

Chapter 9

THE TAX TREATMENT OF BANK LOAN LOSSES

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^{*} I would like to thank Claudia Dziobek, Patrick Honohan, and Victoria Summers for helpful comments on an earlier draft.

The tax treatment of bank loan losses has been a contentious issue in a number of developing and transition countries. Banks and bank regulators generally want the tax rules for recognizing loan losses to conform closely to regulatory accounting in order to encourage banks not to under-provision for loan losses and to ensure a current tax benefit from loss provisioning. Tax officials often are wary of regulatory accounting, and fear that accepting it for tax purposes will significantly reduce income taxes paid by banks.

The treatment of loan losses is the central tax policy issue relating to the taxation of banks, given the importance of loans in bank assets and the cost of bad debts. In the United States, for example, loans and leases represented 60 percent of bank assets in 2000, and loan loss provisioning represented 21 percent of net income before taxes and provisioning (Bassett and Zakrajšek). In many developing and transition economies, loan losses are an even larger share of net income before taxes and loss provisioning.

This paper addresses primarily *when* and *how* loan losses should be recognized as an allowable expense for tax purposes. To address these issues, financial and regulatory accounting of loan losses first must be considered.

Financial and Regulatory Accounting for Loan Losses

Loan losses are an inevitable cost that banks incur in order to earn income, and these losses should be recognized as an expense for both financial and tax purposes.¹ For financial accounting, loans are recorded at their face value until they become fully worthless and are written off. However, a provision or reserve account is established for potential losses *present* in the portfolio of loans. On a bank's financial statement, the value of loans are often shown on a net basis (that is, the face value of the loans corrected by the estimated loss). In particular, International Accounting Standard IAS 30 provides that:

The amount of losses which have been specifically identified is recognized as an expense and deducted from the carrying amount of the appropriate category of loans and advances as a provision for losses on loans and advances. The amount of potential losses not specifically identified but which experience indicates are present in the portfolio of loans and advances is also recognized as an expense and deducted from the total carrying amount of loans and advances as a provision for losses on loans and advances.

Thus, IAS 30 recognizes both *specific* and *general* reserves.² Specific reserves are linked to specific loans and amount of reserve required usually depends on the length of time that

¹ That bank loan losses should be recognized as an expense for both financial and tax purposes is not controversial, at least under Western market-oriented accounting. However, under Soviet-style accounting, banks were not allowed to claim a tax deduction for loan losses. Soviet-style financial and tax accounting and whether or not loan losses should be allowed as an expense are discussed further in the Appendix I.

² In this paper the terms "reserves" and "provisions" will be used interchangeably.

payments of interest and principal have been past due, the value of any pledged collateral, and the financial soundness of the borrower. The general reserve is not linked to specific loans but reflects losses that experience indicates are *present* in the portfolio of loans but not yet specifically identified. Any amounts set aside for *future* losses should be accounted for as appropriations of retained earnings; that is, not recognized as a current expense.³

Regulatory accounting for bank loan losses is very similar to financial accounting required by IAS 30.⁴

The Basel Committee on Banking Supervision has outlined sound practices for loan accounting and disclosure (Basel Committee, 1999). In particular,

A bank should identify and recognize impairment in a loan or a collectively assessed group of loans when it is probable that the bank will not be able to collect, or there is no longer reasonable assurance that the bank will collect, all amounts due according to the contractual terms of the loan agreement. The impairment should be recognized by reducing the carrying amount of the loan(s) through an allowance or charge-off and charging the income statement in the period in which the impairment occurs.

A bank should measure an impaired loan at its estimated recoverable amount.

The aggregate amount of specific and general allowances should be adequate to absorb estimated credit losses associated with the loan portfolio.

Like IAS 30, the Basel Committee recognizes both specific and general reserves. The general reserve is to cover *latent* losses, which are not yet identified, but which are known to exist. The general reserve is not supposed to cover future losses.⁵

The assessment of both specific and general reserves “should be performed in a systematic way, in a consistent manner over time, in conformity with objective criteria and be supported by adequate documentation” (Basel Committee, 1999). That said, the setting of the appropriate level of allowances “necessarily includes a degree of subjectivity” (Basel Committee, 1999).

