Building Transparent Tax Compliance by Banks

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Foreword by the Chairperson of the Paris Forum Meeting

This report was commissioned by the Forum on Tax Administration at its fourth meeting in Cape Town, South Africa in January 2008. The report has been prepared by a Study Team comprised of the Australian Taxation Office, HM Revenue and Customs in the United Kingdom and the OECD Secretariat.

The study team was assisted in its work by a focus group of 12 other FTA countries (Canada, Ireland, France, Germany, Japan, the Netherlands, Singapore, Spain, South Africa, Switzerland and the United States of America). This group participated in three workshops at which the direction and progress of the study was reviewed.

There has been extensive consultation with the private sector. Meetings were held with senior representatives of global banks and some FTA Commissioners in July and October 2008 and there was a follow up meeting in March 2009 between the Study Team and these representatives. Participating countries also held meetings with their national banking industry associations in 2008. During the course of the study, assistance was provided by experienced banking industry personnel who were seconded to the study team.

Throughout the development of the report, all countries that participate in the FTA have had opportunities to contribute to the study. The terms of reference were circulated in draft to participating countries. Drafts of the final report were circulated to all FTA countries in March and April 2009. The objective of this consultation was to ensure that the report reflected the diversity of FTA country experiences in their relationships with banks.

The Study Team recognises that this diversity of experiences means that certain of the recommendations in the report may be less relevant to some countries than others and that each country will have decide how to approach the issues addressed in this report and the most appropriate response to the challenges identified.

I would like to thank all of those who have assisted the Study Team over the last fifteen months in the completion of this report. The report was considered at the FTA Meeting on 28-29 May 2008. I would hope that report is distributed within revenue bodies to those staff involved with the compliance of banks and other financial institutions and within banks and their professional tax advisers and that the recommendations are a catalyst for improvements in compliance in this important taxpayer group.

Pravin Gordhan

Chairperson, Paris Forum Meeting

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Executive summary

Banks play a vital role both in the global economy, and in the functioning of many countries' tax systems. However the extent that banks use, facilitate, or promote aggressive tax planning schemes also poses a significant risk to tax systems.

This study was commissioned by the OECD Forum on Tax Administration (FTA) at the fourth meeting of the FTA in Cape Town, South Africa, in January 2008 as a follow up to the *Study into the Role of Tax Intermediaries*. The aim of the study is to deepen understanding of banks' involvement (direct or indirect) in aggressive tax planning, and to identify the benefits to both revenue bodies and banks from an 'enhanced relationship'.

The global financial crisis developed during the course of this study. Neither tax policies nor tax administration appear to have been significant influences on the events or behaviours which led to the crisis. Nevertheless revenue bodies now have an opportunity to work with other regulators to improve transparency, governance and tax compliance, which in turn may help move towards more sustainable financial systems.

Given the complex nature of some of the financial products developed by banks and the transactions they undertake it can be difficult for revenue bodies to assess whether aggressive tax planning is involved. This report examines these complex structured finance transactions (CSFTs); how they are developed by banks; what controls are in place as they are developed; and how they are then used by both banks and their clients. By understanding these transactions and their commercial drivers, revenue bodies can better differentiate those that have a tax risk from those that do not.

To enable revenue bodies to appreciate fully the commercial and international context of CSFTs, banks should be encouraged to offer a degree of transparency above the minimum legal requirement. By obtaining information at an early stage, revenue bodies can respond to emerging risks and ensure that their resources are targeted effectively, minimising compliance costs for banks. Banks and other large corporate taxpayers operate on a global level but revenue authorities are national organisations. Difficulties in understanding the international context of a bank's transaction or that of their clients can delay a decision on the correct tax outcome.

Revenue bodies can also work together more effectively. By sharing information internationally, they can better respond to emerging aggressive tax planning as well as reduce the time taken to provide certainty to banks on transactions involving multiple jurisdictions.

In relation to their own tax affairs, banks can engage in an enhanced relationship with the revenue body in the same way as many other large corporate taxpayers. When acting as promoters of aggressive tax planning for clients, the information a bank can disclose may be limited by client confidentiality. There are however ways for revenue bodies to obtain the relevant information and for banks to therefore obtain an early view of their tax outcome using rules overriding client confidentiality, rules requiring disclosure, and the

availability of rulings or clearances on actual or proposed transactions. There is in many cases potential for greater dialogue at the pre-marketing stage, and for placing greater importance on a revenue body's likely interpretation of the law as part of the bank's transaction approval process.

Responding to the risks of aggressive tax planning requires a broad range of specialist skills. Revenue bodies particularly need to improve their commercial understanding of the banking industry to be able to better differentiate between commercial arrangements and aggressive tax planning. They can improve their capabilities by engaging with banks and their representatives on a range of initiatives. Banks benefit from revenue bodies' greater commercial understanding through a more informed and co-operative dialogue, an increased focus on significant tax issues and more timely advice.

The key feature of an 'enhanced relationship' for revenue bodies is transparency in relation to all tax-related activities. A wide spectrum of issues and behaviours can generate concern. At the extreme are banks deliberately caught up in tax evasion committed by their clients and while the focus of this study is aggressive tax planning, there have recently been some highly publicised cases of banks or their employees actively assisting their clients to evade tax.

At the April 2009 meeting, G20 countries agreed to take action against non-co-operative jurisdictions, including tax havens. In this changing environment, those taxpayers who shield their assets and income in such jurisdictions may now wish to regularise their affairs at home. Revenue bodies will want to look at ways to encourage the voluntary disclosure of information by their residents and banks may have a role in assisting those taxpayers to come forward. A parallel OECD study, *Engaging with High Net Worth Individuals on Tax Compliance* (OECD, 2009a), sets out proposals on how revenue bodies can best engage with some of those taxpayers.

The recommendations in this report present an opportunity for revenue bodies to improve their ability to address significant tax risk and at the same time provide greater certainty for banks as taxpayers and tax intermediaries. They are aimed at improving the transparency of aggressive tax planning transactions, providing better alignment between the quality of banks' internal governance and revenue bodies' risk assessment, and improving the effectiveness of international co-operation. For banks the benefit is reduced compliance costs as a result of better risk management by revenue bodies, more timely advice based on a better understanding of the commercial context, and greater certainty.

Study approach

The study was led by the tax administrations of the United Kingdom and Australia and the OECD Secretariat assisted by a focus group consisting of 12 other FTA countries: Canada, Ireland, France, Germany, Japan, Mexico, the Netherlands, Singapore, Spain, South Africa, Switzerland, and the United States of America.

The Study Team benefited from extensive input from all focus group members on a range of issues, including revenue bodies' different approaches to managing the risks from aggressive tax planning and their relationship with banks.

As part of extensive consultation with the private sector, the Study Team also invited global banks engaged in investment banking to participate in the study. Representatives of some of the major banks have engaged constructively throughout the process and met

with the Team and some Commissioners from participating countries in July and October 2008 to provide data for the study. Banks and banking associations in many countries also responded to a questionnaire exploring how banks viewed the potential for an enhanced relationship.

As from September 2008 experienced personnel from the banking sector were seconded to work with the Study Team in the United Kingdom, USA and Australia. The Study Team is grateful for their useful contributions and their willingness to discuss aspects of their business in a transparent and co-operative manner.

Recommendations

Each FTA country is faced with a different environment in respect of policy, legislation, administration and culture, which will have shaped their taxation systems. It is therefore up to each country to decide how to approach the issues addressed in this report and the most appropriate response to the challenges identified. Recommendations are broken down into two parts, recommendations for revenue bodies and recommendations for banks. The recommendations have been grouped under particular themes and are not in the order in which they appear in the chapters.

Recommendations for revenue bodies:

To improve staff capabilities and their commercial understanding of financial markets and banking, including CFSTs, revenue bodies could:

- seek the assistance of their national banking association in providing training programmes for their staff;
- develop initiatives with banks where the bank allows revenue staff to build understanding of banking operations, particularly where they can be exposed to the governance structures and product development processes concerning CSFTs;
- recruit banking experts; and
- embark on exchange initiatives with other revenue bodies where less-skilled revenue staff can be given opportunities to work with administrations that have greater experience with banks.

To provide earlier certainty revenue bodies should:

- work with banks as part of an enhanced relationship through guidance, rulings and real time discussion of issues; and
- encourage banks to be more transparent so as to better understand the commercial context and complex details of CSFTs.

To improve risk assessment revenue bodies should:

- ensure they have all necessary strategies in place to better prevent, detect and respond to aggressive tax planning, particularly high risk behaviour, including

working closely with the banks as well as developing close working relationships with other domestic regulators, and with overseas revenue bodies;

- seek to understand CSFTs in the legal context of their own jurisdiction to identify those transactions which pose a significant tax risk;
- learn about control functions within banks to understand if they provide revenue bodies with greater assurance of tax compliance. This would include developing an understanding of:
  - their internal governance processes and the authority of the bank's tax department;
  - the adequacy of corporate governance and risk management systems for managing tax risk which would be taken into account in the revenue body's risk assessment of the bank, its major transactions and products; and
- risk assess the banks and their transactions and products based on their own tax affairs and their activities as advisers using available information where banks are unwilling to offer enhanced disclosure and transparency.

To improve transparent tax compliance revenue bodies should:

- bring to the attention of their tax policy officials and their government those situations where transactions are treated differently for tax purposes in alternate jurisdictions to determine whether they are comfortable with the existence of that arbitrage opportunity;
- engage with financial regulators to improve tax compliance as part of an overall corporate governance framework;
- work co-operatively with overseas revenue bodies and other relevant agencies in accordance with exchange of information provisions available in various bilateral and multilateral treaties;
- consider pursuing multilateral efforts to quickly identify, distinguish and respond to complex transactions; and
- work more closely with enforcement agencies and regulatory bodies in dealing with offshore promoters and offshore tax evasion.

To improve international co-operation revenue bodies should:

- jointly examine and remove the barriers to a more effective exchange of information on banking activities to take full advantage of the recent significant progress on implementing Article 26 of the OECD Model Tax Convention on Income and Capital (Article 26 standard) (OECD, 2008a);
- further exploit the potential of some multilateral instruments such as the joint Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters (Council of Europe/OECD, 2003);
- continue the dialogue amongst FTA Commissioners on enhanced relationships and the effectiveness and inconsistencies of measures taken to limit aggressive tax planning;

- encourage the development of the OECD Aggressive Tax Planning Directory and in particular to use this initiative to share experiences on measures taken to counter schemes; and
- explore whether the FTA could provide a forum for dialogue between Commissioners and Bank executives.

Recommendations for banks

In the course of the Study, the Team also identified a number of ‘good practice’ recommendations for banks:

- the bank’s internal tax department’s decision not to proceed with a transaction should not be overridden without escalation of a decision to the CEO or board;
- banks’ internal tax departments are encouraged to provide a greater degree of transparency in the governance of CSFTs implemented both for clients and on the bank’s own account;
- all banks should ensure that they have appropriately skilled and trained staff to review CSFTs for clients;
- in setting their business strategy, banks should consider the benefits of an enhanced relationship with revenue bodies including early certainty, reduced compliance costs, and reduced reputational risk; and
- as part of this relationship, banks should share their views with revenue bodies on tax risk assessment for products or services where there is potential for uncertainty around the tax treatment.

Introduction

The 2006 'Seoul Declaration' set out the OECD Forum on Tax Administration's concerns about the significant and growing problem of international non-compliance and the role played by tax advisors, financial and other institutions particularly in relation to the promotion of unacceptable tax minimisation arrangements. The FTA's subsequent *Study into the Role of Tax Intermediaries* (*Intermediaries Study*) concluded that some banks play a significant role in developing and implementing aggressive tax planning, both for their clients and on their own account.

Building Transparent Tax Compliance by Banks was commissioned at the fourth meeting of the FTA in Cape Town, South Africa, in January 2008 as a follow up to the *Intermediaries Study* and examines the role of banks in aggressive tax planning, the relationships between banks and revenue bodies, and whether there are benefits in engaging in an enhanced relationship.

A common thread between the work of both banks and revenue bodies is tax risk and each organisation is interested in how the other manages that risk.

Revenue bodies want banks to have sound internal controls for tax planning, which take account of the revenue bodies' understanding of the law. The banks that assisted with the study also saw good tax risk governance as important. To help improve risk assessment and effective deployment of resources, revenue bodies want banks to disclose more information in real time about their business and tax-sensitive transactions.

Banks, along with other taxpayers and their advisers, value certainty and want revenue bodies to provide a predictable environment. Revenue bodies would ideally be open about their approach to risk management, including the types of behaviours or transactions they consider high risk, and give an early indication of how they will respond to such risks.

This report examines how both of these outcomes might be achieved in an enhanced, co-operative relationship.

Not all banks are the same in terms of their regulation, business strategies and internal controls. Banks also have two distinct roles in relation to tax; those activities performed on behalf of their clients and those on the bank's own account. These roles differ in terms of a bank's internal processes, the role of the bank's tax department, and the amount of information a bank can share with revenue bodies.

Each revenue body is also faced with a different environment in respect of policy, legislation, administration and culture, and this will shape their approach to the issues addressed in the report.

Taking this into account, terms of reference were agreed following consultation with representatives of both revenue bodies and banks. They focus on five areas:

- a common, high-level understanding of how banks operate with particular emphasis on structured financing;
- the key roles banks play in the operation of tax systems;
- the planning, design, review and implementation of CSFTs, including those which may be considered aggressive tax planning by revenue bodies;
- identification and description of prevention, detection and response strategies used by revenue bodies; and
- the benefits that revenue bodies and banks could mutually achieve with an enhanced relationship.

Although this study was commissioned before the current financial crisis had fully developed, a number of issues relevant to future tax compliance by banks are addressed in this report. It is not yet clear however, how the global financial crisis will influence future bank behaviour.

A glossary at the end of the report sets out the meaning of key words and phrases.

Contents of chapters

Chapter 1 describes the role banks play in the economy and tax systems, and issues for tax compliance following the financial crisis.

Chapter 2 describes aspects of banking and tax that concern revenue bodies.

Chapter 3 considers the governance and risk management frameworks used by banks to manage risk, including tax risk.

Chapter 4 describes the risk management strategies employed by revenue bodies when responding to tax risk posed by banks and their clients.

Chapter 5 deals with recent examples of tax evasion by clients of some banks.

Chapter 6 contains the report's conclusions.

Chapter 1. The banking environment and the financial crisis

Key points

- Banks play a significant role in the global economy.
- Banks engage with revenue bodies both in relation to their own tax affairs and in their capacity as intermediaries.
- The complexity and lack of transparency of many innovative financial products developed in the course of investment banking is a key concern of banking regulators and revenue bodies.
- The financial crisis is having a major impact on the banking environment and as a consequence revenue bodies will need to consider a number of important regulatory and tax compliance issues.

This chapter looks at the nature of banking, in particular investment banking, and its contribution to the wider economy and to tax revenues. It also examines the current financial and economic crisis and emerging issues that may be important for tax compliance and administration.

Banks' role in the economy and the tax system

Banks are not only essential to the functioning of the global economy, providing a range of deposit taking, lending and advisory services to business, industry and individuals, but they also play an important role in the functioning of the tax system.

Banks collect and remit tax payments for revenue bodies and in some countries also have responsibilities for withholding tax regimes on deposit interest. In the United Kingdom, for example, banks administer the Tax Deduction Scheme for Interest providing taxpayers with interest on bank deposits net of tax. This significantly reduces the number of people who need to complete self assessment tax returns and simplifies the overall administration of the tax system.

Similarly, banks also assist with withholding regimes for interest income paid to non-residents. For example, the USA Treasury's Qualified Intermediary Program allows financial institutions located in an eligible jurisdiction to enter into an agreement with the USA Internal Revenue Service (IRS) where the foreign financial institution assumes certain documentation and withholding responsibilities in exchange for simplified information reporting for its non-USA account holders.

In Mexico since July 2008 banks have assisted with the collection of the *Impuesto a los Depósitos en Efectivo* (IDE), a tax on cash deposits, which was introduced for the purpose of countering the informal economy and tax evasion. The IDE is imposed on

deposits exceeding MXN 25 000 in either pesos or a foreign currency in any type of bank account maintained with any institution in the Mexican Financial System held by individuals or corporations. The IDE is withheld by banks on a monthly basis.

Where the law requires, banks provide certain information on third party income for matching with customer tax records, underpinning tax compliance. They play a major role worldwide in the battle against crime and terrorism by co-operating with law enforcement and revenue bodies, tracking and reporting suspicious transactions and implementing laws to combat fraud and money laundering.

Banks also interact significantly with governments both in relation to their wider economic role and as part of the consultation process for legislation and regulation of the financial services industry.

The nature of banking

Banking activities broadly comprise retail banking, dealing directly with individuals and small businesses; business banking, providing services to mid-market business; corporate banking, servicing large business entities; private banking, providing wealth management services to High Net Worth Individuals and families; and investment banking, relating to activities on the financial or capital markets.

In most countries banks are highly regulated by government and require a special licence to operate. The key elements of a prudent regulatory regime vary between countries but typically include capital adequacy ratios, liquidity adequacy rules and measures to protect the interests of bank customers. In addition, following corporate scandals in the 1990s, regulation imposed on public companies has tightened. The United States' *Sarbanes-Oxley Act* of 2002, for example, imposes requirements on public companies, including banks, on the establishment of internal controls.

Like many of their corporate customers, banking is a global industry with the major banks present in all of the key financial centres and in many other countries throughout the world. Their activities have impacts worldwide and their tax strategies frequently have a global perspective.

By its nature, the investment banking industry in particular involves complex operations and products. Some of these products, designed as solutions for customers, incorporate innovative tax dimensions which revenue bodies frequently perceive to lack transparency. For these reasons the study focuses to a large extent on the activities of investment banking.

Investment banking activities include engaging in public and private market transactions for corporations, governments and investors. These transactions include the underwriting of stock and bond issues, advising corporations on capital market activities such as mergers and acquisitions, and corporate restructurings.

Investment banking today also encompasses securities trading, securitisation, merchant banking, investment management and securities services. For these activities, banks earn fees and commissions. Many of these transactions are conducted on behalf of clients in the bank's capacity as intermediaries but some involve trading on their own account.

Many of these new financial products are created to provide integrated client solutions, sometimes customised and then developing into "off the shelf products". The

growth of financial engineering such as securitisations, derivatives, structured finance, repos and stock lending increased the complexity of the products offered by investment banks. Securitisation (the pooling of cash flow-producing financial assets into securities that are then sold to investors) transformed the business of investment banking but in the process introduced a lack of transparency as some investors and regulators lost sight of their underlying, securitised assets. This is also the case with some other financial derivatives where the value is linked to the value of an underlying asset.

The complexity and lack of transparency of financial products, particularly the kind of complex structured financial products described above, has been at the heart of the concerns of regulators and revenue bodies when attempting to understand their significance for banking regulatory rules, commercial effect and for the treatment for tax purposes.

The financial crisis

Since the end of 2008 the banking sector has experienced liquidity problems, high profile collapses, government bail outs, nationalisations, consolidations within the industry and changes in structure. The major investment banks have moved away from their traditional business model, in some cases establishing bank holding companies. This financial crisis has developed into the most severe global economic crisis since the 1920s.

It is important for both banks and revenue bodies to understand the drivers for the financial crisis and, while it will be some time before the precise causes are known, a number of emerging issues are known to have made significant contributions:

- a sustained rise in asset prices, particularly in housing;
- a period of substantial credit growth, including lending to high-risk borrowers in an environment of relaxed lending criteria;
- the development of the securitisation (originate and distribute) model of transferring risk;
- a high appetite for yield that nurtured a growing demand for high risk assets;
- little understanding of the risks of mortgage-based securities, related derivatives and credit default swaps;
- inadequate corporate governance in financial institutions; and
- under-performance by regulators and rating agencies.

The implications of the crisis for tax administration

In assessments of the factors contributing to the financial crisis, neither tax policies nor tax administration in the financial services sector appear to have been significant influences on behaviours or events. Nor can it be suggested that excessive lending, securitisation of lending, use of innovative financial instruments or any of the other potential causes of the crisis were essentially tax-driven.

However, the financial crisis has highlighted certain issues which have implications for revenue bodies and which may need to be examined by them. In particular whether:

- complexity and limited transparency associated with many of the financial products created by banks clouds the issues for regulators including revenue bodies;
- uncertainty over the tax treatment of innovative financial products (where effective rulings regimes were not in place) impacts on the risk taking positions of banks;
- restrictions on exchange of information prevent revenue bodies and other regulators from co-operating to identify fundamental problems in banks particularly where bank transactions straddle multiple countries;
- any deficiencies in corporate governance, prudent board-level tax strategies and adequate oversight by risk committees in banks impact on tax compliance particularly where these do not extend adequately to tax risk;
- the financial consequences of the crisis for banks may present opportunities for aggressive tax planning:
  - tax avoidance schemes designed around sales of tax losses by banks and other large corporate taxpayers; and
  - tax planning around the repatriation of profits held offshore by banks and other large corporate taxpayers; and
- remuneration packages linked to earnings increases the motivation to engage in aggressive tax planning to achieve the maximum profits and consequently the maximum bonus for the bankers.

Looking forward

As has been discussed, the global financial crisis has highlighted a range of issues, including tax issues, which impact on the relationship between governments, regulators, revenue bodies and banks. These bodies are already working together to improve compliance, to support a return to sustainable economic growth and to reduce the risk of any future crises.

Through this work, revenue bodies and banks have an opportunity to make transparency and tax compliance in banking an important part of any new regulatory environment and integral to good corporate governance.

Chapter 2. Why revenue bodies are concerned about banks

Key points

- Banks develop complex structured financing transactions (CFSTs) both for their own use and for their clients.
- When CSFTs are used for aggressive tax planning purposes, revenue bodies are concerned with the lack of transparency of these arrangements, particularly where aspects of the arrangements are undertaken in different jurisdictions.
- Revenue bodies need to understand CSFTs to better differentiate those that have a tax risk from those that do not.

The *Intermediaries Study* noted that it is often the complexity of financial products including their cross-jurisdictional impact that raises concerns for revenue bodies. Some transactions simply do not have a commercial rationale other than to minimise the tax liability, or include in-built steps which appear to serve no other purpose than to avoid paying tax. In some cases, including structured cross-border transactions between associated banks, the complexity of the arrangement can mask the substance of the transaction and prevent revenue bodies from detecting all of the tax risks. The main customers for such aggressive tax planning products are large corporate taxpayers and High Net Worth Individuals.

This chapter provides an overview of CSFTs: how they are developed by banks; what controls are or could be in place as they are developed; and how they are then used by both banks and their clients. It also examines concerns about the use of CSFTs for aggressive tax planning.

Of course, not all CSFTs are tax driven and revenue bodies need to fully understand the drivers behind them to distinguish those that do pose a tax risk. Better understanding can improve the targeting of enquiries and risk assessment processes, as well as the service offered to banks and their clients by providing earlier certainty on the tax treatment of their complex transactions, and reduced compliance costs.

Distinguishing features of banks

There are a number of features of banks which make them well-placed to develop CSFTs for aggressive tax planning. Firstly, banks have access to capital and the tax planning arrangements used by large corporate taxpayers often involve a substantial flow of funds through a number of entities and jurisdictions, sometimes including circular flows of capital.

Secondly, banks have a global reach, and despite the impact of the financial crisis, banks remain in a unique position through their global lending businesses to channel these funds through multiple entities in multiple jurisdictions.

Furthermore, the financial instruments used in aggressive tax planning arrangements, such as loans, repos and derivatives, are often the same types of instrument developed by banks for use in commercial dealings by their clients and in their own commercial inter-bank trading.

Although aggressive tax planning need not involve complex arrangements, revenue bodies are more concerned with such arrangements which are by their nature difficult to comprehend and place pressure on tax and accounting rules.

Complex Structured Finance Transactions

It is difficult to define a CSFT because by their very nature these transactions are multi-faceted and often customised. Banks, and their investment banking operations, have detailed knowledge of their customers and can offer services tailored to specific circumstances or commercial needs. Other transactions can benefit a number of customers and may be more widely marketed.

This report uses the description of a CSFT offered by the United States Interagency Statements (Interagency Statement) of 2004 and 2007[1]. A CSFT usually shares some or all of the following characteristics:

- it is a non-standard product and is structured to meet the specific financial objectives of the customer;
- it involves the participation of professionals from multiple disciplines within the bank and may generate higher than normal returns or significant fees;
- it may involve the creation and use of Special Purpose Entities (to address economic, legal, tax or accounting objectives) and/or the combination of cash and derivative products; or
- it may involve exposure to elevated levels of market, credit, operational, legal and reputational risk.

In addition CSFTs may include the use of hybrid entities, hybrid instruments and involve multiple jurisdictions.

Characteristics of CSFTs which have elevated risk and warrant closer scrutiny were identified in the 2007 Interagency Statement as follows. Transactions which:

- lack economic substance or business purpose;
- are designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when the transactions are executed at year-end or at the end of a reporting period for the customer; or
- raise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements.

As the 2007 Interagency Statement also notes, "… such structured finance transactions, including the more complex variations, have progressed over time to be an essential part of United States and international capital markets".[2]

It is important to recognise that not all CSFTs have a dominant tax motivation, and that solely tax driven products are only a small part of overall CSFT business. A simple example of a non-tax driven CSFT may be a straightforward receivable securitisation where tiered capital is used to allow for different levels of risk according to investor type. Box 2.1 sets out an example of a structured finance transaction that has been accepted in a particular jurisdiction as not having a significant tax motivation.

Box 2.1. Innovative Tier One Capital

For prudential supervisory purposes, regulatory authorities require banks to keep a proportion (or ratio) of capital available to cover risky assets, referred to as capital adequacy. That capital is separated into Tier 1 and Tier 2, with Tier 1 being the bank's core capital3, normally comprising non-interest bearing instruments such as common shares and preferred shares. With an innovative Tier 1 capital structure, preferred securities which would otherwise pay non-tax deductible dividends are converted into debt instruments through the use of a hybrid partnership structure, which is considered a corporate entity in one jurisdiction and a partnership in another. The preferred shares can be counted as Tier 1 capital for regulatory purposes, notwithstanding the fact that the corporate partnership ultimately issues interest-bearing debt into the market place. The revenue bodies' interpretation is likely to be that if there is a clear non-tax purpose for the choice of the hybrid instrument or entity and a genuine issue into the market then most would reasonably suppose that the principal purpose was not to achieve a tax benefit (HM Revenue and Customs, 2009).

There are a number of elements of CSFTs that need to be examined to gain an understanding of their use by banks such as how they are developed and marketed.

Providers of CSFTs

A wide range of tax intermediaries can be involved in the design of tax-related CSFTs from the major accounting and financial services firms, legal firms and of course the banks (particularly those with investment banking operations), to a range of smaller, boutique firms offering specialised services or concentrating on specific types of customer.

The majority of banks who provide standard banking services will include CSFTs as part of their suite of products. However the degree of involvement can vary, from only providing payment processing for the transaction, to executing a part of the transaction, through to structuring and marketing the transaction as well as being a party to the CSFT and enjoying any tax benefits themselves.

Where a bank is only performing an execution function it may have knowledge as to whether the CSFT has significant tax enhancements. If so, the bank's corporate governance processes would be expected to operate in the same way as if the bank had actually structured the transaction itself. Examples of where this might happen include: where the bank acts as the defeasance holder or intermediary (for a fee) in a transaction to mask the overall connection to the ultimate parties to the transaction; or where the bank provides loan transactions on a very short term basis where funds are provided for an instant in time (*i.e.* for a few minutes or for less than a day) in order to facilitate tax driven arrangements.

Those banks engaging in more significant CSFT business are likely to do so through specialised units, such as a structured products team or a structured capital markets team. The importance of this business will vary from bank to bank; in some cases it represents a relatively small part of the bank's overall business, while in others the structured products team may contribute significantly to the bank's profitability. Such teams will typically involve experts in a number of different disciplines, including accounting, legal, mathematics, regulation and tax, recruiting highly talented staff not necessarily from a financial background. The individuals in charge of these structured products teams can have substantial influence over the decision-making processes within a bank, particularly where they generate high profits. The impact of this influence on the bank's overall appetite for tax risk is a factor which revenue bodies should take into account in their own risk assessments. The ideal would be for a strong culture of corporate governance operating within the bank to ensure a balanced decision-making process and this is discussed in greater detail in chapter 3.[4]

Banks dedicate varying levels of resource to CSFTs depending on the level of their involvement in such transactions. Some banks take the view that tax aspects of a particular CSFT are ancillary to the overall structured transaction business and that developing transactions where tax saving is the primary motivator is generally not a significant part of their business in itself. Some banks devote more resources to development of tax driven products than others. Some structured finance teams within banks are rewarded on the basis of profit participation.

Customers of banks' CSFTs

Banks develop CSFTs both for their own use and for their customers, from large corporations to High Net Worth Individuals.[5]

Banks' internal processes for sign off and risk management are substantially the same whether the CSFT is bank-to-client, or bank-to-bank, including where the bank is counter-party. However, there is a difference between how a bank's own risks and those of its clients are managed because banks can assess reserves and disclosure levels in their own transactions but are not necessarily able to do the same for their clients[6].

Types of CSFT arrangements

There are two types of transaction: customised and mass marketed. It is more common for deals to be arranged on a client by client basis; however**,** banks may also mass market CSFT arrangements in a 'one size fits all' approach.

All CSFTs will include common building blocks (for example, a type of hybrid instrument), but in a customised arrangement significant elements of each deal will be tailored to the circumstances of a specific client (for example, accounting or regulatory treatment might differ for clients in different jurisdictions). Box 2.2 sets out how these customised transactions can become complex, for primarily non-tax reasons.

Box 2.2. **Transaction with complexity**

A client has EUR 2 billion to invest and asks for a product providing a consistent return. At that time the bank sees a need for liquidity in the mortgage market and advises the client of its potential to invest.

The client does not want to hold a collateralised debt obligation, so the bank designs a Total Return Swap product, to give the client the economic benefits but not the ownership risks associated with the underlying asset.

The bank then writes a rate of inflation/fixed interest swap. A special purpose entity is also used and located in a jurisdiction with good tax treatment. The final structure therefore has a special purpose entity, a collateralised debt obligation, two swaps and a cross-border element.

Mass marketed CSFT arrangements are less common. In the past, banks gave approvals for a single structure to be marketed to a large number of clients. However, this approach has changed over recent years. The use of "marketing opinions" was common practice in the past, but increased franchise and reputational concerns have encouraged banks to move away from this approach, particularly after the introduction of the *Sarbanes-Oxley Act*. According to those in the industry, it is now common for banks to manage exposure to particular risks by placing limits on the number of certain types of transactions that are approved.

