COMMON CONSOLIDATED CORPORATE TAX BASE WORKING GROUP (CCCTB WG)

Tax treatment of financial institutions

Meeting to be held on Thursday 9 March 2006

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WORKING DOCUMENT
I. Introduction and purpose of the paper

1. During the discussions on certain structural elements of the Common Consolidated Corporate Tax Base (CCCTB) such as provisions and financial assets, it was pointed out that in several domestic tax systems special rules apply to the 'financial sector', compared to the 'ordinary' manufacturing, trading and servicing sectors. It was agreed to postpone the discussions on such special rules to a later stage, on the basis of a separate Working Document on financial institutions to be prepared by the Commission Services.

2. The purpose of this Working Document is to: (i) identify the financial institutions which may deserve special rules, and (ii) analyse the elements of the tax base where special rules for those financial institutions may be required, such as: financial assets/liabilities; bad debts, and provisions. Members of the CCCTB WG are invited to suggest any further items which should also be considered.

3. The discussions, which could be deepened in a sub-group (either an existing one or a newly established one formed by sectorial experts), should provide input to the Commission Services to eventually decide if financial institutions should be covered by the CCCTB as any other entity, but with specific rules when it is deemed to be necessary or appropriate, or be subject to entirely different rules.

4. It is the Commission Services' opinion that, in general, the financial institutions should be subject to the same set of tax rules as the 'ordinary' entities, except where a special treatment is justified due to the specificity of the financial institutions. In other words, it is not necessary to establish a separate tax base for financial institutions, but rather to foresee some derogations in clearly identified cases.

5. Financial institutions are very often subject to strict supervision by the public regulators, and in some cases (for example the insurance or the credit institutions) the legislation is highly harmonised at EU level. This allows the use of existing definitions in this Working Document. The reason justifying a 'special treatment' is the nature itself of this sector of business, which presents different risks and requires a high level of regulation to protect investors and consumers. However, it should be pointed out that a special tax treatment should only reflect the peculiar feature of the financial sector and should not represent a more favourable treatment or even a disguised incentive.

6. As usual, the analysis starts from a brief overview of the accounting rules. At EU level there are several accounting directives for some financial institutions, among others: Directive 86/635/EEC on the annual and consolidated accounts of banks and other financial institutions; Directive 91/674/EEC, on annual and consolidated accounts of insurance undertakings. In addition, the fourth Council Directive (78/660/EEC) on annual accounts of certain types of companies and the seventh Council Directive (83/349/EEC) on consolidated accounts apply to financial institutions, as well.

7. Under certain conditions, financial institutions apply International Financial Reporting Standards/International Accounting Standards (IFRS/IAS) and in particular IFRS 4 on 'Insurance contracts' and IAS 32 and IAS 39 on Financial Instruments and IAS 30 on 'Disclosures in the Financial Statements of Banks and Similar Financial Institutions', as follows: (i) in accordance with Regulation 1606/2002, all companies

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1 IFRS 7 on Financial Instruments Disclosures will supersede IAS 30 for annual periods beginning on or
whose securities (equity or debt), at their balance sheet date, are admitted to trading on a regulated market of any Member State (MS) must apply IFRS/IAS; (ii) some MS require the use of IFRS/IAS to certain non listed entities of the financial sector\(^2\). This leads to the application of the IFRS/IAS to the vast majority of the financial institutions.

8. This Working Document does not discuss consolidation issues; however, as regards financial institutions, it may be useful to bear in mind that:
   - The IAS 27 on 'Consolidated and separate financial statements' considers that a subsidiary should not be excluded from consolidation because its business activities are dissimilar from those of the other entities within the group;
   - The institutions in the financial sector may be of different types, some of them are incorporated but not all of them (i.e. an investment fund or insurance mutuality), and this may have an effect on the consolidation regime;
   - Some MS currently apply different tax rates to certain financial institutions, and for this reason, for tax purposes, do not consolidate them with other entities that apply the 'ordinary' tax rate.

9. Similarly, this Working Document does not discuss international aspects; however, for the sake of completeness, it should be mentioned that the work carried out within the OECD concerning the attribution of profit to a permanent establishment for the banking and insurance sector and the global trading of financial instruments has shown that these sectors deserve special treatment due to the very particular way they carry out their business.