³ Reserves of an insurance company recognize current and future expenditures that are necessary to settle present obligations. According to IAS 37, where the effect of the time value of money is material, insurance reserves (or provisions) should be discounted using a pre-tax discount rate. Appendix II elaborates on insurance reserves.

⁴ By excluding the word “future” the 1991 amendments to the Basel Accord aligned regulatory accounting with financial accounting. See, Beattie, 1995, p. 20.

⁵ The definition of specific and general provisions and their uses vary across countries (World Bank, 2002).

The additions to specific and general reserves both reduce reported profits. However, they are often accounted for differently on the balance sheet. In Slovenia, for example, the required provision for impaired loans is accounted for on the active side of the balance sheet as an adjustment for doubtful accounts; the provision for performing loans is accounted for on the passive side of the balance sheet as part of “Other long-term liabilities.” Moreover, general reserves for performing loans are often counted as part of bank capital, generally tier II capital (discussed further below), as these reserves are not “pledged” to cover specific loans that are already impaired.

The bank regulatory agency in many countries specifies a scheme for classifying loans and setting minimum reserves. The guidelines for the various loan categories—for example, special mention, substandard, doubtful—are often set in terms of past due payments. More forward-looking criteria to reflect expected probability of default (e.g., the credit worthiness of the borrower) are still uncommon (World Bank, 2002).

For example, in broad outline, Turkey requires specific provision of:

- 20 percent of loans with limited potential to recover or 90 days in arrears
- 50 percent of loans unlikely to be recovered or 180 days in arrears
- 100 percent of loans deemed irrecoverable or with arrears over one year.

These required provisions are reduced to the extent that doubtful or bad debts are covered by guarantees or collateral. The amount of this reduction varies according to the quality of the guarantee or collateral.

In addition, there must be a general provision of 0.5 percent of cash loans and 0.1 percent of contingent liabilities.

The Central Bank of the Philippines requires specific reserves ranging from 5 to 100 percent:

- 5 percent for “loans especially mentioned” (loans that have potential weakness—past due for 30 to 90 days)
- 25 percent for “substandard loans that are unsecured” (loans that involve a substantial and unreasonable degree of risk to the institution because of unfavorable record or unsatisfactory characteristics—past due more than 90 days)
- 50 percent for “doubtful loans” (loans that have the weakness inherent in substandard loans, with the added characteristics that the existing facts, conditions, and values make collection or liquidation in full highly improbable and in which substantial loss is probable)

- 100 percent for “loss” loans (loans considered uncollectible and worthless, and that are past due for a period of at least six months).

In addition to the specific reserve, the Central Bank of Philippines requires a general reserve equal to 2 percent of a bank’s unclassified loan portfolio.

The rationale for reserve accounting is straightforward. In a portfolio of loans, certain loans are non-performing⁶ or otherwise impaired. Some of these loans will ultimately be uncollectible. If, based on past experience, 25 percent of the loans past due for 6 to 12 months are likely to be uncollectible, a reserve should be established for loan losses equal to 25 percent of the amount of these loans. These losses are already present in the portfolio of loans past due for 6 to 12 months and should be recognized as an expense this period even though it is not possible at this time to identify just which loans will ultimately be worthless.

The reserve for loan losses is not for *future* losses (i.e., losses not yet present or latent in the portfolio of loans).⁷ While banks and other companies need to maintain sufficient equity capital to cover unanticipated future losses, additions to the company’s equity should not be treated as a current expense (for either financial or tax purposes).⁸

Under a normal reserve method, regardless of how the actual reserve is calculated, any recoveries for loan losses are credited to the reserve, and any loans charged off the books are debited to the reserve. The expense item for loan losses for any year is equal to the amount necessary to bring the reserve up the end-of-year level, after the beginning-of-year reserve has been adjusted for recoveries and charge-offs. The expense item is computed as follows:

	Reserve at end of year ⁹
Less:	Reserve at beginning of year ¹⁰
Plus:	Loans written off
Less:	Actual recoveries for loan losses previously written off
Equals:	Expense item for loan losses

⁶ The term “non-performing loans” most commonly refers to loans on which the payments are past due by 90 days or more, but practices vary across countries. Non-performing loans are usually subject to a specific reserve. Loans that are past due for only a short period of time are not considered to be non-performing (Cortavarria, 2000).

⁷ It may well be that next year the oil sector will go sour and bank loans to the oil sector will become impaired. These losses are a future expense and they should be recognized in future periods.

