News Analysis: A Breakthrough In The Relationship Between Italy’s Tax Authorities, Banks

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A recent seminar on enhanced cooperation organized by the Italian Revenue Agency in conjunction with the Italian Banking Association, the Italian Association of Foreign Banks, and the OECD brought together more than 150 senior tax officials, bank tax directors, and banking association officials from around the world.

More than 150 participants attending a seminar in Rome titled “Developing an Enhanced Relationship in the Banking Sector” October 10 and 11 witnessed a historic moment in the Italian tax world.

The seminar -- organized by the Italian Revenue Agency in conjunction with the Italian Banking Association (ABI), the Italian Association of Foreign Banks (AIBE), and the OECD -- brought together senior tax officials from a number of countries, the tax directors of Italian and foreign banks, and representatives of banking associations and the OECD.

Discussions during the first two panels concerned the role of banks in the current economic environment, the impact of recent regulatory changes on tax matters, and the experience of various stakeholders with cooperative compliance programs. The subsequent three panels dealt with more technical tax issues, such as those related to bank losses and the criteria for attributing profits to the permanent establishments of banking companies.

The director of the Italian Revenue Agency, opened the seminar, saying Italian tax authorities “will be very judicious in applying a zero-tolerance policy with reference to aggressive tax planning but will act with a great...
sense of responsibility towards other kinds of planning and will provide taxpayers with a higher degree of certainty on tax matters.”

Italian representatives said the Italian Revenue is ready to work with the ABI to develop a code of conduct and hinted that official guidance concerning the attribution of profits to PEs could be issued soon. Details of the panel discussions are included below.

Developing the Enhanced Relationship

Panel 1 -- Setting the Ground

In the first discussion, an OECD official said an enhanced relationship between tax authorities and taxpayers will naturally result in a win-win situation. When considering taxpayers' obligation to pay taxes, he said, authorities should be mindful that taxation should not prevent economic growth. From that standpoint, it is questionable whether a new tax on financial transactions is needed in Italy, he concluded.

A representative of the Italian Revenue’s Central Assessment Department said mutual trust is essential to an enhanced relationship between taxpayers and tax authorities. On the taxpayers' side, this would mean refraining from engaging in aggressive tax planning practices. On the side of the tax authorities, it would imply the determination of a clear line between legitimate and aggressive tax planning.

A representative from the OECD’s International Cooperation and Tax Administration Division noted that the OECD has increased its focus on tax compliance, starting with the 2006 Seoul Declaration. That led to the 2008 “Tax Intermediaries Study” and other OECD studies, he said. Chapter XI of the 2011 OECD Guidelines for Multinational Enterprises recommends that multinationals “comply with both the letter and spirit of the tax laws and regulations” and “adopt tax risk management strategies” at the corporate board level, he added.

The head of the tax department of an Italian banking group said tax directors should be involved in any process that is relevant for tax purposes (including the structuring of financial products) and should refrain from using aggressive tax planning schemes. Tax directors’ compensation should not be linked to net results or tax savings, he said. Tax directors should also consider that disputes with tax authorities usually lead to a 50/50 final result and, even in the event of a positive judicial outcome, that the reputational risk for banks is heavier than for other taxpayers, he said.

Panel 2 -- Implementing the Enhanced Relationship

A tax manager at an Italian branch of a foreign bank explained how his bank is managing tax risks, with different tax service lines devoted to compliance, counsel, financial products and clients, and accounting and internal reporting. A tax risk approval process for new products is also in place, together with an operational risk committee. He asserted that large banking companies expect a fair approach by tax authorities, along with stable tax rules based on binding precedents, and nonretroactive changes in legislation.

A representative from HM Revenue & Customs said that from U.K. tax authorities’ perspective, managing the tax risk associated with banks means dealing with:

- the banks’ own tax planning;
- schemes and shelters provided by the banks to their customers;
- schemes and shelters financed by the banks; and
- a lack of transparency in disclosing customer information.

HMRC would expect an enhanced relationship to be based on full availability of information, transparency, trust, efficient tax administration, and day-to-day contact with the most senior bank personnel, he said.

The vice president of another foreign bank confirmed that most of the results expected by both sides may be achieved through improved transparency. He added that the trend is clear to him: Transparency cannot be avoided, and it is only a
matter of how it is to be implemented (that is, whether it will be encouraged or imposed). Anyhow, in most cases, transparency will require a cultural change.

Country Experiences and Technical Issues

Panel 3 -- Codes of Conduct on Tax Practices
An official from the South African Revenue Service (SARS) said that in 2009, SARS and the Banking Association of South Africa agreed that banks should avoid aggressive tax planning. They also signed an agreement providing for constructive cooperation, a voluntary code of conduct, and the development of transparent and mutually trusting relationships. The agreement is aimed at developing a common understanding of the banks' business practices and the negative impact of aggressive tax planning, and effective remedies to such practices.

Communication between the parties has significantly improved since the signing of the agreement, the SARS official said. In particular, relationship managers are now answering day-to-day inquiries, transactions allowing tax benefits are reported in real time, and a new advance tax ruling regime has been introduced. Individual settlements with some banks have often resulted in a binding obligation on the taxpayer to cease tax practices that are considered to be abusive.

A commissioner of the Spanish Revenue Service explained that the Spanish authorities implemented a code of conduct for large businesses in 2010 after developing relationships with large taxpayers over the previous six years. In particular, the Central Office for Large Taxpayers was introduced in 2005 and a forum made up of Revenue officials and representatives of 27 large companies was set up in 2009.