10. The same applies to the formulary apportionment, as the allocation keys for financial institutions may be different, because, for example, for some of these entities the factor 'sales' is not really relevant, while the factors 'assets' and 'risks' are more important.

► Would members of the group agree that the CCCTB should consider the specialities of the institutions in the financial sector?

► Would members of the group find it appropriate that the financial institutions are subject to the same set of tax rules as the 'ordinary' entities, except where a special treatment is justified due to the specificity of the financial institutions?

\(^2\) Belgium for credit institutions; Italy for the supervised financial companies, companies with financial instruments widely distributed among the public, insurance companies; Portugal for the consolidated accounts banks and financial institutions from 2006; Sweden for financial institutions and insurance companies to apply from 2006; Estonia for annual and consolidated accounts of credit and financial institutions; Latvia for the annual and consolidated accounts of banks, insurance and other supervised financial institutions; Lithuania for annual and consolidated accounts of for banks and their controlled financial institutions; Malta for annual and consolidated accounts of all types of companies; Poland for annual accounts of banks; Slovakia for all companies and Slovenia for banks and insurance companies.
II. Types of financial institutions to be analysed

11. Credit Institutions: Directive 2000/12/EC of 20 March 2000 (as amended) 'relating to the taking up and pursuit of the business of credit institutions' defines the "credit institution" as an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account. The legal form of such institutions can vary: banks, savings banks (caisses d'epargne), co-operatives or others.

12. Additionally, it should be noted that Directive 2000/12/EC of 20 March 2000 (as amended) 'relating to the taking up and pursuit of the business of credit institutions' provides a long list of financial activities subject to mutual recognition\(^3\), in order to obtain the 'passport' that allows them to operate in all MS without additional authorization.

13. In this respect, Financial Institutions are undertakings the principal activity of which is to acquire holdings or to carry on one or more of the financial activities referred to in the list, except taking deposits or other repayable funds from the public than can only be carried on by credit institutions.

14. From a financial point of view, the distinction between credit and financial institutions triggers significant consequences in terms of requirements (such as prior authorisations, capital, and management) and freedoms of establishment and of providing services within the European Community. It also effects the technical instruments of the prudential supervision (own funds, solvency ratio, large exposures etc.).

15. However, from a tax point of view, credit institutions and financial institutions as defined above present similar issues and MS will have to decide if they deserve equal treatment.

16. Insurance Undertakings: this heading covers those undertakings which are engaged in one of the following activities:

\(^3\) 1. Acceptance of deposits and other repayable funds;
2. Lending;
3. Financial leasing;
4. Money transmission services;
5. Issuing and administering means of payment (e.g. credit cards, travellers' cheques and bankers' drafts);
6. Guarantees and commitments;
7. Trading for own account or for account of customers in:
   a. money market instruments (cheques, bills, certificates of deposit, etc.);
   b. foreign exchange;
   c. financial futures and options;
   d. exchange and interest-rate instruments;
   e. transferable securities;
8. Participation in securities issues and the provision of services related to such Issues;
9. Advice to undertakings on capital structure, industrial strategy and related questions and advice as well as services relating to mergers and the purchase of undertakings;
10. Money broking;
11. Portfolio management and advice;
12. Safekeeping and administration of securities
13. Credit reference services
14. Safe custody services
- Life insurance as defined in Directive 2002/83/EC of 5 November 2002 concerning life assurance;


17. Similarly to credit institutions there are different legal forms of entities, such as profit entities, mutual funds, co-operatives or others.

18. Collective Investment Vehicles, are undertakings whose sole object is the collective investment in transferable securities and/or in other assets and whose units are, at the request of holders, re-purchased or redeemed, directly or indirectly, out of those undertakings' assets.

19. There are various types of collective investment companies, depending on legal forms, characteristics, etc. They can be established under the law of contract (as common funds managed by management companies) or trust law (as unit trusts) or under statute (as investment companies). They can be closed-ended when the number of units is pre-determined and not subject to modification, or open-ended when the value of the equity changes constantly due to new subscriptions and/or reimbursements from/to the unit-holders. All of them may invest in movable or immovable property.

