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U.S. BANKS WITH CLAIMS ON DEVELOPING COUNTRIES

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*International Finance Division, Federal Reserve Board. This paper represents the views of the author and should not be interpreted as reflecting the views of the Board of Governors of the Federal Reserve System or members of its staff.

ABSTRACT

This paper examines some implications of the President's 1985 tax reform plan for U.S. banks with claims on developing countries. An assessment is presented of how the plan would modify, or eliminate, a variety of mechanisms by which banks shelter income from taxation. A particular focus of the paper is an analysis of the consequences for large U.S. banks of the proposed change in the computation of the U.S. tax credit for taxes paid to foreign countries.

1. Introduction

This paper provides an assessment of the proposed treatment of banks under the President's 1985 tax reform plan.^{1/} The plan would modify, or eliminate, a variety of mechanisms by which a bank's income from a given asset is not fully taxed, that is, by which such income is sheltered. The major conclusion of the assessment is that the President's program would, if enacted as proposed, result in a relatively less favorable tax environment for the current asset portfolios of major U.S. banking organizations. The conclusion is based on: (1) the impact on banks' earnings and capital of a proposed shift in the basis for taking tax deductions on bad debts; (2) the proposed elimination of the current deduction of interest expenses incurred by banks to carry tax-exempt bonds; and (3) the proposed limitation on the ability to credit against U.S. tax liabilities any taxes paid to foreign countries.

Section 2 focuses on the proposal to make current reserves for bad debts subject to tax. Section 3 analyzes the interaction of the second and third proposals listed above. The second proposal would completely disallow the tax-deductibility of interest expense incurred by banks to carry tax-exempt securities. The third proposal, discussed in section 3, would change the computation of the limitation on U.S. tax credits for taxes paid to foreign countries to a per country basis from the present total, or overall, basis. Section 4 turns to the interaction of various parts of the tax proposal on banks' credit decisions. Section 5 presents the concluding remarks.

^{1/} The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity, May 1985.

2. Bad Debt Loss Reserve

Historically, banks have been allowed under IRS rulings to build reserves for bad debts through deductions from before-tax incomes. The Tax Reform Act of 1969 provides statutory guidance concerning the maximum additions to bad debt reserve accounts that banks can use as a basis for tax deductions. In particular, the 1969 Act provides that banks can use either the "experience" method or the "percentage" method in determining the maximum permissible additions to their IRS bad debt reserves. The Act schedules step reductions of the maximum percentage and, starting in 1988, the Act requires all banks using reserve accounting to adopt the experience method.

The President's tax plan has two proposals, which are unchanged from those in the November 1984 Treasury plan, related to the tax deductibility of loan losses. First, starting with the effective date of the new tax law, banks and other financial institutions could no longer claim tax deductions for unrealized loan losses on the basis of any reserve technique; instead, loan loss deductions would be limited to actual charge-offs as they occurred. It has been pointed out that this proposal would bring the tax treatment of financial institutions into line with that of other taxpayers who are not allowed to set up tax-deductible reserves against anticipated losses. However, because of higher, and rising, levels of actual loss, few large banking organizations have been recently able to take advantage of the reserve deduction. Thus, the proposal, if it had been in effect, would not have had a significant effect on banks' recent earnings.

The second proposal would require a financial institution to recapture in its taxable income, over a 10-year period, the net accumulation of tax-deferred income reflected in its loan-loss reserves, which amounts to its IRS reserve. The proposal is designed to prevent a double deduction for claims that become partially or wholly worthless after the effective date. That is, the proposal is designed to avoid providing financial institutions with a windfall gain, namely, the forgiveness of deferred tax liabilities. However, because it would not impose a lump sum tax, the proposal might prompt banks to alter lending and investment activities in favor of certain assets that continue to carry tax benefits.^{2/} Banks might invest in tax-preferred assets which, through mechanisms such as excess deductions, provide a tax shelter for income from non-tax-preferred assets. One such mechanism, under current law, involves the deduction by banks (but not other investors) of interest incurred to carry tax-exempt bonds.

3. Tax-Exempt Related Interest Deductions/Foreign Tax Credit Limitation

The President's plan would end the deduction by banks of interest incurred to carry tax-exempt bonds acquired after January 1, 1986, and would also change the foreign tax credit limitation for all taxpayers from an overall to a per country computation.^{3/} Under current tax provisions the 80 percent interest deduction for carrying tax-exempt

^{2/} A lump sum tax has only income effects.

