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# The use of tax law from a macroprudential perspective: the impact of some recent tax measures on procyclicality and banks' stability

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*Summary*

A number of recent changes to Italian tax law have important implications for financial stability. The taxation of banks' loan losses has been revised, attenuating its procyclicality, encouraging the adoption of more prudential loan valuation policies and contributing to the transparency of banks' balance sheet. For all firms, financial and non-financial alike, the allowance for corporate equity (ACE) system, which reduces the penalization of equity with respect to debt financing, has been reinforced, encouraging capital strengthening. Lastly, changes to the taxation of hybrid capital fund-raising have removed the impediments to issuing subordinated securities.

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## Introduction and main conclusions

The Stability Law for 2014 has modified the tax treatment of banks' loan losses.1) The timeframe for their deduction for purposes of corporate income tax (IRES) has been altered, permitting banks to complete it in 4 years (as against 18 previously). Further, the deduction has been extended to apply also to IRAP, the regional tax on productive activities (banks had previously paid IRAP on their loan losses). These two measures have removed a penalization that put Italian banks at a disadvantage by international standards; they make it less costly for them to adopt more prudential loan valuation policies and lessen the implicit cost of the "forced loan" that banks make to the tax authorities owing to the instalment structure of the deduction. Both these effects lighten the tax burden on banks in periods of heavy losses, allowing them to deduct larger amounts in cyclical downturns and thereby reducing the tax system's procyclicality. According to our simulations, in a year of heavy losses, such as 2012, the new rules would have reduced the banking system's tax bill by about €1.3 billion; in a "normal" year, such as 2006, the reduction would have come to €0.3 billion.

Other measures introduced with the Stability Law encourage banks' capital strengthening. Like all Italian firms, banks benefit from the changes to the allowance for corporate equity (ACE), the mechanism introduced in Italy in 2011 to reduce the tax distortion in favour of debt financing. The notional return on equity that can be deducted from income, equal to 3.0 per cent in 2013, will gradually increase to 4.75 per cent over the three years 2014-16. In addition, the implicit cost of issuing hybrid instruments has been reduced by making income deriving from write-downs of such securities upon their conversion into equity no longer taxable. Both measures, insofar as they make it less costly for banks to resort to equity capital, help to strengthen banks' stability and thereby increase their capacity to finance the economy.

## 1. The tax treatment of loan losses: the old rules

*The tax treatment of loan losses was particularly penalizing*

The tax treatment of loan losses was particularly penalizing for Italian banks up to 2012. The rules for their deductibility from the tax base differed depending both on the tax (corporate income tax, IRES, with a rate of 27.5 per cent, or the regional tax on productive activities, IRAP, with an overall rate of about 5.5 per cent) and on the manner of accounting for value adjustments (losses realized on disposals, write-offs, write-downs).

For purposes of IRES, write-downs were immediately deductible up to an amount equal to 0.3 per cent of balance-sheet loans; amounts exceeding that limit could be deducted in equal portions in the following 18 financial years. Write-offs and losses on disposals were deductible in their entirety and immediately. For purposes of IRAP, only losses on disposals could be deducted completely in the first year, while write-downs and write-offs were non-deductible (see the table on page 4). This structure had multiple negative effects for banks.