Demand for CSFTs

The demand for CSFTs is not constant, but varies throughout the economic cycle both in the volume and type of transactions required, and among the users or taxpayers.

Demand is influenced by factors such as:

- differences in interest rates and the availability of tax concessions between countries leading to the design of financial products that take advantage of the lowest cost of funds in one country while earning large fees from arranging and structuring new and innovative types of transactions;
- the appetite for credit by borrowers at different points in the economic cycle;
- change in corporate tax rates which can lead to taxpayers attempting to trade away high effective tax payments in one jurisdiction with counterparties in low or no tax positions and share the tax benefits or tax savings; and
- changes in franchise or reputational risk levels for the bank which may be affected by events for example, from negative public perception following unsuccessful litigation.

Origin and marketing of CSFTs

Banks aim to offer their clients a service which addresses all of the client's needs. They are not the only source of CSFT product ideas; accounting firms and legal advisers regularly produce material covering these products as part of the service to their clients.

Banks have detailed knowledge of their customers and can offer services tailored to a customer's specific circumstances or commercial needs. In seeking to offer products that are appropriate to each client's individual circumstances, banks may need to take account of the client's tax position to determine the suitability of a proposed transaction. Alternatively clients can request CSFTs from the bank and in some circumstances may create a competitive pressure on the banks to do so in order to retain their business.

Most banks have a review process in place to ensure that any marketing materials produced by the bank (including "pitch books") are reviewed and signed off by the relevant control functions, including the tax group, before they are sent out to clients. In some instances the marketing of transactions to clients is not permitted prior to review by a new products and/or structured product review committee.

Many revenue bodies encourage banks to bring details of new products to their attention prior to marketing, in order to discuss the tax treatment and to ensure that they comply with relevant tax laws. In such cases product rulings or advance binding rulings offer certainty as to the tax treatment of particular products before the banks market them to clients.

CSFTs and Aggressive Tax Planning

Revenue bodies need to be able to distinguish CSFTs that have a commercial (non-tax) purpose from those which are specifically designed for aggressive tax planning purposes and pose a significant tax risk.

This report adopts the same definition for 'aggressive tax planning' as the *Intermediaries Study* and covers arrangements broadly involving two areas of concern:

- planning involving a tax position that is arguable but has, in terms of legislative intent, unintended and unexpected tax revenue consequences; or
- taking a tax position that is favourable to the taxpayer without openly disclosing that there is significant uncertainty as to whether it accords with the law.

Banks' internal risk management and corporate governance systems should include robust processes to enable businesses and revenue bodies to identify transactions which present an elevated tax risk. These should take account of whether the revenue body would view the transaction as aggressive.

There are certain features which may indicate aggressive tax planning, including transactions:

- which generate no pre-tax profit or have no commercial rationale;
- which include off-market terms or have un-commercial terms or steps;
- in which there is a circular flow of funds;
- in which the tax benefit is disproportionate to the other benefits in the transaction;
- which rely on "accommodation" parties which have no substantial role in the transaction;
- in which two parties in the same jurisdiction claim differing tax treatments;

- which use complex structures and intra-group transactions associated with generating tax benefits unrelated to economic substance of a commercial activity; and
- which in substance produce unintended multiplication of tax benefits in different jurisdictions.

Transactions which involve different tax treatments in two jurisdictions are not necessarily aggressive. A transaction may be characterised differently by alternate jurisdictions, either with policy-makers in both countries regarding their rules as achieving the correct national outcomes, or as potentially inoffensive by one country and aggressive by the other.

The above list of features of aggressive tax planning is drawn from a variety of sources including:

- Court decisions (especially in the jurisdiction of a parent company), including leading anti avoidance doctrines from *Furniss v Dawson*[7] (United Kingdom) and *Coltec Industries v. United States*[8]. In some countries there may not be a legal precedent to provide a clear definition of anti avoidance, anti abuse or where the structuring is deemed inappropriate.
- General legal concepts which continue to evolve and which describe unacceptable effects of transactions common to most legal systems, such as Fiscal Nullity, Sham, *Abus de Droit* (France), *Fraus Legis* (Netherlands), Economic Substance (United States) and Misuse and Abuse (Canadian GAAR concepts). These concepts can cover both general legal and tax issues.
- General anti-avoidance provisions such as those that exist in Australia[9] (dominant purpose of avoiding tax), Canada[10] (transactions not undertaken primarily for *bona fide* purposes that result in a tax benefit and a misuse or abuse of the provisions of the tax legislation), Ireland[11] (primary purpose of producing a tax advantage where there is a misuse or abuse of the provisions of the tax legislation) and South Africa[12] (sole or main purpose to obtain a tax benefit).
- Published revenue body guidance, including "black listed" transactions[13].
- International law or double tax treaty applications. For example, international cases such as *Indofood International v JP Morgan Chase*[14] involving the use of conduit companies in treaty countries to avoid withholding tax under double tax conventions.

In applying the law revenue bodies must establish the facts, circumstances and rationale for transactions and material steps of transactions to determine whether they are considered to be aggressive tax planning.

Examples of aggressive tax planning

Below are three examples of tax-driven transactions which are of concern to revenue bodies (boxes 2.3 to 2.5). A more detailed step-by-step description of these three example schemes has been provided in Annexes A.1 to A.3. Each transaction is described in the annex in the detail required by revenue bodies to properly understand and describe the CSFT. This detailed approach allows revenue bodies to properly assess the commerciality of each step or transaction and to better understand the overall cross border effect.

Box 2.3. **Cross border sale/repurchase ("repo") arrangement**[15]

Using a circular flow of EUR 2 billion, two banks convert a EUR 1 billion inter-bank loan into a EUR 3 billion complex arrangement, part of which is a cross-border transaction that has the effect of a sale/repurchase ("repo") arrangement. This part of the transaction is considered as a collateralised loan in one jurisdiction and as a sale & repurchase of shares in the other. The proceeds from the final sale of the underlying securities under the "repo" transaction are treated as deductible interest for the "borrower" and capital proceeds in the hands of the "lender", for whom capital gains are tax free.

Box 2.4. **United States of America foreign tax credit (FTC) generator scheme**[16]

The *Intermediaries Study* has previously described some arrangements which generate foreign tax credits for a bank. More aggressive arrangements of this kind have emerged, including the well-publicised example of highly structured FTC generator schemes used by United States taxpayers. It involves the taxpayer intentionally incurring foreign tax even where there is no or significantly less foreign tax in the basic underlying transaction, in a manner that allows the parties to obtain duplicate tax benefits and share the economic burden of the tax payments.

Box 2.5. **Jurisdictional arbitrage financing transaction involving duplicate credit claims**[17]

This example involves the use of a hybrid instrument to exploit a mismatch in tax treatment between different countries. Two parties (one domestic and the other foreign) invest in a domestic entity using hybrid instruments that arbitrage the different debt/equity classifications in both jurisdictions. The structure of the investments allows each party to claim tax credits for the same tax payment made by the domestic entity.

Conclusions

CSFTs present difficulties for risk assessment by revenue bodies because they are used for both purely commercial transactions and in aggressive tax planning.

Revenue bodies have developed various strategies for detection of CSFTs with elements of aggressive tax planning. However, without a good grasp of the variety of innovative and complex financial instruments being used in the financial market and an understanding of how they work in a particular arrangement, it can be difficult for revenue bodies and banks and their clients to be certain of the tax treatment. Where there is concern about the effect of a transaction, the revenue body response will be to examine more fully the CSFT and obtain the full set of documents associated with the transaction to determine its correct tax position.

When banks are willing to be open and transparent to assist in deterring aggressive tax planning, the incidence of uncertainty should decrease and the relationship with revenue bodies will improve.

Recommendations

Revenue bodies should ensure they have all necessary strategies in place to better prevent, detect and respond to aggressive tax planning, particularly high risk behaviour, including working closely with the banks as well as developing close working relationships with other domestic regulators, and with overseas revenue bodies. The latter is particularly important given the global reach of these types of arrangements.

Revenue bodies should pursue the advantages of bilateral and multilateral efforts to quickly identify, distinguish and respond to acceptable complex transactions as well as those viewed as aggressive tax planning transactions to provide greater certainty.

Banks are encouraged by revenue bodies to provide a degree of transparency above the minimum legal requirement to enable revenue bodies to fully appreciate the commercial context and details of CSFTs.

Revenue bodies should bring to the attention of their tax policy officials and their governments those situations where transactions are treated differently for tax purposes in alternate jurisdictions to determine whether they are comfortable with the existence of that arbitrage opportunity.

Notes

1. Refer to the USA Department of the Treasury Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities The Federal Register Vol 60 No. 97 May 19 2004 Office of the Federal Register, Washington www.thefederalregister.com/d.p/2004-05-19-04-11270 (proposed Interagency Statement) and the USA Department of the Treasury Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities The Federal Register Vol 72 No. 7 January 11 2007 Office of the Federal Register, Washington www.thefederalregister.com/d.p/2007-01-11-07-55 (Final Interagency Statement). The Final Interagency Statement applies to national banks, state banks, bank holding companies (other than foreign banks), federal and state savings associations, savings and loan holding companies, U.S. branches and agencies of foreign banks, and SEC-registered broker-dealers and investment advisers engaged in CSFTs.
2. The Final Interagency Statement outlines at page 24 that “Most structured finance transactions, such as standard public mortgage-backed securities transactions, public securitizations of retail credit cards, asset-backed commercial paper conduit transactions, and hedging-type transactions involving “plain vanilla” derivatives and collateralized loan obligations, are familiar to participants in the financial markets, and these vehicles have a well-established track record. These transactions typically would not be considered CSFTs for the purpose of this Statement.”
3. For an explanation of core capital refer to "Basle Capital Accord. International Convergence of Capital Measurement and Capital Standards (July 1988, updated to April 1998)" page 3, www.bis.org/publ/bcbsc111.pdf?noframes=1.

4. See also OECD (2004), Compliance Risk Management: Managing and Improving Tax Compliance Guidelines on Tax Risk Management OECD, Paris. www.oecd.org/dataoecd/21/55/37212610.pdf.

5. The OECD (2009a), *Engaging with High Net Worth Individuals on Tax Compliance* examines different strategies to improve compliance within the High Net Worth Individual taxpayer segment.

6. See OECD (2009b), "Corporate Governance and Tax Risk Management".

7. [1983] UKHL 4.

8. 454 F.3d 1340 (Fed. Cir. 2006), cert. denied, 127 S.Ct. 1261 (2007).

9. Part IVA of the Income Tax Assessment Act 1936.

10. Section 245 of the Canadian Income Tax Act.

11. Section 811 of the Irish Taxes Consolidation Act 1997.

12. Section 80A of the South African Income Tax Act 1962.

13. For example United States Treas. Reg. Sec. 1.6011-4 which describe reportable transactions and United States Treas. Reg. Sec. 1.6011-4(b)(2) which provide guidance on listed transactions.

14. [2006] EWCA Civ 158.

15. See Annex A.1 for a detailed descriptions and diagram flows of the enhanced repo arrangement.

16. See Annex A.2 for an example of a FTC generator scheme, as identified by the IRS in T.D. 9416, 73 F.R. 40727 (30 June 2008).

17. See Annex A.3 for a detailed description and diagram flow of the arrangement which has been sourced from the OECD Aggressive Tax Planning Directory of Working Party 8.

Chapter 3. Governance and risk management in banking

Key points

- Revenue bodies want assurance that banks' risk and governance processes offer protection to both banks and revenue bodies.
- The governance and risk processes of some banks may not be sufficiently robust for revenue bodies to rely on.
- Risk and governance processes are an important feature of a bank's overall regulatory risk framework. Understanding them and testing their effectiveness can assist revenue bodies in their risk assessment of banks.

Governance and risk management in banking

Risk is prevalent in the work of both banks and revenue bodies and the ability to identify, monitor and manage risk is critical to both groups' success.

Revenue bodies select issues to investigate and make resourcing decisions based on an understanding of a taxpayer's tax risk. A better understanding of how banks manage their risks and the surrounding governance processes assists revenue bodies in their own assessment of the banks and subsequently in targeting their enquiries.

Banks' corporate governance and risk management frameworks have been designed to manage a range of risks. From the banks' perspective the most significant risks are either to the reputation of the franchise or to the financial stability of the bank. However, it is how tax risk, particularly the tax risk posed by CSFTs, is managed that is the revenue bodies' main concern.

Understanding a bank's risk management and governance processes is therefore key for a revenue body. Not only can the information be used in their assessment of the risk posed by the bank, both in relation to the bank's own tax affairs and as an intermediary providing financial products to customers, it can also be used to improve decisions on the allocation of resources, the selection of issues for intervention or audit, and to help target requests for information.

For these reasons this chapter looks at the impact of bank governance and risk management processes for CSFTs and at the role of the tax department in a bank. It also looks at how banks and revenue bodies might engage on the effectiveness of the governance and risk management processes for tax risk.

External regulation

External regulators maintain standards within the financial services industry, often focusing on risk management and control, and banks are required to meet regularly with them to discuss their risk management processes and procedures. Discussions between external regulators and banks also consider specific transactions including CSFTs.

The purpose of regulating banks is to maintain efficient and orderly financial markets, protect depositors and help retail consumers receive a fair deal. Regulation also ensures that banks have sufficient capital reserves to satisfy customer demand and ensures the long term viability of the enterprise. This is partly to protect customers and partly to protect the economy as a whole.

The response of external regulators to crises or corporate governance failures can have a fundamental impact on structures and processes within banks. In the wake of the collapse of Enron in the United States, the *Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Financial Transactions* insisted that financial institutions have processes, policies and procedures for elevated risk CSFTs to cover approvals, documentation, monitoring compliance, training, audit and reporting.

Failure of corporate governance in relation to tax issues can in some circumstances lead to financial regulator action, with severe financial consequences for an institution and individual officers, as set out in box 3.1.

Box 3.1. **Tax issues leading to financial sector regulator action**

The United Kingdom Financial Services Authority imposed a GBP 4 million fine on a bank which was found to have deliberately misled the Japanese regulatory and tax authorities. During an audit by Japan's National Tax Agency on whether the bank was conducting business in Japan through a permanent establishment, bank officers had deliberately concealed the relationship between the bank and the subsidiary and had provided the revenue authority with misleading responses to information requests. (Financial Services Authority, 2002)

Responses to such failures of governance usually include a thorough review of and improvements to governance processes and often a change in key personnel. However, there is a risk that such changes in behaviour can be temporary. It is important that there is ongoing monitoring to ensure that the changes are embedded into the banks processes. Revenue bodies have a role in enforcing changes to behaviour and removing competitive disadvantage by ensuring that all like cases are treated in the same manner.

Internal regulation

All banks operate an internal risk management framework, partly as a requirement of external regulators, but predominantly because it is part of the approach to effectively managing the bank's own risk. The risks managed under the bank's internal risk management frameworks include franchise, fiduciary, market, credit, legal, liquidity and funding, operational and tax risks.

The specific design of such a framework, its complexity and robustness will vary from institution to institution, but typically it will include a number of committees to consider the risks, whether they are operational or franchise risks, as well as committees to formally approve structured transactions or new business for the bank.

The level of involvement in such processes will vary between banks, but all will require some form of documentation. Some banks for instance will not undertake a CSFT with a significant tax risk component unless they have received a legal opinion confirming that the transaction is sound and creates no unexpected tax problems[1].

The purpose of a bank's governance and risk management process is to ensure that the transaction meets the banks standards for proceeding and that a bank does not execute a transaction without having considered all the relevant issues, including economic, legal, compliance and other non-tax constraints as well as tax law and revenue body views.

Revenue bodies should note that a bank's approach to risk management and governance will typically be outlined within its annual report, with many pages dedicated to the processes and should be used both to improve understanding and in risk assessment.

Tax risk

Tax risk can be defined as the risk that the bank will fail to comply with tax legislation in any of the jurisdictions in which it does business. Tax risk includes managing uncertainty about tax outcomes, and this is true for banks and for revenue bodies. From a bank's view these tax uncertainties can also encompass:

- the risk of errors in tax filing;
- the risk of errors in tax reporting in financial statements;
- the risk of additional tax becoming due as a result of a disagreement between the bank and the revenue body;
- the risk of double taxation;
- interpretation of tax laws or regulation; and
- reputational damage, including damage to the bank's relationship with the revenue bodies or adverse publicity in respect of tax matters.

To understand the banks' perspective, revenue bodies need to be aware of how a bank assesses tax risk at the transaction level. Banks may take a number of criteria into consideration:

- the principal amount invested in the transaction;
- tax capacity: whether it is sufficient; whether there is a limit placed on tax capacity used by tax planning;
- amounts at risk governed by credit risk, counterparty risk and similar procedures;
- commercial or economic rationale for the transaction;
- technical tax risk: the likelihood that the claimed tax treatment is sustainable if challenged;
- legal risk: incorporating the opinion of likelihood of success from legal advisers, assessed along with regulatory and accounting risk;
- downside risk: the risks of additional tax liabilities, interest and penalties if the transaction is successfully challenged by a revenue body;
- implementation risk: the complexity and practicality of the transaction;
- relationship risk: the impact on a bank's relationship with revenue bodies including any future consequences and the perceived level of 'tax aggression';

- reputation risk/franchise risk: damage to reputation or brand and public perception of the bank; and
- concentration risk: consideration of the number of similar transactions or the number of transactions with same counterparty.

Typical processes for managing tax risk in CSFTs

While processes may vary between banks, most banks will have a well-defined, fully documented, risk management and governance process to follow when implementing CSFTs, involving a number of stages and a wide range of participants within the bank's business and internal control units.

Consideration of product risk starts at the development stage. It is normally a business unit, for example a structured products department, which develops a CSFT. During product development the business unit will consult with other areas of the bank, for example, the tax, legal and accounting departments, to obtain their views on the viability of the CSFT.

During this development phase, a CSFT will be required to go through a number of reviews to address all the risks inherent in it. One such example is the New Product Approval (NPA) process, which involves a committee comprising of representatives from a number of areas of the bank including legal, compliance, market risk, credit risk, regulatory, as well as tax. The business unit or team that generated the product or transaction cannot approve their own products. The committee's role is to review and to provide sign off on the risks associated with the transaction, including tax risk. If a transaction is not approved by this forum, it will not go any further.

In addition to an NPA review, many of the more complex CSFTs will also be required to undergo a franchise risk review, for example, by a Franchise Committee (often called a Structured Product Review Committee). Franchise risk review considers the potential impact a transaction may have on the reputation of the bank, for example whether the bank would be comfortable with their name being associated with this transaction in the press. There would also be consideration of any external opinions received such as tax opinions from lawyers. The Franchise Committee will also consider the potential or actual suitability of the specific client for the transaction, for example the level of sophistication of the client, the degree of seniority of the personnel at the client who have been involved in signing off the transaction, and the existing reputation of the client and their relationship with the revenue bodies.

If the Franchise Committee considers any risks are too great, it may reject the transaction or it may develop policies and procedures to mitigate those risks or look to manage any potential conflicts, for example it could impose restrictions or limitations, especially around size and number of transactions that can be undertaken.

Given the significant amount of time and expense incurred in developing a transaction, it is preferable to determine at the outset if a CSFT is likely to pass franchise review before committing resources to it. Therefore transactions are often presented to the Committee early on for an initial view and only a small number of CSFTs are rejected at this franchise stage. The role of the Franchise Committee, or equivalent, is to ensure that transactions involving a complex tax point have been properly assessed and then to determine, taking account of all factors, including revenue body views, that it is appropriate to proceed. The fact that a bank proceeds with a transaction does not

necessarily mean that the revenue body's views were not taken into account. However, revenue bodies question whether this stage of the process adequately takes account of their view, as many transactions which revenue bodies consider to be aggressive tax planning do pass through Franchise Committees.

That said, there are a number of other controls in place. In the majority of banks there must be a consensus of opinion within the control functions as to whether a transaction is viable. Each control function may have a right of veto over a transaction or, in some cases they may refer a transaction to a higher committee for review if they believe there is a franchise risk issue. Knowledge of how such vetoes work in a bank is key for revenue bodies in understanding the bank's appetite for risk.

Banks also have a number of review processes which revisit a transaction at the point of implementation both to ensure that it has been developed in line with the original details of the proposal and also to evaluate the impact of any changes to laws or the operating environment. If there are adverse changes which bring in to question the suitability or viability of a transaction then it may be terminated at this point in the process.

Revenue bodies have questioned banks' processes to ensure that the product approved is the product implemented, given the number of transactions which are found to be unsuccessful for tax purposes because of failures in implementation.

An effective risk management process will include reviewing these controls and taking strong disciplinary action against individuals who circumvent them. This is one further way that a bank can demonstrate the strength of its process.

The role of the bank's tax department

Effective risk management requires independent review and approval from within the bank away from those purely motivated by profit. The tax department is an important element of managing risk in a bank and revenue bodies need to understand the role it plays in relation to transactions. The review of a transaction for tax risk has a direct impact on the performance of the business unit that proposed the transaction and on any performance-based remuneration of individuals in that unit. This can create tensions between the business units and the tax department and revenue bodies need to understand how such tensions are resolved.

The role of the tax department and its relationship with the business units will invariably differ from bank to bank, but the tax department is almost always responsible for the bank's relationship with revenue bodies. It deals with two very distinct areas: enquiries or audits relating to the bank's own liabilities as a taxpayer; and enquiries made to the bank as a developer of products for its clients.

For bank-to-bank structured finance transactions which have an impact on the bank's own tax return, the tax department will become directly involved in the discussion and the approval process. It is normally a business unit (for example, a structured products team) and not the tax department which initially proposes a bank-to-bank structured finance transaction. The business unit will have the relationship with the counterparty and will internally or externally obtain the tax expertise needed to structure the transaction. As it can be specialists in the business unit who oversee all the tax issues in the transaction (apart from its approval), they have a vested interest in its success.

The typical functions performed by tax departments as part of governance and approvals processes include:

- providing an independent assessment of the tax risk;
- considering if the transaction passes an initial 'smell test';
- where the results of the test raise questions, working with the business units and lawyers to determine ways to improve the transaction;
- ensuring that the transaction satisfies an independent economic substance, or pre-tax profitability assessment;
- reviewing external advice provided by advisors (accountancy firms or legal firms) to determine whether it is reasonable and appropriate;
- reviewing any changes to the structure, and advising of any changes to the law or interpretations of the law, which may affect the original analysis;
- where numerous jurisdictions are affected, ensuring that advisors have provided their analysis based on a consistent set of facts and circumstances, and have acknowledged the impact of the advice in the corresponding jurisdiction;
- determining the need for any reserves, caps or limitations, given that reserve issues can often affect whether or not the bank continues with the transaction;
- assessing the impact of the transaction on the relationship of the bank with tax or other fiscal authorities and regulators;
- considering the impact of adverse publicity arising from the transaction; and
- protecting the franchise of the bank.

Both revenue bodies and banks should note that a key issue for determining how well a corporate governance and risk management process operates is whether the tax department has the power to veto any transaction that it believes the bank should not execute, for example, where the tax department:

- does not agree with the tax analysis put forward by the business unit or with external opinions obtained by the business unit;
- sees the transaction as involving unacceptable tax risk;
- believes that the transaction would have an undue adverse impact on its relationship with the revenue body;
- does not believe that the bank will have sufficient tax capacity to be able to utilise whatever tax attributes may result from the transaction; and
- believes the transaction is not consistent with the bank's overarching business and tax strategy.

From a revenue body's point of view, a bank's internal tax department would ideally have the authority to reject any transaction with significant tax uncertainty which it believes the bank should not execute. In some cases the tax risk management process requires the CEO's or the Board's approval before a tax department's opinion can be overridden. In other cases approval processes involve negotiation with business units and the tax department potentially loses control over whether the transaction should proceed.

Where transactions are approved the tax department still has an important role in establishing tax reserves it deems appropriate.

Where the tax department does not have authority to reject a transaction with significant tax uncertainty, or where any review of its decision is not escalated to the CEO or Board, the bank's governance and risk management systems are unlikely to be as effective in managing tax risk.

The banks that assisted in the study advised that they all had internal tax functions that were represented in their respective structured product and reputational review processes for clients' and their own CSFTs. The representation of the internal tax function in the review of CSFTs should represent good practice for banks' management of tax risk.

Banks tax departments should also be encouraged to provide greater transparency to the bank's home revenue body in relation to the governance of CSFTs for clients and for the bank's own account. This should include a description of the review process and corporate governance around CSFTs.

Management of risk across borders

Many banks are global organisations which operate through branches or subsidiaries in a number of countries and risk management processes are often set at the top of an organisation. Revenue bodies should be aware that good practice for banks is a consistent approach to risk management regardless of jurisdiction, and therefore the risk management framework which is applied to an overseas subsidiary will reflect that of the parent location. However standards are sometimes applied differently across jurisdictions.

The level of risk appetite within a particular jurisdiction will be influenced by a number of factors including the local rules, regulations and tax legislation, as well as the local culture. Just because a transaction would be deemed acceptable in the parent jurisdiction, does not mean it would be acceptable in an overseas jurisdiction if the rules there are different, and vice versa. Banks employ regional experts, including local risk management experts, who are versed on the rules and regulations of the overseas jurisdiction to know if there is a requirement for regional specific guidelines, or variations to risk control frameworks to reflect different cultures or attitudes.

Many banks report that in all instances of conflict between two jurisdictions the higher level of acceptability would be the minimum standard, regardless of whether that is in the parent or a subsidiary jurisdiction. However, competitive pressures will often dictate a bank's approach. This is particularly relevant in territories with less developed regulatory or corporate governance practices, where local competitors apply the much less stringent standards of the local jurisdiction, compared to those set by their head office.

In addition to local experts on the ground it is usual for senior management, including heads of tax departments, to undertake a significant amount of international travel to ensure that risk is being appropriately managed outside the parent jurisdiction. The degree to which this takes place varies, but it is viewed as industry good practice.

Revenue body risk assessment and bank risk management

Revenue bodies need to understand how banks' risk management and corporate governance processes work, but banks must also be aware of how these processes are perceived by revenue bodies.

In an open and co-operative relationship corporate governance and risk assessment documents would be made readily available to the revenue body and indeed the willingness to share such information is taken into account in evaluating a bank's tax risk.

Another key indicator for revenue bodies is the importance put on tax compliance by senior management, how that is communicated through the organisation, and its influence on a bank's risk culture.

A bank's risk management strategy is likely to evolve over time given the nature of the financial services business. By taking account of the role of revenue bodies in upholding the law, banks can improve their relationship with revenue bodies, develop trust, and reduce their compliance costs.

Conclusions

All banks should have governance frameworks and approvals processes in place for new complex financial products, and revenue bodies need to understand these processes and the attitudes of a bank to be able to carry out a comprehensive and accurate risk review.

Processes on their own are not sufficient without the appropriate exercise of good judgement and good internal controls.

There will be instances where banks may take a different view to the revenue body. This may be because: there is genuine doubt over the correct legal interpretation of a provision; in some cases weaknesses in processes or controls do not adequately identify or correctly analyse new complex transactions; in others the appetite for tax risk within the bank is such that there is a perception that potential reward from such transactions outweighs the risks of the transaction being successfully challenged by a revenue body; and sometimes revenue bodies may simply not have properly understood the transaction. There will be occasions where, having considered all the relevant issues, a bank decides to take a position at variance with the revenue body views. In such cases the issues may need to be resolved by the courts.

Whilst banks' governance and risk management frameworks are not specifically designed to solely manage tax risk, understanding the particular procedures can assist revenue bodies in risk assessment, selection of issues for intervention or audit, and can help target information requests. This should facilitate and expedite the overall compliance process for both revenue bodies and banks.

The role of the bank's tax department in the approval process for new products is critical to the adequacy of the bank's internal controls in managing tax risk. Where the tax department's advice not to proceed with the transaction can be overruled by business units or without consideration by senior management, it is unlikely that the bank's internal controls adequately manage tax risk.

Recommendations

Revenue bodies should encourage dialogue with banks to find out how their internal control functions can offer greater assurance of tax compliance in connection with CSFTs and this could include audits of the control function by the revenue body.

Revenue bodies should understand banks' internal governance and approvals processes for more effective risk assessment and to improve the overall compliance process. This includes understanding the authority of the bank's tax department in assessing tax risk as an indicator of the strength of the process in managing tax risk.

Good practice for a bank's internal governance for the management of tax risk is, if the tax department has advised that a transaction should not proceed, that that decision is not overruled without escalation to the bank's CEO or Board.

Revenue bodies should also consider exploring with banks the scope for greater and earlier recognition of the likely revenue body view in banks' internal approvals processes, through guidance, rulings and real time discussion of issues.

Banks should approach revenue bodies at the earliest opportunity to discuss transactions where they take a position at variance with the revenue body view.

Note

1. In practice there are a number of different levels of legal opinion which the law firms issue, for example "will" *i.e.* probability that that the claimed tax treatment will be sustained is greater than 85%, "should" (70-85%) and "more likely than not" (>50%). The risk analysis attached to different levels of opinion will influence the bank's likelihood of entering into the transaction in the first place, the view on the level of reserve required on the transaction, and the requirement to place limits or restrictions on the transaction. In most instances, banks will only proceed with a CSFT when they have at least a "should" level of opinion.

Chapter 4. Revenue body risk management and response strategies

Key points

- Revenue bodies have developed a range of responses to challenges resulting from the tax risk posed by banks.
- These responses have not been sufficiently robust to prevent and detect all instances of aggressive tax planning.
- Revenue bodies need to develop response strategies which promote improved transparency and compliance with benefits for both revenue bodies and banks.

Revenue bodies want to be able to identify and take prompt action to curtail aggressive tax planning transactions. They want an open and co-operative relationship with banks to achieve this. In turn, banks would benefit from a real-time dialogue with revenue bodies to assist their risk assessments of new financial products.

The purpose of this chapter is to describe measures used by revenue bodies to respond to aggressive tax planning by large corporate taxpayers, and identify opportunities to improve compliance. The chapter begins by describing some policy and administrative features of response strategies used by FTA members. It then outlines the benefits of a more transparent compliance relationship between banks and revenue bodies, and how revenue bodies can use their understanding of banks' internal controls to assist their management of tax risks. Finally it looks at opportunities to build capability by working more closely with the banking industry to improve skills and commercial awareness, and opportunities for more effective international co-operation.

A survey of revenue bodies from OECD FTA countries on the prevention, detection and response strategies for aggressive tax planning transactions revealed a range of approaches from simple audits to more innovative relationships with taxpayers and tax advisors. Some components of those responses are set out below, alongside approaches targeted at those challenges described in Chapter 2 (a full summary of responses is set out in Annex B.1).