20. At EU level the Undertakings for Collective Investment in Transferable Securities (UCITS) have been regulated by means of Council Directive 611/1985⁴, as subsequently amended. Recently, a Green Paper on the Enhancement of the EU Framework for Investment Funds⁵ has been published by the Commission. The UCITS benefit from a 'passport' allowing them - subject to notification - to be offered to retail investors in any of the EU jurisdiction once authorised by one MS.

21. Pension Funds are without doubt an important part of the financial sector. The Directive 2003/41/EC of the European Parliament and the Council on the activities and supervision of institutions for occupational retirement provision was adopted on 3 June 2003. Its objective is to allow pension funds to benefit from the Internal Market principles of free movement of capital and free provision of services. In some countries these entities do not have legal personality.

22. Venture Capital. The Venture Capital institutions actively invest in business with high growth potential, and help them create value over several years, by participating in the equity of the company. The investment is made through a negotiated process and over a limited number of years to make the business more efficient and help in its development.

23. The Venture Capital institutions may have different legal forms such as funds, trust or companies.

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⁵ SEC (2005) 947
Do members of the group agree with the list of entities that should be analysed? Do members of the group consider that there is need to analyse any other entity? If so, which entities should be additionally analysed?

III. Specificities of financial institutions to be considered

A) Credit institutions and other financial institutions

24. The main EU Directive in relation to the accounts of credit institutions and other financial institutions is Directive 86/635/EEC on the annual and consolidated accounts of banks and other financial institutions (the so-called Bank Accounts Directive). This Directive describes the layout and content of the annual and consolidated accounts of such institutions and includes reference to the valuation of certain items. The Directive recognises that each MS has its own national accounting practices.

25. Due to the specific characteristics of this business, at least the following aspects should be analysed:

26. Recognition, measurement and evaluation of financial assets. The financial assets represent the 'core business' and the most important items in the accounts credit institutions and other financial institutions.

27. The accounting and tax treatment of financial assets has been already touched upon in a previous Commission Services Working Document (CCCTB\WP\023), where reference was made to the existing International Accounting Standards, and therefore a similar analysis will not be repeated here.

28. However, some MS currently apply different rules for financial assets belonging to financial institutions compared to the rules which are applicable to 'non-financial' institutions and some have already shown their preference to continue this application. In particular, some MS apply a 'mark to market' approach for accounting and taxation of the trading books of financial assets and it would be very difficult to convert back to historical costs.

29. The bad debts provision: a special treatment for credit institutions and other financial institutions is probably justified as their lending activities are part of their main business. There are very specific ways of calculating provisions for bad debts, in the Bank Accounts Directive and in the IAS 30, essentially both require a case-by-case approach and a global approach based on past experience. The Bank Accounts Directive establishes a maximum amount for the latter.

30. The IAS 30 refers to the losses on loans and distinguishes between:

   - The amount of losses that has been specifically identified.
   - The amount of potential losses not specifically identified but which experience indicates that they are present in the portfolio of loans.

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6 Article 37.2.a) Directive 86/635/EEC
- Any other amount that local circumstances or legislation may require or allow a bank to set aside in addition to the formers.

31. The first two groups are considered as expenses, while the third group represents retained earnings and not expenses. The IAS 30 does not establish a limit to the amount of the second group, and considers that it should be based on 'the judgment of the manager', with the only requirement that the criteria apply in a consistent manner from period to period.

32. The MS may authorize a 'Fund for General Banking Risk', that shall include the amounts which a credit institution decides to put aside to cover the particular risks associated with banking. These funds are considered retained earnings, so they should not be treated as deductible provisions.

33. Finally, as there are financial institutions with different status (e.g. some of them are non-profit entities), it should be analysed whether there should be any difference in the treatment depending on – for example - their legal form. Among the various MS, some differentiate such institutions by means of a different treatment as regards the tax rates (this would be of course outside the scope of the CCCTB) or as regards specific incentives. This would also affect the consolidation regime (such institutions may be excluded from consolidation even though they belong to a group).

► Do members of the group consider that the financial assets owned by credit entities should be valued at fair value following the rules contained in the IFRS/IAS, and taxed accordingly (i.e. taxation of unrealised gains and losses)?

