank Loans in Selected Countries

	General provisions		
	Minimum required	Tax deductible?	Limitation on deductibility
Australia	A benchmark of 0.5 percent of risk-weighted credit risk assets	No	Not applicable
China	1 percent of loans outstanding for domestic enterprises; 3 percent of loans outstanding for foreign investment enterprises	Yes	None
France	None	No[1]	Not applicable
Germany	None	Yes	Average ratio of credit losses to loans reduced by 40 percent over the past five years
Hong Kong SAR	None	No	Not applicable
Italy	1 percent of qualifying loans	Yes	Annual limit of 0.6 percent of the loan portfolio up to a cumulative amount of 5 percent
Japan	Based on actual loss over the past three years	Yes	Based on actual losses over the past three years
Korea, Rep. of	None	No	Not applicable
Netherlands	None	No	Not applicable
New Zealand	None	No	Not applicable
Singapore	Up to 3 percent of qualifying loans and investments are encouraged	Yes	Up to 3 percent of qualifying loans and investments
United Kingdom	None	No	Not applicable
United States	Must maintain provisions adequate to absorb estimated credit losses associated with loan portfolio	No[2]	Not applicable

Sources: World Bank, *Bank Loan Classification and Provisioning Practices in Selected Developed and Emerging Countries* (Washington, 2002); and author's compilation.

[1]Except for general provisions for country risk.

[2]Small banks, as defined in the tax law, can choose to use a "reserve" method under which additions to the bad-debt reserve are tax deductible. The size of the bad-debt reserve is based on a six-year moving average of loan write-offs as a percentage of loans. Banks not using the reserve method may deduct only their actual write-offs of specific individual loans.

[3]Uses the "charge-off" method, where bad debts are tax deductible only when deemed completely irrecoverable.

Specific provisions		
Discretionary?	Tax deductible?	Limitation on deductibility
Yes	Yes	Actual write-offs
No	No	Not applicable
Yes	Yes	None
Yes	Yes	None
Yes	Yes	None
Yes	Yes	Limited to highly certain losses
Yes	Yes	Yes
No	Yes	Up to minimum regulatory requirements
Yes	Yes	Actual write-offs and highly unlikely recoveries
No	Yes	Actual write-offs
No	Yes	None
Yes	Yes	None
Not applicable[3]	Not applicable[3]	Not applicable[3]

Table 1.2. Specific Provisions for Bank Loans in Selected Countries

		Pass	Special mention	
	Number of loan categories	Provisions (in percent)	Provisions (in percent)	Months overdue
Australia[1]	—	0.5	—	—
China[2]	5	1	2	—
France[3]	3	—	—	Up to 3
Germany[4]	4	—	—	—
Hong Kong SAR	5	1	2	Up to 3 (unsecured), up to 12 (secured)
Italy[6]	5	1	—	—
Japan	5	—[7]	—[7]	Up to 3
Korea, Rep. of	5	0.5	2	—
Netherlands	—	—	—	—
New Zealand	1	—	—[9]	—
Singapore[10]	5	Up to 3	—	—
United Kingdom	—	—	—	—
United States	5[11]	—	—	—

Sources: World Bank, *Bank Loan Classification and Provisioning Practices in Selected Developed and Emerging Countries* (Washington, 2002); and author's compilation.

Note: — denotes zero.

[1]Banks are allowed to determine their provisioning policy in consultation with external auditors.

[2]Loans have to be classified as nonperforming (substandard, doubtful, and loss) once principal or interest is past due for three months or more.

[3]Loans can also be classified as doubtful if a bank decides that there is a probable risk of default or the loan is the subject of legal proceedings. Special-mention loans are called past-due loans.

[4]Loans with no discernible risks, loans with increased latent risk, loans categorized as nonperforming, and bad debt (losses).

[5]A benchmark of 20–25 percent could be used.

[6]Nonperforming loans are grouped by decreasing order of risk into bad debts, substandard loans, loans being restructured, and restructured loans. Unsecured loans to borrowers from high-risk countries

Selected Issues

Financial Instruments[13]

Derivatives and other financial instruments may be seen as falling into three main categories: (1) interest rate, exchange rate, and other market price-related instruments; (2) other commitments; and (3) guarantees and similar contingent

[13]Derivatives and other such financial instruments are dealt with in more detail in another paper in this volume. Here, only the general approach to the taxation of such instruments held by banks is outlined.