There are three separate aspects:

- Revenue bodies' strategies have to operate within the broader context of their country's tax system. Policy and legislative choices are for policy-makers, not for revenue bodies, and this report makes no recommendations in relation to policy matters. Nevertheless, some tax policy choices can have an impact on aggressive tax planning and this chapter therefore records some of the choices that have to be made.

- Revenue bodies make choices about the administrative arrangements they adopt to identify and deal with tax risk. This chapter makes recommendations about these choices.
- Revenue bodies need to develop the capability to deliver improved responses. This chapter makes recommendations about skills required as part of that capability.

Policy features

The following features of some countries' tax systems have influenced the administrative responses to aggressive tax planning.

Statutory advance disclosure

In order to respond effectively to aggressive tax planning, (and deterrence depends on effective response), revenue bodies need to be able to detect it reliably. Information sources are the key to detection. Revenue bodies' greatest need is for information at an early stage to be able to deal with aggressive transactions as soon as they have been made available to users, if not before. Some countries have rules that require the disclosure of schemes or transactions in advance of filing a tax return. These require a report to be made to the revenue body when a transaction meets certain parameters or definitions.

The operation of disclosure rules varies in different countries and can require disclosure either from taxpayers or from promoters of tax planning products. Rules which require a taxpayer to disclose details of transactions they have undertaken give the revenue body information about those transactions but may not give any indication of the nature of a generic tax planning scheme or the extent to which it is used by others. Rules which require the promoters of tax planning products to disclose marketed schemes in some cases extend the reporting requirement to identify users of those products.

Both the United States of America and United Kingdom disclosure rules specify key features often found in aggressive tax planning arrangements, which are set out in box 4.1. Results indicate that disclosure rules can lead to a reduction in the marketing of aggressive tax planning products.

Box 4.1. **United States of America and United Kingdom disclosure regimes**

United States disclosure regime

The regime contains a total of 6 categories of reportable transactions:

- listed transactions: those which have been identified in public guidance as, or are similar to, tax avoidance transactions;
- transactions offered under conditions of confidentiality;
- transactions with contractual protection: fees are contingent on the intended tax consequences being sustained;
- transactions producing a tax loss over a certain threshold; and
- transactions publicly identified as ‘transactions of interest’.

United Kingdom disclosure regime

Direct tax schemes involving a promoter have to be disclosed if one of the main benefits of the scheme is a tax advantage and the scheme has elements which fall within any of these six categories:

- confidentiality;
- a premium fee;
- off-market terms;
- standardised tax product;
- a loss scheme; or
- certain leasing arrangements.

A key feature of the United Kingdom disclosure rules is that disclosure is required by the promoter within 5 days of the scheme being made available or implemented. A taxpayer who uses a disclosed scheme must declare it when filing their tax return. There are separate disclosure rules for VAT and for Stamp Duty Land Tax.

Some banks expressed concern that mandatory disclosure requirements might limit the amount of information banks choose to provide voluntarily, but experience in some FTA countries, including the United Kingdom and United States, shows that mandatory disclosure requirements and voluntary disclosure arrangements or real time discussion can work well together in practice.

Anti-avoidance rules and ‘abuse of law’ principles

A number of countries have anti-avoidance legislation, abuse of law rules, or a judicial doctrine which includes abuse of law principles disallowing tax advantages from transactions which breach the rule. They can act as a deterrent to aggressive tax planning, particularly where linked to penalties and also provides the statutory authority for revenue bodies to challenge aggressive tax planning arrangements. To avoid disincentives to disclosure of schemes, some anti-avoidance rules offer protection from penalties for abuse where there is early disclosure.

The risk of breaching an 'abuse of law' provision could be considered as part of an approvals process for new products, and would influence decisions on whether to market a product in a particular jurisdiction.

Penalties

Most countries apply penalties to deal with the misreporting of taxable income, but there are a number of circumstances in which they are used as both a deterrent and a punishment. Australia has introduced 'promoter penalties' which deter the promotion of schemes and change the economics of aggressive tax planning by imposing civil penalties for those who engage in promotion of tax exploitation schemes. Early evidence suggests that such penalties can significantly reduce the number of mass-marketed schemes.

Administrative features

Revenue bodies employ many administrative approaches to manage compliance risk with large taxpayers, including banks. However, the survey results indicate that most countries use audit or examination, including specialised programs carried out by staff that have industry expertise. Annex B.2 contains an example of this approach. Some countries use a team-based approach, drawing on a range of tax, accounting, legal and other expertise.

Most FTA countries use risk management techniques to allocate resources to high risk taxpayers and identify high risk issues. Conversely such techniques are also used to identify lower risks in order to better target resources. The *Intermediaries Study* and the 2004 FTA guidance note *Compliance Risk Management; Managing and Improving Tax Compliance* describe the benefits and application of a risk-management approach for detecting and responding to compliance risk. Risk management is an essential tool for revenue bodies, and risk assessment allows revenue bodies to make important choices on where to devote resources, and to determine the most appropriate responses. Annex B.3 sets out three countries' risk assessment approaches for large businesses.

Risk assessment can take account of behavioural features, including the degree to which the taxpayer is open about its tax strategy, its governance, appetite for aggressive tax planning, willingness to work in real time and willingness to share details of transactions involving tax uncertainty. The ways in which revenue bodies can take account of these aspects as part of their risk assessment, and one practical methodology, are described later in this chapter.

Countries have adopted a range of measures to provide clarity on revenue body's interpretation or view of the law.

Public or private binding rulings are one approach used effectively in some countries to provide certainty of treatment by a revenue body on a new transaction. The Taxpayer Alert mechanism is another approach that has been used as a public notice to describe arrangements, highlight features which cause concern, set out tax issues and advise of penalties which could be incurred as a result of underpaying tax. See Annex B.4 for an example of a Taxpayer Alert issued by the Australian Taxation Office.

A number of FTA countries have adopted an approach of building or improving an enhanced or co-operative relationship framework with large taxpayers, who may include

banks. This report advocates such an approach as a strategy that may provide benefits for some revenue bodies, complementary to other traditional methods.

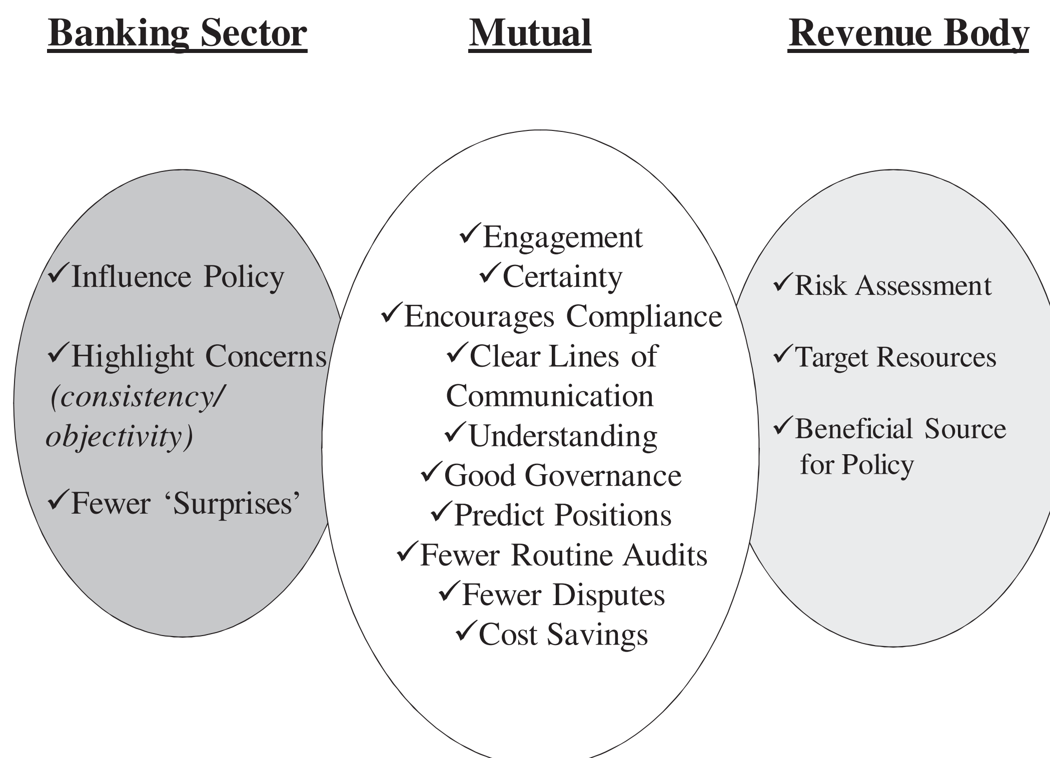
The enhanced relationship: an open and transparent dialogue between banks and revenue bodies

The basic relationship between the revenue body and the taxpayer in any country can usually be characterised by the parties interacting solely with reference to what each is legally required to do. However, the *Intermediaries Stud*y described an enhanced relationship based on mutual trust between large business taxpayers, tax advisers and revenue bodies and recommended that revenue bodies establish a tax environment in which trust and co-operation can develop. Such a relationship depends on disclosure and transparency by taxpayers and requires commercial awareness, impartiality, proportionality, openness and responsiveness on the part of revenue bodies.

The rationale for relationships of this kind is to create a joint approach to improving tax risk management and overall tax compliance, with benefits for both parties. Countries who have engaged in such initiatives, such as Ireland, the Netherlands, Singapore and Switzerland generally do so as one important component of a wider compliance strategy which encompasses a balance between guiding and supporting risk management by taxpayers, alongside audit and other enforcement actions.

Banks and revenue bodies were surveyed by the study team to identify mutual benefits that might be achieved from an enhanced relationship and the results are summarised in the following diagram.

Figure 4.1. **Benefits of enhanced relationship for banks and revenue bodies**



Since revenue bodies and banks both face uncertainty of tax outcomes, an enhanced relationship can minimise tax uncertainties by providing a framework to deal with any misunderstandings. Annex B.5 examines whether the nature of the banking business presents any barriers to an enhanced relationship, the views of banks and revenue bodies on the benefits of such a relationship and identifies the key elements between banks and revenue bodies.

When dealing with banks as taxpayers, revenue bodies can engage in an enhanced relationship in the same way they would with any other large corporate taxpayer. However, revenue bodies must first consider confidentiality and other limits on exchanging information when dealing with banks as promoters or facilitators of tax planning schemes. Banks said that often a statutory requirement to provide information was needed to allow them to provide information without breaching confidentiality.

Early indications are that such enhanced relationship initiatives have achieved relationships characterised by higher levels of trust and transparency, lower levels of confrontation, and the quicker resolution of disputes. Annex B.6 contains an accord between the South African Revenue Service and the Banking Association of South Africa, establishing a framework for co-operation between the parties in order to improve levels of tax compliance, discourage impermissible tax avoidance arrangements and enhance levels of service.

Chapter 8 of the *Intermediaries Study* identified three mechanisms to assist in building an enhanced relationship. However, each country will, of course, operate within its own laws and culture and revenue bodies must develop improved relationships with banks in a way that is consistent with the rules and framework in their own country.

Using knowledge of a bank's own tax governance to assess risk

In recent years there has been increased scrutiny of corporate governance (including tax governance) by external stakeholders such as regulators, investors, and revenue bodies and at its fifth meeting in Paris, France, the FTA discussed a paper on *Corporate Governance and Tax Risk Management* (OECD, 2009b) which examined the interface between corporate governance and tax. One aspect of this new approach is the increasing dialogue between Commissioners and CEOs and corporate Boards.

Revenue bodies are beginning to use large businesses' governance processes to explicitly encourage and support tax compliance. A number of revenue bodies now take account of a business's internal tax governance as part of their risk assessment process by:

- understanding the tax strategy and how tax fits into the wider business;
- understanding and, where necessary, testing controls and other components put in place to address key areas of risk or uncertainty to ensure that the tax strategy is being properly implemented within the organisation;
- discussing the tax department's own assessment of identified risks; and
- entering into forward or annual compliance arrangements with banks that have a robust risk (including tax risk) governance framework.

A robust governance framework may also give the revenue body greater assurance on certain tax risk areas allowing it to reduce the number of enquiries on routine tax return items.

Chapter 3 described typical governance and risk management processes used by banks in the approval of new financial products. The Study Team were advised of a number of key considerations for such a control system which revenue bodies would find useful to consider when reviewing a bank's internal controls in this area:

1. **Whether there is a process for identifying transactions where the tax outcome is significant and uncertain.** It is important that a product control process focuses on transactions that are likely to present significant issues rather than the thousands of transactions conducted by the bank that do not.
2. **The structure of the control process,** for example, is there a committee that meets regularly? Are decisions made by one individual or a group? How do they obtain appropriate expertise? Who do the committee or other decision makers report to?
3. **Committee membership and authority.** If there is a committee then does it have representation from all relevant functional areas, and who has authority to reject inappropriate proposals? Good practice would require that all relevant control functions be represented by voting members and that a unanimous vote is required for approval.
4. **The point in the process that approval is obtained.** Banks do not want to entice clients by marketing unapproved products because this exposes the bank to undue

reputational risk and can be detrimental to client relationships. Delaying the product approval process until a client is interested in a transaction may result in pressure from the business unit to approve in order not to disrupt the client relationship. Good practice suggests products should be approved before substantial marketing occurs.

5. **Whether an independent view is taken by the relevant control functions, including:**
   - whether all material technical and reputational issues have been addressed;
   - whether an opinion is required and, if so, whether the opinion:
     - reflects all relevant facts;
     - adequately applies the law to the facts;
     - otherwise addresses all material substantive issues; and
   - whether any applicable disclosure requirements have been satisfied.
   - Good practice dictates that the bank's tax department is empowered to make judgments on these matters.
6. **Where the decision to approach the revenue bodies to obtain views on a product lies, whether it be informally or formally.** Does the committee consider whether a product can be marketed without obtaining formal or informal guidance from the revenue bodies?
7. **Where responsibility lies for ensuring that the transaction is implemented and executed in the form that was approved**. Where responsibility lies for identifying any material change to the transaction, or to the rules or guidance governing the tax, accounting, regulatory, or legal consequences and who is responsible for making disclosure to the revenue body, for example if required by statutory disclosure rules.
8. **What controls exist to ensure that products which have not been submitted for approval are not marketed?** Whether there is a process in place to ensure that formal approval processes are not circumvented by overly ambitious business units.

Chapter 3 also concluded that banks should be prepared to share with revenue bodies relevant documents from their approvals process. In some jurisdictions this happens routinely and this represents a significant step towards transparency on the part of those banks, and has had a positive impact on the relationship between the bank and revenue body. However, this level of disclosure was restricted to a small number of countries, is not uniform across all banks, and usually does not extend to disclosure of transactions designed for clients which do not impact on the bank's own tax liability.

A methodology for a risk assessment dialogue with banks

There are a number of key features in those risk assessment approaches which are based around an open dialogue and take account of a business's internal governance.

Potential risks can be identified from examining filed tax returns or from audit work, but an overall strategic approach requires processing information collected across a number of areas. Tax return data needs to be supplemented with an understanding of the industry environment and culture within which the bank operates, and any attributes

specific to the bank. Factors considered should include the bank's attitude to tax risk and the way it controls or mitigates that risk.

Assessment tools that bring together information can assist revenue bodies to differentiate levels of tax risk and also serve as a basis for open and co-operative discussions with banks about their industry pressures, their attitude to tax risks as taxpayers and as intermediaries in respect of their tax-structured products, and their internal governance controls.

A suggested approach which takes all these factors into account is described in Box 4.2. Such a review could be carried out annually or at less frequent intervals depending on the risk profile.

(a) Methodology

Box 4.2. **Risk assessment methodology**

Step 1: Information to collect:

- Background knowledge of the banking industry.
- Develop a group of relevant factors or benchmark questions for banks.

Step 2: Information gathering:

- Use tax return data and publicly available information to perform initial risk screening, for example analysis of ratios such as effective tax rates.
- Perform a preliminary analysis on possible reasons for a bank's apparently higher risk, for example an extraordinary, one-off transaction.
- Ask banks to self-assess themselves against relevant risk factors, for example through the use of a set of survey questions (see Annex B.7 for a sample survey).
- Assign a rating to all of the factors or answers.

Step 3: Assessment:

- Add up the ratings. If they are above the median this may indicate a higher risk.

Step 4: Begin co-operative discussion:

- Share assessment with the bank.
- Discuss factors that tend to contribute to a lower risk rating, for example:
- avoiding the development and sale of risky aggressive tax planning products;
- strong corporate governance controls;
- very good levels of consultation, collaboration and co-design with revenue bodies; and
- veto rights of the bank's tax department.
- Give the bank an opportunity to respond.

Step 5: Overall evaluation:

- Review by revenue body of the bank's rating based on outcome of step 4 discussions.

Based on the risk score of the bank as a whole and after further discussions with the bank on specific material transaction risks, the revenue body advises the bank as to any next steps, for example no further action for low risk banks unless other matters of concern arise.

(b) Risk differentiation

Once results from the assessments have been gathered, the revenue body can rank and differentiate each bank against its peers for comparative internal analysis.

However, note that a bank may be low risk generally but engage in a large high risk transaction. In such a case, review of the high risk transaction may be warranted and enquiries can be limited to that transaction.

(c) Applying the results to determine risk levels and revenue body responses

Based on the risk differentiation results, the revenue body can then determine the risk level of the bank, and apply the appropriate risk treatment.

See Annex B.8 for examples of risk differentiation and analysis tools.

The above model is an example of an initial risk assessment framework that may provide a starting point for an open and transparent dialogue between banks and revenue bodies. The building of a co-operative relationship is an incremental and ongoing process and further work may be required after the initial risk assessment to provide a more detailed tax risk finding.

The risk assessment framework provides incentives to taxpayers to build trust with revenue bodies about their approach and attitude to tax risk in an open and co-operative environment, with real-time dialogue. Taxpayers benefit from reduced uncertainty and lower compliance costs. Revenue bodies obtain better and earlier access to information and emerging risks.

This framework also encourages revenue bodies to be more transparent with banks about their risk differentiation and risk assessment of the bank.

Rulings and other voluntary early disclosure initiatives

Some revenue bodies also operate processes for voluntary disclosures by taxpayers in advance of filing. These can occur as part of a formal process, such as Germany's binding ruling process, or they can be made as part of other compliance initiatives, such as the Compliance Assurance Process in the United States, or Annual Compliance Agreements in Australia. The common feature of all of these initiatives is that once again they provide the revenue body with timely information to allow it to take a view and respond promptly.

A bank can be prevented from voluntary disclosure of tax planning products provided for specific clients by its duty of client confidentiality and this might only be overcome by a statutory requirement to provide information to revenue bodies.

For many banks, knowing the revenue body view of a transaction following disclosure was valuable, reduced uncertainty and increases saleability of the transaction; others placed limited value on this and preferred reliance on their own legal advice.

Rules and administrative processes should support the behaviours of those who choose to adopt a transparent relationship. Revenue bodies need to deal firmly with those who choose not to fully meet their obligations, so as to ensure a level playing field. As recommended in the *Intermediaries Study,* risk assessment may lead to significantly more resources being used in auditing, investigating and pursuing exploratory issues with

taxpayers who do not seek a more enhanced relationship than need to be used in dealing with more transparent taxpayers.

There are however limitations to disclosure processes and challenges in understanding the totality and impact of complex cross-border transactions. Often only the facts relating to the leg of the transaction which took place in their jurisdiction are made available to the revenue body and the availability of information through an exchange with another revenue body is dependent on when the transaction had to be disclosed in the alternate jurisdiction. Such processes have also suffered from disparate response timescales and the varying availability of clearances or rulings in different jurisdictions. The answer for revenue bodies lies in improved multi-lateral efforts complemented with appropriate exchange of information powers.

International cooperation

The exchange of information article in Double Taxation Treaties and its use in appropriate circumstances offers a better understanding of the global impact of transactions. Other benefits include better identification of high tax risk transactions, improved understanding of the business purpose or the economics of transactions, and enhanced commercial awareness.

The potential for a more effective exchange of information has significantly changed since the beginning of 2009. Today all OECD countries have endorsed the Article 26 standard. Major financial centres outside of the OECD such as Hong Kong and Singapore have also endorsed the Article 26 standard and there is now a spreading network of Tax Information Exchange Agreements. More than 50 such agreements have been signed this year and many more are under negotiation. All these developments mean that countries are better equipped to obtain information from their partners.

The OECD Aggressive Tax Planning Directory, which provides a platform for sharing information and experiences in dealing with aggressive tax planning, has enhanced revenue bodies' overall understanding of abusive transactions. The Joint International Tax Shelter Information Centre (JITSIC) in Washington DC and London[1] has improved the effectiveness of such exchanges for the countries who participate in the project.

Multilateral exchanges of information and simultaneous examinations in more than one territory, which are provided for under the Convention on Mutual Administrative Assistance in Tax Matters,[2] are powerful tools in a global economy and are increasingly used. They improve the ability of revenue bodies to address the global impact of transactions, and to alert revenue bodies to emerging risks.

Banks told the study team that gaining certainty on cross-border transactions was often difficult due to the different timeframes in each jurisdiction and that greater international co-operation offered potential for improvement. It is important for revenue bodies to promote better international co-operation and examine how bilateral and multilateral mechanisms for the exchange of information can be made more effective.

Working with financial regulators

Banks in most jurisdictions deal with multiple regulatory bodies. Regulators including revenue bodies can collaborate in compliance and enforcement activities to address tax

risk. Regulators also set or influence internal governance and controls in banks which could be expanded to include the full spectrum of risk including tax risk.

Capability

Skills

Revenue bodies need staff in sufficient numbers with appropriate skills to deal effectively with complex areas not only of aggressive tax planning but also complex banking arrangements with a commercial (non-tax) purpose. Revenue bodies in many jurisdictions recognise that specialized examination teams with a broad range of expertise are more effective in identifying and resolving issues. Similarly such expertise is required in differentiating between high risk arrangements and those with a commercial purpose and shape. It is also required in giving timely advice that can assist banks. Development of specialised expertise can either be achieved by recruiting or seconding experienced personnel into the organisation or through extensive training of existing personnel. In either case, revenue bodies enhance their commercial awareness improving risk detection, resource allocation effectiveness, and collaboration with banks. Specialised examination teams are more effective in identifying and resolving issues and can work effectively with other revenue bodies on simultaneous examinations.

One example of an extensive formal education programme is that used in Germany, see box 4.3.

Box 4.3. **Training for bank auditors - Germany**

Training and education of auditors is the responsibility of individual German states and involves a three year training course at a financial college, at least two years work experience in tax assessment, one year's basic training as an external auditor and at least two years practical experience as an external auditor of small and medium sized businesses.

In addition, there are further annual education courses and special training programs, exchange events and comprehensive written information on the specific problems involved in bank taxation.

Some revenue bodies have found that a policy of recruiting officials with legal or accountancy training helps to maintain a suitably skilled team. As a means of gaining a better understanding of the commercial environment and to more effectively present legal challenges, some revenue bodies have also recruited experienced individuals from a banking or financial market background.

Other initiatives include short term placements of revenue body staff into companies in order to gain exposure to the commercial environment, and exchange initiatives with revenue bodies where less skilled revenue staff can be given opportunities to work with administrations that boast robust technical skills. Revenue bodies may also wish to explore multilateral training activities with other countries since this would be a very effective way of developing a clearer understanding of issues.

Similarly, the banks that assisted with the study suggested that their internal tax department staff also needed to have appropriate training, experience, and knowledge to perform their duties in relation to the review of CSFTs for clients. It is therefore important that all banks should ensure that they have appropriately skilled and trained staff.

Improved commercial awareness

Commercial awareness is an essential requirement to gain understanding of banking transactions and arises from experience in the banking industry generally and specifically from deep expertise of CSFTs. Many revenue bodies have used national and multinational meetings to bring together revenue body or bank representatives to share information on emerging issues, trends and environmental conditions affecting banks to increase commercial awareness of staff. These sessions enhance collaboration, improve understanding, and allow for increased expertise.

The most beneficial sessions include a mix of representatives from banks, regulators and revenue bodies. The USA Securities, Investments and Financial Markets Association (SIFMA) has proposed a joint workshop structure involving both banks and revenue bodies. The detail of how such a workshop could be constructed is at Annex B.9.

Conclusions

Revenue bodies continue to face challenges in deterring, detecting and responding to aggressive tax planning, and in obtaining real time information on new aggressive tax planning structures. Challenges come from the complexity of transactions; the need for greater commercial understanding; the cross-border nature of transactions; the need for information from a number of jurisdictions to obtain a holistic picture; and disparate timescales in information availability.

The starting point is risk management, which is an essential tool for revenue bodies, allowing them to determine where to deploy resources to best effect and to choose appropriate responses. Information is important to effective risk management. Information can be obtained through statutory obligation or through voluntary disclosure, as part of a transparent relationship. Statutory disclosure rules based on key features of aggressive tax planning have been successful in reducing mass-marketing of products and in giving the revenue bodies that use them information at an early stage. General anti-avoidance provisions can act as a deterrent to aggressive tax planning and provide a statutory mechanism to challenge such arrangements.

Revenue bodies can improve their capability by understanding how banks' internal governance operates in respect of aggressive tax planning transactions, and can take account of the strength of a bank's internal controls in their own risk assessment process. Revenue bodies can develop a methodology for risk assessment and share the results with the taxpayer as the starting point for an open dialogue towards a co-operative relationship.

Banks can engage with revenue bodies in a co-operative relationship in the same way as other large corporate taxpayers in relation to their own tax affairs, but face issues of client confidentiality in dealing with their role as promoter or facilitator for others.

Where there are good working relationships that allow useful and open dialogue between banks and revenue bodies:

- the rationale for the relationships is to create a joint approach to improving tax risk management and overall tax compliance;
- the initiative was taken by revenue bodies to build relationships with the senior management of large businesses, including banks, and to secure commitments by both sides to improve tax risk management;
- relationships are characterised by increased trust and transparency and lower levels of confrontation rooted in a deeper understanding of each others' business and roles;
- both banks and revenue bodies value certainty in relation to the tax consequences of banking transactions and systems are required to facilitate this; and
- these have had a positive impact on overall compliance behaviour, with benefits for both parties.

For banks the benefits include a reduction in the number of routine enquiries, greater selectivity of information requests from revenue bodies, a clearer view of what the revenue body considers to be high risk, and faster dispute resolution. These all contribute to earlier certainty for banks.

It is important that revenue bodies develop the capability to deliver these responses. Specialist expertise and commercial awareness can be developed in a number of ways including recruiting or training specialists, sharing expertise between revenue bodies, and through building good relationships with industry bodies to generate joint learning opportunities. A number of recent country experiences point to opportunities for revenue bodies to develop better relationships with financial regulators.

Recommendations

Revenue bodies should use risk management techniques to make best use of resources, devoting more resources where risks are higher or unknown through lack of information. For those banks that choose not to engage in a transparent relationship, revenue bodies should develop appropriate responses, including devoting greater resources to those displaying higher tax risks.

Revenue body responses should include a strategy for obtaining information from banks. Where available, revenue bodies should use statutory disclosure rules and rulings processes to encourage disclosure, including circumstances where client confidentiality would otherwise be a barrier.

To promote an environment of greater trust, transparency, early disclosure and co-operation revenue bodies should review their opportunities to:

- provide a single point of contact for large taxpayers, responsible for managing the relationship between the revenue body and taxpayer;
- share with banks their assessment of tax risks; and
- invite early voluntary disclosure and discussion of issues containing significant uncertainty.

Where revenue bodies undertake such initiatives they should publish guidance on how taxpayers may engage with them.

Whether or not there is transparency or co-operation, revenue bodies should understand banks' internal governance processes and use that information as part of their risk assessment. Revenue bodies should consider developing relationships with financial regulators as a way of ensuring that industry regulation supports tax compliance.

Revenue bodies need to re-examine how they can take advantage of the recent commitments to the Article 26 standard and the growing network of bilateral Tax Information Exchange Agreements, as well as exploring the possibilities offered by multilateral agreements such as the *European Union Directive on Administrative Co-operation in the Field of Taxation* (Commission of the European Communities, 2009) and the joint *Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters* (Council of Europe/OECD, 2003). Now that all the major financial centres have endorsed and are implementing the Article 26 standard, work needs to intensify on how to remove potential barriers to a more effective use of information obtained from treaty parties.

Also to promote earlier disclosure and more efficient use of exchange of information in relation to cross-border transactions revenue bodies should explore the potential for bi-lateral or multi-lateral use of rulings or clearance processes, and how these processes and exchange of information processes can be made more effective.

To improve the effectiveness of audits or examinations, and to improve dispute resolution for taxpayers, revenue bodies should make greater use of simultaneous examinations in more than one jurisdiction, where domestic laws allow. Taxpayers should normally be informed of a simultaneous examination, though there will be circumstances where this would not be appropriate, including for example where tax evasion or criminal activity is suspected.

Revenue bodies could ensure they develop the capability and skills required to deliver an effective response. To improve their commercial awareness and specialist skills revenue bodies should:

- train staff or recruit specialist financial expertise from industry; and
- develop joint educational initiatives with banking industry associations.

All banks should ensure that staff who participate in CSFT approval processes are appropriately skilled and have the authority to challenge transactions if necessary.

Notes

1. In 2004 Australia, Canada, the United Kingdom and USA created JITSIC in Washington DC to supplement the ongoing work of tax administrations in identifying and curbing abusive tax avoidance transactions, arrangements and schemes. In 2007 Japan joined the project and a new office opened in London.
2. Joint Council of Europe/OECD *Convention on Mutual Administrative Assistance in Tax Matters*, Article 8 provides that a simultaneous tax examination means "an arrangement between two or more parties to examine simultaneously, each in its own territory, the tax affairs of a person or persons in which they have a common or related interest, with a view to exchanging any relevant information which they so obtain". www.oecd.org/dataoecd/11/29/2499078.pdf

Chapter 5. Tax evasion

Key points

- Transparency in relation to all tax-related activities of banks is important to revenue bodies. There is a wide spectrum of issues and behaviours which can generate concern, and at one extreme are banks that are deliberately caught up in tax evasion committed by their clients.
- Recent scandals involving banks have highlighted the impact of tax evasion on the economies of both developed and developing countries.

During the course of the study some instances of banks or their employees actively assisting their clients to evade tax have emerged and cannot be ignored. This behaviour carries with it a very high level of reputational risk to a bank, serious legal consequences for individual employees, and challenges the adequacy of the bank's internal controls.