⁸ Capital adequacy standards for banks is discussed briefly below.

⁹ Based on the classification of loans at the end of the current year.

¹⁰ Based on the classification of loans at the end of the prior year.

Determining the expense for loan losses based on a reserve method appears to provide a double deduction for losses. Each loss, however, reduces profits only once. There is no double deduction because the actual charge-off is debited against the reserve,¹¹ and once a loan is charged off, there would be no end-of-year reserve with respect to that loan.¹² The end-of-year reserve relates only to loans outstanding on the bank's books at the end of the year.

There is a closely related issue to the treatment of loan losses and that is the treatment of unpaid interest. Most banks, at least large banks, are on the accrual method of accounting¹³ and thus accrue interest income on loans as the claim arises and not when the income is received. The Basel Committee recommends that a bank should cease accruing interest when a loan is identified as being impaired. For countries that use a loan classification scheme, a loan would be considered impaired when a specific reserve is required for the loan. In addition, when interest ceases to accrue on a loan, uncollected interest that had been previously accrued should be reversed. This treatment of unpaid interest seems reasonable, as the bank's claim on unpaid interest may be of lower quality than the bank's claim on the principal amount of the loan.

Banks like other businesses need to maintain sufficient capital to provide a cushion to cover large, unanticipated future losses. To ensure this, the bank regulatory authority in each country requires banks to meet capital adequacy standards. Under the Basle Accord,¹⁴ tier I capital (basic equity) must be at least 4 percent of risk-weighted assets and tier I and tier II capital (undisclosed reserves, revaluation reserves, subordinated debt, and general loan loss provisions) must be at least 8 percent of risk-weighted assets. The general loan loss provision, however, cannot be greater than 1.25 percent of risk-weighted assets. This, in part, ensures that the regulatory authority does not set a high mandatory general provision to offset the tendency of certain banks to under-provision non-performing loans.

¹¹ In some countries, worthless loans are charged directly against income (and not debited against the reserve). When this approach is followed, the necessary addition to the reserve to bring the reserve up to the end-of-year balance would be correspondingly reduced.

¹² If 75 percent of the loan had been reserved at the end of the prior year, then charging the loan against the reserve, will give a tax deduction in the current year for 25 percent of the loan. The tax deduction would be equal to reserve at the end the year minus the reserve at the beginning of the year plus the bad debt written off ($0 - 75 + 100$).

¹³ Under the International Accounting Standards (IAS), the accrual method is a fundamental accounting policy. Transactions and events are recognized when they occur and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Expenses are recognized in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income (matching). Under the accrual method, the timing of the actual payment or transfer of consideration is not relevant.

¹⁴ Basel Accord, 1988.

To the extent that the prudential rules for loan loss provisioning and the capital adequacy standards require banks to maintain more equity capital than is truly needed, the capital cost of the bank is increased and non-bank financial institutions may have a competitive advantage.¹⁵ For example, insurance companies may guarantee bank loans. This may reduce the bank's need for specific reserves as the guarantee will reduce the reserve required for non-performing loans (see the Turkey prudential rules described above). In addition, the insurance companies may not have to meet as stringent capital requirements giving them a lower cost of capital than banks. Though beyond the scope of this paper, this all suggests that when prudential rules for loan loss provisioning and capital adequacy standards are too conservative, banks can be put at a competitive disadvantage.

The Tax Treatment of Loan Losses—an Introduction

The tax treatment of loan losses varies widely across countries.¹⁶ Some countries (United States for large banks—more than \$500 million in assets,¹⁷ Australia, Korea, Malaysia, and Philippines) only allow the *charge-off method*, under which loan losses are recognized only when loans become worthless. In determining whether a loan is worthless, all pertinent evidence, including continual non-performance, adequacy of collateral and the financial condition of the debtor should be considered. Under the charge-off method, if an amount previously charged off as uncollectible is later recovered or the loan again becomes performing, the amount previously written off is restored to income.

In the Philippines, loan losses are allowed only for worthless and uncollectible loans that have been charged off the books of account of a bank as of the end of the taxable year. The tax authority allows a debt to be written off for tax purposes once it has been written off by the bank with the approval of the Central Bank of Philippines. Some countries (Japan and Thailand) set limits on the tax deduction for loan losses. In Thailand, banks can deduct loan loss provisions from taxable income up to 25 percent of net income or 0.25 percent of total outstanding loans, whichever is less. Loan losses may be written off for tax purposes only when civil action has been brought against the debtor, the debtor has declared bankruptcy or died.