Under the code of conduct, the taxpayers committed to key involvement by their boards of directors and the avoidance of aggressive tax planning. The tax authorities committed to the publication of tax law interpretations and the answers to any question concerning the application of the tax rules. Both sides made a commitment to reduce tax litigation and to be more transparent and cooperative during tax audits.

A representative of the London branch of a foreign bank discussed his bank's decision to sign the U.K. Code of Practice on Taxation. Based on his experience, he said, the decision was mainly driven by reasons such as:

- keeping the bank's classification as “low risk” after a positive 2007 audit;
- being consistent with a history of constructive engagement with HMRC; and
- limiting inquiries and audits by HMRC, and having the authorities rely on the bank's risk self-assessment and respective disclosures.

Informal and real-time communication with the authorities improved significantly after the bank signed the code of practice, he said.

Panel 4 -- The Tax Treatment of Bank Losses
The head of the noncompliance unit of the OECD Centre for Tax Policy and Administration outlined the main features of the OECD Report “Addressing Tax Risks Involving Bank Losses” (2010). The report showed that banks incurred $1.3 trillion in write-downs and losses up to January 2010 as an effect of the global financial crisis. Such losses represent a significant tax risk for both banks and tax authorities, particularly because existing rules on tax losses are complex, which in itself is a source of risk.

The OECD speaker mentioned three main risk areas identified in the report: transfer pricing, corporate reorganizations, and derivatives and other complex financial instruments. He referred to a number of schemes relating to losses and highlighted the main conclusions and recommendations of the report.

An official from the Austrian tax authority explained that Austrian rules on tax losses generally provide for an unlimited carryforward with some limitations in the event of a change in control or activity, losses of foreign subsidiaries, and other circumstances. The tax authority is concerned about the circumvention of those limitations, mainly through corporate reorganizations and inaccurate transfer pricing.
Those practices are addressed mainly by tax audits and the creation of teams of tax auditors that specialize in bank audits, but also through advance rulings and enhanced dialogue with the taxpayers.

The tax director of another Italian banking group identified banks’ key problems in dealing with tax losses, mentioning in particular increases of the effective tax rate and uncertainty about the future use of losses and the concept of “change of activity” when it may result in the forfeiture of the use of losses. He then mentioned key benefits that an enhanced relationship could bring in the area of losses, such as certainty over the use of losses in the future, the avoidance of aggressive tax planning by banks, and improved coordination between tax and regulatory rules. He concluded by describing recent changes to the Italian rules on loss carryforwards.

Another ABI commissioner emphasized two good examples of the benefits of an enhanced relationship. The first example is legislation recently introduced by the Italian government to minimize the side effects of the losses incurred by banks. In particular, if a bank realizes a statutory book loss, then a percentage of the deferred tax assets (corresponding to nondeducted write-downs on loan receivables and future tax deductions of goodwill amortization) is converted into a tax credit that can be used to offset tax payable. This also positively affects the determination of the equity for regulatory purposes by way of the implementation of Basel III requirements.

The second example addresses the tax uncertainty Italian banks were facing as a result of issuing certain hybrid instruments combining features of both debt and equity. A new provision allows the deduction of interest and equalizes the hybrid instruments to listed corporate and government bonds for withholding tax purposes.

Panel 5 -- The Attribution of Profits to the PEs of Banks

A representative of the Italian Revenue discussed Part II of the OECD “Report on the Attribution of Profits to Permanent Establishments.” He explained the two-step analysis contained in the report and illustrated some of the peculiarities of banking PEs, referring especially to the concept of key entrepreneurial risk-taking functions. He also addressed the issue of the allocation of free capital to an Italian PE of a nonresident bank and declared that the Italian Revenue is open to accepting all methods suggested by the OECD report on profit attribution, including the safe harbor approach.

A transfer pricing specialist from HMRC illustrated the U.K. approach to the attribution of profits to banking PEs. He mentioned that the U.K. rules are in line with the authorized OECD approach (AOA) and explained how the U.K. generally adopts a cleansed BIS capitalization level to determine the level of free capital attributable to the PE.

A representative of the U.S. Treasury Department then talked about the U.S. rules for the attribution of profits to PEs. He made it clear that the United States accepts the AOA for purposes of applying income tax treaties, but that a different set of rules applies under U.S. domestic law to determine the income that is effectively connected to a U.S. PE.

He also mentioned that the United States has signed a number of income tax treaties that incorporate the principles of the AOA. He then identified some technicalities for the attribution of free capital to PEs, referring to the fact that the United States generally adopts a cleansed BIS ratio approach.

An AIBE official outlined some of the issues banks face when dealing with the attribution of profits to PEs. The regulatory rules need to be taken into account, he said, and the determination of the amount of free capital to be allocated to PEs is often a contentious issue. He concluded by saying that foreign banks would welcome enhanced cooperation with the Italian tax authorities and are ready to work to ensure a level playing field.

A Global Trend

Many tax administrations have recently put into practice policies to enhance their relationships with banks. The seminar focused on the positive experiences carried out by specific countries that have already implemented a code of conduct for banking groups and other taxpayers. The adoption of such a code was shown to improve...
the stability and understanding of the tax rules and to increase tax compliance.

Our Take

The seminar set expectations very high for enhanced relationships between tax authorities and taxpayers by presenting the experiences of the most advanced countries in this field.

Italy does not have a long-standing tradition in this respect. However, things have improved with the recent establishment of the Large Business Office within the Revenue Agency and the associated tutoring and monitoring programs. A lot is still to be done and we look forward to seeing the code of conduct implemented by the Italian Revenue and analyzing its concrete application. Guidance on the attribution of profits to PEs would also provide additional clarity to the dialogue between tax authorities and businesses.

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