Tax evasion, extending into criminal activity, is an area of serious concern for revenue bodies as it shows a disregard for the rule of law. Improving access to bank information for tax purposes has been highlighted as one way that revenue bodies can counter evasion.[1]

Banks in some jurisdictions have been found to have a major role in the promotion of structures to hide foreign nationals' investments and their worldwide income. In such cases it is alleged that no income was reported or no tax was paid on the income from these offshore investments. Some of these jurisdictions do not presently share information with revenue bodies, but may provide assistance in certain criminal matters pursuant to mutual assistance protocols. Entities typically have a bank account, and may hold, directly or indirectly, other investments, for example equities and assets such as boats or real estate.

These legal entities and their associated bank accounts can also be used for evasion to hide the (non-disclosed) profits of domestic or international business dealings.

Box 5.1 sets out a recent example where a bank accepted that its employees assisted a large number of their clients to conceal their ownership or beneficial interest in offshore bank accounts.[2]

Box 5.1. **Concealed identities and bank accounts**

On 18 February 2009, a bank entered into a deferred prosecution agreement with the United States Department of Justice relating to charges of conspiring to defraud the United States by impeding the IRS (United States Department of Justice, 2009).

In the agreement the bank:

"... acknowledges and accepts (that the bank)…through certain private bankers and managers in the United States cross-border business, participated in a scheme to defraud the United States and its agency, the IRS, by actively assisting or otherwise facilitating a number of United States individual taxpayers in establishing accounts (at the bank) in a manner designed to conceal the United States taxpayers' ownership or beneficial interest in these accounts. In this regard, these private bankers and managers facilitated the creation of accounts in the names of offshore companies, allowing United States taxpayers to evade reporting requirements and to trade in securities as well as other financial transactions (including making loans for the benefit of, or other asset transfers directed by, the United States taxpayers, and using credit or debit cards linked to the offshore company accounts)."

…"Additionally these private bankers and managers would actively assist or otherwise facilitate certain undeclared United States taxpayers, who these private bankers and managers knew or should have known were evading United States taxes, by meeting with these clients in the United States and communicating with them via United States jurisdictional means on a regular and recurring basis with respect to their ... undeclared accounts".

"… Executives and managers delayed this (a wind down) decision due to concerns that it would be costly….and damage (the bank's) business reputation."

Revenue bodies' response to tax evasion

Governments are determined to stamp out tax evasion especially in the context of the current financial crisis which is placing extreme stresses on public finances. Revenue bodies are intensifying their efforts to detect and deter such activities and are stepping up their co-operation with other countries, including in the context of the FTA. In serious cases of tax evasion, particularly where taxpayer operations have a global reach, revenue bodies can achieve better outcomes by sharing information under bilateral and multilateral tax agreements, sharing intelligence, and working in dedicated multi-national teams. Revenue bodies can apply a range of investigatory responses by working more closely with law enforcement agencies and regulators in dealing with offshore promoters and offshore tax evasion. For example the issue of alerts can raise awareness of banks and customers to the revenue body's concerns regarding certain structures and activities.

In some instances revenue bodies have also offered incentives to encourage disclosure or repatriation of offshore income, earnings or profits, including reduced or capped penalties over a limited time period. Box 5.2 provides details of recent voluntary compliance initiatives.

Box 5.2. **Voluntary Disclosure Initiatives**

United States of America – Offshore Voluntary Compliance Initiative

Launched on 14 January 2003 with the aim of bringing taxpayers who used "offshore" payment cards or other offshore financial arrangements to hide their income back into compliance with the tax law.

Key features:

- Taxpayers to come forward by 15 April 2003.
- All taxes, interest and applicable accuracy and delinquency penalties to be paid.
- Taxpayers who came forward did not face civil fraud or failure to file penalties or certain information return civil penalties.

Outcomes:

- More than 1,300 taxpayers came forward and paid taxes, interest and penalties and provided the IRS with information regarding the person who promoted the offshore arrangements to them.
- Over USD 270 million in unpaid tax and penalties collected.

Ireland

Launched late in 2003 to tackle suspected tax evasion using offshore accounts held in financial institutions outside Ireland in the first instance, by promoting the voluntary disclosure of unpaid tax liabilities in respect of those accounts.

Background:

A wide ranging investigation into holders of offshore accounts and other financial products began in 2004. Prior to the beginning of the investigation, a series of meetings were held by Revenue in December 2003 with the top officials of a number of financial institutions at which they were advised on the impending investigation. As a result, the financial institutions, thorough their offshore affiliates, wrote to their customers advising them of the imminent investigation and informing them of the benefits of a voluntary disclosure.

Key features:

- Taxpayers to make a voluntary disclosure by 10 June 2004.
- All taxes, interest and penalties to be paid at the time of the voluntary disclosure.
- Penalties mitigated if a voluntary disclosure made.
- There would be no investigation for prosecution purposes, following a voluntary disclosure.
- After 10 October 2004, Revenue would seek court orders to access bank account information to pursue those who did not make a voluntary disclosure.

Outcomes:

- Approximately 15 000 offshore account holders came forward or were investigated.
- More than EUR 856m collected from these taxpayers.

Box 5.2. **Voluntary Disclosure Initiatives (*Continued*)**

United Kingdom – Offshore Disclosure Facility

Launched in April 2007 to encourage those with offshore accounts with unpaid tax and duties to pay what they owed and bring their tax affairs up to date.

Background:

From 2006 HMRC gained access to information on offshore accounts held by individuals with a United Kingdom address from a number of United Kingdom financial institutions and obtained similar details through the European Union Savings Directive.

Key features:

- Open to those who held or who had held an offshore account, either directly or indirectly, that was in any way connected to a loss of United Kingdom tax and/or duty.
- Full disclosure of all undeclared liabilities required, not just those connected with an offshore account
- Registration required within a short period (17 April-22 June 2007).
- Disclosure required within a short period (23 June-26 November 2007).
- Tax to be paid in full with interest and a fixed penalty of 10% before November 2007.

At the end of the disclosure period HMRC to target those with offshore bank accounts and undeclared tax liabilities who choose not to come forward voluntarily.

Outcomes:

- 45 000 disclosures
- GBP 400 million in additional tax collected.
- Cost GBP 6m.

Source: OECD (2007).

The *Overview of the OECD's Work on Countering International Tax Evasion* (OECD, 2009c) summarises actions taken by OECD members to respond to the challenges of tax evasion.

Recent developments in transparency and the exchange of information

In the closing statement from their meeting in November 2008 in Washington DC the G20 leaders emphasised, in reference to OECD work on the issues of transparency and exchange of information, that "lack of transparency and failure to exchange tax information should be vigorously addressed" (Leaders of the Group of Twenty, 2009a).

Since this G20 summit gave new impetus to the process, more than 30 new tax information exchange agreements have been signed or announced. In March 2009 Austria, Belgium[3], Luxembourg and Switzerland announced that they would adopt an internationally agreed standard of exchange of information developed by the OECD[4] in their tax treaties.

In the light of these developments, the Statement from the Summit on 2 April 2009 stated the G20 leaders "agree to take action against non-co-operative jurisdictions, including tax havens. We stand ready to protect our public finances and financial systems." (Leaders of the Group of Twenty, 2009b).

The G20 Heads of State also issued a Declaration, *Strengthening the Financial System* (Leaders of the Group of Twenty, 2009c), setting out what they called a 'three pronged' approach to restoring integrity and transparency in financial markets and how tax fitted into this broader perspective. The declaration included an agreement to develop a toolbox of effective counter measures for countries to consider using against those jurisdictions which do not meet international standards in relation to tax transparency. The OECD's Committee on Fiscal Affairs will be following up this initiative over the coming months.

Notes

1. See OECD (April 2000), *Improving Access to Bank Information for Tax Purposes*, OECD, Paris www.oecd.org/dataoecd/3/7/2497487.pdf?bcsi_scan_3CB14DF0471C3DC0=0&bcsi_scan_filename=2497487.pdf; two progress reports examining the implementation of the standard of access from the 2000 report have also been issued in July 2003 www.oecd.org/dataoecd/5/0/14943184.pdf and October 2007 www.oecd.org/dataoecd/24/63/39327984.pdf?bcsi_scan_3CB14DF0471C3DC0=0&bcsi_scan_filename=39327984.pdf

2. For a more detailed discussion of voluntary compliance initiatives see Chapter 5 of OECD (2009), *Engaging with High Net Worth individuals on Tax Compliance*, OECD, Paris, forthcoming.

3. Belgium had already signalled a move towards the international standard in 2008 with entry into a bi-lateral treaty with the United States.

4. The standard provides for full exchange of information on request in all tax matters for the administration and enforcement of domestic law without regard to a domestic tax interest requirement or bank secrecy for tax purposes. It also provides for extensive safeguards to protect the confidentiality of the information exchanges.

Chapter 6. Conclusions

This study set out to improve revenue bodies' understanding of complex structured finance transactions (CSFTs), the role banks play in designing and implementing aggressive tax planning and the prevention, detection and response strategies applied by revenue bodies to respond to the challenges posed by banks. The recommended approach outlined in this study is based on good governance by the banks and enhanced relationships between revenue bodies and banks with potential mutual benefits. The key conclusions from the study are:

i) Bank governance and risk management frameworks for new complex financial products are not specifically designed to manage tax risk from a revenue perspective. However, revenue bodies can, by understanding the particular processes for approval of new products, improve their selection of issues for intervention or audit, and better target questions and information requests. In a transparent and co-operative relationship it is expected that relevant documents would be made available to the revenue body for open discussion. Willingness to share such information should be taken into account in evaluating risk profiles.

ii) There is a range of examples of transactions considered by revenue bodies to be aggressive tax planning that have been used or marketed, after having passed through approvals processes within banks. Bank governance and risk management frameworks are not sufficient without the appropriate exercise of good judgement. However not all CSFTs are driven by tax planning, but the financial instruments that underpin them are often the same type as those used in aggressive tax planning arrangements.

iii) There are a number of pressures on risk control functions including: increasing complexity; lack of transparency; offshore elements of a transaction; conflict between front office functions and risk managers; and remuneration incentives in a high risk/reward culture. Revenue bodies need to understand how these conflicts are managed to assess the level of assurance they can take from a bank's internal controls.

iv) Good working relationships that allow open dialogue between banks and revenue bodies have had a positive impact on overall compliance behaviour and a reduction in compliance costs. The relationships:

- have as a rationale the creation of a joint approach to improving tax risk management and overall tax compliance;
- involve engagement with the top management of large businesses, including banks, and commitments by both parties to improve tax risk management; and
- are characterised by increased trust and transparency and lower levels of confrontation rooted in a deeper understanding of each others' business and roles.

v) A number of mutual benefits for banks and revenue bodies were identified from open and transparent relationships. These include certainty, cost savings and fewer disputes.

vi) These relationships work best with clear scope and commitments from both parties and with appropriately skilled staff.

vii) The relationship will be facilitated and maintained with the appointment of relationship managers or single points of contact in both the bank and the revenue body.

viii) The success of the relationship will be improved where it is voluntary and where there are clearly understood rules of engagement and planned outcomes, with commitments by both parties, supported at senior levels.

The Study Team recognises that it is possible that not all banks will be willing to engage in an enhanced co-operative relationship programme. It is also likely that some banks will continue to engage in aggressive tax planning and to promote aggressive tax planning to their clients. In such circumstances revenue bodies should allocate significantly more resources to auditing, investigating and pursuing exploratory issues with these taxpayers than would be used in dealing with more transparent taxpayers.

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Annex A. Examples of why revenue bodies are concerned about banks

This annex relates to Chapter 2 as it provides examples of why revenue bodies are concerned about banks. In particular, it contains:

A.1. Cross border sale/repurchase ("repo") arrangement,

A.2. Foreign tax credits (FTC) generator schemes,

A.3.Jurisdictional arbitrage financing transaction.

A.1. Cross border sale/repurchase (“repo”) arrangement

Overview

Sale/Repurchase Agreement

A repurchase agreement (or repo) is an agreement between two parties whereby one party sells the other a security at a specified price with a commitment to buy the security back at a later date for another specified price. Its economic effect is that of a secured loan. The difference between the sale and repurchase price paid for the security represents interest on the loan.

Use in tax schemes

There are opportunities for cross-border dealings where repo transactions are characterised differently by separate jurisdictions. Some jurisdictions treat the transaction as a sale and purchase, while others characterise it as a collateralised loan. The difference in treatment makes it possible, for example, to generate tax deductions in one jurisdiction without a matching taxable receipt in another.

The following example demonstrates how the mismatch in characterisation for a repo arrangement is used to generate artificial tax deductions.

Enhanced cross-border arbitrage

Tax Issue:

Lack of economic purpose to the major part of the circular flow of funds.

Funds all designed to flow on one day and not all loan transactions are reflected in the consolidated accounts of the relevant groups in each country.

Use of repo agreement for tax purposes to exploit mismatch between two countries.

Facts:

A is the subsidiary of the Country 1 Bank Group in Country 1.

B, C and D are all subsidiaries of the Country 2 Bank Group. C is owned by B prior to the beginning of the scheme.

The scheme involves:

the real transaction of EUR 1 billion loan from Country 2 Bank to Country 1 Bank; and

a circular flow of EUR 2 billion from Country 2 Bank entity B back to B

Steps:

Country 2 Bank Subco D acquires EUR 1 billion capital in another subsidiary of the same group located in Country 1, C, using real external borrowing of EUR 1 billion.

Country 2 Bank entity B lends EUR 3 billion at 7% interest to A (Country 1 Bank entity) using funds from the real external borrowing of EUR 1 billion (via C through step 4) and its own accumulated profits of EUR 2 billion.

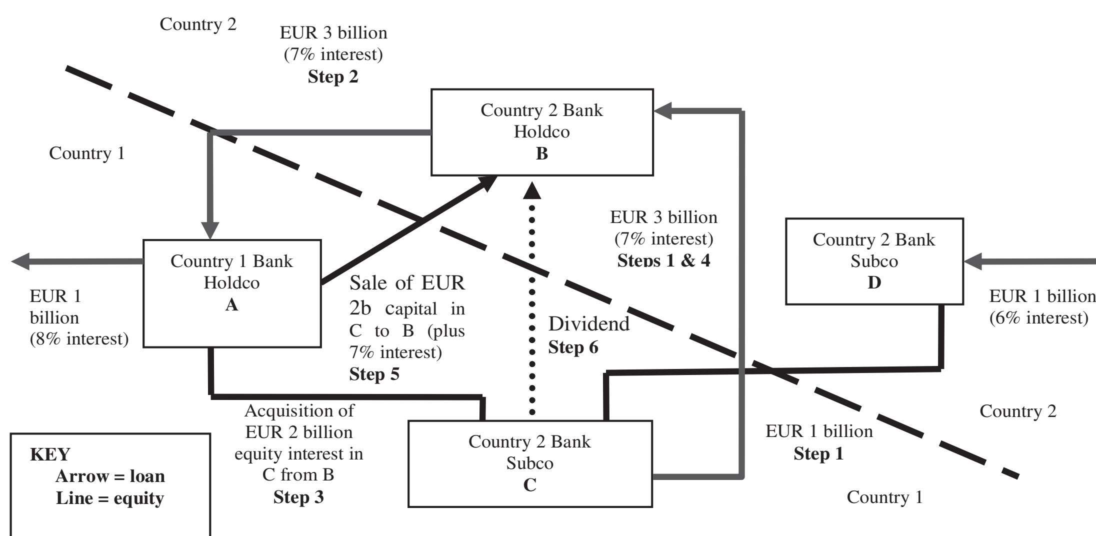
Country 1 Bank entity A lends EUR 1 billion to real external borrowers, and purchases EUR 2 billion equity interest in C from B. At the same time, Country 2 Bank entity B writes a put option and acquires a call option to acquire stock in C from A at EUR 2 billion plus interest (7%).

C on lends the EUR 1 billion (from step 1) and the EUR 2 billion (from step 3) back to Country 2 Bank entity B in Country 2. This provides funding for the loan by B in Step 2.

Exercise of put and call option: sale by A to B of its capital in C at EUR 2 billion plus interest (7%).

C then distributes to B a dividend in the amount of the interest C earned under its loan to B in Step 4.

Figure A.1. **Illustration of Cross Border Sale/Repurchase ("Repo") Arrangement**



Tax Analysis:

Country 1

In Country 1, the capital injection by A in C is considered to be equity and the subsequent sale of the capital (under the put & call options) by A to B as a capital gain, which is non-taxable in Country 1.

Country 2

In country 2, with the combination of (i) the sale of interest in C from B to A; and (ii) the put & call options giving A the right to sell the stock in C to B at a specific point in time in the future at the specific price, these two transactions (the sale & the options guaranteeing repurchase) are treated as a collateralized loan between A and B, with B being the borrower, the stock in C being the underlying security, and the 7% paid on repurchase interest on the loan.

The tax outcome for Country 2 Bank is that the interest paid at the repurchase of the stock in C (EUR 2b x 7%) is treated as deductible interest.

In Country 2, recipients of foreign dividend are entitled to claim foreign tax credits on the foreign tax paid on the underlying profits. Accordingly, B is entitled to foreign tax credits in respect of the foreign dividend received from C in step 6.

Tax Outcome - Country 1 Bank:

C would be considered part of the group while it was being held by A.

Loan to external borrowers: taxable interest income of EUR 1 billion x 8% = EUR 80million.

Sale of stock in C to B: non-taxable capital gain of EUR 2 billion x 7% = EUR 140 million.

Loan from B to A: Bank A could claim a tax deduction for the interest income on the EUR 3 billion loan from B

Loan from C to B: However, as C would be part of the group while it was being held by A, Bank C would also be entitled to interest income from its EUR 3 billion loan to B, netting off the interest deduction.

Tax Outcome - Country 2 Bank

Loan from external borrowers: interest deduction of EUR 1 billion x 6% = EUR 60million.

Repurchase of stock in C from A: interest deduction of EUR 2 billion x 7% = EUR 140 million.

Bank B has interest income from the EUR 3 billion loan to A but it will also have interest deduction of the same amount from the EUR 3 billion loan from C, netting off the interest income.

Interest paid by B to C is later distributed back to B in the form of dividend payment after B re-acquires equity interest in C through the exercise of the options. The dividend from C to B is essentially tax-free for B due to the availability of foreign tax credit in Country 2.

After-Tax Effect: All transactions happened in one day to allow for the non-commercial manufacture of an interest deduction (under the repo) in Country 2, without a matching taxable income in Country 1. It was achieved by the circular flow of the EUR 2 billion funds from B back to itself.

Why tax administrations are concerned:

Country 2:

In Country 2, the arrangement is considered negative as the structure is designed to leave the parties neutral both in terms of cash and credit/market risks, while producing a net tax advantage, namely the interest deduction available to B on its repurchase of the stock in C.

Country 2 will apply its specific anti-avoidance rules to counteract the negative tax effect of the arrangement in Country 2.

Country 1:

In Country 1, there are no specific tax rules to counter the arrangement. Country 1 revenue body would challenge it because it regards the scheme as having little economic substance apart from the accumulative tax advantage.

A.2. Example of FTC generator schemes

Use in tax schemes

Foreign tax credits (FTC) are intended to prevent double taxation on cross-border income flows. However in FTC generator schemes, transactions are structured so that the taxpayer is able to claim FTC where there is no such double taxation. In these situations, the FTC becomes an unintended monetary benefit generated by the transaction. These transactions are particularly offensive to revenue bodies because they are capable of generating credits in any amounts desired by the parties.

The following USA FTC generator scheme illustrates how unintended tax benefits can be generated through the FTC regime using transactions designed to give rise to artificial foreign tax liability.

Example of FTC Generator Schemes[1]

USA borrower

Tax Issue:

Highly structured arrangement where a USA party intentionally incurs foreign tax where there is no or significantly less foreign tax in the basic underlying transaction.

Elaborate transactions structured to generate foreign tax credits by converting interest paid in ordinary course financing arrangement into creditable foreign tax payment.

Designed for the parties to duplicate tax benefits and share the economic burden of tax payments (*e.g.* through pricing of arrangement).

Economic substance:

USA Bank seeks to borrow USD 1.5 billion from a foreign party (Country B Bank).

Steps:

USA Bank establishes a corporation in Country B (“Country B SPV”) and contributes USD 1.5 billion to acquire 100% equity interest in the corporation.

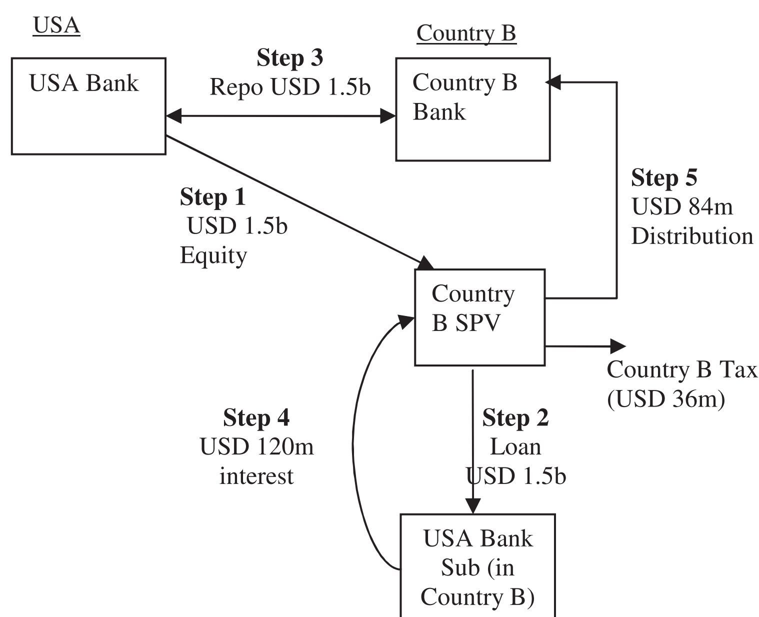
Country B SPV loans the entire USD 1.5 billion to USA Bank Sub, a wholly owned subsidiary of USA Bank also incorporated in Country B.

USA Bank enters into a sale and repurchase arrangement (“repo”) with the Country B Counterparty (Country B Bank), selling its stock in Country B SPV to Country B Bank for USD 1.5 billion while agreeing to repurchase it in 5 years.

Country B SPV receives interest of USD 120 million from USA Bank Sub and pays 30% Country B tax (USD 36 million) on the income.

Country B SPV then distributes the remaining USD 84 million to Country B Bank.

Figure A.2. **Example of FTC generator scheme**



Tax outcome – United States

The USA characterises the repo as a collateralised loan. USA Bank is treated as receiving a distribution of USD 84 million from Country B SPV and paying interest of the same amount to Country B Bank. The desired tax outcome for USA Bank is:

Dividend income from Country B SPV (USD 84m + gross-up of USD 36m tax paid = USD 120m);

- Foreign tax credit of USD 36m for Country B tax paid by the SPV;
- USA Bank Sub has interest deduction of USD 120m from step 4; and
- USA Bank has an interest deduction of USD 84m from Step 5.

In the aggregate, USA Bank and its subsidiary claim a foreign tax credit of USD 36 million and a net interest expense deduction of USD 84 million.

Tax Outcome – Country B

Country B characterises Step 3 as a sale & repurchase. The distribution from Country B SPV is dividend income for Country B Bank. Country B Bank receives credit for tax already paid by Country B SPV and is not subject to additional tax.

After-Tax effect:

The lender obtains tax exempt income resulting in an after-foreign-tax return that is higher than the after-foreign-tax interest it would have earned on a direct loan generating taxable interest income. The borrower incurs a lower funding cost on an after-tax basis because it has converted deductible interest expense into creditable foreign tax payments.

A.3. Jurisdictional arbitrage financing transaction

International arbitrage financing transaction involving duplicate tax credit claims[2]

Background

Country A operates a dividend imputation system. Under this system the corporate income tax paid by a company (at a flat 30% rate) is credited against the shareholder level tax on dividends received. The tax credit is referred to as a "franking credit." A "fully franked" dividend means that the whole dividend carries a tax credit at the 30% company tax rate.

Tax Issue:

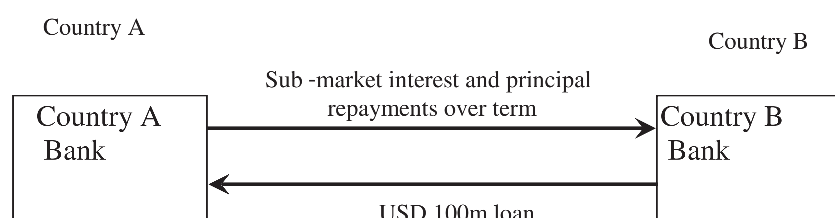
Arrangement to duplicate credits for tax paid in Country A via a franking credit for the Country A party and a foreign tax credit for the foreign party in their home jurisdiction.

Use of hybrid instrument to exploit mismatch in tax treatment between different countries.

Economic substance:

The economic substance of the scheme is that a loan is provided by the foreign party to the Country A party at under market rate, as shown in the diagram below:

Figure A.3. **Economic substance of jurisdictional arbitrage financing transaction**



Steps:

A subsidiary of Country A Bank is established that is treated as a stand-alone entity in Country A but a flow through entity in the other jurisdiction.

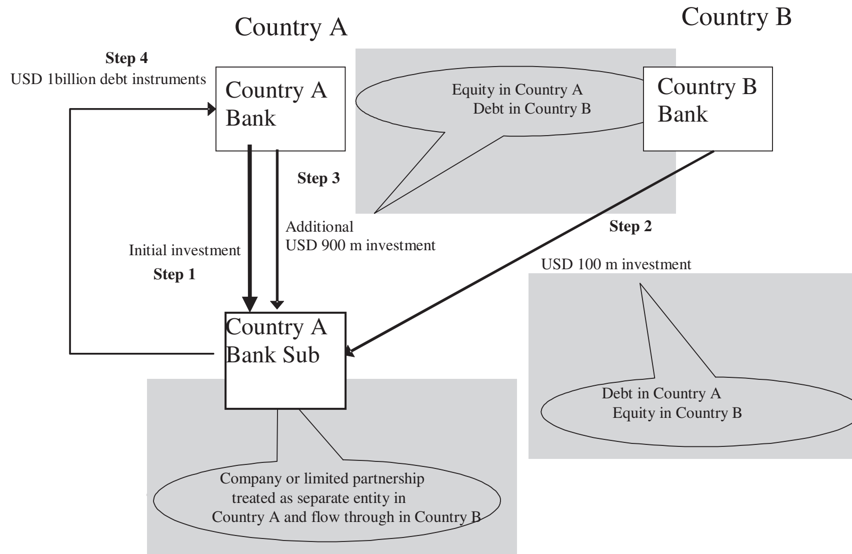
The Country B Bank invests in Country A Bank Sub via a hybrid instrument which arbitrages debt/ equity classifications in Country A and Country B.

Country A Bank invests a typically much larger sum in Country A Bank Sub in a form that is treated as equity in Country A but debt in Country B (*e.g.* convertible notes).

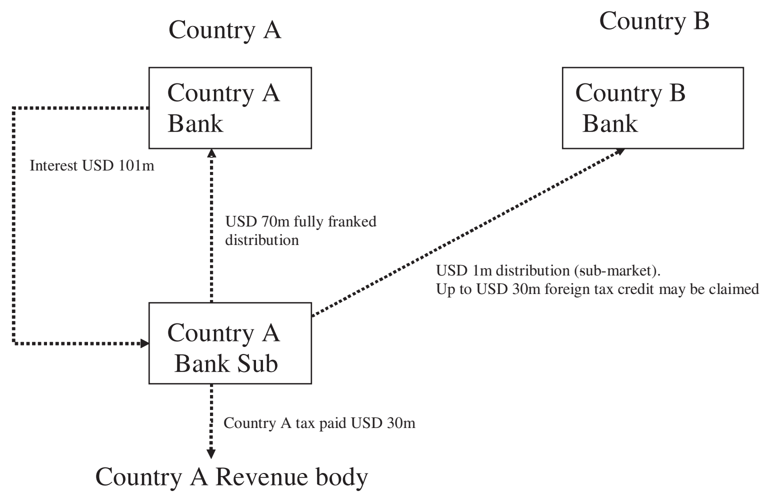
The total of the funds injected into Country A Bank Sub is invested in Country A Bank (or entities it controls) usually in the form of debt.

Figure A.4. **Example of jurisdictional arbitrage financing transaction**

Setup



Step 5
Annual Cash Flows



Over the term of the arrangement (*e.g.* 5 years), Country A Bank Sub earns income from its investment in Country A Bank. Country A tax is paid on this income. The post tax profits are distributed to Country A Bank and Country B Bank in accordance with the investments they have made in Country A Bank Sub.

Tax Outcome - Country A:

Country A Bank Sub returns its USD 101m interest as assessable income and gets a deduction for the USD 1m return paid to Country B Bank (because that return is a return on a debt interest for Country A tax purposes). Country A Bank Sub pays USD 30m Country A tax on its USD 100m taxable income and returns USD 70m to Country A Bank as a fully franked dividend.

Tax Outcome - Country B:

Country B Bank is treated for Country B tax purposes as owning 100% (or close to that proportion) of Country A Bank Sub because its investment is treated as equity while Country A Bank's interest is treated as debt. Country B Bank includes its share of Country A Bank Sub's taxable income for Country B purposes in its Country B taxable income. Assuming it is treated as owning 100% of Country A Bank Sub, this would probably be USD 31m. Because Country B Bank would be treated as having paid the USD 30m Country A tax, it could get up to that amount as a foreign tax credit in the Country B. This could leave excess foreign tax credits for the Country B Bank to apply against its other foreign source income.

Why tax administrations are concerned:

The allowance for a credit for tax paid is intended to be offset once. In this arrangement, Country A received one tax payment which is used by two different parties to achieve a duplicate benefit. While there is no adverse impact on the revenue of Country A, this transaction results in an inappropriate outcome in Country B, where Country B Bank is able to claim foreign tax credits generated by the same payment of Country A tax which has also generated franking credits for Country A Bank.

Notes

1. Example from IRS Internal Revenue Bulletin 2007-17 T.D. 9416, 73 F.R. 40727 (30 June 2008), www.irs.gov/irb/2007-17_IRB/ar15.html.
2. Example sourced from the OECD Aggressive Tax Planning Directory of Working Party 8.

Annex B. Revenue body risk management and response strategies

This annex provides background material to Chapter 4 on revenue body risk management and response strategies. It covers:

B.1. Analysis of the survey to national revenue bodies;

B.2. Co-operation between the revenue authorities and banks in Germany;

B.3. Risk management approaches of different revenue bodies in France, Singapore and the United Kingdom;

B.4. Taxpayer Alert TA 2009/9 by the Australian Tax Office;

B.5. Enhanced relationship as a pathway to high tax compliance;

B.6. South African Banking Accord;

B.7. Risk assessment survey questions;

B.8. Examples of differentiation, plotting and analysis tools;

B.9. Creating an enhanced relationship through education.