Substandard		Doubtful		Loss	
Provisions (in percent)	Months overdue	Provisions (in percent)	Months overdue	Provisions (in percent)	Months overdue
—	—	—	—	—	—
20–30	3	40–60	—	100	—
—	—	0–100	Over 3	—	—
—	—	—	—	—	—
Loan by loan[5]	Over 3 (unsecured), over 12 (secured)	Loan by loan	Over 6 (unsecured)	100	—
—	—	—	—	—	—
15	Up to 6[8]	70	—	100	—
20	—	50	—	100	—
—	—	—	—	—	—
—	—	—	—	—	—
At least 10	3 or more	At least 50	Over 3	100	—
—	—	—	—	—	—
—	—	—	—	—	—

are treated as nonperforming. Bad debts are claims on insolvent borrowers. Substandard loans are claims on borrowers in temporary difficulty where at least 20 percent of the exposure is more than 6–12 months past due. Loans being restructured are loans where the debtor is indebted to several banks and has applied for consolidation in the previous year. Restructured loans are loans granted a moratorium on repayment and renegotiated at below-market rates.

[7]Based on the actual losses over the past three years of each category.

[8]The use of classification is not a legally binding requirement but rather a supervisory recommendation.

[9]For the amount of the loan that is not expected to be recovered.

[10]Banks are required to classify accounts based on the borrower's financials, creditworthiness, and repayment capability. Loans have to be classified as nonperforming once principal or interest is past due for three months or more.

[11]At a minimum, banks must use these five classification categories but are encouraged to use a larger number, particularly in the pass category.

liabilities. Banks may be involved with such financial instruments by providing them over the counter to clients; as members of stock or futures exchanges; as market makers; as players in the interbank market; for hedging, speculative, or arbitrage purposes on their own account; and, finally, as intermediaries—for example, providing a guarantee for a fee.

The general practice is for such instruments in the hands of banks to be marked to market. Thus, payments and receipts are recognized on a due and payable basis and contracts brought into account at a fair value (the value a company would be able to obtain or willing to pay if it disposed of the contract to

a knowledgeable and willing party at arm's length). The main exceptions are instruments held by a bank for the explicit purpose of hedging its own risks. An accrual treatment may apply when there is documented and specific identification of the intention that the instrument should fulfill a hedging function, and the other side of the hedge is not marked to market. The intention is that there should be consistency, both sides of the hedge being valued on the same basis.[14] In the case of the accrual approach, payments are recognized over the period to which they relate, regardless of when they are paid (thus, for example, the premium for an interest cap may be spread over the life of the cap).

Foreign Exchange Gains and Losses

As a general rule, companies in most countries are required to keep their accounts in domestic currency.[15] On this basis, foreign exchange gains and losses on monetary items—the great majority of banks' assets and liabilities—are calculated at the balance sheet date and recognized as taxable profit or loss. In general, the foreign exchange cost of fixed tangible assets (such as buildings and machinery) and intangible assets (such as equity shares of subsidiaries) is calculated at the date of purchase, and any gain or loss is recognized on disposal. However, when the fixed asset is hedged by borrowings in a relevant foreign currency, gains and losses on the hedged instruments may be offset, and only the net gain or loss on the monetary items may be recognized for tax.

Double Tax Relief

In the main, the same rules for tax credit relief apply to banks as to other businesses. Credit is allowed for tax paid abroad on income earned abroad (or, under some double tax agreements, tax "spared" on such income[16]). The amount of credit for foreign tax is limited to the rate of tax that would have been charged under the domestic tax system on income earned in the domestic economy. Any excess of foreign tax may be deducted from total income as a cost.

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[14]However, when there is a conflict between the accrual approach and the accounting concept of prudence—for example, when there is significant doubt about the future performance of a counterparty—some tax legislation accepts that the prudential concept should prevail.

[15]Exceptionally, a very few countries may allow a company to keep its accounts for tax purposes in a foreign currency that is the currency of its primary economic environment. In practice, this is likely to apply only in the special case of banks operating in U.S. dollars in the international markets. In such cases, profits may be calculated in the foreign currency and converted to the domestic currency only for the purpose of determining the tax payable.

[16]A "tax sparing" clause in a double tax agreement refers to the home country's recognition of foreign taxes paid, even when such taxes are in fact spared by the foreign country (for example, because of applicable investment incentives).

However, there may be some important modifications. Some countries consider that the country of origin should have the primary taxing rights over interest income and therefore allow tax credit relief for foreign tax on interest income only up to an arbitrary limit, for example, 15 percent. Other countries that, in general, grant tax credit relief only to resident businesses extend such relief to interest on loans made through domestic branches of foreign resident banks. In such cases, relief may be limited to the foreign tax that would have been charged on such income earned by a domestic resident bank.[17] Relief may be allowed only in respect of tax charged by third countries, as distinct from the parent bank's country of residence.