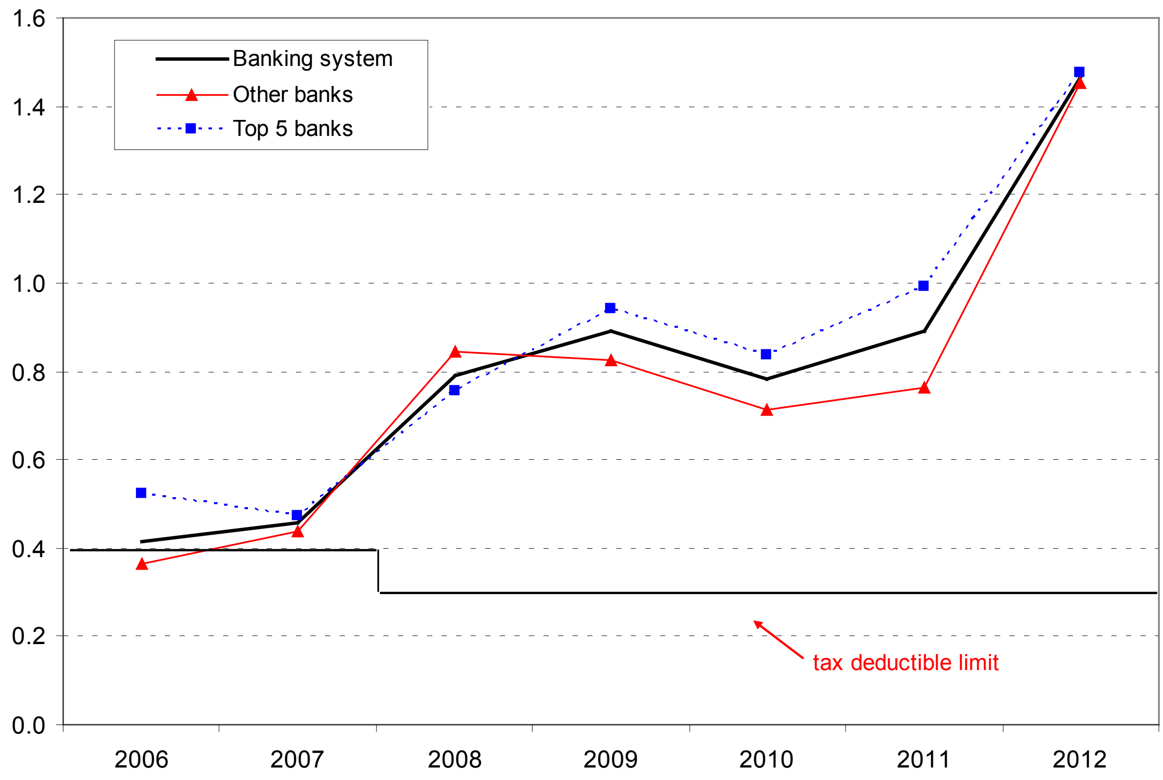
1) Law 147/2013 published in *Gazzetta Ufficiale* No. 302 of 27 December 2013. We use "losses" as a generic term for the different ways in which banks can account for loan value adjustments (write-downs, write-offs, losses recognized upon disposals of loans).

*The IRES regime did not have direct effects on the profit and loss account ...*

Let us begin with the effects stemming from the corporate income tax. From 2006 to 2012 write-downs were by far the leading method of accounting for losses. The figure shows the evolution of write-downs as a percentage of balance-sheet loans and compares them with the deductible limit for corporate income tax purposes. Up to 2007 that limit permitted the banking system to deduct about 90 per cent of its loan write-downs immediately. From 2008 onwards, with the recession and the associated deterioration in credit quality, the gap between the volume of write-downs recorded in the accounts and the immediately deductible amount widened. The lowering of the limit of immediate deductibility from 0.4 to 0.3 per cent since 2008 contributed to this trend. In 2012, when the incidence of write-downs reached a peak, the immediately deductible portion represented barely one–fifth of the total amount.

This mechanism translated into an advance payment of corporate income tax by banks, offset by a corresponding increase in deferred tax assets. Consequently, it did not have a direct impact on the profit and loss account, which is drawn up on an accrual basis.[2)]

**Write-downs on loans and the limit of deductibility for corporate income tax purposes**
*(as a percentage of balance-sheet loans)*




Note: From 2005 to 2007 the limit was 0.4 per cent; from 2000 to 2004, 0.6 per cent. In both periods, the amount in excess was deducted in the 9 subsequent financial years.