Many countries allow a *reserve method* (that is, provisioning) for accounting for loan losses for tax purposes in addition to requiring it for regulatory purposes. However, only a few

¹⁵ Also, differences in loan loss provisioning and the capital adequacy standards across countries will impact the competitiveness of banks (Beattie, 1995).

¹⁶ For an international comparison of the tax treatment of loan losses in developed countries, See Escolano, 1997, pp. 167-76; and Beattie, 1995, pp. 148-51 and 156-59.

¹⁷ Although the United States requires large banks to use the charge-off method, it allows banks a partial write-off of debts, mitigating the harsh effects of the charge-off method (Dziobek, 1996).

countries attain full conformity between financial and tax accounting for loan losses. Many countries (e.g., United Kingdom, France, Canada, Kazakhstan) grant tax deductibility to specific allowances or charge-offs in the year they occur, but not for general allowances. Serbia allows a tax deduction only for the specific allowance but gives the allowance a “haircut.” Under the new Serbian income tax, banks are allowed a tax deduction equal to 90 percent of the addition to the loan loss provision required by the National Bank for non-performing loans. The Russian Tax Code establishes its own reserve rules (related to the rules of the National Bank). A reserve is allowed for loans past due only 45 days, and the total reserve cannot exceed 10 percent of the gross receipts of the tax year. In the Kyrgyz Republic, banks may establish a reserve based on the experience of the leading banks of the world. The reserve shall not exceed 10 percent of the loans outstanding. A few countries allow general provisioning for tax purposes (e.g., based on a percentage of eligible loans), but limits are usually placed on the general provision. Germany requires that the general provision for tax purposes not exceed 60 percent of average loan losses over the past five years. Singapore limits the general provision to 3 percent of the amount of qualifying loans (World Bank, 2002).

Given this wide diversity in tax treatment, there clearly is no generally accepted international standard as to the appropriate tax treatment of loan losses. In determining the tax treatment of loan losses, a country should consider whether: (1) the charge-off or the reserve method best measures the income of the bank; (2) there should be full or partial conformity between the regulatory and tax treatment of loan losses; (3) a tax deduction should be allowed for general reserves. If the tax law is changed, for example, to allow a reserve method, how should the transition be treated for tax purposes?

Charge-off vs. Reserve Methods

Both the charge-off and reserve methods recognize that bad debts are costs of earning income, and thus their cost should be a deductible expense for financial and tax purposes. In general, the reserve method accelerates the recognition of the expense compared to the charge-off method. The fundamental question, however, is which method results in a better matching of income and expenses. This is an empirical question.

A test of whether a method for recognizing bad debts results in a proper matching of income and expense is to determine whether it results in the effective tax rate on a portfolio of loans being equal to the nominal tax rate. If the effective tax rate, measured as the percentage reduction in the rate of return due to taxes, is less than the nominal tax rate, the recognition of the losses is too accelerated. If the reserve is true, the recognition of the losses is too delayed.¹⁸

¹⁸ Calculation of effective tax rates on theoretical portfolios of loans buttressed the case for the United States switching from the reserve method to the charge-off method (Joint Committee on Taxation, 1986).

Consider first the following simple example. A bank makes 1,000 loans for \$1,000 each at the end of year 0 (Table 1). Each year 2 percent of the loans default. If the interest rate on these loans is 12.2449 percent, the interest income will cover the 2 percent loss and provide a 10 percent before-tax return.¹⁹ If each year's loss—the principal amount of the loans that defaulted during the year—is allowed as an immediate tax deduction and the nominal tax rate is 30 percent, the after-tax rate of return is 7 percent. Thus the after-tax rate of return is 30 percent lower than the before-tax rate of return, implying an effective tax rate of 30 percent, which is equal to the 30 percent nominal tax rate.

In this example, the true economic loss²⁰ in value of the loan portfolio would be permitted as a tax-deductible expense each period. This is the necessary and sufficient condition to ensure that the effective and nominal tax rates are equal (Samuelson, 1964).