B.1. Survey analysis

The Study Team carried out a survey of national revenue bodies to find out how they prevent, detect and respond to aggressive tax planning involving banks.

(1) Revenue body strategies-responses to identified risks

This section provides a summary of the input from the 19 countries surveyed, and generally provides a high level description of the manner in which tax administrations organise themselves to address risks generally as well as specifically to banks/financial institutions. The responses fall into 10 categories as enumerated below:

a. Enforcement through examination/audit programs

b. Creating specialized compliance/enforcement programs

c. Imposing penalties

d. Sharing information with other countries

e. Providing published guidance to taxpayers and their advisors

f. Developing settlement initiatives

g. Stepping up enforcement through judicial processes

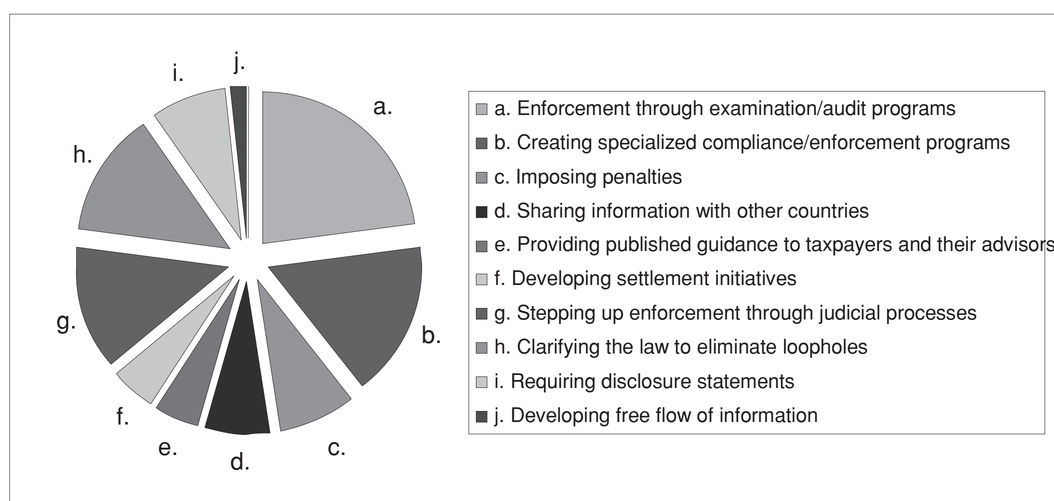
h. Clarifying the law to eliminate loopholes

i. Requiring disclosure statements

j. Developing free flow of information

The following pie chart illustrates the frequency of responses from the 19 countries responding to the survey. The responses most frequently employed are a, b, g and h.

Figure B.1. **Revenue body strategies - responses to identified risks**



The greatest frequency of responses fall into categories a and b reflecting the focus of tax administrators to conduct examinations/audits of banks, and to frequently have specialized programs with a high level of expertise assigned to these audits. A number of tax administrations have developed programs with centres of excellence/expertise and other rapidly deployable units. The centres/units are responsible for providing a high level of technical expertise to the complex arrangements encountered in banking and financial institution examinations/audits.

Tax administrators also deploy various judicial processes (category g) to respond to risks created by aggressive tax planning. Processes range from the use of summons/formal record requests to litigation necessary to cause taxpayers to supply required information. Tax administrations also deploy litigation to challenge the results of various transactions they determine to be inappropriate, and several have utilized general anti-avoidance provisions intended to disallow/unwind transactions that achieve a result outside of the intent of the relevant legislation.

Finally, several countries indicate the use of their legislative process to eliminate loopholes (h). The range of actions includes enactment of general anti-avoidance provisions to those that focus upon a very narrow area of law to stop a particular item of identified risk.

Are banks recognized as Intermediaries in your domestic tax system?

This question resulted in a yes/no response from 15 tax administrators, and little further information was required or provided. Nine countries said that banks are recognized as intermediaries while six responded “no.”

How do you address risks from tax planning by banks?

a. On their own account?

b. In inter-bank transactions?

c. As promoters of tax planning products?

The methods employed by tax administrators to address risks from tax planning are very similar to the responses provided for Question 1. However, several unique methods employed provide a broader spectrum of activities for consideration. For example, several tax administrators described contacts with the banks or their industry associations/representatives to discuss issues of concern over known or suspected transactions/arrangements that may achieve an unintended/inappropriate result. The objective of such contacts is to alert the taxpayer(s) to the fact that the tax administrator is aware of the transaction/arrangement, that it may be a cause for concern, and the behaviour (consuming, acting as counter-party or promoting) needs to change, *i.e.*, cease the activity.

It is important to note that many responses included contacts with Treaty Partners to obtain information via the Exchange of Information as a specific method employed to address risks from tax planning. Specifically, the objective of such exchanges is to understand the facts/documents as provided to other tax administrators. Tax administrators suggest that understanding the transaction (facts and documents) early in

the process allows for more rapid certainty on the part of the taxpayer and the tax administrator.

Several countries have regimes to address promoters of aggressive tax planning products, and while the specific focus is not banks/financial institutions they are subject to the requirements of the regimes. The objective of these regimes is generally to prevent inappropriate behaviour (promoting improper transactions /arrangements) and penalizing, civilly and criminally, those who are not in compliance with the respective promoter regime.

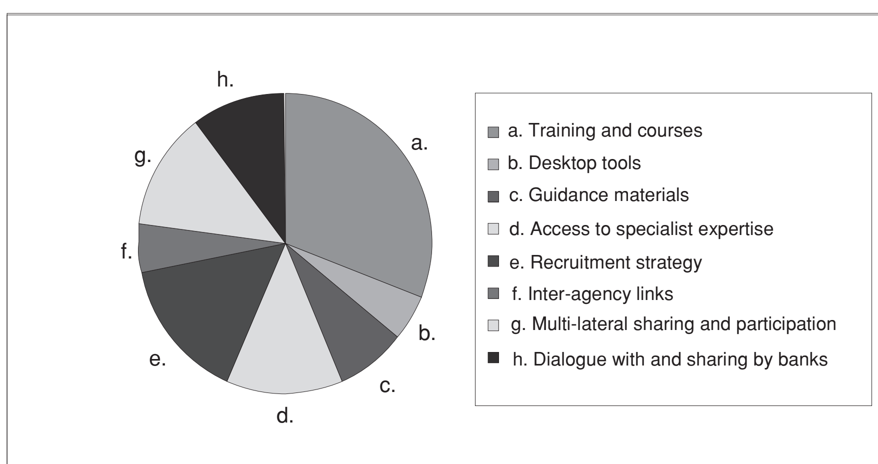
What do you do to equip your officials to deal with aggressive tax planning by banks?

To effectively deal with aggressive tax planning, it is recognized that tax administrators need to equip officials with adequate and appropriate training, tools and resources. This section covers the varied ways that revenue bodies use to equip their officials to deal with issues relating to aggressive tax planning. Following are broad methods adopted by the surveyed tax administrators:

a. Training and courses
b. Desktop tools
c. Guidance materials
d. Access to specialist expertise
e. Recruitment strategy
f. Inter-agency links
g. Multi-lateral sharing and participation
h. Dialogue with and sharing by banks

The survey responses are illustrated in the following pie chart:

Figure B.2. **Survey responses equipping officials to deal with aggressive tax planning by banks**



Officials in some Revenue bodies are equipped with tools to perform their functions more effectively and efficiently. Examples include desktop tools with web search capability, links to other regulators, and access to information on aggressive tax planning information within their own authority as well as the OECD Aggressive Tax Planning Directory.

Some Revenue bodies recorded that they:

- disseminate relevant guidance materials to their officials on topics relating to aggressive tax planning. Examples include procedure manuals, practice statements on industry specific matters, and published guidance combined with how-to guides to assist with issue identification, development and resolution. The various responses suggest the need to provide deep technical expertise in terms of relevant tax law and commercial awareness to address complex financial transactions/arrangements.
- Have focused upon the banking/financial institutions to identify and hire expert personnel while others have focused upon large accounting and law firms to obtain similar expertise to organizationally achieve a better understanding of the business environment.

Additional methods include working with other government and regulatory bodies in the relevant nation; coordinating with other national tax administrators to discuss trends and transactions relevant to the banking/financial institution sector; and working closely with banks in the relevant jurisdiction to conduct information sharing where new regulations are discussed to ensure appropriate and consistent application.

Products

How do you identify tax-planning products used or marketed by banks?

This section generally provides a high level description of the manner in which tax administrations identify aggressive tax planning products used or marketed by banks/financial institutions. The responses fall into 8 categories as enumerated below:

a. Examinations/audits of banks and financial institutions

b. Joint International Tax Shelter Information Centre (JITSIC)

c. Mandatory Disclosures

d. Published Materials/Guidance

e. Whistleblowers

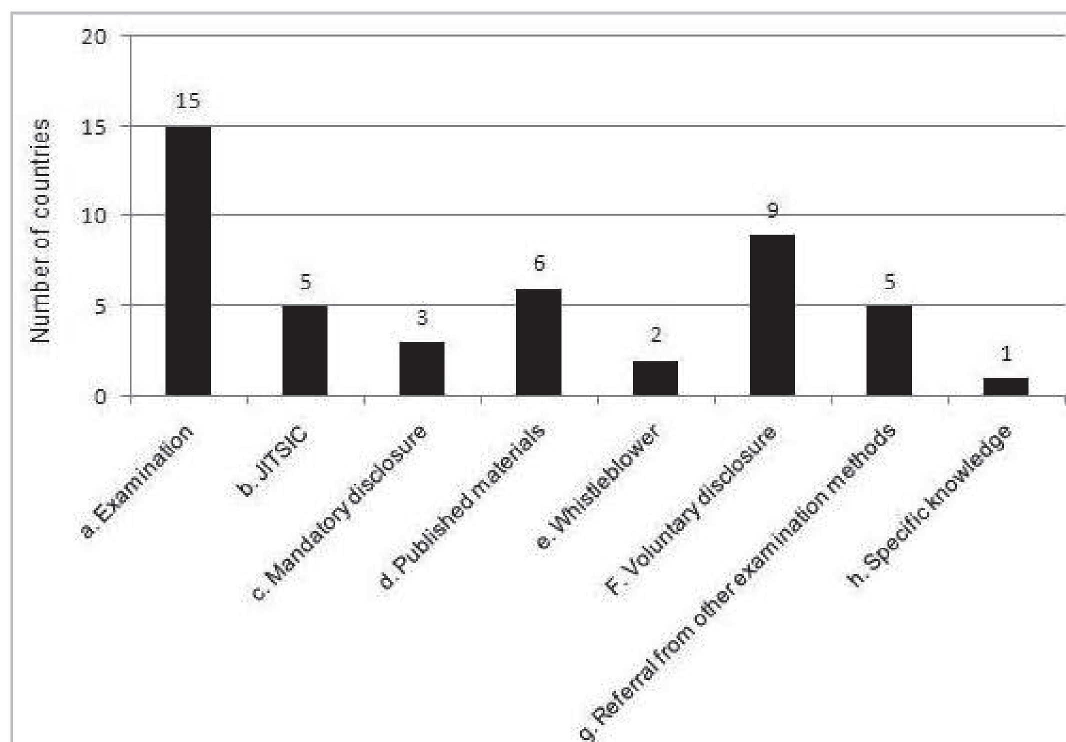
f. Voluntary Disclosures

g. Referrals from other examinations

h. Specific knowledge

The following graph illustrates the frequency of responses falling into the 8 categories. The identification methods employed with the greatest frequency are a, b, d, f and g.

Figure B.3. **Identification of tax-planning products used or marketed by banks**



Method a, examinations as the source of identifying the risks, is consistent with responses to Question 1. That is, enforcement of tax laws through traditional examinations or those conducted by specialized units is most frequently deployed to identify risks posed by banks'/financial institutions' aggressive tax planning. Due to the expansive use of the term "examination," the actions employed by tax administrations range from the review of filed returns compared to information publicly available, to post-filing letters of inquiry to formal records requests during an audit/examination. The result being that tax administrators take a number of steps in examinations to better understand results achieved by financial arrangements/transactions reported on filed tax returns.

Several countries, including some who are not members, identified JITSIC (b) as an effective method for identifying aggressive tax planning. JITSIC's initial focus included learning about the ways in which financial products are used in aggressive tax transactions by corporations and individuals to reduce their tax liabilities, the identification of promoters developing and marketing those products and arrangements, and exchanging this information with co-located treaty partners under the provisions of the applicable bi-lateral income tax treaties.

Tax administrators employ disclosures (voluntary as well as mandatory) to identify risks of aggressive tax planning by banks and financial institutions. The disclosure regimes employed range from those that specifically define reportable items (and those which operate similarly) to those likely to cause further inquiry by the tax administrator. Some of the regimes employ penalties to raise the financial cost of non-compliance with non-disclosure while others employ increased scrutiny to the taxpayer's activities. The responses to this question also included tax administrators requiring information reporting of customer account information as well as the use of disclosures required under public entity regulatory reporting requirements.

Finally, several countries indicate the use of referrals from other examinations (g) to identify risks of aggressive tax planning by banks and financial institutions. The range of actions includes learning of aggressive transactions/arrangements by auditing the customer (bank as promoter) or counter-party (bank as consumer) of a bank/financial institution to using characteristics of reporting in one sector to suggest aggressive tax planning in another sector.

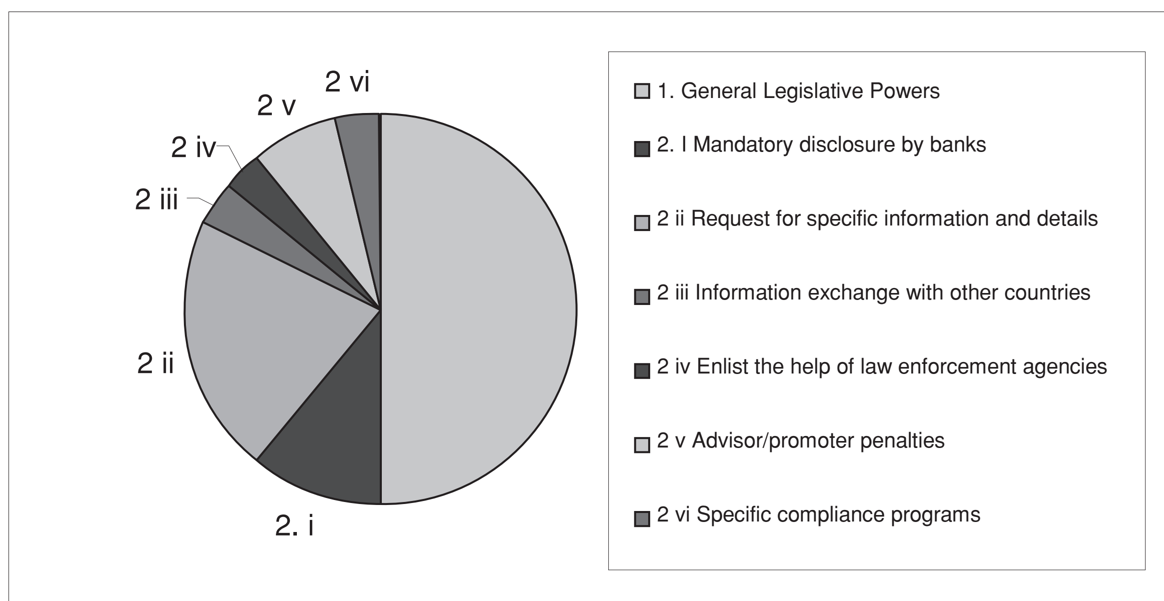
What powers do you have to investigate the non-compliance and tax minimization activities of banks as intermediaries?

This section provides some of the examples that tax administrators reported upon in response to this question. Other than powers under general legislation, some revenue bodies have specific powers to address the risks of tax avoidance transactions promoted by tax intermediaries. Based upon tax administrator responses, the powers are broadly grouped into the following categories:

1. General Legislative Powers
2. Specific Powers to investigate non-compliance and tax minimization activities
    - i. Mandatory disclosure by banks
    - ii. Request for specific information and details
    - iii. Information exchange with other countries
    - iv. Enlist the help of law enforcement agencies
    - v. Advisor/promoter penalties
    - vi. Specific compliance programs

The responses are illustrated in the following pie chart:

Figure B.4. **Investigation Powers**



In general, all the countries that responded to this question have legislative powers to investigate matters related to tax returns. These powers include requiring a taxpayer to furnish a revenue body with its books and records, to produce substantiation for the amount included in the records, to gain access to premises, and to question and interview the taxpayer for clarification. In summary, these are the necessary powers to carry out an audit.

The specific power most frequently available to be employed by tax administrators is b) ii) above – requests for specific information and details. The responses ranged from formal records requests for specific transaction details to John Doe/Unknown Requirements to Produce, and are generally enforceable by the tax administrator through legal requirements including formal court proceedings.

The deployment of any one specific method is dependent upon the relevant domestic law as well as the taxpayer behaviour, *i.e.*, the proportional response, as described in the original *Intermediaries Study.* This report stated that taxpayers would be more likely to engage in an "enhanced relationship" with revenue bodies if the revenue bodies demonstrate the following five attributes: understanding based on commercial awareness; impartiality; proportionality; openness; and responsiveness. The report concluded that revenue bodies should be reasonable, balanced, and proportionate, in allocating resources and setting priorities in conducting tax examinations to obtain full co-operation from taxpayers.

What barriers are there to an effective response to these challenges?

The responses provided by the Revenue bodies fell into three categories:

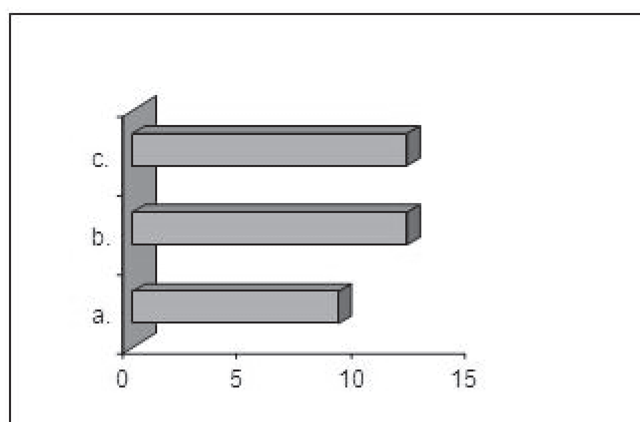
a. Compliance costs

b. Complex and sophisticated transactions

c. International cooperation

The following graph reflects the frequency of the responses, and demonstrates that all three are considered as barriers by most of the respondents.

Figure B.5. **Three main barriers to effective response**



How can International co-operation in managing the risks posed by tax intermediaries be improved?

The responses provided by Revenue bodies suggest three broad themes:

a. Exchange of Information

b. Simultaneous Audit

c. Disclosure

A number of countries stated that exchange of information amongst revenue bodies would improve the management of risks posed by tax intermediaries, and some referenced improved formal exchanges (*e.g.* JITSIC – taxpayer specific) and informal (OECD and other multi-national bodies) relationships as a method for managing these risks. Simultaneous audits are suggested to allow for rapid transaction/arrangement factual development from a cross-border perspective while achieving a consistent understanding of the result that the taxpayer is attempting to obtain in the affected jurisdictions. The cross-border simultaneous audit allows for an enhanced understanding of the law in both jurisdictions improving the commercial awareness of the officials, and application of relevant laws to cross-border verified facts.

Summary

Overall survey results point to four broad areas where initiatives may be implemented to meet the goals of prevention, detection, and response strategies by revenue bodies:

1. Dialogue with and sharing of information by banks/financial institutions including settlement initiatives, pre-filing ruling/agreements, and publicly issuing guidance for use by taxpayers, representatives and revenue bodies. These strategies allow for earlier recognition of compliance risks by revenue bodies as well as providing greater certainty sooner to taxpayers.
2. Initiating or expanding mandatory and voluntary disclosure programmes to obtain information regarding complex financial transactions/arrangements to enhance certainty for taxpayers and revenue bodies.
3. Sharing information with other national tax administrators via Bi-lateral Treaty Exchange of Information provisions (spontaneous, requests and JITSIC). This process allows for more rapid understanding of transactions, and may alert revenue bodies to emerging risks thus allowing for necessary prevention, detection and response strategies.
4. Creating specialised examination programs staffed with experts to focus upon the sector equal to the challenge in terms of number of specialists and commercial awareness allows the revenue body to better prevent, detect and respond to risks posed by banks.

Additional areas of benefit that countries in the study group added:

1. Exchange of Information from Cash Flow Tracking Systems, *e.g.*, Australian Transaction Reports Analysis Centre (AUSTRAC), to assist with addressing the risks posed by potentially illegal cross-border flows.
2. Multinational Meetings/Seminars focused upon Banks (Revenue Bodies and Bank Representatives) to share information, emerging issues and trends, and broad environmental conditions which may affect the businesses. The result would be improved commercial awareness thus enhancing a revenue body's capability to prevent, detect, and respond to banks' compliance risks.
3. Engagement at the Board and/or Senior Levels, *i.e.*, CFO, of Banks to discuss areas of mutual concern, and to provide a forum for improving revenue body's commercial awareness as well the banks' awareness of the concerns of the revenue body.

As a result of the discussion at the Commissioners and Banks Meeting on October 31, 2008 the following item was also raised for consideration for implementation:

4. Tax Administrators to be involved with regulators as rules are developed to ensure consistency where possible among tax and regulatory schemes.

The importance of having all relevant information promptly cannot be understated when it comes to the ability of a revenue body to get to the right result. The facts and availability of knowledgeable persons in the bank expedites transaction evaluation for compliance risks as well as more informed steps to address the risks posed. Revenue bodies have implemented many strategies around the world in an effort to better and more quickly understand and respond to risks posed by banks – sharing this with treaty partners may be necessary to ensure consistency of presentation to other treaty partners by the bank. It is the auditor's maxim, "To trust, but verify." The result of better informed revenue bodies is increased confidence that they have achieved the right result - the bank will have greater confidence that certainty will occur sooner. Both result in a mutually beneficial outcome – timely certainty.

B.2. Co-operation between the revenue authorities and banks - Germany

The experience of German state and federal tax authorities

Co-operation between the revenue bodies and the banks can often work very well in respect of external audits on banks as large corporate businesses. Ongoing monitoring of banks allows a regular dialogue to develop which both parties find beneficial and allows earlier certainty on transactions in specified circumstances.

Taxation in Germany - background

Banks must abide by the same taxation rules that apply to large corporate businesses throughout Germany and are subject to corporate income tax and where applicable to value-added tax and (municipal) trade tax.[1]

External audit and regular dialogue

Because the large banks in Germany are monitored on an ongoing basis, a constant dialogue develops between bank employees and auditors. Both sides generally have a vested interest in ensuring that this dialogue runs smoothly. It gives auditors the information they need and helps them conduct their audits in a timely manner. The banks then get faster results as regards where they stand legally. In most cases, a good working relationship of mutual trust ensues. But to ensure that auditors remain objective, they should generally perform no more than three audits at any one company.

Opportunities for real-time dialogue

Informal

Before embarking on certain activities, bank employees often approach auditors with legalities of the situation. While the outcome of such talks is not binding in respect of the revenue office, an auditor's recommendation carries considerable weight on account of their expertise.

Formal -Option to Request a Binding Ruling

The banks have the option to request a binding ruling from their local revenue office or – at national/international level – from the Federal Central Tax Office. The local revenue office then issues an assessment based on a specific **but theoretical set of circumstances/transaction** which could have a considerable impact on the bank's tax situation. This differs from an external audit in that audits only assess actual transactions/situations. To request a binding ruling, banks must meet the requirements set out in Section 89 (2) of the German Fiscal Code (AO) and Germany's Tax Information Ordinance (StAuskV). The binding ruling is only binding on the requestor's tax assessment if the subsequent situation does not or only marginally deviates from that on which the ruling was based (Section 2 (1), first sentence StAuskV).

The binding ruling then applies when the tax office eventually deals with that specific case. A binding ruling can, however, only be requested with regard to a bank's own tax

situation. Banks cannot, therefore, request binding rulings on customers' tax situations. Bank customers can, however, request their own binding rulings. The great advantage of a binding ruling lies in the legal certainty it brings. Binding rulings are not issued in cases where the main objective is to achieve a tax advantage (in the case of tax-saving schemes, for example).

The tax payer has as well the possibility to request a binding commitment. Once an external audit has been performed banks have the option of requesting a binding commitment that a transaction will be treated the same way for tax purposes in future the way they were audited in the past if the situation is of importance to the tax payer's business activities. This is also binding for the tax office, but only in respect of the transaction in question.

Professional Skills

In performing their work, bank auditors draw upon the knowledge and skills gained in their intensive initial and further training. Training and education of auditors is the responsibility of the individual German states and can be described as follows: a three-year training course at a financial college, at least two years' work experience in tax assessment, one year's basic training as an external auditor and at least two years' practical experience as an external auditor of small and medium-sized businesses. In addition, there are annual further education courses and special training programmes, exchange events and comprehensive written information on the specific problems involved in bank taxation.

B.3. Risk management approaches of different revenue bodies

The following illustrate risk management approaches for large businesses used by three revenue bodies.

FRANCE[2]

The Large Business Directorate (DGE) approach

The Large Business Directorate has developed specific strategies and tools in terms of risk management, with two complementary approaches, bottom-up and top-down.

Individual taxpayer level

The teams obtain a great deal of pertinent data to assess the level of tax risk of businesses in the process of examining their repayment claims. In doing so, they use several IT tools, which were specifically developed for their operations, to identify elements of interest. For instance, monthly data processing allows early detection of declaration and payment failure. Due to a quick follow-up of any failure, more than 96% of firms dealt with in the Large Business Directorate declare and pay their VAT in due time.

The results of former audits are taken into consideration when assessing a company's risk.

High or group level

It is usually difficult to identify non-compliant behaviour from the examination of a single company file, but it may be more apparent from examination of the entire group or business sector.

Some tools have been developed which help to obtain that view, including:

- Risk mapping by branch of activity (reliability of data, VAT credit repayment processing, etc);
- More recently, the Large Business Directorate has created a groups-monitoring watchdog to centralize information about the various entities of the groups, in order to develop controls which integrate the group approach. It currently includes the 40 companies of the CAC 40 (the Paris Stock Exchange) and 45 other important economic groups. They represent about 20 000 companies (62 % of the large taxpayers registered in the). The objective is to include all the groups. In this area, the Large Business Directorate and the DVNI (Directorate of National and International Audit) work closely together in order to share their tools and knowledge.
- The group approach also allows the Large Business Directorate teams to discuss with employees or tax directors of main companies how to improve the compliance of their subsidiaries.

- When their teams have gathered elements that could reveal a non-compliant behaviour, they establish proposals for audit by the Directorate of National and International Audit.

The DVNI (Directorate of national and international audit) approach

The Directorate of National and International Audit is implementing a specific risk analysis approach.

Inside the directorate, a working group made up of tax auditors has been created in order to adapt and reinforce the risk analysis review. They assess the results of the studies already done, and develop new data processing methods. In particular, they take the legislative changes and the behaviour of large companies into account.

Firstly, the risk analysis made by Directorate of National and International Audit relies on files gathering information transmitted by companies in the framework of their tax returns (OASIS). Those files are reviewed through data processing, in order to detect any feature or any change t could reveal a failure.

Secondly, the Directorate of National and International Audit applies risk analysis methods relying on databases made up of general financial and business statements of large companies. These studies concentrate on international taxation issues.

The results are transmitted to the tax auditing teams in addition to proposals made by tax auditors and information transmitted by other departments, e. g. Large Business Directorate. First of all, they audit the companies from the office, in order to check and analyze the features that have been detected. Taking all the relevant information into account, the Directorate of National and International Audit is able to plan comprehensive or targeted (limited to some pre-identified matters) audits.

SINGAPORE[3]

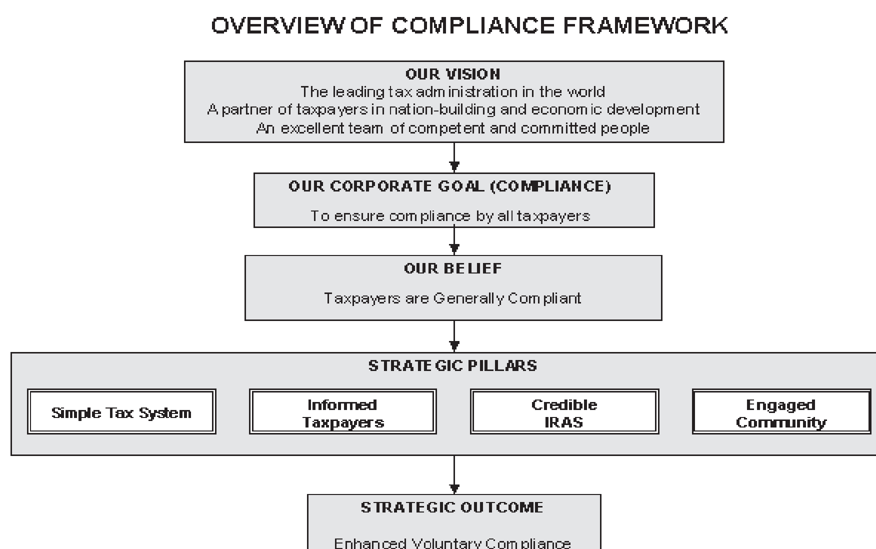
INLAND REVENUE AUTHORITY OF SINGAPORE[4]

RISK MANAGEMENT APPROACH TO LARGE BUSINESSES

1 IRAS' Strategic Compliance Framework

1.1 In IRAS, our **Strategic Compliance Framework** (as shown in Figure 1) and risk-based compliance management process guide us in the way we manage the compliance of our taxpayers, including large businesses. IRAS adopts a **risk-based approach** in carrying out our compliance actions. Our compliance actions can be costly, and at times, disruptive for taxpayers and IRAS. Therefore, our actions and programs are tailored largely based on our assessment of the taxpayers' risks to revenue.

Figure B.6. **IRAS' Strategic Compliance Framework**



2 Managing Compliance of Large Businesses in IRAS

2.1 IRAS believes that large businesses are generally compliant and have access to the necessary professional advice to handle their tax matters, including their exposure to taxation. Our compliance strategies towards the large businesses are anchored on the four strategic pillars of our Strategic Compliance Framework – Having a simple tax system, ensuring taxpayers are informed, establishing a credible IRAS and creating an engaged community.