2) Assume that a bank with a €50,000 loan portfolio records a result gross of write-downs equal to €1,000, write-downs equal to €500 and hence a gross profit of €500. Under the regime in force up to 2012, the write-downs are deductible only for corporate income tax purposes and only for €150 (€50,000*0.3%). IRES is therefore calculated on taxable income of €850. With a tax rate of 27.5%, the bank pays €233.75 of tax but is now entitled to pay less tax in the next 18 financial years: this allows it to record deferred tax assets of €96.25 (€350*27.5%). In the profit and loss statement, below gross profit, the bank enters €233.75 of tax due on a cash basis and an "income item" of €96.25 (smaller amounts of taxes due in the financial years to come). The net tax liability is €137.50 (27.5% of €500 gross profit for the year), so the accrual principle is observed. The net profit of €362.50 (€500-€137.50) is entirely distributable: the fact that it is composed in part of deferred tax assets is immaterial.

*... but resulted in a forced loan to the tax authorities*

As a consequence of this mechanism, however, the banks granted the tax authorities a substantial interest-free "forced loan", which drained liquidity from the banking system and had an opportunity cost equal to the income that the banks would have received if they had been able to invest the same amount in interest-bearing activities. With reference to end-2012 deferred tax assets, we estimate this opportunity cost at €100 million per year for the banking system.

*The IRAP regime resulted in the payment of taxes on loan losses*

As mentioned, for purposes of the regional tax on productive activities, write-downs and write-offs were not deductible from the tax base;[3] this had a negative impact on the profit and loss account, all the more so during cyclical downswings.

## 2. The effects of the new system

*The new rules attenuate these disadvantages*

The new system, which applies starting from the 2013 financial year and does not regard losses recognized in the previous years, unifies the rules on deductibility: for both taxes, write-downs and write-offs are deducted in equal portions over 5 financial years; losses on disposals continue to be immediately deductible (Table 1). To assess the effects of the new rules, it is necessary to distinguish between IRES and IRAP and among different types of impact: on the profit and loss account, on liquidity, and on banks' capital.

**Characteristics of the new tax treatment of loan losses**

| | Corporate income tax (IRES) | | Regional tax on productive activities (IRAP) | |
|---|---|---|---|---|
| | In 2012 | From 2013 | In 2012 | From 2013 |
| Write-downs | Losses up to 0.30 per cent of the value of balance-sheet loans deductible in the year; the excess deductible over the next 18 financial years | Constant portions in 5 years | Not deductible | Constant portions in 5 years |
| Write-offs | Immediately deductible | Constant portions in 5 years | Not deductible | Constant portions in 5 years |
| Losses on disposals | Immediately deductible | Immediately deductible | Immediately deductible | Immediately deductible |

For corporate income tax purposes, the new system does not entail direct effects on the profit and loss account: as under the previous system, the recording of deferred tax assets sterilizes the impact of the deferment of the tax deduction on profit/loss for the year. However, the shortening from 18 to 4 years of the span of time for deducting the

3) Consequently, a bank with interest income of €100 that had made write-downs of €100 would still have paid IRAP on €100.

part not immediately deductible reduces the length of the "forced loan" from the banks to the tax authorities.

*The changes to IRAP eliminate the taxation of losses ...*

By contrast, the changes to the regional tax on productive activities make previously non-deductible cost components deductible and so reduce the tax liability compared with the old regime. A counterfactual exercise using 2012 profit and loss accounts shows that the new rules would have reduced the banking system's IRAP tax liability that year by about €1.3 billion (with an increase of 0.3 percentage points in ROE). The tax saving reflects the large volume of write-downs recorded in 2012. Instead, in the case of a pre-crisis financial year (e.g. 2006), the tax saving would have been much smaller, only about a quarter as great.

*... reducing the tax burden in cyclical downswings*

The procyclical effect of the tax treatment of write-downs to loans is therefore attenuated by comparison with the rules in force up to 2012: the tax burden diminishes during cyclical downswings, encouraging more prudent provisioning notwithstanding declining profitability.

*The effects on liquidity are uncertain*

The new rules' effects on liquidity depend on the size of the losses. Under the rules in force in 2012, in the first financial year it was possible to deduct, only for IRES, an amount of losses (write-downs up to 0.3 per cent of balance-sheet loans and all write-offs) that possibly could have completely covered loan loss provisions for the year. Under the new regime, instead, only one-fifth of write-downs and write-offs can be deducted in each year for purposes of both IRES and IRAP. Considering write-downs alone, the new regime allows deduction of a larger amount in the first financial year than under the old system when write-downs exceed 1.25 per cent of the value of balance-sheet loans.

