Taxation of Financial Institutions

International Monetary Fund Proposes Imposition of Two New Taxes on Financial Institutions and Establishment of Resolution Agencies

SUMMARY

The International Monetary Fund has drafted an interim report titled “A Fair and Substantial Contribution by the Financial Sector” (the “Report”), which proposes that governments impose two new taxes on financial institutions in order to fund the cost of any future direct government assistance to the banking sector. The first proposed tax, the “Financial Stability Contribution”, would be paid by all financial institutions and calculated as a percentage rate applied against a “broad balance sheet base”, including some off-balance-sheet items but excluding capital and insured liabilities. The rate would initially be a flat rate across financial institutions but would subsequently be risk-adjusted to address institutions’ contribution to systemic risk. The second proposed tax, the “Financial Activities Tax”, would be paid by a financial institution on the sum of its profits and remuneration paid to employees. The Report also calls for the establishment of “resolution agencies” that would promptly address failing financial institutions, including through placing them under “official administration”. Finally, the Report proposes reducing the tax bias in favor of debt financing and addressing more firmly aggressive tax planning in the financial sector. The Report, obtained by the British Broadcasting Corporation, is reported to have been delivered on April 20, 2010 to the governments of the Group of Twenty in advance of a meeting of the finance ministers of that group held in Washington, D.C. on April 23 - 24.

DISCUSSION

The International Monetary Fund (“IMF”) authored the Report in response to a request from the governments of the Group of Twenty (“G-20”) for suggestions as to how the financial sector could make a fair and substantial contribution toward paying for any burden associated with government interventions to repair the banking system. The Report assesses the costs of the recent crisis in the financial sector and establishes objectives against which to evaluate potential measures to limit and fund the financial
cost of any future crisis. These objectives include reducing the risk of a failure in the financial sector and ensuring that the financial sector itself pays for the expected cost of any such failure. The Report then makes the proposals described immediately below, noting that the success of these proposals is dependent, in part, upon coordinated action among the major financial centers.¹

Financial Stability Contribution

The Report’s first proposal is the imposition on financial institutions of a “Financial Stability Contribution” (“FSC”). The FSC would be imposed on all financial institutions initially at a flat rate. The rate subsequently would be adjusted to reflect “explicitly (systemic) risk.” The FSC would apply against a broad balance-sheet base, including some off-balance-sheet items, but excluding capital (e.g., Tier 1 capital) and insured liabilities. It should be noted that the term “financial institutions” will potentially include insurance companies and hedge funds, and not just the banks which received taxpayer support in the last two years. This has caused considerable concern in the London insurance market.

The FSC would include two components. The main component is an amount intended to fund the expected cost of direct government support of the financial sector, which may be set aside in a fund specially designated for such purposes, although it could equally be part of general public revenue. This component is also intended to help reduce, by way of disincentivizing, excessive risk-taking by financial institutions. The second and smaller component would pay for the availability of a credit line to ensure that in the event of a future banking crisis, necessary financing could be obtained even if the resources accumulated through the first component prove insufficient. This second component would be part of the government’s general funds.

The Report also proposes that the FSC could be supplemented, if necessary, by a temporary recovery charge imposed on financial institutions immediately after a direct government intervention in the sector, although the Report is lukewarm about this idea because such a charge could jeopardize the recovery of the relevant institution.


The Obama Administration and the US Congress have proposed and are considering alternatives for fees and assessments of large financial institutions -- generally, those with more than $50 billion in assets -- to cover the cost of restitutions of financial institutions. In January, 2010, the Obama Administration proposed a “Financial Crisis Responsibility Fee” that would be levied on large financial firms at an illustrative rate of 15 basis points against a base calculated as total consolidated assets minus Tier 1 capital and FDIC-assessed deposits. The financial reform legislation currently under consideration in the US Senate provides for the establishment of an “Orderly Liquidation Fund” having a targeted size of $50 billion, to be funded by assessments on bank holding companies with consolidated assets of $50 billion or more and certain systemically important non-bank financial institutions, and to be used by the FDIC to resolve a broader definition of covered financial companies.
Financial Activities Tax

The second proposal is the imposition on financial institutions (as defined above) of the Financial Activities Tax (“FAT”). FAT would be imposed on the sum of a financial institution’s income and remuneration paid, with proceeds going to the government’s general fund. The Report does not specifically propose whether FAT should apply to all income and remuneration, or instead only to income and remuneration that exceeds an established threshold. If, in fact, FAT applies to all income and remuneration, the Report sees it as a surrogate for VAT which does not typically apply to financial transactions. The Report comments that the absence of VAT on financial transactions may have led to excessive growth in the financial sector. This part of the Report notes the existence in some countries of taxes on certain financial transactions (e.g., the UK Insurance Premium Tax) which are not dissimilar to VAT, and the need to reconcile such existing taxes with FAT. Questions also arise regarding the operation of FAT in a cross-border context and the impact of double taxation treaties.

Significantly, the Report rejects imposing a tax on the gross amount of financial transactions, or a “stamp tax”, because such a tax “does not appear well suited to the specific purposes set out in the mandate from G-20 leaders”. Instead, the FAT would, in effect, tax the net amount of financial transactions.

Resolution Agencies

In connection with the funds raised by the FSC and FAT, the Report proposes the establishment of resolution agencies that would use such funds promptly to address “weak” financial institutions. The resolution agency would intervene upon a determination that a financial institution is “insolvent or unlikely to be able to continue as a going concern.” Upon intervention, the resolution agency would take a failing financial institution into “official administration” and would exercise “all rights pertaining to the board of directors and shareholders (including by replacing managers, recognizing losses in equity accounts, and, as necessary, exposing unsecured creditors to loss).” The goal of the resolution regime, according to the Report, is to allow the failing financial institution to continue operating in order to limit disruption and value destruction, in a way which general insolvency regimes may be unable to facilitate.

Additional Proposals

The Report also proposes reducing the tax bias in favor of debt financing over equity investments. This bias is largely the product of the allowance of a deduction to a borrower in respect of interest payments, combined with the unavailability of an analogous deduction to the recipient of an equity investment. A further bias stems from the fact that equity investors are typically exposed to dividend-withholding tax, whereas lenders often benefit from exemptions from interest-withholding tax. The Report suggests that any of a range of reforms might properly be used to reduce the deductibility bias, and specifically suggests providing a tax deduction for a notional return on equity (and possibly limiting the deduction in

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2 See Section 163 of the Internal Revenue Code.
respect of interest paid) as one possible plan of reform. The Report does not address the different withholding-tax treatment of debt and equity.

Finally, the Report proposes addressing more firmly aggressive tax planning in the financial sector, and suggests building on the cooperation established in relation to tax havens. This proposal should be placed in the context of developments already taking place, for example, the US codification of the economic substance doctrine and ongoing changes to the UK tax shelter disclosure regime, coupled with the non-statutory UK Code of Conduct for banks.

Future Final Report
The Report, which is itself an interim report, provides that the IMF will prepare a final report to coincide with the G-20 leaders’ summit to be held in June, 2010, which will reflect comments from Ministers of the G-20.
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