^{3/} Historically, the base for the foreign tax credit limitation has varied between total foreign income, per country income, or both. The most recent change was made in the Tax Reform Act of 1976, which eliminated the option of the per country computation; however, this change had little significance for banks because of their strong preference for the overall method.

bonds and the foreign tax credit computation have an important interactive influence on banks' portfolio decisions. Furthermore, as the following framework sets out, this interaction is also influenced by other parts of the tax code, such as the proposed recapture of IRS loan-loss reserves.

A Framework of U.S. Bank Taxation

Three basic principles underlie U.S. taxation of a U.S. bank's foreign source income. First, to avoid double taxation of the U.S. bank's foreign income, the United States defers to foreign host governments with respect to the taxation of foreign income by allowing U.S. tax credits for foreign taxes paid. Second, the United States limits these tax credits to whichever amount is the smaller: the bank's U.S. tax liability against its foreign source income or against its worldwide income. Third, all sources of borrowed funds to a bank are viewed as interchangeable or fungible, and, in U.S. tax regulations for the deductibility of interest, the assignment of a bank's interest expense to foreign income is simply based on the ratio of its foreign to its total assets. Thus, regardless of how a bank finances its U.S. tax-exempt investments, the deductible part of the interest expense associated with the financing is assigned against the bank's domestic taxable income. It follows that under current U.S. tax rules, the limit on foreign taxes that a bank may credit against its U.S. tax liability is equal to its U.S. tax rate applied to: (1) its foreign taxable income when the bank has a U.S. domestic taxable profit and (2) its worldwide taxable income when the bank has a U.S. domestic taxable loss.

Elimination of the current deduction of interest incurred to carry tax-exempt securities would raise domestic taxable income and, correspondingly, raise the ceiling on a bank's creditable foreign taxes if otherwise the bank would have reported a domestic taxable loss. Similarly, the enactment of the proposed recapture of loan-loss reserves would raise a bank's limitation on creditable foreign tax payments. Under either circumstance, the bank might find it profitable to react by raising the share of its holdings devoted to foreign taxable assets. For a bank with excess foreign tax credit capacity, a sufficient condition for this to be advantageous is that the bank not bear the full cost of higher foreign tax payments, or, in other words, that foreign borrowers bear part of the burden of a U.S. bank's creditable foreign tax payments.

Governments of developing countries have revealed their awareness of the tax environments of their bank creditors by imposing and/or altering withholding tax statutes. Such taxes against interest payments by eligible domestic borrowers to foreign creditors are widely recognized to be a means by which borrowing countries have extracted interest subsidies from creditor banks' "home" governments.^{4/}

A numerical example may be useful to illustrate this tax-arbitrage possibility. Assume that a bank's U.S. tax rate is 50 percent and that it has a 10 percent cost of funds. Then assume that the bank is faced

^{4/} To minimize the actual tax burden on borrowers, developing country governments have provided tax rebates. In some countries, such as Brazil, the rebates have been overtly paid. In turn, this led U.S. tax authorities to challenge the full U.S. creditability of the Brazilian withholding tax. In other countries, "hidden" rebates have been paid through incremental budget allocations to state-owned enterprises or through the issuance of licenses to purchase foreign exchange at preferential rates.

with the choice of adding to its holdings either a \$100 domestic loan (no withholding tax) or a \$100 foreign taxable loan with a 25 percent foreign (withholding) tax against gross interest, each with a "quoted" 2 percent before-tax spread to the bank. Both loans would have a one-year term.

Comparisons of the after-tax profitability of the loan options are shown in Table 1. Columns 2 and 3 are, respectively, based on the two extreme assumptions that the borrower fully pays the 25 percent withholding tax or, alternatively, the bank fully pays the tax.^{5/} Overall, Table 1 reveals that a foreign taxable loan will be more profitable (line 8) than a domestic loan with an equal, adjusted gross spread (line 5) if the borrower bears some portion of the tax. This larger net (after-tax) spread for foreign loans, as compared with domestic loans, arises because the U.S. tax credit for foreign taxes (line 7) more than offsets the larger pre-credit U.S. tax liabilities on the foreign loan (line 6).

Foreign Tax Credit: Treasury Proposal

The President's plan proposes that the foreign tax credit limitation be based on a taxpayer's foreign income from each separate country. Under a per country limitation, taxes paid to any country could be used against only the pre-credit U.S. tax on income from sources within that country.

^{5/} The determination of the sharing of the initial incidence of the withholding tax is a separate matter from the assignment of tax-related interest rate risk. Bank loan agreements specify whether the creditor bank ("gross" loan) or the foreign debtor ("net" loan) absorbs the interest-rate-related risk generated by the taxation of the borrower's gross interest payments. Under either type of loan agreement, the full amount of foreign tax payments is now creditable against a U.S. bank's U.S. tax liability.