Simple Tax System

2.2 A simple tax system makes it easier for large businesses to get their tax matters right and reduces the scope for them to cheat the system. To provide greater transparency and clarity to businesses, the advance ruling system was introduced and subsequently legislated. It allows for a written interpretation of how a certain provision of the legislation will apply for a proposed business arrangement. This is especially useful for multinational large businesses as it gives greater certainty and clarity on the application of the tax laws to their complex transactions.

Informed Taxpayers

2.3 Large businesses which know what their tax obligations are how to fulfil their tax obligations and when to fulfil their tax obligations, are mostly likely and able to get their tax matters right. A senior tax specialist or an experienced officer is designated as the main contact point for the taxpayer and his agents to discuss tax issues and administrative procedures relating to the company, as well as to handle private rulings requests. In addition, a group of companies identified as strategic investors is specifically managed. Special efforts are committed to respond to the taxpayer within a shorter time frame, and to anticipate and resolve potential tax issues. The proactive engagement of our large businesses helps keep them informed of any changes in tax laws and procedures so as to increase their compliance levels.

Credible IRAS

2.4 The ability of the tax administration to ensure that taxpayers comply with their tax obligations is crucial in instilling public trust and confidence. We maintain a high level of presence amongst taxpayers through education, audits, and having a more open public communication of compliance programs and non-compliance discoveries. For large businesses, officers review their income tax returns and accounts based on a risk assessment framework. Each industry group identifies a list of potential risk areas which officers will pay more focus on in their review of returns. To give focused compliance attention to large businesses that made supplies of SGD 1 billion or more, we launched the GST Compliance Assurance Program. Through this program, IRAS seeks to establish a constructive and closer relationship with the top management of these businesses to ensure that their GST returns are filed timely and accurately, to provide them with an opportunity to identify existing and potential GST risks and to prevent recurrence of such errors. Large businesses found to have good internal controls would be subject to reduced audit contacts over a defined period.

Engaged Community

2.5 Engaging our community is a longer-term holistic strategy to treat the large businesses. IRAS hopes to inculcate a strong sense of righteousness with respect to tax paying and leverage on the community's ability to influence and change behaviours. This will help to improve and sustain the voluntary compliance of the large businesses. Large businesses typically rely on tax agents for their tax matters. Recognising the role of tax agents in facilitating taxpayer compliance, IRAS developed a framework for engaging tax agents and undertook specific action plans to work and collaborate with tax agents.

3 Conclusion

3.1 We believe that to build a more sustainable strategy for securing compliance, IRAS should not just focus on short term reactive actions against non-compliance. The compliance strategy must build its foundation on a sustainable system that eases compliance for the large businesses and encourages their compliant behaviour in the long run. In particular, our overall compliance approach towards large businesses is as follows:

(a) Firstly, we provide clarity and certainty about tax rules and laws so that there is little reason for large businesses not to be able to comply;

(b) We also facilitate large businesses in taking the necessary due diligence in managing their internal controls and assurance of their processes in tax compliance; and

(c) We detect and deter non-compliance by focusing compliance efforts on the higher risk areas.

3.2 In summary, our overall focus for large businesses is to build a transparent, co-operative and lasting relationship with them so as to facilitate their compliance, while gaining an in-depth understanding of their businesses at the same time. We believe that this will translate into our capability to identify and address any revenue risks from large businesses early. In the longer run, creating a relationship with the large businesses will help secure their tax compliance and protect our revenue base at the same time.

UNITED KINGDOM[5]

Tax Compliance Risk Management Guidance for Large Business Service (LBS) staff

1. Introduction

This guidance is for LBS staff involved in customer facing work and explains in more detail the Tax Compliance Risk Management Process. It replaces Tax compliance risk management: Guidance for LBS customers and staff, published in December 2007. The key to the approach is to build and maintain effective relationships with our customers.

Building effective relationships

For all our customers we will aim for a relationship in which HMRC

- is knowledgeable about their business and appreciates their commercial and business drivers
- is joined up as an organisation in its interactions with them
- focuses on significant identified risks
- responds proportionately to the significance of those risks
- provides clarity to our customers about the process and time frame in which areas of dispute will be resolved
- makes clear and targeted requests for information and data
- communicates professionally and uses appropriate channels.

Terms used in this Document

- **Business Risk Review** – the process by which HMRC evaluate and discuss with the customer where they sit on the compliance spectrum *i.e.* Low Risk or Non-Low Risk.

- **Risk Assessment** – the process where particular sources of information *e.g.* tax returns are reviewed by HMRC staff to establish whether there is a tax compliance risk.

- **Tax Compliance Risk Management Process** – the whole process as laid out in this document. This includes Business Risk Review and Risk Assessment but also risk working and monitoring customer’s business performance and developments.

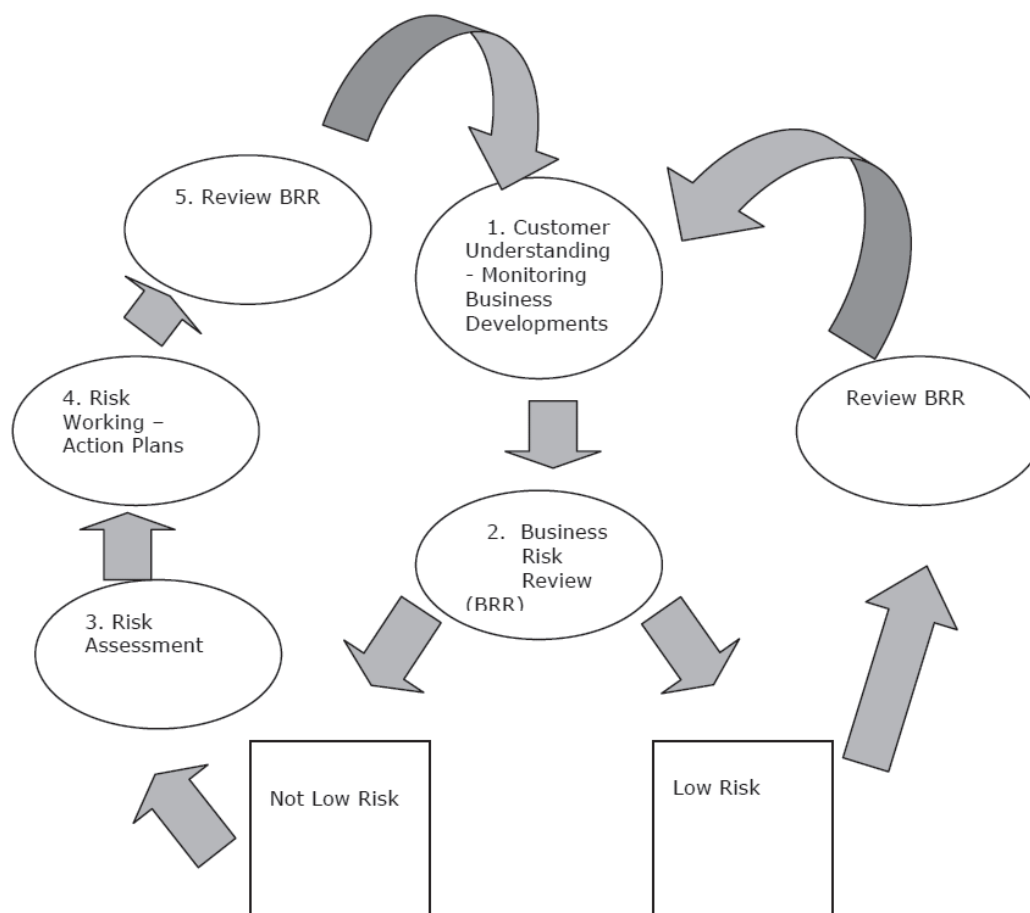
- **Tax Compliance Risk** – this is a risk that the correct amount of tax or duty may not be paid to the exchequer.

2. Tax Compliance Risk Management Process

The tax compliance risk management process is cyclical in nature and is different for Low Risk and non Low Risk customers. This guidance includes help for dealing with both types of customers.

The process for Low Risk and non Low Risk customers is set out diagrammatically below. This is a simplified diagram as low risk customers will still have activity between the original completion of the Business Risk Review and the review. This may include risk working activity.

Figure B.7. **Tax Compliance Risk Management Process**



2.1. Business Risk Review

The starting point for determining our approach to working with our customers is our knowledge of the size and complexity (inherent factors) of the business, our understanding that these factors can make it more challenging for our customers to meet their legal obligations under taxation law and our knowledge of the extent to which customers are effectively managing those inherent factors (behavioural factors).

Our understanding is summarised on the Business Risk Review Summary Template *(space restrictions do not allow inclusion here)*

The factors to consider when completing a Business Risk Review are - *(space restrictions do not allow inclusion here)*

The process to complete a Business Risk Review is shown at- *(space restrictions do not allow inclusion here)*

The Business Risk Review is to be shared with the customer and any areas of difference discussed and hopefully resolved. Any areas of disagreement are to be recorded on the template.

Customers who were in LBS in 2007 have had a Business Risk Review completed and been evaluated as either being able to benefit from a low risk relationship ('Low Risk') or not ('non-Low Risk'). For those we evaluated as Low Risk, even if evidence was limited, we will accept this evaluation until the next scheduled review unless clear evidence becomes available that calls the evaluation into question. This evaluation determines the nature and frequency of our interactions with the customer in the future.

Low Risk Customers

2.2.1. Our relationships with low risk customers

The designation of Low Risk status marks a significant change in approach to these customers, deliberately and effectively creating a cliff-edge with other customers. We have full trust in our Low Risk customers and they will therefore have control over our interactions with them, apart from certain interventions which apply to all customers, such as mandatory work or projects and campaigns.

Throughout this guidance the expression 'Low Risk customer' is used for convenience. The full description of this type of customer is 'a customer who benefits from a low risk relationship'. The relationship with Low Risk customers can be summarised as one which is open and transparent, where the customer drives the agenda and

- brings to our attention transactions/issues where there is uncertainty and/or particular complexity and/or a high level of judgement is required to determine the tax treatment
- increasingly the conversations are taking place at the time that the uncertainty arises rather than after the return is submitted. A customer may want us to adopt our new approach to governance, and delivery to understand such uncertainty; however, we would not instigate this approach.

A full description of the relationship is detailed in the guidance but space restrictions do not allow inclusion here.

For Low Risk customers:

We will

- carry out mandatory work required to meet HMRC and EU legal obligations, processes required by other Departments and National Audit Office/Public Accounts Committee
- carry out work required by other directorates within HMRC

- carry out national or LBS initiated projects/campaigns (including tax avoidance projects).

Another section gives more clarity to what is meant by mandatory, other directorate requirements, projects or campaigns but space restrictions do not allow inclusion here. This was previously called 'Demand led' work but will now be referred to as HMRC initiated activity. Our approach to this type of work will be different for low risk customers.

No work on projects/campaigns may be started with a customer without permission of the Sector Leader.

We will carry out customer initiated work on

- specific issues/areas where there is uncertainty and the customer expects the matter to be something we would want to enquire into
- clearances
- systems assurance
- clear errors that the customer brings to our attention.

Voluntary Disclosures (subject to de minimis limits)

We will continue to monitor business developments and performance by:

- maintaining a knowledge of the tax receipts position from the LBS data pack and RADAR (Risk Assessment and Data Analysis Reports) summary reports
- continuing to monitor significant customer events via press releases, websites and examination of 'glossies'. Only in exceptional circumstances will we examine submitted returns, accounts and computations. This is to be agreed with the Sector Leader.
- having sufficient communication to maintain understanding with at least a yearly meeting with the customer.

We will not carry out any HMRC initiated risk assessment activity for at least two to three years, the length of the period to be agreed between the Client Relationship Manager (CRM) and the Sector Leader.

This means:

- no risk assessment activity on Corporation Tax (CT), Petroleum Revenue Tax (PRT), Indirect Tax, Self Assessment (SA) or Employer Compliance (EC) returns
- no HMRC initiated visits to customers to determine whether risks exist
- no HMRC initiated systems assurance
- no activity carried out under the auspices of 'regime integrity' alone. Regime integrity (Annex F) will be maintained by our customer-focussed interventions and national or LBS projects/campaigns
- not applying the new approach we have developed to assessing the behavioural factors of 'governance' and 'delivery'

2.2.2. Revisiting the Business Risk Review

The Sector Leader and the CRM will agree the point at which the Business Risk Review will be revisited and the approach to be taken. The aim is to carry out the work that is required to determine whether the Low Risk status can be maintained. Where open communications have occurred during the intervening period, the Business Risk Review should be able to be completed with minimum effort on both sides.

In revisiting the Business Risk Review for Low Risk customers:

We will not

- examine all the returns and computations that have been submitted to HMRC in the previous three year period
- examine any return if it is not necessary to do so for the customer to maintain its Low Risk status.
- make retrospective enquiries.

For Low Risk customers where the Sector Leader and CRM have agreed that some risk assessment activity is needed we will only examine the returns and computations received in the last 12 months period.

If at any point a change from Low Risk status is proposed this should be agreed by the National Business Director (NBD).

2.2.3. Clear Errors

If a customer draws our attention to a clear error we should work with the customer to agree the approach in addressing this error and collect any additional liability due for the current year. If a Low Risk customer has quantified the extent of the additional liability we should accept this. If it is clear that the error has occurred in earlier years then the additional liability should be collected in accordance with the existing departmental instructions, legislation and case law relevant to that tax or duty.

If properly due and payable we would expect the tax/duty to be brought to account and not ignored because of its size or informally moved to a later accounting or return period as has been the practice in some regimes.

In this situation we would aim to deal with the error as economically as possible - for instance an informal telephone call will often suffice. If we are not querying the amount of the error notified to us by the customer then this should be recorded under the Demand Led/ Mandatory or Other screen on Core System.

2.2.4. Voluntary Disclosures

Voluntary Disclosures are made to HMRC by the customer and are a standard procedure for notifying VAT under or over paid on a VAT return. They will not be down to any action or activity taken by HMRC. The collection of VAT declared on a voluntary disclosure does not count towards yield. Only if the quantum of the liability identified is challenged should the voluntary disclosure be recorded under the Core System risk working screen. For low risk customers there will rarely be a need to challenge the liability declared on a voluntary disclosure unless there is a national project or campaign.

2.2.5. Retrospective Enquiries

If the customer draws to our attention a risk present in earlier periods the customer should be invited to 'self review' the impact of that risk. If additional liabilities are due they should be recovered in accordance with the existing departmental instructions, legislation and case law relevant to that tax or duty. If the customer's self review identifies no additional liabilities then this should be accepted.

If the revisiting of the Business Risk Review identifies a potential risk the approach to addressing that risk in the current year must be agreed with the customer. Before examining the position for earlier years with the customer it must be absolutely clear that the risk existed in these earlier periods and approval from the National Business Director (NBD) must be obtained to examine the position.

Another section provides answers to some common questions on managing low risk relationships *(space restrictions do not allow inclusion here).*

2.3. Non-Low Risk Customers

2.3.1. Our relationships with non-Low Risk customers

Where the Business Risk Review indicates that a customer can not benefit from a low risk relationship HMRC will initiate the interventions with that customer. There is a fuller description of this relationship at another section *(space restrictions do not allow inclusion here).*

For non-Low Risk customers the Tax Compliance Risk Management process follows 5 steps as laid out in the introduction.

1. Understanding the Customer

2. and 3. Completing the business risk review and risk assessment activity and sharing this with the customer.

4. Action planning.

5. Reviewing the Business Risk Review

For non-Low Risk customers:

We will

- take action to address clear errors
- carry out national or LBS initiated projects/campaigns.
- carry out mandatory work
- carry out customer initiated work
- carry out ongoing/annual risk assessment activity to identify specific tax risks and an annual Business Risk Review, including completion of the risk review template and discussing it with the customer.
- seek to apply our new approach to governance and delivery for specific risk areas.

We will not carry out work under the auspices of 'regime integrity' alone. Regime integrity (*described in another section but space restrictions do not allow inclusion here)* will be maintained by our customer focussed interventions and national or LBS projects/campaigns.

2.3.2. New approach to Governance and Delivery

This approach is focused on understanding our customers' governance and processes (*described separately but space restrictions do not allow inclusion here).*

It is important to emphasise that this represents a shift in approach for HMRC in this area. We want to move away from enquiries which work backwards from disclosures on tax computations, which are time consuming for customers and us, to understanding a customer's processes and systems for determining the numbers disclosed in the tax computation.

Key aspects of this approach are:

- understanding customers' governance of key tax areas through an initial discussion during risk assessment and, where possible, in the context of business events to better understand the operation of such governance
- a walkthrough of the end-to-end process for identified risk areas with a view to getting assurance that there is a robust process for producing tax return numbers
- more detailed systems audits will only be undertaken where weaknesses are perceived.
- our aim is to rely on work done by customers and, wherever possible, avoid duplication of effort.

Consideration of tax governance and underlying processes and systems is relevant to the Business Risk Review, risk assessment and risk working. During risk assessment, understanding of a customer's approach to governance is intrinsic to our review of likely tax compliance risks. When applying this approach to risk working, understanding the tax systems and governance around a particular risk and working with the customer to resolve any weaknesses can prevent the risk recurring. Where possible we will seek to apply this approach to current events or transactions.

B.4. Taxpayer Alert TA 2009/9

Source: Australian Tax Office, 2009

Contrived cross-border arrangements that seek to generate debt deductions for non-assessable non-exempt income

FOI status: may be released

Taxpayer Alerts are intended to be an 'early warning' of significant new and emerging higher risk tax planning issues or arrangements that the Australian Taxation Office (ATO) has under risk assessment, or where there are recurrences of arrangements that have been previously risk assessed.

Taxpayer Alerts will provide information that is in the interests of an open tax administration to taxpayers. Taxpayer Alerts are written principally for taxpayers and their advisers and they also serve to inform tax officers of new and emerging higher risk tax planning issues. Not all potential tax planning issues that the ATO has under risk assessment will be the subject of a Taxpayer Alert, and some arrangements that are the subject of a Taxpayer Alert may on further examination be found not to be of concern to the ATO. In these latter cases the Taxpayer Alert will be withdrawn and a notification published which will be referenced to that Taxpayer Alert.

Taxpayer Alerts will give the title of the issue (which may be a scheme, arrangement or particular transaction), briefly describe the issue and will highlight the features which are of concern to the ATO. These issues will generally require more detailed analysis to provide the ATO view to taxpayers.

Taxpayers who have entered into or are contemplating entering into an arrangement similar to that described in this Taxpayer Alert can seek a formal determination of the ATO's position through a private ruling). Such taxpayers might also contact the tax officer named in the Taxpayer Alert and/or obtain their own advice.

This Taxpayer Alert is issued under the authority of the Commissioner.

This Taxpayer Alert describes certain cross-border financing arrangements which seek to generate debt deductions in Australia. These arrangements have little or no commercial or economic purpose and appear to be driven by the tax benefits that arise under section 25-90 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Section 25-90 of the ITAA 1997 allows a deduction for an amount or outgoing that is a cost in relation to debt interests where the cost is incurred in deriving non-assessable non-exempt income under section 23AI, 23AJ or 23AK of the *Income Tax Assessment Act 1936* (ITAA 1936).

This Alert focuses on blatant, artificial and contrived cross-border financing arrangements that attempt to generate a deduction under section 25-90 for costs incurred in deriving non-assessable non-exempt dividends under section 23AJ of the ITAA 1936.

Description

1. Arrangements covered by this Alert show at least one, but may show several, of the following relevant criteria:

    a. the arrangement which is returning non-assessable non-exempt income is in substance the provision of financial accommodation to an unrelated party and by contrivance the return for the provision of financial accommodation is made a non-portfolio dividend from a related party;

    b. the arrangement which is returning non-assessable non-exempt income is in substance an investment by a non-resident entity in another non-resident entity, where Australia is artificially interposed in the investment to secure a tax deduction matched by non-assessable income;

    c. the arrangement which is returning non-assessable non-exempt income is in substance an investment by an Australian resident in another Australian resident, and a non-portfolio investment in a non-resident company is artificially interposed in the investment to secure non-assessable income;

    d. the arrangement which is returning non-assessable non-exempt income is designed to match the income with the cost deducted under section 25-90 to secure a '"free" tax deduction. Funds advanced under the arrangement are effectively returned to the provider of the funds, or an associate. Promissory notes or other non-cash means of making advances may be employed;

    e. the structure used in the arrangement is unduly complex or contrived - an example of such complexity is where an entity is interposed into the arrangement structure where such interposition is unnecessary from a commercial viewpoint. In some cases, the Australian resident may be instructed by the marketer or lender to add apparently unnecessary layers of complexity to the financing arrangement;

    f. absent the tax benefits, the arrangement has little or no commercial or economic purpose;

    g. the flow of funds in the arrangement is circular, so that the funds ultimately flow back to the initial investor or lender (for example, a borrowing from the capital markets may be linked to the counterparty to the transaction), **or**;

    h. there may be no commercial reason for involving an Australian resident entity in the transaction - that is, in an ordinary commercial arrangement the foreign entity would not have sourced its investment from Australia. For example, the arrangement might economically be an investment from Europe into Asia but routed through Australia apparently for the dominant purpose of obtaining tax benefits available under section 25-90 of the ITAA 1997, **and**;

    i. deductions are claimed under section 25-90 in respect of costs incurred in deriving the non-assessable non-exempt income.

2. Relevant arrangements may also include one or more of the following features:

    a. many or all of the participants in the arrangement are related parties;

    b. the transaction may be structured in a manner such that no income or minimal income is included in the assessable income of the Australian resident entity

under the controlled foreign company (CFC) and foreign investment fund (FIF) provisions;

c. in economic substance, the income received from the non-resident entity is more like interest rather than a share of business profits;

d. the net pre-tax return on the investment is less than the target rates of return of the entity in its general business;

e. the return from the non-resident entity has been structured to eliminate the operational and market risk that would normally be expected from commercial business transactions;

f. in the case of an investment by way of redeemable preference shares, returns are predetermined and the Australian entity is not entitled to participate in any upside of the investment;

g. where the transaction structure has a variable element such as a floating return or variable rate of interest, this may be swapped for a fixed return or cost to lock in the income and fix the tax benefits generated by the arrangement, or;

h. the transaction may be structured so that no tax or minimal tax is paid in the offshore jurisdiction. This includes arrangements where tax is paid offshore and then claimed back as a credit by an associated non-resident entity.

3. Some arrangements involve a third party who, although prima facie at arm's length, participates in the arrangement in order to share the tax benefits generated by the arrangement.

4. Such a third party will often be a marketer of the arrangement and will receive a fee that will generally take the form of a commercial return associated with the arrangement. In substance that commercial return will often be a disguised fee for marketing the arrangement.

EXAMPLES OF TYPICAL DEBT DEDUCTION GENERATOR ARRANGEMENTS

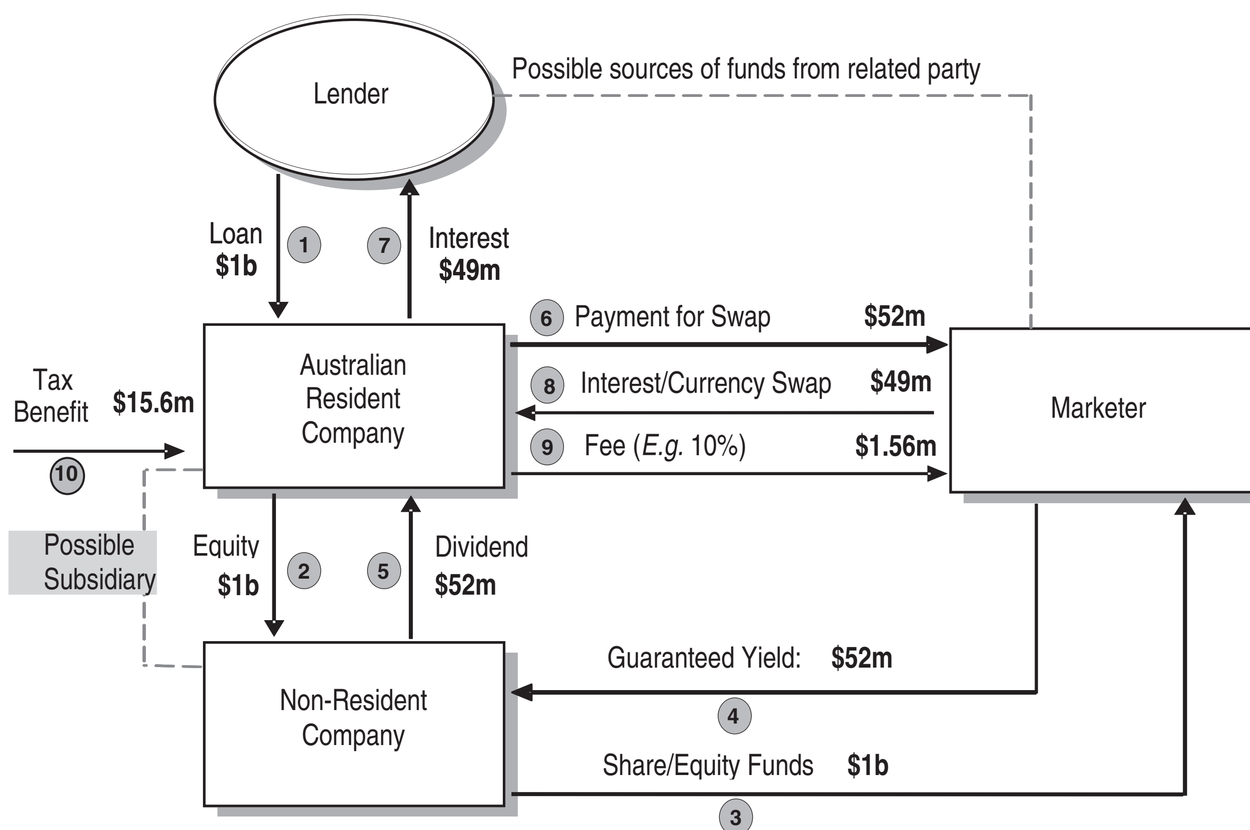
Example 1

1. The Australian resident entity enters into the arrangement by borrowing funds (in this example, AUD 1bn) from the capital markets or from a related party with the intention of using the funds to obtain equity in a non-resident entity. In some cases, it appears that the borrowed funds may be sourced from the marketer of the arrangement. In other cases, it appears that the funds are borrowed short-term and that all or a substantial part of the funds quickly flow back to the lender via a series of back to back steps in the transaction structure.

2. The marketer of the arrangement agrees to effectively return part of its fee to the non-resident entity. This part of the fee is then returned to the Australian resident as non-assessable non-exempt income and provides the Australian resident with an apparent commercial return on their investment.

This is illustrated in the diagram below:

Figure B.8. **Example of typical debt deduction generator arrangement: One**

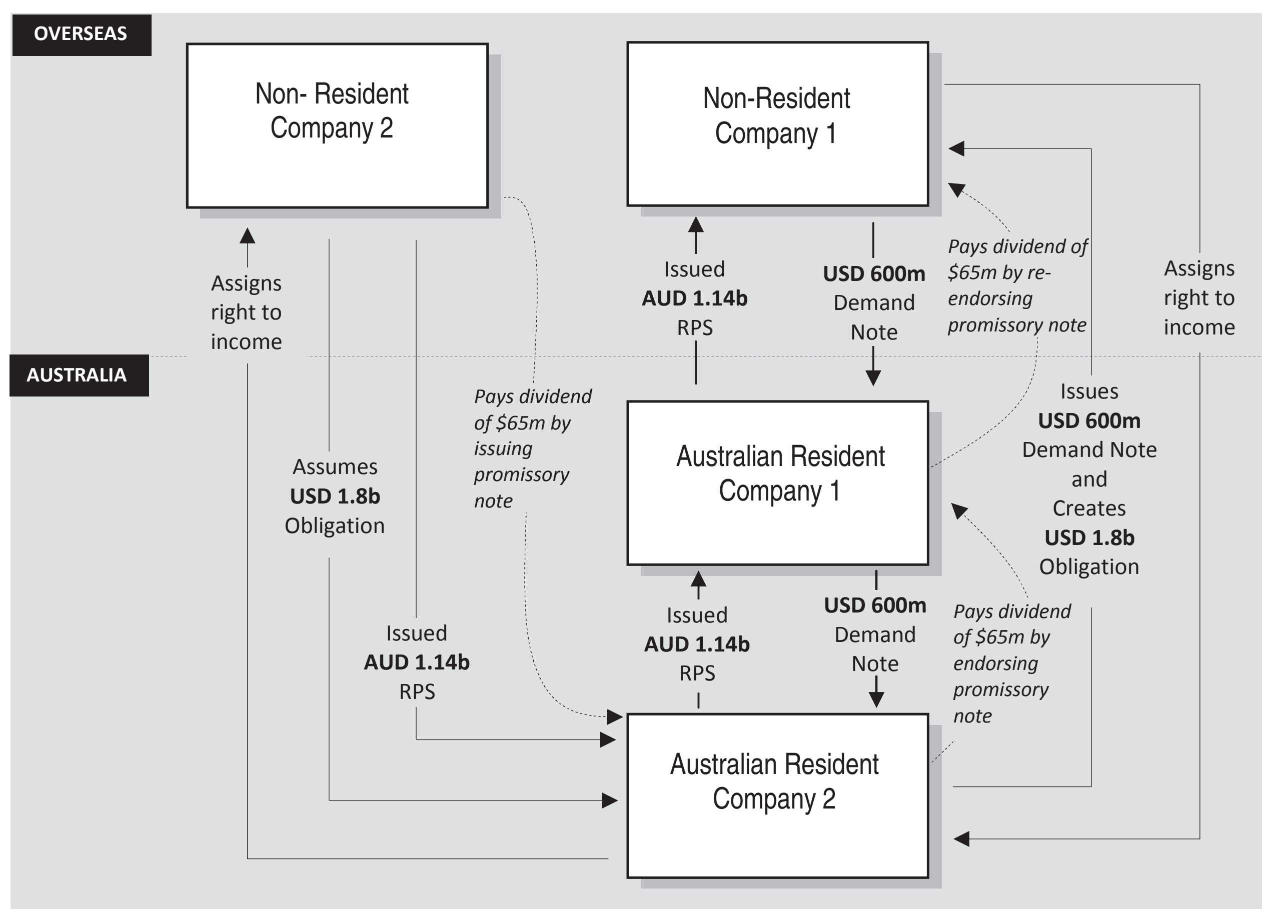


Example 2 The arrangement involves an intra-group transfer of an income stream from a non-resident entity to an Australian resident which in turn transfers it to another non-resident entity. Redeemable preference shares are issued by the related entities as part of the financing of the transfer of the income streams.