A special problem arises with funds that a bank lends abroad. Foreign withholding tax may be charged on the entire amount of interest received from abroad, but the bank's taxable profits are only the net margin between its borrowing and its lending rates. Some countries have special provisions to ensure so far as possible that tax credit relief extends only to the profit margin and does not spill over to shelter profits made in the bank's domestic business. For this purpose, when (as is usually the case) it is not possible to match particular borrowings with particular lendings, tax laws may make an arbitrary deduction for assumed financing costs and may allow double tax relief only on the net margin thus calculated.[18] Anti-avoidance provisions may be included to catch transactions routed directly or indirectly through connected businesses.[19]

Subsidiaries and Branches of Foreign Banks

The general rules commonly embodied in double taxation agreements apply to subsidiaries and branches of foreign banks and to foreign subsidiaries and branches of domestic banks, subject to certain modifications and special challenges. Many countries follow so far as possible OECD guidelines with respect to income taxation and transfer pricing,[20] with one important modification:

[17]The effect of different national double tax agreements may be that the withholding tax charged by country A on interest paid to a branch in country B of a third country bank may be greater than the withholding tax payable on interest paid to a resident country B branch, since the tax agreement between country A and country B may well have provisions that are different from those in the tax agreement (if any) between country A and the third country.

[18]When lending rates are related to the interbank offer rate for the currency in question, the financing costs may be assumed to be the comparable interbank bid rate, or, in the absence of such a market, a margin may be assumed of, say, ⅛ of 1 percent.

[19]One example would be when financing costs are borne by one company within a banking group and the loan interest received by another, and the interest is then remitted to the parent in the form of a dividend—the parent then making a claim for credit relief for the underlying tax.

[20]See OECD, *Model Tax Convention on Income and on Capital* (Paris, 2000); and OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris, 2001).

whereas interest paid by a branch to a foreign head office is not normally tax deductible, interest payable on loans made in the normal course of banking business is deductible, in recognition of the fact that lending and borrowing are the main business of banks.[21] Interest on a branch's free capital, however, is not deductible—see above.

Transfer pricing poses a special problem for the taxation of multinational banks. The usual objective is to ensure that tax relief is not given for transactions between connected persons that would not take place between two independent businesses acting at arm's length and that, in other cases, the transactions are undertaken at genuine arm's-length prices.[22] The practical application is made notoriously more difficult by the ability of modern financial concerns to transfer information, instructions, assets, and liabilities across national frontiers with the click of a button.

One special set of issues concerns ascertaining the source of the profit derived from traditional banking advances. OECD publications suggest that the activity can be broken down into six main components: (1) obtaining offers of new business, (2) establishing new borrowers' creditworthiness and risk profiles, (3) negotiating loan terms with borrowers, (4) deciding whether to make the advance and setting the necessary terms and conditions, (5) concluding the contract and disbursing the loan, and (6) administering the advance, monitoring service, and controlling any securities pledged.

The first four of these components are most important. When they are handled mostly by a resident arm of a multinational bank, the tax authority of the country of residence may claim the right to tax the lion's share of the relevant profit (regardless of where the final contract is concluded) and may not, for example, accept merely a "turn" on funds raised in its territory and channeled by the bank to one of its usual clients through one of its offshore arms.[23]

Another—and perhaps even more problematic—set of issues arises with the location of profits from investment banking. As a matter of commercial practice—even apart from motives of tax avoidance—a bank may draw on specialist expertise located in different arms of its group located in different tax jurisdictions (on different continents) to complete a single contract. It is often

[21]For details, see OECD, *Transfer Pricing and Multinational Enterprises: Three Taxation Issues* (Paris, 1984); and OECD, *Model Tax Convention: Attribution of Income to Permanent Establishments* (Paris, 1994).

[22]Allocation of head office costs is a problem common to banks and other multinational enterprises.

[23]By the same token, a tax authority would not accept a claim for relief in respect of a loss on an advance when the substantive work had been undertaken by a nonresident arm of a bank merely because the contract had been concluded in its jurisdiction, or the advance transferred to it.

impossible to identify the value of the contribution of each separate function. Accordingly, some form of profit-splitting formula may be appropriate. There is no simple rule of thumb for this purpose. Relevant considerations, depending on the precise details of the transaction, may include what risks and costs are borne, what assets are employed, and how these are shared between the different functions or arms.

Turnover Taxes

Some countries impose a form of turnover tax on the gross interest and other income of banks and other financial institutions. Taxes of this kind have a long history, going back several centuries. They have the familiar advantage: they can yield significant revenue without the technical complexities of identifying a net commercial profit. By the same token, however, they have the disadvantage of bearing no relation to ability to pay, and they can be especially harsh on businesses—like most banks—whose profits are a relatively small margin between much larger gross flows of debits and credits. Such taxes are not seen as best practices and thus tend to be absent in most modern tax systems.[24]

[24]See the paper on securities transactions in this volume for more detailed discussions of relevant issues.