► Should the bad debts provision of the credit entities be treated in a different way than the bad debts provision of 'ordinary' entities? If so, should a global approach be accepted? If yes, with which limits (if any)?

► Are some specific rules required for some credit entities with special characteristics?

► Are there further issues that MS wish to discuss in this respect?

B) Insurance Undertakings

34. There are several accounting Directives for the insurance sector, the most recent one is Directive 91/674/EEC of 19 December 1991 on the annual and consolidated accounts of insurance undertakings (the so-called Insurance Accounting Directive), that applies to all the insurance entities (life, non life and reinsurance). The Directive contains several provisions concerning the Balance Sheet and the Profit and Loss account as well as some valuation rules. In addition, the Directive also provides guidance on how to calculate provisions which are specific to the insurance sector. However, such guidance is not detailed and nowadays one can observe significant differences amongst MS.

35. Among the areas where - possibly - the insurance sector requires a special treatment there are the following ones:

36. Recognition, measurement and evaluation of financial assets. The same questions raised in the previous section may apply (see paragraphs 26 to 28).
37. Additionally, the life-assurance policies where the investment risk is borne by the policyholders (Unit Linked) create a link between the assets and the liabilities: the policyholder assumes the investment risk of the assets (totally or partially) in which the life insurance provision is materialised, while the actuarial risk is assumed by the insurance undertaking. For this reason, the assets need to be differentiated in the Balance Sheet of the company. It may be reasonable to evaluate these assets at fair value, as symmetry between the assets and the liabilities for these contracts is desirable.

38. As regards the insurance technical provisions, as already mentioned, there may be large differences between the MS. The differences may lie in the types of provisions or the way to calculate them. A practical way forward would be to apply a mutual recognition of domestic technical provisions, as was considered for other provisions (such as clean-up costs).

39. The provisions regulated in the Directives are as follows:

40. Provision for unearned premiums: this comprises the amount representing that part of gross premiums written to be allocated to the following financial year(s). This method is consistent with the generally accepted accounting concept of accruals and matching.

41. Such a provision should in principle be computed separately for each insurance contract. MS may, however, permit the use of statistical methods, and in particular proportional and flat-rate methods, where they may be expected to give approximately the same results as individual calculations.

42. This provision should be deductible, because it fulfils the criteria discussed in SG2.

43. The provision for unexpired risks is the amount set aside in addition to unearned premiums in respect of risks to be borne by the insurance undertaking after the end of the financial year, in order to provide for all claims and expenses in connection with insurance contracts in force in excess of the related unearned premiums and any premiums receivable on those contracts.

44. The provision for unexpired risks supplements the unearned premium provision on contracts that are reasonably foreseeable to be loss making. This provision should be constituted when the insurance undertaking at the end of the year realises that the amount of the premiums allocated for the following financial year is not enough to cover all claims. It is possible that potential claims were underestimated or changes in the law or case-law require insurance undertakings to cover more risks than those considered when the premiums were calculated.

45. Provision for unexpired risks is usually calculated on a global basis and its deductibility is more questionable compared to provisions for unearned premiums. It should be noted that some countries do not allow its deductibility, as it is intended to

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7 For example, all the 'old' EU Member States but Greece permit the use of statistical methods, but such methods are rarely used in practice (according to the Study 'into the methodologies to assess the overall financial position of an insurance undertaking from the perspective of prudential supervision', published by the Commission Services in May 2002, and prepared by KPMG)
cover potential future losses estimated sometimes according with the past experience of
the company, although it refers to contracts that are in existence at the reporting date.

46. Provisions for claims outstanding: the Insurance Accounting Directive defines this
provision as the total estimated ultimate cost to an insurance undertaking of settling all
claims arising from events which have occurred up to the end of the financial year,
whether reported or not, less amounts already paid in respect of such claims.

47. The provision for claims outstanding refers to different situations:
   - The events incurred but not reported (IBNR).
   - Notified claims to date (agreed and not yet agreed) less paid claims to date.

48. According to the Directives the provision should in principle be computed separately
for each case on the basis of the costs still expected to arise. Statistical methods may be
used if they result in an adequate provision having regard to the nature of the risks.