1. The obligations of the parties to pay dividends on the redeemable preference shares are satisfied by way of the initial issue and subsequent endorsement and re-endorsement of a promissory note. The dividend paid on the redeemable preference shares issued by the non-resident entity to the Australian resident is then returned to the Australian resident as non-assessable non-exempt income. This dividend is then on-paid by the Australian resident to another Australian resident and then ultimately to the original non-resident entity. This generates a deduction under section 25-90 of the ITAA 1997.

This is illustrated in the diagram below:

Figure B.9. **Example of typical debt deduction generator arrangement: Two**



FEATURES WHICH CONCERN US

The ATO considers that arrangements substantially of this type give rise to taxation issues,

including whether:

a. the arrangement or certain steps within it constitute a sham at general law;

b. any amount of income received by any entity involved in the arrangement is assessable to them under section 6-5 of the Income Tax Assessment Act 1997 (ITAA 1997);

c. any amount of income received by any entity involved in the arrangement is assessable to them under paragraph 44(1)(a) of the Income Tax Assessment Act 1936 (ITAA 1936);

d. any income received or receivable is a non-portfolio dividend for the purposes of section 23AJ of the ITAA 1936;

e. any amount expended by the Australian resident entity would be deductible under section 8-1 of the ITAA 1997, including the extent to which such an amount was incurred in gaining or producing non-assessable non-exempt income;

f. any costs incurred on the borrowed funds are properly incurred under section 25-90 of the ITAA 1997 in deriving non-assessable non-exempt income;

g. any income derived by the non-resident entity should be attributable income of the Australian resident entity for the purposes of the CFC rules under Part X of the ITAA 1936;

h. any income derived by the non-resident entity should be attributed to the Australian resident entity as FIF income under Part XI of the ITAA 1936;

i. any transaction which forms part of the arrangement may be subject to the transfer pricing provisions contained in Division 13 of the ITAA 1936 (for example, the rate of interest payable on any loan);

j. any articles in applicable tax treaties between Australia and a relevant country may apply;

k. the general anti-avoidance rules contained in Part IVA of the ITAA 1936 apply to cancel any tax benefits under the arrangement; and

l. any entity involved in the arrangement may be a promoter of a tax exploitation scheme for the purposes of Division 290 of Schedule 1 to the Taxation Administration Act 1953.

The ATO is currently reviewing these arrangements. After considering two variations on such arrangements, the preliminary ATO view is that they are ineffective at law or that the general anti-avoidance provisions contained in Part IVA of ITAA 1936 apply to them.

Note 1: Base penalties of up to 50% of the tax avoided can apply where Part IVA is applied. Base penalties of up to 75% of the tax avoided can apply where you make a false and misleading statement to the Commissioner. Reductions in base penalty will be available if the taxpayer makes a voluntary disclosure to the ATO. If you have any information about the current arrangement, phone us on 1800 177 006. Tax agents wanting to provide information about people or companies who may be promoting arrangements covered by this alert should call the tax agent integrity service on 1800 639 745.

Note 2: Penalties of up to 5 000 penalty units for individuals, 25 000 penalty units for bodies corporate or up to twice the amount of consideration received or receivable may apply to promoters of tax exploitation schemes under Division 290 of Schedule 1 to the Taxation Administration Act 1953. The Commissioner can also apply to the Federal Court of Australia for restraining and performance injunctions against promoters where prohibited conduct has occurred, is occurring or is proposed.

Subject references

Aggressive tax planning

Arrangement

Promoters

Legislative references

All available on the ATO Legal Database: http://law.ato.gov.au/atolaw

Income Tax Assessment Act 1936

Part IVA

Part X

Part XI

Division 13

Section 23AJ

Section 44

Income Tax Assessment Act 1997

Section 6-5

Section 8-1

Section 25-90

Taxation Administration Act 1953

Schedule 1 Div 290

Related Rulings/Determinations

TD 2008/23

TD 2008/24

TD 2008/25

B.5. Enhanced relationship as a pathway to high tax compliance

Background

The *Intermediaries Stud*y recommended that revenue bodies establish a tax environment in which mutual trust and co-operation can develop between large corporate taxpayers, tax advisers and themselves. It referred the issue of identifying the benefits of such an "enhanced relationship" to a follow up study.

Revenue bodies currently have a diverse range of relationships with banks. Some countries have positive relations while others, for a variety of reasons, may have a less than ideal engagement with banks. Where they exist, the rationale for an enhanced relationship is a joint approach to improving overall tax compliance.

Normally the initiative for these relationships has come from revenue bodies seeking to build structured relationships with the top management of large business (including banks), which involves commitments by both sides to improve tax risk management.

Some revenue bodies have found that engagement at the Board or senior levels of large businesses provides an excellent opportunity to discuss areas of mutual concern, and offers a forum for improving compliance. These discussions aim to ensure that senior management in the large business has an appropriate understanding of both the businesses' relationship with the revenue body and its tax risk appetite, and they also provide an opportunity for the revenue body to share its risk profile. The objective is to enhance understanding of the commercial pressures and risk profile of the large business and to collaborate to improve certainty and to minimise tax risk.

Enhanced relationships – Is banking different from other large businesses?

On enhanced relationships with banks, the *Intermediaries Study* "did not sufficiently deepen its analysis of banks to develop firm recommendations" and "did not have a clear view on the extent to which the recommendations of [the] report can have an impact on banks behaviour". This study picks up from that and considers whether revenue bodies' experience of enhanced engagement with large business could also work with banks.

There are some reasons why it might be more difficult for banks than for other types of business to engage in enhanced relationships. However, from survey responses, the view of revenue bodies is broadly that while some aspects of the banking business make the relationship more difficult to manage it can be made to work equally effectively. A number of issues peculiar to banks do, however, need to be considered:

Banks are engaged in high value, frequently complex transactions, which are often not easily understood by those outside the industry, including by some revenue bodies.

Banking is a time-critical business both for innovative transactions but also for all market price based business (because prices change continuously). Tax is a challenge in a time- critical business for a number of reasons**:**

- innovative products are traded immediately, but their tax treatment might not be clear until later (*e.g.* the tax treatment of credit derivatives or the tax costs of trading on new exchanges);
- products designed around CSFTs can give rise to difficult tax issues which might not become clear for some time even beyond the lifetime of the particular deal and it is therefore not possible to advise revenue bodies of the tax consequences of the product at the point of design. This timing issue is not a problem that is confined to CSFT transactions and in some ways is more acute in innovative, volume businesses such as hybrid capital issuances, structured derivatives and loans (*e.g.* credit derivatives); and
- a bank's risk management is focused on real time decisions (*e.g.* through a bank's relationship with its regulators, who will generally be expected to give their clearance before a deal is done).
- The other significant distinction between banks and other taxpayers is that banks have separate roles in their capacities as:
- taxpayers – arising from the conduct of both general banking and proprietary trading; and
- intermediaries designing and implementing financial solutions for clients (frequently with tax dimensions)

Although there are no insurmountable barriers to enhanced relationships between revenue bodies and banks, either by the complexity or currency of their operations or from their dual capacities as businesses and intermediaries, revenue bodies do need to invest more heavily in building business knowledge and awareness than might be the case for other business sectors. Revenue bodies must have an understanding to engage effectively at a senior level, provide guidance rapidly and ensure that interventions, where necessary, are risk-based and targeted.

The view of the banking sector on enhanced relationships with revenue bodies

The Study Team surveyed national banking associations in a number of countries and held consultative meetings with senior representatives from global investment banks to seek their views on what they see as key elements of their relationship with revenue bodies.

Most banks would agree that their current relationship with revenue bodies is good and could provide a foundation for an enhanced relationship; however there is a perceived lack of trust between the industry and some revenue bodies.

A fundamental motivation for engaging in a more co-operative relationship with revenue bodies is to simplify overall compliance obligations while ensuring consistency of treatment.

Tax certainty is very important and managing risks on transactions is a high priority. As a consequence, in addition to the daily management of their tax matters, banks would like revenue bodies to provide an efficient, consistent ruling or opinion process where revenue body views are delivered by highly-skilled staff in a timeframe that is acceptable to both parties.

Revenue bodies need to build a greater understanding through commercial awareness of their business in particular in the area of CSFTs. Early disclosure by revenue bodies of audit positions, operational policy positions and technical views through published guidance notes and interpretations on legislation was particularly important.

There is poor information flow both ways between banks and revenue bodies in relation to current issues and events. Some revenue bodies do not respond to taxpayers in real time and this has a negative impact on the risk management of CSFT transactions for banks.

Banks would also like an opportunity to be consulted on and to influence tax policy. Banks sometimes did not understand the purpose of tax legislation affecting their industry. Banks would also like to be consulted before policy decisions and legislative changes affecting their industry are implemented.

The view of the revenue bodies

Revenue bodies were similarly surveyed for their views on the benefits of a more co-operative relationship.

Revenue bodies see engaging with banks (and other businesses) in an enhanced relationship as one dimension of a holistic tax risk treatment strategy. This integrated risk management approach encompasses guiding and supporting risk management by banks alongside risk-driven, audit and enforcement interventions, where appropriate, and mandatory or voluntary aggressive tax planning disclosure regimes where the law provides.

Revenue bodies saw the current state of their relationships with banks as generally good, but felt that it worked best where there was ongoing dialogue through regular meetings between senior revenue officials and senior bank management.

Many revenue bodies provided positive feedback in relation to the impact of enhanced relationships on overall compliance behaviour, while some other administrations considered relationships of this kind potentially problematic in the context of their legal systems or cultures.

Important motivators to engage co-operatively with banks are to improve their ability for risk detection, prevention and response and to improve targeting of administrative resources, as well as to obtain improved input for policy making.

Revenue bodies recognise that they need a better understanding of industry practices and in particular of how risks are managed by banks, of how they are organised and the nature and extent of corporate governance. They see enhanced engagement as providing a vital avenue to build this knowledge.

Revenue bodies said that they were looking for banks to explain the nature and significance of complex structured finance operations, to know which types of banks provide this service and why there is a demand for structured finance products.

They had a sense that sometimes banks raised issues with them too late in the process or provided limited information and that this hampered their ability to provide early certainty on banks' tax positions.

Revenue bodies felt that developing their relationship with banks would enable them to identify and respond to aggressive tax planning schemes more efficiently, thereby

better focussing compliance initiatives. Some revenue bodies also indicated that, in their experience, less formal co-operative relationships with banks were possible and could also be effective.

Key Elements for an enhanced relationship

The key objective of any enhanced relationship with banks is to provide greater certainty in relation to the banks' tax liabilities and revenue streams as well as a reduced compliance burden. The feedback from revenue bodies and banks identified the following key dimensions for an enhanced relationship program to deliver on these objectives.

Nature of agreements

All countries have opted for voluntary engagement in enhanced relationship arrangements. However, where a relationship is based on voluntary engagement, it needs to have some clearly stipulated *rules of engagement* and planned outcomes. These rules of engagement would enshrine a set of commitments by both parties.

Openness and transparency: what it would involve

For an enhanced relationship to work effectively, both parties should commit to engage transparently and with openness to build mutual trust. In the context of banking this would require open dialogue between revenue bodies and the banks.

The revenue bodies' expectation is that banks will volunteer information where they see potential for a significant difference of interpretation with the revenue body that may lead to a significantly different tax result.

Ideally, as anticipated in the *Intermediaries Study*, this would lead to banks engaging in an open and transparent way, going beyond strict statutory requirements and disclosing potentially aggressive tax planning, structures, schemes or products (*e.g.* CSFTs with a significant tax planning dimension) to the revenue body in a timely and comprehensive manner.

This kind of relationship would also involve the revenue body sharing their risk assessment with the bank's senior management and discussing how this assessment was made and what it means in terms of revenue body actions.

The revenue body should, where permissible, provide the early certainty sought by banks through timely views on tax positions and structures either in the form of indicative views or advance rulings and clear published guidance on issues and structures.

The revenue body and the banks would put in place structures for dialogue in relation to current issues and concerns and possible remedies.

Finally, both sides would need to accept that, even if this increased level of openness and transparency can be introduced, there will always be some differences in interpretation and views and that this also will need to be managed within the framework of the relationship.

Responsiveness

Due to the time-critical nature of banking business, responsiveness on both sides is a very important element in any enhanced relationship.

Banks are seeking early certainty and revenue bodies need to be able to quickly and efficiently respond to bank requests. It is necessary to establish a framework for real time responses from the revenue body, subject to an undertaking from the banks to keep the revenue body informed at the earliest opportunity of the issues.

Revenue bodies will require comprehensive information from the bank so that they can understand the significance of the issues, deploy appropriate resources and reach the right tax conclusions in a timely way.

Commitment

A clear commitment from the senior management of both the bank and the revenue body is fundamental to its success. This is the key to ensuring that tax compliance becomes both an issue for the Boards of banks and a dimension of corporate governance.

The success of an enhanced relationship programme is ultimately dependent on ensuring the provision of appropriately skilled dedicated staff by both parties and on ensuring that they are provided with the requisite authority to deliver on the commitments of the parties.

Focus on engagement

The fundamental purpose of the enhanced relationship is to improve compliance. It is therefore important that in participating in the relationship both parties ensure that staff understand this objective.

Clarity on taxes and functions

It is important that all parties are clear on the scope of the engagement. Ideally the relationship would encompass all the taxes administered by the revenue body (for example, corporation tax, income tax including withholding obligations and value added taxes) and all the bank's obligations under those taxes (for example, lodgement or filing, withholding, and payment functions).

Relationship Managers

A number of countries have large business taxpayer programmes which provide a single point of contact for the taxpayer with the revenue (variously known as Client Relationship Managers, Large File Case Managers, Account Managers, Client Managers, Case Managers, Case Directors, and Banking Specialists). The programmes vary in the functions undertaken by the contact officer but the officer invariably acts as the liaison point for the taxpayer. Large business taxpayers have indicated that they find this beneficial in managing their relationships.

Joint management of issues

It is important to the success of the relationship that the bank and the revenue body build a shared view of any tax risks posed by the bank's operation thereby narrowing the gap in perception between revenue bodies and banks in relation to what constitutes unacceptable tax planning.

Building Capability and Resources

As noted in the *Intermediaries Study*, a critical factor affecting the viability of an enhanced relationship is the capacity of the revenue body and the bank to deliver on the commitments required. For the revenue office this will require an assessment of the staff resources assigned to banks' tax work, of their knowledge and expertise on the banking business, and on associated tax issues. For banks it will require an assessment of staff knowledge of how revenue bodies operate and of the rationale for interventions and information requirements.

The education of revenue bodies in commercial understanding of financial markets and banking, including CFSTs, is critical to the ongoing effectiveness of an enhanced relationship. Options for addressing this challenge include:

- recruitment of staff with the appropriate competencies and experience or with the capacity to build these competencies in relatively short timeframes;
- sourcing training modules dealing with key aspects of the banking (or overall financial services) sector, preferably integrated with consideration of tax risk issues;
- commissioning academic programs or modules covering banking and financial services;
- seeking the assistance of national banking associations in providing training programmes for revenue body staff; and
- embarking on exchange initiatives with other revenue bodies where less skilled revenue staff can be given opportunities to work with administrations that boast robust technical skills.

Review and resolution

There are from time to time likely to be issues which do not lend themselves to agreement and it is therefore important to have an agreed process for the resolution of these issues. This normally involves appropriate escalation processes to senior levels within both the bank and the revenue body.

Some current revenue body approaches to enhanced relationships

Revenue bodies in a number of OECD countries have experience with co-operative compliance type programs for large business taxpayers. These programs are variously called Co-operative Compliance, Annual Compliance Agreements or Compliance Assurance Programs. Their common aim is to improve practical certainty for large businesses and revenue bodies by reviewing tax risks in real time or at an early stage.

The following table summarises four OECD countries' experiences with co-operative compliance programs for large business taxpayers. Whilst these programs are not

specifically directed at taxpayers in the banking sector, they provide an indication that relationships based on transparency and openness can work for large business taxpayers and revenue bodies.

Four OECD countries' experiences with co-operative compliance programs for large business taxpayers

AUSTRALIA **"Annual Compliance Arrangement"** *Commenced in 2008*	**KEY FEATURES:** • For income tax, available to top 50 businesses by turnover. For other taxes (*e.g.* excise, goods and services tax) available to any taxpayer. • By signed arrangement between revenue body and customer following a commitment by the CEO/CFO of customer to full and true disclosure of material tax issues and meeting sound standards of tax risk management processes as published by the Revenue body. • Reviewed annually by both parties. • Customers agree to make full and true disclosure of material issues and provide sufficient information to enable the revenue body to understand the transaction and its tax impact. • Commitment to sign-off a tax return within 6 months of lodgement. • Positions of material risk are agreed between the revenue body and the company and resolved within an accelerated time frame. **KEY OUTCOMES:** • A reduction in compliance costs for both Revenue body and customer. • More effective deployment of resources to significant and material issues. • Effective clearance for a particular year of income subject to risk Mitigation plan. • Streamlined processes to resolve issues on Mitigation plan, including alternative dispute resolution procedures, administrative arrangements, priority access to private ruling processes.
THE NETHERLANDS **"Horizontal Monitoring"** *Introduced as a pilot in 2005*	**KEY FEATURES:** • Process open to all very large businesses and applicable to all taxes. • By signed mutual Compliance Agreement between revenue body and the company setting out manner and intensiveness of monitoring. Company must show it is in control of its tax processes and working towards a reliable Tax Control Framework (TCF). • Reviewed regularly by both parties. • Customers agree to give early notification of issues with a possible and significant tax risk and can expect a timely and full response from the revenue body about the legal consequences. If information is needed or an audit is required the revenue will explain and clarify the tax risks. **KEY OUTCOMES:** • Improved compliance and enhanced relationship through

	increased transparency, understanding and trust. • Reduction of administrative burden and lower compliance costs to the customer and revenue through faster filing and settling of returns and fewer post filing audit adjustments due to relying on the TCF and the joint tax risk assessment. • Greater certainty from reliable and quantifiable tax positions that can be reported almost immediately. • More effective and efficient supervision through sharing of responsibility for compliance and using the work of others (*e.g.* internal and/or external auditors).
UNITED KINGDOM **"Tax Compliance Risk Management Process"** *Introduced in 2007*	**KEY FEATURES:** • Process open for all Large Business customers (770+) subject to risk review. • By discussion with customer following a Business Risk Review. • Reviewed timetable dependent on risk status and in discussion with customer. • Customers in a low risk relationship can expect support and infrequent risk reviews and no interventions led by revenue. • Customers not in a low risk relationship can expect more regular risk reviews, more interventions and more targeted intensive projects to improve compliance. **KEY OUTCOMES:** • Certainty through real time discussions supported by new system of advance rulings and clearances for significant commercial issues, with reduction in low value issues. • Improved resource allocation to high-risk businesses with almost 40% of customers in a low risk relationship with corresponding increase in yield from compliance. • Speedy resolution to resolve issues and interventions to an agreed timetable with the business. • Clarity through increased informal consultation on new operational issues.
UNITED STATES OF AMERICA **"Compliance Assurance Process"** *Introduced in 2005*	**KEY FEATURES:** • Invitation by IRS and voluntary participation for some of the largest USA corporations (95 participants in 2008). • By Memorandum of Understanding between the revenue body and the company. • Annual agreement. • Corporations agree to pre-filing disclosure with the goal to resolve issues in pre-filing period so that the return can be filed with certainty. **KEY OUTCOMES:** • Saves time and resources for both the revenue body and the corporate through the elimination of extensive post filing examination, reducing prolonged litigation. • Increased and earlier certainty for the corporate and supports corporate governance responsibilities. • Improves tax administration by rewarding compliant behaviour, focusing on material issues and improving audit process.

B.6. South African Banking Accord

The South African Revenue Service and the Banking Association of South Africa on 29 January 2009 signed an Accord that establishes a framework for co-operation between the parties in order to improve levels of tax compliance, discourage impermissible tax avoidance arrangements and enhance service.

Extract from the Accord

1. Parties to Accord

The parties to this accord are the South African Revenue Service ("SARS") and the Banking Association, South Africa ("the Banking Association").

2. Objectives of Parties

2.1 The objectives of SARS are the effective and efficient collection of revenue and the control over the movement of certain goods in and through South Africa to protect our borders and facilitate trade.

2.2 The Banking Association is the representative body for the banking industry and the industry body whose role it is to establish and maintain the best possible platform on which banking groups can do responsible, competitive and profitable banking, and seeks to ensure that is members maintain best international practice.

3. Broad Principles recognised by the Parties

3.1 It is important that sufficient tax revenue is raised to provide South Africa with sufficient fiscal flexibility and stability to inter alia sustain economic growth and development, increase employment opportunities and to provide social support with regard to the basic and other needs of the people of South Africa.

3.2 It is also important that South Africa has a stable, vibrant, competitive, responsible and efficient banking industry to serve the interests of all its stakeholders.

3.3 That a good working relationship has been built up between SARS, the Banking Association and the banking industry over the last few years, and there are several areas of common interest between SARS and the Banking Association. Both SARS and the Banking Association are therefore committed to a collaborative approach to promote compliance with the laws of South Africa.

4. Broad Purpose of Accord

This Accord establishes a framework for co-operation between the parties, inter alia to:

4.1 enhance service delivery by SARS to the banking industry;

4.2 promote and encourage the highest standards of tax compliance by the banking industry and its clients;

4.3 discourage impermissible tax avoidance arrangements which the banks become aware of or which may be conducted by or through banks;

4.4 regularly determine the effective tax rates of banks and the banking industry and to review the effective tax rate of the industry;

4.5 co-operate in identifying and resolving areas of mutual concern; and

4.6 establish an appropriate disclosure practice consistent with the requirements of South African law.

5. Specific Undertakings by the Banking Association

The Banking Association undertakes to:

5.1 regularly determine the effective tax rate of banks and the banking industry and co-operate to review the effective tax rate of the industry;

5.2 promote the fact that taxation should be dealt with by banking industry and its members as a corporate governance issue at board level;

5.3 promote the introduction of appropriate risk management and quality control practices and systems to promote and encourage the highest standards of tax compliance;

5.4 discourage the use of and involvement in the promotion of impermissible tax avoidance arrangements;

5.5 promote the timely supply and disclosure of information by the banking industry to SARS consistent with the requirements of South African law

5.6 co-operate in identifying and resolving areas of mutual concern;

5.7 participate in the Banking - SARS Operational Forum.

6. Specific Undertakings by SARS

SARS undertakes to enhance service levels vis-à-vis the banking industry by virtue of the following initiatives:

6.1 dedicated services by the SARS Large Business Centre (LBC) to the banking industry;

6.2 the appointment of a Taxpayer Relationship Manager to focus exclusively on the banking industry;

6.3 increasing professionalism and technical skills amongst the SARS officers dealing with the banking industry;

6.4 an advance ruling system that within reasonable time limits provides increased certainty in tax law, which may also benefit the banking industry;

6.5 promoting compliance with SARS'S Taxpayer Service Charter;

6.6 promoting and encouraging the highest standards of tax compliance;

6.7 discouraging tax practices that are inconsistent with the law;

6.8 participating in the Banking - SARS Operational Forum

7. Banking - SARS Operational Forum

A Banking - SARS Operational Forum is hereby established.

7.1 The purpose of this Forum will be to facilitate interaction between SARS and the Banking Associate in relation to all tax related issues which are relevant to the banking industry and SARS. This interaction should promote certainty and consistency of tax treatment, and be sensitive to each party's rights and obligations.

7.2 To give effect to the decisions of the Forum, each party will escalate the issue to its principal, which in the case of SARS will be the Commissioner and in the case of the Banking Association, its Board.

7.3 Once accepted by both SARS and the Board, the matter becomes an industry standard. Members of the Banking Association shall adopt such industry standard, and any member who chooses not to do so, will discuss this with SARS.

7.4 The Forum will be made up of senior officials of SARS and senior tax executives from the Banking Association. It will meet every six (6) months or at such other times as is appropriate and agreed to by SARS and the Banking Association.

7.5 This Forum may specifically discuss the following issues:-

7.5.1 Tax compliance issues and the consistent application of the tax laws;

7.5.2 Operational and/or administrative issues and service levels both within the banks and SARS; and

7.5.3 Legislative issues

8. Meetings between the Commissioner and Board of the Banking Association

The Commissioner and the Board of the Banking Association will endeavour to meet:

8.1 at least once a year; and/or

8.2 at such times as may be determined jointly by SARS and the Banking Association

9. Good Faith and Commitment

9.1 The Parties undertake to observe the utmost good faith in the implementation of the Accord.

B.7. Risk assessment survey questions

The following survey questions provide a simple way to risk profile a bank's overall business. At an initial meeting, both bank and revenue body will discuss the nature of the bank's operations, which questions are relevant and how to respond to those questions. Once completed by the bank, the survey can be used as a basis for joint discussion. Differences will inevitably arise around the interpretation of the responses and each party will need to be open and transparent when explaining their position.

It is suggested that a rating system be used that allows for something besides a simple yes/no answer. For example, one methodology is to score the strength of response using a 1 – 10 scale. Alternatively, an assessment of high, medium or low may be useful to give shades of meaning. The example questions below have incorporated the high, medium or low ranking method.

Box B.1. **Risk Assessment Survey Questions**

A) Cultural & behavioural factors – qualitative:

1. Strength of taxpayer systems around transparency of internal controls or disclosure.

A ranking of low: procedures are highly transparent and well documented with separate levels of control function between the initiator of a deal or transaction and the assurer or administrator.

A ranking of high: procedures are not documented adequately and there are limited internal controls indicating a high degree of risk around the reliability of the systems.

2. Quality of corporate governance controls and oversight by senior risk or board members.

A ranking of low: an effective level of oversight.

A ranking of high: no oversight or inadequate corporate governance compared to competitors.

3. Tax department is resourced according to the complexity of functions, appetite for risk in product design and/or aggressive tax strategy.

A ranking of low: effective resources to match the level of compliance risks.

A ranking of high: low resources and a high appetite for risk, possibly coupled with a history of unacceptable tax schemes.

4. Uncertain tax positions are fully disclosed to revenue bodies as to level of risk with materiality and an explanation of tax issues.

A ranking of low: full disclosure of tax risks – *e.g.* FIN 48 alignment.

A ranking of high: tax risks are not adequately discussed.

5. Size of and profitability of any structured finance department relative to firm size.

A ranking of low: the client does not have a structured finance department.

A ranking of high: the client's structured finance department accounts for a large proportion of the organisation's business.

Box B.1. **Risk Assessment Survey Questions (*Continued*)**

B) Control Process for Complex Structured Financial Transactions:

6. Ability to identify transactions with significant tax consequences where there is material uncertainty.

A ranking of low: effective control processes are in place for identifying those transactions that are likely to present significant issues *e.g.* a committee with representatives from all relevant control functions, unanimous vote required for approval of transactions.

A ranking of high: the control process lacks the effectiveness required for any number of reasons *e.g.* inappropriate expertise represented on the committee, inadequate level of control over final decision.

7. Appropriate timing of complex product approval process.

A ranking of low: a complex product is approved before any substantive marketing occurs.

A ranking of high: unapproved complex products are marketed to clients thus exposing the bank to undue reputational risk, stressing the client relationship and resulting in pressure from the business unit to approve the product when a client becomes interested.

8. Independence of each relevant control function in the complex product approval process.

A ranking of low: each relevant control function is independently empowered to ensure that in relation to their particular function all material technical and reputational issues have been addressed, appropriately informed opinions are sought, any applicable disclosure requirements have been satisfied, and ultimately, they may reject the product if deemed inappropriate.

A ranking of high: each relevant control function is not independently empowered of the business unit to make decisions regarding the above factors.

9. Control over the implementation and execution of transactions.

A ranking of low: effective control processes are in place to ensure that only approved transactions are marketed, and that all transactions are implemented and executed in the form that was approved.

A ranking of high: there is no effective control process in place to ensure only approved transactions are marketed and that transactions are implemented and executed in their approved form.

C) Factors relating to financial products for HNWI Clients

10. Full disclosure of transactions that have been stated as areas of concern to revenue bodies.

A ranking of low: the client has not been involved in these specific transactions.

A ranking of high: the client has heavy involvement in these types of transactions.

11. Degree of limitation or control on product design and the complexity of arrangements resulting in elimination of tax.

A ranking of low: a standardized range of products that have been proven in the industry.

A ranking of high: the client is free to specify that no tax applies to a deal by the complexity of its structure; there is no apparent commercial purpose or adequate oversight by banks.

Box B.1. **Risk Assessment Survey Questions (*Continued*)**

12. In-house product design division(s) producing tax driven benefit schemes where the pricing of products or benefits obtained are dependent upon the availability of tax concessions.

A ranking of low: a standardized range of products that have been proven in the industry.

A ranking of high: no design controls.

D. Quantitative factors of a bank's own compliance history:

13. Financial performance that varies from sector industry standards or marked changes in key ratios or risk buckets used in that industry.

A ranking of low: financial performance is in line with economics indictors and risk is appropriate for the category of assets and level of transparency.

A ranking of high: significant divergence of financial performance from industry norms.

14. Significant variation in amount of tax payments compared to relevant economic indicators or past performance.

A ranking of low: steady financial performance is reflected in the tax payments.

A ranking of high: significant variation in the trend of tax payments over time which poorly reflects different economic or accounting performance.

The idea of the proposed survey questions is to interrogate internal control systems under four categories:

A. Cultural & Behavioural factors

B. Control Process for Complex Structured Financial Transactions

C. Factors relating to financial products for HNWI Clients

D. Quantitative factors of banks own history of compliance

The aim of these questions is to instigate discussions and reach agreement about how well the control mechanisms are going to work to recognize those transactions that present tax risk and whether they will be elevated to sufficiently high levels within the bank for consideration.

It is suggested an initial meeting should take place to find out what the bank does and discuss how to answer the questions, and which questions are actually relevant. It is essential that appropriately high level representatives from both the bank and the revenue body are involved in this process.

B.8. Examples of differentiation, plotting and analysis tools

Differentiation Tool

Example of constructing a risk ranking table for 'other global' or regional banks based on key functionality factors

Tools to rank banks to their peers: plotting tools for comparative analysis of answers are useful where a jurisdiction has many banks. This is only a starting point for further analysis.