Table 1

After-Tax Profitability of \$100 Loan Alternatives
(Overall Foreign Tax Credit Limitation)

	Domestic Loan	Foreign Loan with 25 percent withholding tax:	
		Fully Paid by borrower	Fully paid by bank
	(1)	(2)	(3)
	(in dollars)		
1. Gross Interest Income	12	16*	12
2. Cost of Funds	<u>10</u>	<u>10</u>	<u>10</u>
3. Gross Spread (= L.1 - L.2)	2	6	2
4. Foreign Tax (= .25 x L.1)	<u>0</u>	<u>4</u>	<u>3**</u>
5. Adjusted Gross (Quoted) Spread Over Cost of Funds (= L.3 - L.4)	2	2	-1
6. Pre-Credit U.S. Tax (= .50 x L.3)	1	3	1
7. Tax Credit for Foreign Tax Payments (= L.4)	<u>0</u>	<u>4</u>	<u>3</u>
8. Net After-Tax Spread (= L.5 - L.6 + L.7)	1	3	1

* Includes a foreign tax of \$4 (.25 x \$16) which is fully paid by borrower.

** Foreign tax of \$3 equals 25 percent of the \$12 gross interest income of the bank.

Table 2 compares the net spreads which would be realized by a U.S. bank creditor if it made the loans examined in Table 1 under an overall and a per country computation of its U.S. foreign tax credit limitation.^{6/} A comparison of lines 4(a) and 4(b) indicates that the net spreads on foreign loans would be smaller if the per country, rather than the overall, method were used to compute the U.S. tax credit limitation for foreign tax payments. In fact, line 4(b) reveals that if the borrower is not willing to pay enough of the tax, then the bank should choose to make the domestic loan. Finally, a comparison of lines 5(a) and 5(b) indicates that the lower relative profitability of the foreign loan under a per country computation of the U.S. tax credit is accounted for by the absence of a (cross-national) tax subsidy.

Table 3 has been prepared to provide a rough indication of the possible impact of the proposed change. It reveals that if the per country limitation had applied in 1980, rather than the overall limitation, the after-tax earnings of the largest U.S. banks would have been as much as \$208 million smaller, or about 10 percent of the 1980 retained earnings of U.S. money center banks. The \$208 million figure is an estimate of what excess U.S. tax credits would have been, under a per country limitation, on tax payments by U.S. banks to the governments of Brazil and Mexico--25 and 15 percent tax rates, respectively. Unfortunately, post-1980 estimates cannot be made because of the absence of comparable data. Nevertheless, large 1981 and 1982 increases in U.S.

^{6/} The comparison is somewhat overdrawn because of the assumption that the creditor bank has no other source of income within the foreign borrower's country.

Table 2

After-Tax Profitability of \$100 Loan Alternatives
(Per Country vs. Overall Foreign Tax Credit Limitation)

	Domestic Loan	Foreign Loan with 25 percent withholding tax:	
		Fully paid by borrower	Fully paid by bank
	(1)	(2)	(3)
	(in dollars)		
1. Adjusted Gross Spread Over Cost of Funds (= Table 1 L.5)	2	2	-1
2. Pre-Credit U.S. Tax (= Table 1 L.6)	1	3	1
3. Tax Credit for Foreign Tax Payments			
(a) Overall Limitation (= Table 1 L.7)	0	4	3
(b) Per Country Limitation (= L.2 for foreign loans)	<u>0</u>	<u>3</u>	<u>1</u>
4. Net After-Tax Spread			
(a) Overall Limitation (= L.1 - L.2 + L.3(a) = Table 1 L.8)	1	3	1
(b) Per Country Limitation (L.1 - L.2 + L.3(b))	1	2	-1
Memorandum			
5. Incremental Impact on U.S. Tax Receipts			
(a) Overall Limitation (L.2 - L.3(a))	1	-1*	-2*
(b) Per Country Limitation (L.2 - L.3(b))	1	0	0

* - indicates a tax-subsidy shared by the borrower and the bank.

Table 3
U.S. Banks' Excess Foreign Tax Credits Under a Per Country
Foreign Tax Credit Limitation*
(millions of dollars)

Borrowing Country	Taxable Incomes of U.S. Banks** (1)	Creditable Foreign Taxes Against Interest Reported by U.S. Banks (2)	Excess Foreign Tax Credits at 14 percent 1980 Effective Tax Rate on 6 Large U.S. Banks' Foreign Incomes (3)
Brazil	257	137	101
Mexico	467	172	107

* Based on published and unpublished data from the Internal Revenue Service. The published source is "Corporate Foreign Tax Credit, 1980: An Industry Focus", by William States (Statistics of Income Bulletin, Summer 1984).