49. This provision should be deductible as it fulfils the general criteria of deductibility
discussed in SG2.

50. Life assurance provision: this provision is used to stabilize the premiums payable
along the life of the contract, with the consequence that the premium paid by the insured
person when s/he is young is usually higher compared to the risk and vice-versa.

51. The provision should comprise the actuarially estimated value of an insurance
undertaking's liabilities after deducting the actuarial value of future premiums.

52. The life assurance provision should in principle be computed separately for each life
assurance contract. Member States may, however, permit the use of statistical or
mathematical methods where they may be expected to give approximately the same
results as individual calculations.

53. The life assurance provision represents future obligations of the undertaking. This
provision is usually deductible in the MS, and fulfils the criteria of deductibility agreed in
SG2.

54. Provision for bonuses and rebates: the amounts intended for policyholders or contract
beneficiaries by way of bonuses and rebates; this provision is only significant for life
insurance.

55. The Directive does not establish how to calculate it. In principle this provision fulfils
the general criteria of deductibility.

56. The equalization provision (also referred to as equalization reserve): that shall
comprise any amounts set aside in compliance with legal or administrative requirements
to equalize fluctuations in loss ratios in future years or to provide for special risks.

57. The catastrophe and equalisation provisions provide additional safety margins in
volatile areas of non-life business. Where amounts are set aside in financial statements
and regulatory returns to equalise fluctuations in future claims experience, these are
usually treated as provisions for regulatory purposes (that is as a liability rather than as a
component of capital). These provisions are in addition to the requirement to set up
outstanding claims provisions for liabilities arising out of insurance contracts in so far as they can be reasonably foreseen.

58. EU Directives only require the equalisation provision to be set up for credit insurance. For all other classes of insurance each member state is free to define the rules it wants to or to make no requirements.

59. According to the IFRS 4 an insurer shall not recognise as a liability any provisions for possible future claims, if those claims arise under insurance contracts that are not in existence at the reporting date (such as catastrophe provisions and equalisation provisions).

60. The deductibility of this provision is more questionable as it refers to contracts that do not exist at the balance sheet date. According to the definition of provision agreed in SG2 this would not be a provision but a reserve.

61. The need to allow the deductibility of the equalization provision is related to the possibility to carry losses back and forward. If unlimited carry back and forward of losses were allowed, this provision would probably not be needed, but on the contrary, the deductibility of this provision may be desirable for those risks with high fluctuations.

62. Catastrophe provisions: A distinction should be noted between equalisation provisions, which equalise loss ratios over time for volatile lines of business, and catastrophe provisions, which insurance undertakings sometimes incorporate within claims provisions to recognise the potential impact of future catastrophic claims events. The concepts and accounting considerations are similar, but it is the former which are required by the European Directives.

63. The problematic will be very similar to the one of the equalization provisions.

64. Technical provisions for life-assurance policies where the investment risk is borne by the policyholders (Unit Linked): This item shall comprise technical provisions constituted to cover liabilities relating to the Unit Linked policies.

65. These provisions have the same characteristics as the life insurance provisions and should follow the same treatment. They must be disclosed separately in the Balance Sheet because they are invested in a different way: the policyholder is the one that bears the investment risk.

66. Finally, there are, also for insurance, entities with different characteristics (some of them are non-profit entities), it should be analysed whether there should be any difference in the treatment depending on the legal form. A possibility could be to differentiate as regards the tax rates (this would be of course outside the scope of the CCCTB) or as regards incentives. When dealing with consolidation some of these entities may have to be considered as they may fall outside the group.

► Do members of the group consider that the financial assets owned by insurance undertakings should be evaluated at fair value following the rules contained in the IFRS/IAS, and taxed accordingly (ie taxation of unrealised gains and losses)?
Should the technical provisions of the insurance undertakings be deductible? All of them? With which limits (if any)?

Are some specific rules required for some insurance undertakings with special characteristics?

Are there further issues that MS wish to discuss in this respect?

C) Collective Investment Vehicles

67. The tax treatment of Collective Investment Undertakings varies considerably among MS, although MS tend to give the same treatment even if the legal form of the Investment Vehicle is different. The investment funds are not legal entities but are undivided joint ownerships, this explains why sometimes tax legislation treats funds as taxpayers themselves, and sometimes the income generated inside the fund is taxed in the hands of the participants (fiscal transparency and look-through mechanism).