Table B.1. **Table of results high risk ranking (scale of worst to best H/M/L)**

High risk banks	A. Cultural & Behavioural factors - Qualitative	B. Control Processes for Complex Structured Financial Transactions	C. Factors relating to financial products for HNWI Clients	D. Quantitative factors of banks own history of compliance	Ranked high on risk measure used by revenue body
	A1 – A5	B6 – B9	C10 – C12	D13 – D14	
Bank 1	H	M	M	M	M
Bank 2	H	H	M	M	H
Bank 3	H	H	H	M	H
Bank 4	H	H	H	H	H
Bank 5	H	H	H	H	H

Table B.2. **Table of results Low risk ranking (scale of worst to best H/M/L)**

Low risk banks	A. Cultural & Behavioural factors - Qualitative	B. Control Processes for Complex Structured Financial Transactions	C. Factors relating to financial products for HNWI Clients	D. Quantitative factors of banks own history of compliance	Ranked low on risk measure used by revenue body
	A1 – A5	*B6 – B9*	*C10 – C12*	*D13 – D14*	
Bank 1	L	M	M	M	M
Bank 2	L	L	M	M	L
Bank 3	L	L	L	M	L
Bank 4	L	L	L	L	L
Bank 5	L	L	L	L	L

Findings of risk ranking:

What does it mean if a bank self rates itself as HIGH OR LOW or revenue body ranks a bank as HIGH OR LOW?

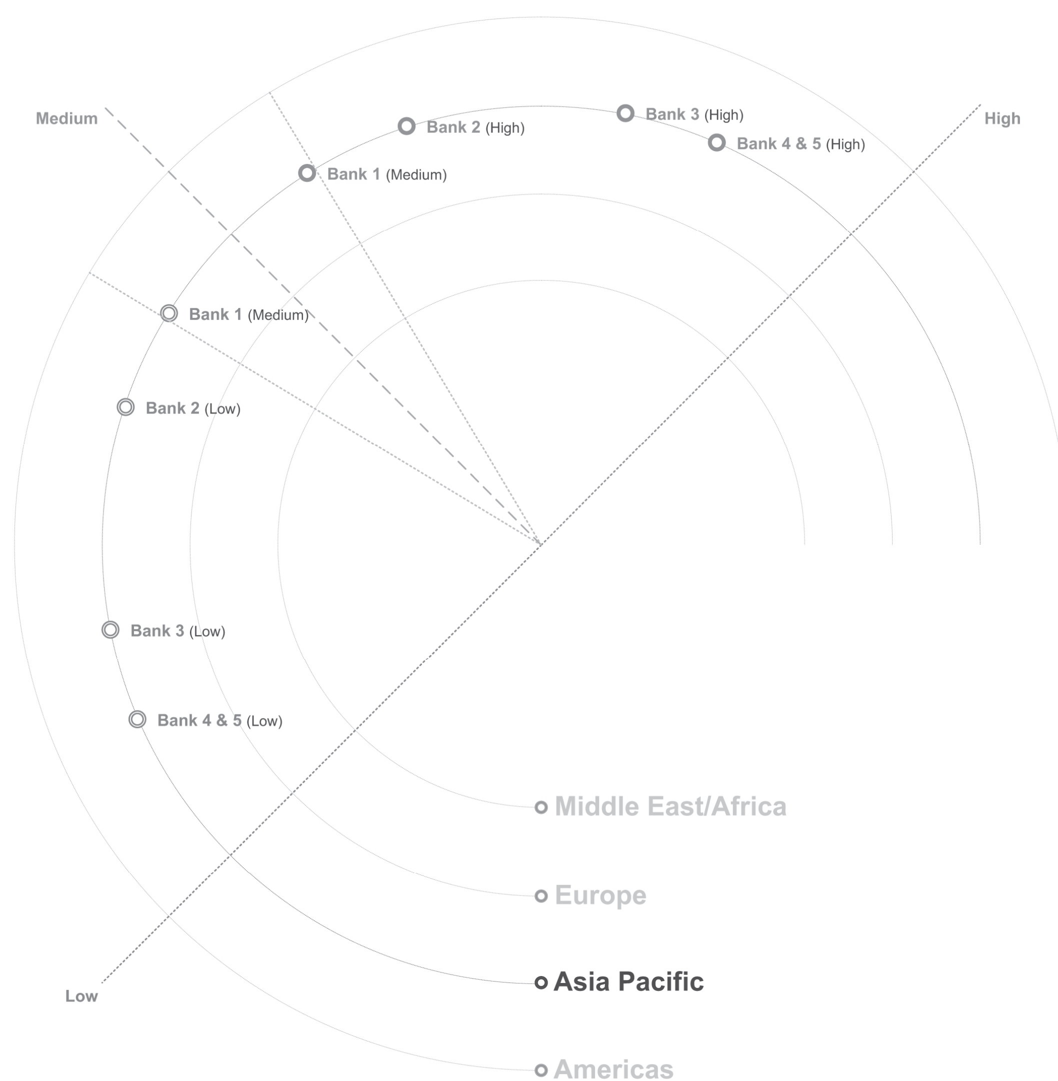
- High risk ranking suggests a greater likelihood of non compliance with tax laws for either themselves or their clients.
- Low risk ranking suggests less likelihood of non compliance with tax laws for this taxpayer

Further analysis based on risk scores

In addition to providing a risk ranking on individual banks, the above risk assessment can also be used by some revenue bodies for risk pattern analysis where there are many banks (or branches) operating within the jurisdiction.

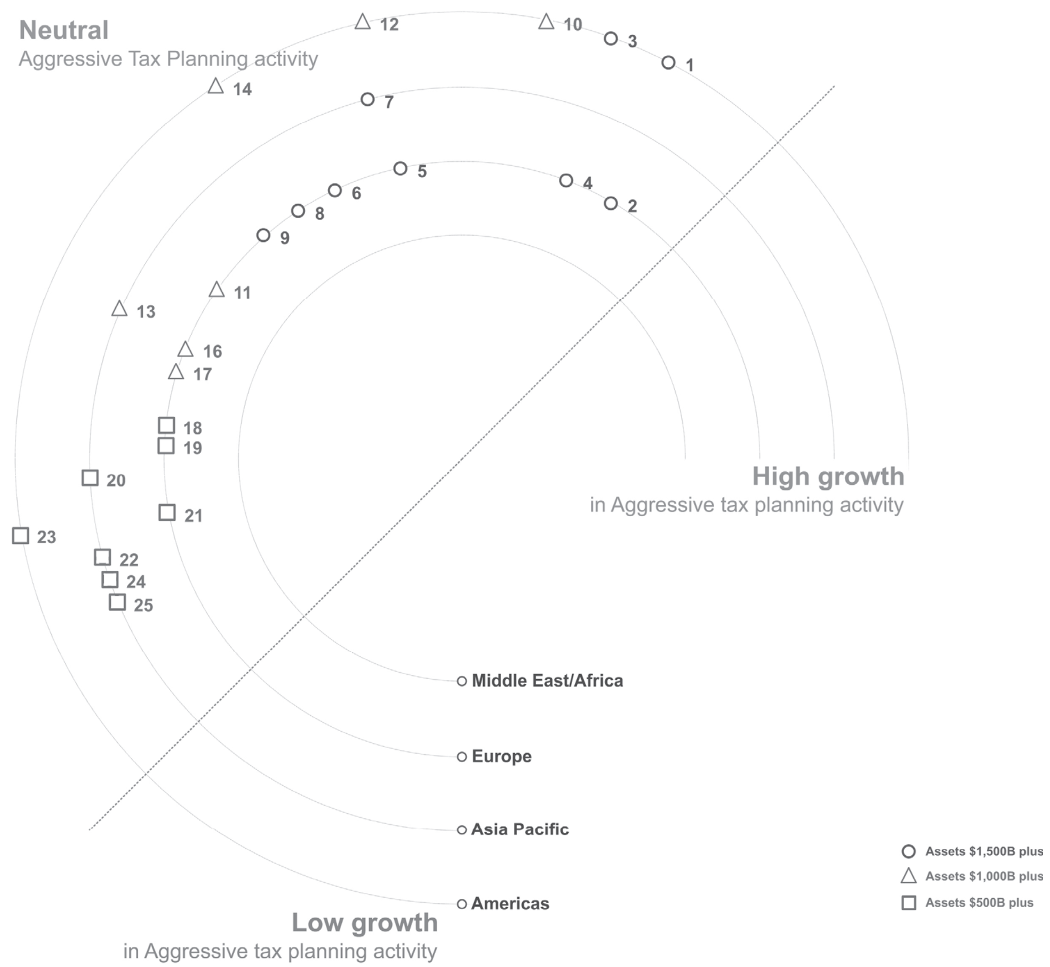
Plotting Tools: *The following plotting tools are examples of how risk rankings can be used for tax risk analysis across a wide area to picture different clusters and identify outlier entities:*

Figure B.10. **Global Analysis which shows comparative levels of banks at risk levels across a grid**



NOTE: Methodology is to plot banks across a grid to illustrate whether each one is either high growth or low growth orientation to aggressive tax planning.

Figure B.11. **Relative spread of banks across a grid based on asset size**

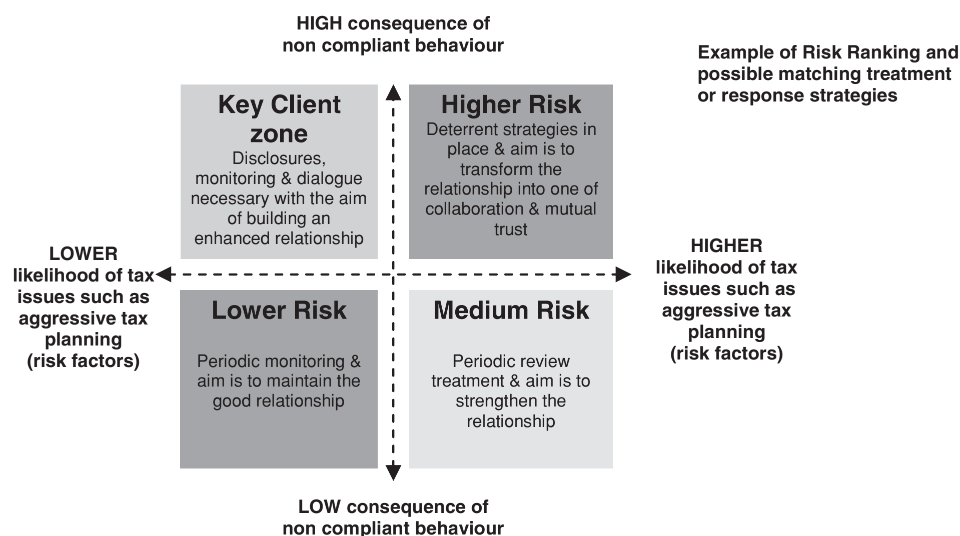


Analysis Tools

Applying the results to determine risk levels and treatment approaches

Two examples of tools that may be used for illustrating the relationship between risk level and suggested approaches are provided below.

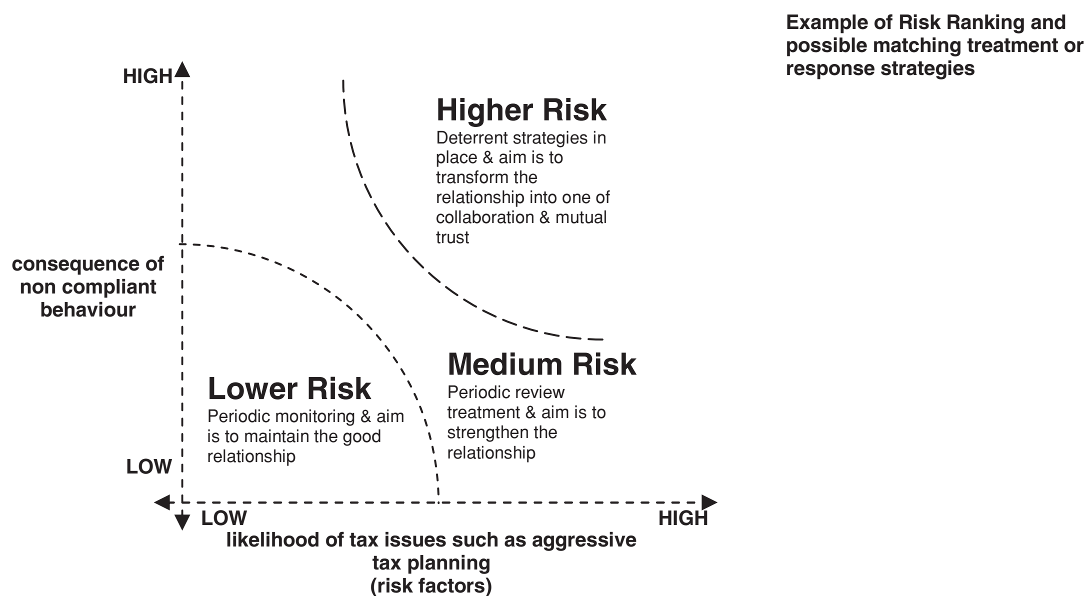
Figure B.12. **First Tool to provide treatment according to risk – model version 1**



Note:

All the results will not neatly fit neatly into equal groupings and create four equal size boxes as above. For example if we do a 80/20 likelihood split (so 80% considered lower likelihood and 20% higher likelihood) and a 70/30 consequence split then the % of higher risk clients is 20%x30% = 6%. The percentage of medium risk clients (higher likelihood and lower consequence) is 20%x70%=14%. The percentage of key clients (lower likelihood and higher consequence) is 80%x30%=24%. Finally the % of lower risk clients (lower likelihood and lower consequence) is 80%x70% = 56%.

Figure B.13. **Second Tool to provide treatment according to risk – model version 2**



Explanation of treatment strategy that evolves as a consequence of risk rating:

1. Key Client Zone = monitoring
2. Higher Risk = more targeted enforcement
3. Medium Risk = part of general enforcement or project work
4. Low Risk = engagement, help and education

B.9. Creating an enhanced relationship through education

Introduction

On November 2, 2007, the Securities Industry and Financial Markets Association (SIFMA) submitted comments in connection with the OECD's drafting of the Study into the Role of Tax Intermediaries. Those comments outlined in detail how SIFMA envisioned creating an "enhanced relationship" with the revenue bodies. The cornerstone of establishing an enhanced relationship was to create an educational program, whereby SIFMA would become active in the training and development of the revenue bodies.

This type of program would allow the revenue bodies to gain additional information that they believe is critical in the enforcement of the tax laws. Possessing such information would, in addition, help revenue bodies to more efficiently allocate limited resources. Banks, in turn, would acquire contemporaneous feedback regarding certain products, and could incorporate that feedback in how best to continue to implement such products.

SIFMA continues to believe that such a program would have mutual benefits for both banks and the revenue bodies. The general themes that were considered when proposing to create a program still remain. However, in light of the extraordinary economic conditions that have existed since creating an educational program was first proposed, SIFMA believes that an update regarding the implementation of the program would be useful.

Providing Educational Programs for the Revenue Bodies

The OECD has said that, in order for revenue bodies to gain a greater understanding of banks that the revenue bodies need to acquire a "commercial awareness." One aspect of commercial awareness requires the revenue bodies to understand various broad concepts, including how banks operate in the markets. Another aspect requires the revenue bodies to understand, among other things, "the peculiarities or unique characteristics" of the banking industry. In short, revenue bodies need to become more "connected" to banks in order to gain a better understanding of matters from both a commercial and a tax perspective. A business-provided education or training program is an appropriate way to acquire such "commercial awareness."

SIFMA is uniquely qualified to provide this "commercial awareness" to the revenue bodies in affording education regarding both financial products and the financial services industry globally. In terms of the training and educational development of the revenue bodies, SIFMA has stated previously that its members are willing to take an active role and pursue programs that are of mutual interest to the revenue bodies and SIFMA members.

SIFMA members would expect revenue bodies to approach the educational program committed to reciprocity. That reciprocity should take the form of an open dialogue on any issues of concern, followed by responsiveness in a timely manner in the form of guidance. SIFMA members do not always expect the immediate response from the revenue bodies to be in the form of technical guidance. Rather, SIFMA members expect,

at a minimum, an objective general reaction to the products or issues being discussed, including any perceived changes that are required, or any problems or concerns that the revenue bodies may have. In short, SIFMA expects a “business-like” discussion regarding the matters that allows banks to reduce uncertainty and clarify areas of agreement and disagreement.

“Rules Of Engagement” for Educational Programs

This proposal provides suggested “Rules of Engagement” and guidelines for consideration by the OECD for purposes of establishing how such an educational program would operate. These “Rules of Engagement” are intended to clarify the roles and responsibilities of both the revenue bodies and SIFMA members in the educational process, as well as provide procedural guidance.

Categories of Education

SIFMA envisions an educational program consisting of two categories. The role and responsibility of SIFMA members in the educational process would not vary on the basis of classification within a category. However, the role and responsibility of the revenue bodies would differ based upon the particular category within which an issue is placed.

Category I

Category I educational programs would include training and development of the revenue bodies on general matters. For example, SIFMA may provide education to the revenue bodies regarding the capital markets in general. Such types of programs may not require comments or responses from the revenue bodies. There are several current issues regarding the capital markets in general for which it would be useful to have an informed discussion with the revenue bodies. Examples of specific topics that may be included are:

Examples – Category I Educational Programs

Current Market Issues

It would be very beneficial to discuss the current liquidity crisis in the financial markets, and the resulting impact on banks, with the revenue bodies. It would be valuable to all parties to have an understanding of the business and tax implications (including the mark-to-market rules) created by the liquidity crisis.

Business Changes

It would also be useful to have a discussion regarding the changes in the global market for financial services firms. Changes in the global market have resulted in corresponding changes in how financial services firms do business. The revenue bodies would benefit from understanding the modifications that financial services firms have made to their business practices.

Accounting Rule Changes

In addition, a discussion regarding global accounting changes (such as the adoption of International Financial Reporting Standards) would be valuable to the revenue bodies. These changes may create different financial or business motivations for banks. It would be constructive for the revenue bodies to understand the tax implications resulting from such accounting changes, and how the changes may affect a taxpayer's motivation for using a particular product or engaging in a certain transaction.

Category II

Category II educational programs would be more targeted and specific. For example, as new capital markets products are issued in the marketplace, SIFMA may be willing to conduct meetings with the revenue bodies in order to explain such products to them. Depending on the topical requests of the revenue bodies, the educational programs regarding these products could also be classified further. For example, the educational programs could be classified into products marketed to institutional companies, products that are cross-border, products marketed to retail entities, or products that are marketed to individuals.

Engaging in discussions regarding these topics would be particularly useful in terms of efficiency and allocating resources, for both the revenue bodies and banks.

SIFMA recognizes that certain topics of discussion in Category II may not be conducive to a broad, industry-group presentation. Nuances and differences in fact patterns among transactions could make it difficult to reach a consensus regarding a presentation. In those situations, it may be useful to have a combination of an industry meeting for a high-level review of the topic, and then separate "one-off" meetings with members of the industry.

Examples of specific topics that may be included are:

Examples – Category II Educational Programs

Tax Ownership of Securities

Revenue bodies, and various other government entities, have taken a particular interest in the tax ownership of securities, and the resulting withholding tax issues (or imputation credit issues) that arise with respect to cross-border investors. In addition, the USA Senate Permanent Subcommittee on Investigations recently conducted a hearing and issued a report with respect to this issue. There have been several active audits with respect to this issue; but as there had been no guidance promulgated in this area, banks took the initiative and created their own internal guidelines to address the issue. A technical discussion of this subject would be extremely useful for both banks and the revenue bodies.

Cross-border Hybrid Instrument Transactions

Revenue bodies have taken a particular interest in cross-border hybrid instrument transactions. Such transactions are international financing arrangements in which securities are treated differently as debt or equity in different jurisdictions. The approach of the revenue bodies in examining such transactions, however, appears to be all-

inclusive and indiscriminate. Revenue bodies approach an audit of these types of transactions by requesting a vast amount of information, much of which will not end up being relevant for any determinations they may make. If an educational program was conducted regarding these types of transactions, the revenue bodies, perhaps, could be more selective in their audits and, therefore, allow for a more efficient allocation of resources from all perspectives.

Credit Default Swaps

The credit crisis has highlighted credit default swaps for the revenue bodies and various other government entities. Credit default swaps are a type of credit derivative in which a credit protection buyer purchases credit protection with respect to a reference obligation, often some type of debt instrument or a reference index that is comprised of debt instruments, from a credit protection seller. New York State has announced that it will begin regulating certain credit default swaps as insurance products. In addition, the USA House of Representatives Financial Services Committee has recently stated that regulation of credit default swaps is needed. Credit default swaps have been widely used for over ten years by many market participants in various structured finance and securitization applications. To date however, uncertainty remains regarding the proper tax treatment of a credit default swap.

Reciprocity

As stated previously, and as recognized by the OECD, transparency in this manner through educational programs cannot be a one-sided benefit in favour of the revenue bodies. SIFMA members look to the mutual sharing of information and conclusions in a timely manner. SIFMA members are willing to conduct periodic training meetings provided that, prior to the meetings, the revenue bodies commit that they will give their reactions and opinions at the meetings (or shortly thereafter) with respect to any perceived problems or tax issues.

The revenue bodies should also discuss with SIFMA any audit initiatives, enforcement plans, or other issues which they are contemplating pursuing. This would be mutually beneficial in that SIFMA may be able to explain the business and tax considerations of an issue to the revenue bodies at the outset of an information gathering effort. Such knowledge at the beginning of a project would be very useful to the revenue bodies. Furthermore, SIFMA might be in a position to make constructive suggestions concerning possible approaches to examining the issue.

SIFMA members would also look for a priority commitment to issue guidance within a reasonable period of time following an educational program. This would represent an excellent opportunity for collaboration between the revenue bodies and SIFMA, as SIFMA members could be turned to for reactions to potential approaches to guidance, outlines of possible guidance or other assistance as deemed helpful by the revenue bodies in expediting guidance.

Impartiality

The OECD has stated that revenue bodies must take an impartial approach to the resolution of tax disputes. Just as impartiality and proportionality are necessary for the successful resolution of tax disputes, they are also necessary for the revenue bodies in terms of the education process.

Impartiality and proportionality are integral and necessary for any "enhanced relationship." In order for an educational program to be worthwhile and successful, the revenue bodies must act impartially, rather than as an advocate. SIFMA envisions that, by definition, Category II issues in the educational program will likely involve some degree of tax uncertainty.

The stated goal of most revenue bodies is to collect the correct amount of tax. For example, the IRS mission statement states as its objective to "apply the tax law with integrity and fairness to all." However, many corporate taxpayers, through direct experience and anecdotal information, have reached the conclusion that this is not "real world" practice, and we welcome the OECD commitment to the Impartial Approach as described in the *Intermediaries Study*. As noted by the OECD, disclosure through the type of educational program envisioned by SIFMA may provide the revenue bodies with a "roadmap" of banks' conclusions with respect to an uncertain tax position. For such a discourse to work, the revenue bodies cannot use the educational process merely as a method to facilitate making adjustments. Accordingly, in order for the educational process to be meaningful for all of those involved, it is important that the revenue bodies act with impartiality and proportionality.

Frequency and Audience

Procedurally, SIFMA envisions that educational programs would be conducted quarterly. In addition, we believe that such programs would be more beneficial and productive if they were conducted with the revenue body of a particular country (*i.e.*, the revenue body from which clarification is most required) rather than being conducted in a multi-jurisdiction format. Such a format would facilitate the issuance of informal as well as formal guidance. However, if the pertinent revenue body believed it was necessary or helpful, attendance at the program would be open to the revenue bodies of other jurisdictions.

In terms of scheduling the programs, SIFMA suggests that the programs alternate between Category I and Category II level issues. As an alternative, depending on the interest or urgency with which the revenue bodies want to discuss a particular issue, programs could also be split, with half of the program dedicated to a Category I issue and the other half dedicated to a Category II issue.

As the OECD has recognized, the enhanced relationship cannot be forged through forcing the waiver of privileges or the disclosure of work papers. Therefore, it is expected that through this educational process that the revenue bodies will not request, and SIFMA members will not disclose, privileged documents.

Finally, SIFMA anticipates that representatives of SIFMA and the revenue bodies will agree beforehand regarding the secondary details of an educational program (*e.g.*, how many people will attend, who will serve as spokespersons, will outside counsel/advisors attend, etc).

Notes

1. For details see OECD (2009) Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series (2008), OECD, Paris. www.oecd.org/dataoecd/57/23/42012907.pdf
2. Based on a response provided by Direction Générale des Finances Publiques (the French Treasury Department).
3. Based on response provided by the Inland Revenue Authority of Singapore.
4. An Abridged Version.
5. Extract from Chapter 2, HM Revenue and Customs Tax Compliance Risk Management Guidance for LBS Staff.

Glossary

Advance Ruling. A letter ruling, which is a written statement, issued to a taxpayer by revenue bodies that interprets and applies the tax law to a specific set of facts.

Aggressive tax planning. This refers to two areas of concern for revenue bodies:

- **Planning involving a tax position that is tenable but has unintended and unexpected tax revenue consequences.** Revenue bodies' concerns relate to the risk that tax legislation can be misused to achieve results which were not foreseen by the legislators. This is exacerbated by the often lengthy period between the time schemes are created and sold and the time revenue bodies discover them and remedial legislation is enacted.
- Taking a tax position that is favourable to the taxpayer without openly disclosing that there is uncertainty whether significant matters in the tax return accord with the law. Revenue bodies' concerns relate to the risk that taxpayers will not disclose their view on the uncertainty or risk taken in relation to grey areas of law (sometimes, revenue bodies would not even agree that the law is in doubt).

Arbitrage. The exploitation of asymmetries between different tax regimes, or parts of the tax code, to achieve a reduction in the overall level of tax payable

Audit. All revenue bodies have processes to check the accuracy of tax returns and to allow them to obtain further information to verify the accuracy of items included. The means by which these processes are undertaken and the mechanisms and objectives of each country differ. Terms such as audit, examination, enquiry, control, intervention and investigation (although in some countries the term "investigation" is only used for criminal matters) are used by different countries. For the purposes of this report, the term "audit" describes all these processes.

Auditor. Revenue body staff who carry out audits.

Business and Industry Advisory Committee (BIAC). BIAC is the officially recognised representative of the OECD business community. BIAC's members are the major business organisations in the 30 OECD member countries. For more information see www.biac.org.

Credit risk. The risk that a borrower will not repay a loan. Can be broken down into Country risk or Sovereign risk where concerned with the credit risk of lending to a particular nation.

Cross-border transactions. Transactions involving parties in more than one country.

Debt Instrument. A written promise to repay a debt, such as a bill, bond, banker's acceptance, note, certificate of deposit or commercial paper.

Effective Tax Rate. The rate at which a taxpayer would be taxed if his tax liability were taxed at a constant rate rather than progressively. This rate is computed by determining what percentage the taxpayer's tax liability is of his total taxable income.

Equity. The ownership interest possessed by shareholders in a corporation – stock as opposed to bonds.

Exchange of Information. Most tax treaties contain a provision under which the revenue bodies of one country may request the revenue bodies of the other country to supply information on a taxpayer. Information may only be used for tax purposes in the receiving country and it must be kept confidential, *i.e.* it can only be disclosed to the persons or authorities concerned with the assessments or collection of taxes covered by the treaty.

Fiduciary risk. The risk that the bank may fail to carry out customers' instructions correctly or in a way, that is negligent or unprofessional leading to claims for compensation.

FIN 48. An accounting standard issued by the USA Financial Accounting Standards Board that determines the income tax disclosures required in publicly available accounts.

Financial institutions. Collective name for firms operating in the financial sector (*e.g.* investment and retail banks, insurers, asset managers).

Financial statement. Report which contains all of the financial information about a company. The report generally consists of a balance sheet, income statement and may include other information as well.

Foreign Tax Credit. A method of relieving international double taxation. If income received from abroad is subject to tax in the recipient's country, any foreign tax on that income may be credited against the domestic tax on that income. The theory is that this means foreign and domestic earnings of an entity will as far as possible be similarly taxed, although usually the credit allowed is limited to the amount of domestic tax, with no carry over is tax is higher abroad.

Forum on Tax Administration. The Forum on Tax Administration was created in July 2002 by the OECD Committee on Fiscal Affairs (CFA) with the aim of promoting dialogue between tax administrations and of identifying good tax administration practices. Its members are the heads of tax administrations from 40 OECD and non OECD countries.

Franchise risk. The risk that the bank's reputation will be damaged as a result of negative publicity or criticism of their business as a result of any of their actions, including the type of business they enter into.

High Net Worth Individual. Individuals at the top of the wealth or income scale. The term "High Net Worth Individuals" is used broadly and thus includes both high wealth individuals[1] and high income individuals.[2]

Hybrid instrument: Any instrument with characteristics typical of both equity and loan capital.

Liquidity and funding risk. The risk that a bank will have insufficient cash to meet all demands in normal operations – so that customers cannot withdraw funds. This can

lead very quickly to a run on the bank and the possibility of the total collapse of the banking system. It can arise from mismatches in the timing of cash flows.

Operational risk. Risk that the trade is disrupted for example by terrorist attack or computer failure. Alternatively, simply that internal system, people and procedures fail leading to a loss.

Sarbanes-Oxley. The United States *Sarbanes-Oxley Act 2002* is a corporate governance law. It applies from July 2002 and was introduced in the aftermath of corporate collapses such as Enron. It strengthened accountability standards for directors and officers, auditors, securities analysts and legal counsel and introduced corporate financial reporting requirements to protect shareholders and the general public from accounting errors and fraudulent practices in corporations.

Securitisation. The process of issuing new negotiable instruments backed by cash flow producing existing assets such as loans, mortgages, credit card debt or other assets.

Study Team. Those who worked full-time on the study from the Australian Taxation Office, the United Kingdom's HM Revenue and Customs and the OECD Secretariat. The Study Team also included banking professionals on short-term attachments from major investment banks.

Tax risk. The risk that the bank will fail to comply with tax legislation in any of the jurisdictions in which it does business or that unexpected issues arise in relation to Effective Tax Rates.

Notes

1. The term "net wealth or "net worth" is generally understood to refer to assets less liabilities. The term "high net wealth" or "high net worth" is used interchangeably in this report with the term "high wealth" to loosely refer to those at the top of the wealth scale.

2. The term "high income individuals" is used very broadly to refer to those at the top of the income scale.

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Building Transparent Tax Compliance by Banks

What role do banks play in the provision of aggressive tax planning arrangements? This book analyses the nature of banking, the complex structured financing transactions developed by banks and how they are then used by both banks and their clients. It also explores the internal governance processes that banks use to manage tax risk and the prevention, detection and response strategies applied by different revenue bodies in responding to the challenges that banks pose.

The book makes a number of recommendations for revenue bodies and identifies best practices for consideration by banks. For example, revenue bodies should gain an understanding of how individual banks manage tax risks, as robust risk management processes can provide them with greater assurance of a bank's tax compliance. In turn, banks are encouraged, in setting their business strategy, to consider the benefits of an enhanced relationship with revenue bodies, including early certainty, reduced compliance costs and reduced reputational risks.

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