Tax NewsFlash

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Global Financial Services

IMF Interim Report for the G-20 – "A Fair and Substantial Contribution by the Financial Sector" – new taxes for the financial sector

The Interim Report released today by the IMF responds to the earlier request of the G-20 for the IMF to prepare a Report on the range of options available to countries on how the financial sector could make a contribution towards paying for government interventions to repair the banking system.

Summary

The Report refers to the significant fiscal cost (and also to other economic and social costs) of recent government interventions and support of the financial system. In that context, the Report notes the various approaches that have been adopted to recover the costs of direct fiscal support from governments and that there are a number of proposed or implemented approaches (for example the US Financial Crisis Responsibility fee to recover intervention costs and the temporary bonus tax in the UK and France).

On the specific point of recovering costs in relation to the recent financial crisis, the Report notes that the least distortionary way to recover such costs would be by way of a "backward looking" tax, probably based on some balance sheet variables as the base for such a tax. However, the bulk of the Report is focused on the future and in particular in the context of noting that the focus of attention has shifted to addressing future financial failures. The Report therefore concentrates on proposals to impose levies and taxes on financial institutions with a view to enacting measures to reduce and address the fiscal costs of such future failures. The Report is clear that, even with strengthened regulatory supervision, there will be such future failures of financial institutions and, equally, that the potential costs of this failure should be borne by the financial sector. Measures related to levies and taxes are intended to ensure that the financial sector meets the fiscal cost of any future support required and also are intended to make failures less likely and less damaging, most importantly by facilitating an effective resolution scheme.

In addition to the above objectives, it is suggested that any measures should also be reasonably easy to implement, requiring only a modest degree of international coordination on the core framework; enable a contribution of the financial sector to reflect the wider fiscal and economic cost of the financial crisis; and also address existing tax distortions and consider the overall burden of regulation and taxation. In particular, it is noted that no single instrument, levy, or tax is likely to achieve all these objectives and therefore a package of measures will be needed.

Two specific categories of measure are therefore proposed. First, it is proposed there should be a levy on financial institutions to cover the net fiscal costs of direct public support to financial institutions and to help reduce excessive risk taking. The levy would be a "Financial Stability Contribution" (FSC). Second, a further contribution from the financial sector would be raised by a "Financial Activities Tax" (FAT) levied on the sum of the profits and remuneration of financial institutions.

In addition to the above measures, there is a call to address current tax distortions (e.g. the bias in relation to debt finance) and aggressive tax planning.

It is noted that more analysis is required and a final set of the measures will be developed for proposal to the G-20 at their June 2010 Summit.

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Financial Stability Contribution Levy

The IMF Report notes the proposals for a levy that have already been announced in Germany, France the UK and the US. The Report proposes that any levy should be linked to an effective resolution regime to avoid the perception that it is just for supporting failing institutions. The Report makes a number of comments on the approach to the design of a levy. First, and perhaps most significantly, it proposes a wide perimeter of the levy – i.e. not just banks to be included – given that a broad coverage would better cover institutions which could be systemic in the future. Thus, a wide variety of financial institutions may well be subject to the levy. In designing the base of the levy, it is noted that this must reflect “riskiness and systemicness” – i.e. those who are more likely to cause fiscal costs should pay more. It is noted that the levy may start off with a simple broad balance sheet base, including some off-balance sheet items but excluding capital, but that over time it may be refined to better capture risks.

No specific rate for the levy is identified but, on the basis that the rate of the levy needs to reflect the risks which are to be provisioned for and that past experience indicates a provision in the range of 2%-4% of GDP, the general approach to determining the basis for a rate of the levy is identified. The Report suggests that the levy would be applied uniformly across financial institutions at first but might be adjusted in time as the methodology of the levy is refined.

It is suggested that the proceeds of a levy should finance a dedicated fund, possibly to finance a resolution agency whose duty, amongst other things, would be to manage failing institutions.

It is noted that the formation of both the levy and such resolution funds should be guided by an internationally accepted set of principles. These principles could, for example, cover the determination of the target size of the fund, the level of annual levies and the base on which they are imposed, together with the treatment of foreign branches and foreign subsidiaries and the treatment of different classes of creditors. The possibility of creating a multi-country (e.g. pan-European) fund is also envisaged and it is suggested this is virtually a necessity for closely integrated financial markets.