68. When Collective Investment Vehicles are treated as taxpayers themselves, various technical solutions for their taxation are possible. Some domestic legislation applies the same tax rules which apply to manufacturing or trading enterprises, sometimes with a special rate. In cases of very low rates there is a quasi exemption or exemption of the Collective Investment Vehicles. This avoids having to apply the look through mechanism (very complicated if the number of participants in the fund is large). Some other countries apply a separate tax mechanism which substitutes the ordinary corporate income tax, for example by applying to the result of the investments in the previous year (the difference between the equity at the beginning and at the end of the year, taking into account subscriptions and reimbursements during the year) a substitutive tax rate.

69. When Collective Investment Vehicles are treated as flow-through entities, the unit holders may be taxed: (i) only in the event that the profit earned by the undertaking (if any) is distributed; or (ii) even when any profit has not been distributed. This can be very complicated, since the number of unit holders (which can be large) varies often. Some MS require the Collective Investment Vehicles to distribute periodically the income among the participants (so the participants are only taxed on the distributed income).

70. The work and the discussions in the CCCTB WG consider a consolidated approach; these entities, due to their specific characteristics, in most of the cases will be unable to consolidate. MS should therefore decide if the CCCTB should apply to the Collective Investment Vehicles even if they are excluded from the consolidated group.

71. If the Collective Investment Vehicles are included in the CCCTB, perhaps some specific rules should be envisaged for the treatment of financial assets. If the general rule applying to financial assets were to be the exemption of unrealised gains it is hardly feasible for the Collective Investment Companies to keep track of historical values.

Should the Collective Investment Vehicles be included in the scope of the CCCTB?
If Collective Investment Vehicles are to be covered by the CCCTB, should they deserve a different treatment for certain structural element of the tax base (such as the tax treatment of financial assets) or should they follow the 'ordinary' CCCTB rules?

If Collective Investment Vehicles are not covered by the CCCTB, should there be a harmonised approach concerning their taxation to curtail the scope for tax planning opportunities?

Are there further issues that MS wish to discuss in this respect?

D) Pension Funds

72. Pension Funds, similarly to the Collective Investment Funds, are not legal entities but are undivided joint ownerships; therefore, the same problems analysed for the Collective Investment Funds may arise.

73. Pension Funds are usually subject to the corporate income tax but could either be exempted or taxed at very low expeditiential rates. Most current MS tax occupational pensions according to the EET system (Exempt contributions, Exempt investment income and capital gains of the pension institution, Taxed benefits) or ETT principle (Exempt contributions, Taxed investment income and capital gains of the pension institution, Taxed benefits). Usually there are some requirements to be fulfilled to exempt or apply special rates.

74. The work and the discussions in the CCCTB WG consider a consolidated approach; but pension funds will be unable to consolidate. MS should therefore decide if the CCCTB rules should apply to the Pension Funds even if they are excluded from the consolidated group.

75. If the pension funds are to apply the CCCTB rules some specific treatment of the financial assets may be desirable.

Should the pension funds be included in the scope of the CCCTB?

Are there further issues that MS wish to discuss in this respect?

E) Venture Capital Institutions

76. The Venture Capital Institutions may again have different legal forms, mainly companies, funds or trusts. Some of these entities do not have legal personality but even though they are sometimes subject to corporate income tax. The problems that may arise because of the legal form of these entities do not differ from the ones already analysed when dealing with the Collective Investment Vehicles. In any case, the Venture Capital Companies are usually subject to the Corporate Income Tax as any other corporation.

77. Again, when adopting a consolidated approach, some problems may arise, as some of these entities may fall outside the consolidated group due to their specific legal form and characteristics.
78. The MS very often provide the Venture Capital Institutions with some special incentive, which usually consists of the exemption or the deferral of the realised capital gains subject to certain requirements. However, this will have to be dealt with in the future when dealing with tax incentives.

► Should all venture capital vehicles be included in the scope of the CCCTB? If no, should the Venture Capital Companies be included in the scope of the CCCTB?

► Are there further issues that MS wish to discuss in this respect?