A simulation regarding write-downs only and their deductibility for IRES purposes shows that in 2012 the amount not immediately deductible would have been about the same under the old rules and the new. In the year before 2012, marked by lower volumes of write-downs (Figure 1), the new rules would have resulted in a smaller immediately deductible amount, compensated for, in the subsequent years, by a faster "recouping" of the excess amounts.

*The reform should increase banks' capitalization*

Higher profits should help to improve banks' regulatory capital. The new rules permit deferred tax assets to be created through IRAP as well as through IRES. These deferred tax assets are treated as tax credits and, under the Capital Requirements Regulation transposing Basel III into European law, can be counted in regulatory capital.[4)]

4) Deferred tax assets are not actually tax credits. They give the right to pay less tax only in the financial year in which the cost that generated them becomes deductible, so they are illiquid, non-interest-earning items. Tax credits, by contrast, may be refunded upon request, sold to other taxpayers, or used, under certain conditions, to offset other taxes; they thus can be readily liquidated.

*The notional return on equity for ACE purposes increases ...*

### 3. The strengthening of the ACE

The allowance for corporate equity (ACE) has been in force in Italy since 2011. For financial and non-financial alike, it makes the notional return on equity increases deductible for corporate income tax purposes, primarily with a view to attenuating the markedly advantageous tax treatment of debt compared with equity financing. The ACE operates by means of a notional return on equity, which, like the cost of debt, can be deducted from taxable income, thus contributing to firms' capital strengthening. The Stability Law for 2014 raised the notional return on equity significantly, from 3.0 per cent in the previous financial years to 4.0 per cent in 2014, 4.5 per cent in 2015 and 4.75 per cent in 2016. The notional return applies to equity increases carried out since 2011 in the form of both share issues and retained earnings.

*...with positive effects on the solidity of banks and firms*

The ACE can have positive effects on the banking system both directly, by reducing the cost of equity financing, and indirectly, by helping to increase borrower firms' equity and thus making loans to them less risky.

### 4. The treatment of hybrid instruments

*Income associated with the conversion of AT1 and AT2 securities will not be taxed ...*

Banks may also strengthen their regulatory capital by issuing hybrid instruments. To qualify for inclusion in regulatory capital (within Additional Tier 1 capital, AT1), these securities must have certain characteristics. From the standpoint of loss absorbency, where the bank's Common Equity Tier 1 (CET1) ratio falls below a defined threshold,[5] the instrument helps to strengthen the CET1 ratio through conversion into shares or, alternatively, permanent or temporary write-down.

In the event of conversion or write-down of the security, the associated reduction in value of the liability generates income for the bank that would be subject to ordinary taxation. The consequent creation of CET1 would thus be smaller by 33 per cent (the amount of IRES and IRAP due on this profit) than the amount of the write-down.

*...maximizing the securities' loss absorbency*

Lastly, the Stability Law for 2014 establishes that income from variations in the value of AT1 and AT2 instruments is not subject to both IRES and IRAP. The measure, which applies to securities issued from 1 January 2014 onwards, takes account of the fact that such income does not reflect a bank's actual state of health, inasmuch as the conversion is triggered by a fall in the capital ratio, typically due to large losses on the asset side. It maximizes the loss absorbency of hybrid instruments and removes an obstacle to their issuance by banks. This legislative change, too, fosters banks' capital strengthening and helps to mitigate the procyclicality of the tax system.[6]

5) Typically, this threshold is defined by contract; however, the legislation establishes that for a hybrid instrument to be counted in AT1 regulatory capital, the threshold cannot be lower than 5.125 per cent.

6) An analogous arrangement was recently adopted in the United Kingdom: The Taxation of Regulatory Capital Securities Regulations, 18 December 2013, No. 3209.