Financial Activities Tax

Two reasons are given in the Report for the consideration of additional tax measures, going beyond a levy of the type discussed above. First, it is noted that the large fiscal, economic and social costs of financial crises themselves suggest a contribution of the financial sector to general revenues going beyond the fiscal cost of direct support. Second, various proposals have been made for taxes aimed at correcting “adverse externalities” from financial sector decisions, such as the creation of systemic risk and excessive risk taking. The discussion assumes that any revenues from such additional tax instruments would go to general revenues rather than to a special fund.

It is noted that the crisis has renewed interest in the possibility of a financial transactions tax, such as a “Tobin” tax on transactions. The Report states that most G-20 countries already have some financial transaction taxes in various forms so the possibility of an internationally co-ordinated financial transaction tax should not necessarily be dismissed on the grounds of practicality. However, it is noted that there are various issues which make a financial transaction tax less attractive (e.g. that it would not be the best way to finance a resolution mechanism of the kind discussed above; that it would not be focused on core sources of financial instability; and that its real burden may fall largely on final consumers rather than earnings in the financial sector. Further concerns are also expressed that it may have a distorting effect and be subject to tax avoidance.

A FAT is presented as a preferable option. This would be levied on the “sum of profits and remuneration of financial institutions”. The Report notes that there are precedents for such an approach to taxation, and cites Israel by way of example. It noted that a FAT would be less distorting in effect and would also meet the objectives of the G-20. The proposal for a FAT seems to be based on the view that the financial sector is under taxed and it is discussed in the context of the broad-based VAT exemption which applies to the financial sector. The intention seems to be that the FAT would reduce the size of the financial sector and would be intended to

offset the risk of the financial sector becoming unduly large because of its favourable (VAT exempt) tax treatment.

The FAT would be a tax on “excess” returns and would therefore be regarded as mitigating excessive risk taking. It is clear from the discussion that a relatively low tax rate is contemplated on the basis that a higher rate (e.g. in excess of the VAT rate) would have a distorting effect and also on the basis that a low rate could in any event raise significant revenue. An example is given in the Report that a 2% FAT in the UK could raise about 0.1% to 0.2% of GDP.

The Report does not contain much detail on how the FAT would operate and in particular does not comment on how the two distinct elements (profits and remuneration) would combine to form the tax base. However, the FAT proposal is seen by the IMF as relatively straightforward, given that taxing profits and applying withholding on remuneration are “everyday functions of almost every tax administration”, although it is noted that certain “border” issues would need to be dealt with.

PwC Comments

There are a number of important points emerging from this interim Report.

The most striking feature of the proposals is that they are very broad based and go well beyond application to banks alone. This is the case not just with the proposed FAT but also with the FSC levy which seems likely to apply to a very wide range of financial institutions. Clearly, as the detail is developed, there will be significant questions that will need addressing as to the scope and definition of financial institutions for these purposes.

The FAT also seems to be wide ranging both in relation to the type of measures that are contemplated and the type of tax payers affected.

The measures proposed will require an unprecedented level of cooperation with regulators, presumably both in-country and internationally. A very significant level of cooperation would also seem to be required between tax authorities across the globe.

There are likely to be some challenging questions in relation to how these measures fit within the existing treaty framework, including particularly measures preventing double-taxation. Even if the proposed FSC levy falls wholly outside the scope of tax treaties, it is clear that other aspects of the package – particularly the FAT – will lead to a number of questions in relation to the interaction with existing double-tax treaties.

It is also somewhat surprising that the IMF has extended their review and recommendations into the areas of aggressive cross-border tax planning and also wishes to address what look like some fairly fundamental tax principles in the financial services arena. It is not yet clear whether this aspect of the work (which is not discussed in any detail in the Report) will lead to a wider co-operation between the IMF and the OECD.

This package of tax measures is likely to lead to a steep increase in the taxation for the financial sector in the short term with potentially more tax change later (as a result of a review of the perceived tax bias towards debt, etc). However, it is by no means the only development and further material regulatory change is also likely to emerge in the coming months. From a combined tax and regulatory perspective, the financial sector faces a difficult – and expensive – future. To the extent that this causes financial firms to retrench or cut back activities, for example by reducing trading or lending or increasing costs, this would lead to unwelcome and adverse economic impacts. These broader impacts require further analysis and consideration.

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