** Other than branch income.

bank lending to Brazil and Mexico provide a strong basis for an a priori judgment of much larger effects (at any interest rate level) on post-1980 earnings of a switch to a per country tax credit computation.

4. Interaction

Consider a "what-if" situation, namely that the President's proposal removing the interest deduction for banks carrying tax-exempt securities is enacted, but the proposed change in the foreign tax credit limitation computation is not. This change in tax structure would tend to reduce the overall availability of tax-based subsidies, although banks' limits on tax credits for their foreign tax payments would be raised. Therefore it follows from the above analysis that, in response to such a reorientation of tax incentives, banks would more actively solicit foreign loans where a foreign tax credit could be made available. Under present circumstances, such solicitations might be focused on reconfiguring exposures to developing countries rather than enlarging them.

Changes in U.S. tax credit rules affect lending to borrowers in developing countries, more than to those in industrialized countries, largely because of the structure of the U.S. tax treaty network. The United States has bilateral tax treaties with most of the major industrialized countries but none with a major developing country debtor. The lack of such treaties reflects the long-standing absence of interest on the part of the governments of developing countries in securing tax

concessions for the external investment activities of home-country investors and the U.S. policy against entering into tax-sparing agreements.^{7/}

All other things being equal, a per country (relative to an overall) foreign tax credit limitation, on the one hand, might penalize banks for excessive country concentrations of withholding tax loans. On the other hand, Brazil and Mexico, major beneficiaries of the current U.S. tax code, might find their borrowing terms adversely affected by the proposed change in the computation of the foreign tax credit limitation. However, if accompanied by the disallowance of interest to finance tax-exempt securities, the diversification incentive provided by the changeover to per country computation would be weakened.

5. Concluding Remarks

In the past, banks negotiated loans to foreign borrowers on the basis of "net" interest rates.^{8/} It was the general presumption that withholding taxes should be disregarded, by treating such taxes as a deduction in computing taxable net incomes, or by a bank's restricting its reported income to the interest received net of withholding taxes.

In the 1970s, U.S. banks successfully sought a change in the U.S. tax treatment of foreign withholding taxes. Starting in the mid-to-late 1970s, these taxes were regarded as the equivalent of creditable income taxes even if, as in most cases, the borrower and not the bank retained

^{7/} Under tax-sparing agreements, one country agrees not to tax the income received by investors from a second country. In turn, the second government agrees to allow its investors to claim tax credits as if the tax had been paid.

^{8/} For a thorough international comparative study, see Foreign Tax Credit for Banks, Peat Marwick, Mitchell and Company, June 1984.

responsibility for payment of the tax (through withholding at source). Recognition of this change by borrowers was incorporated in their demands for improved "net" credit terms. Finally, non-U.S. banks' increasing participation, over the period from the late 1970s through the early 1980s, in international bank credit markets appears to have been accommodated by favorable rulings of their home-country tax authorities.

At a Congressional hearing on the President's tax program, a representative of the American Bankers Association reported on the significance of the availability of the foreign tax credit.^{9/} In particular it was asserted that "...if the foreign tax credit were not available, U.S. banks would have to increase interest charges in order to maintain an adequate return. Competition from other banks will not permit such pricing. The increased tax cost would put U.S. banks at a competitive disadvantage with foreign banks, whose costs would not be similarly increased, and might well force U.S. banks out of important overseas markets."

The more limited burden associated with the proposed change in the foreign tax credit (as compared with the elimination of the foreign tax credit) might have to be absorbed by banks with (ex post) excess country concentrations of withholding tax loans.^{10/} However, some of these banks might be able to dissipate the cost by shifting loans to other tax

^{9/} "Statement of John R. Petty on behalf of the American Bankers Association before the Committee on Ways and Means", U.S. House of Representatives, July 26, 1985.

^{10/} The development of a swap market in loans to developing country debtors has been inhibited by bank concerns about required writedowns in loan values that might be triggered by swap transactions.

jurisdictions; that is, they might take advantage of favorable treatments of withholding tax loans available under the tax codes of other countries in which they have banking offices.^{11/} The objective of such shifting would be to minimize the overall tax burden through both net reductions and restructurings (in terms of countries to which taxes are paid) of foreign tax payments. In effect, such activity would amount to a bank-managed redistribution of the fiscal burden among governments of the favorable tax treatment of international bank lending to developing country borrowers.

^{11/} The U.K. Finance Act of 1982 introduced an upper limit of 15 percent on the amount of credit for foreign withholding tax on loan interest. Reportedly, this legislation was, at least in part, in response to U.S. banks' efforts to minimize their net U.K. taxes through the booking of withholding tax loans (to Brazil) at their London branches.