The key assumption is that the loans default at a constant percentage rate per year (declining balance assumption).²¹ Suppose, instead, that all loans remain fully performing until the end of the fifth year (Table 2). At that time 9.6 percent of the loans default, which is just equal to the cumulative amount of defaults in the first example. If the bad debts were deductible for tax purposes instantaneously at the end of year 5, the effective tax rate would be 31.4 percent. For the effective tax rate to equal the nominal tax rate, a reserve for future losses would have had to been established in the earlier years, even though no loans are past due. The annual addition to this reserve would need to be just equal the decline in the value of the loan portfolio, and this addition would need to be deductible for tax purposes. Over the

¹⁹ $(100)(1 - .02)(.122449) - 2 = (100)(.10)$.

²⁰ The economic loss in the value of the portfolio would be measured by comparing the present value of the future before-tax cash flows, discounted at 10 percent, at the end of year, compared to the value of the end of the prior year.

²¹ Another key assumption is that the loan loss is charged off immediately. This assumption is discussed further below.

Table 1. Income and Cash Flow from Loan Portfolio 1/

Year	Principal	Interest	Before-tax Cash Flow	Present Value (r = .10)	Taxable Income	Tax (30 %)	After-tax Cash Flow	Present Value (r = .07)
0	1,000,000		-1,000,000	-1,000,000			-1,000,000	-1,000,000
1	980,000	120,000	120,000	109,091	100,000	30,000	90,000	84,112
2	960,400	117,600	117,600	97,190	98,000	29,400	88,200	77,037
3	941,192	115,248	115,248	86,588	96,040	28,812	86,436	70,558
4	922,368	112,943	112,943	77,142	94,119	28,236	84,707	64,623
5	903,921	110,684	1,014,605	629,990	92,237	27,671	986,934	703,670
Total				0				0

1/ At the end of year 0, the bank makes \$1,000,000 of 5-year loans. At the end of each year, 2 percent of the loans default. The interest rate is 12.2449 percent per annum on the outstanding principal amount at the end of each year. The portfolio yields a 10 percent before-tax rate of return (column 5). Taxable income is equal to interest income for the year less the amount of loans that defaulted during the year. The after-tax rate of return is 7 percent (last column). The effective tax rate is 30 percent.

Table 2. Income and Cash Flow from Loan Portfolio 1/

Year	Principal	Interest	Before-tax Cash Flow	Present Value (r = .104958)	Taxable Income	Tax (30 %)	After-tax Cash Flow	Present Value (r = .072034)
0	1,000,000		-1,000,000	-1,000,000			-1,000,000	-1,000,000
1	1,000,000	122,449	122,449	110,818	122,449	36,735	85,714	79,955
2	1,000,000	122,449	122,449	100,291	122,449	36,735	85,714	74,582
3	1,000,000	122,449	122,449	90,765	122,449	36,735	85,714	69,571
4	1,000,000	122,449	122,449	82,143	122,449	36,735	85,714	64,896
5	903,921	110,684	1,014,605	615,982	26,270	7,881	1,006,724	710,997
Total				0				0

1/ At the end of year 0, the bank makes \$1,000,000 of 5-year loans. At the end of year 5, 9.6 percent of the loans default. The interest rate is 12.2449 percent per annum on the outstanding principal amount at the end of each year. The portfolio yields a 10.4958 percent before-tax rate of return (column 5). Taxable income is equal to interest income for the year less the amount of loans that defaulted during the year. The after-tax rate of return is 7.2034 percent (column 9). The effective tax rate is 31.4 percent.

five-year period, the portfolio would decline in value from \$1,000,000 to \$903,921 and the end of the five-year period approaches. Put another way, the value of the portfolio at the beginning of year 5 would not be \$1,000,000 even though no loans have defaulted as yet.

In contrast to the assumption that loans only go bad in the final year, a bank could originate loans at the end of year 0 and certain loans would instantaneously go bad.²² All the other loans would remain performing for five years when the principal amount would be paid in full. Both the charge-off method and the reserve method, by permitting the loan losses to be written off in year 1, would provide too generous tax treatment of the bad debts in that the resulting effective tax rate would be less than the nominal tax rate. The loan losses in year 1 are a cost of earning income not only in year 1 but also over the life of the portfolio. Thus these losses should be spread over the five-year period and not deducted solely in the first year.

These examples are admittedly artificial, but they allow one to determine the effective tax rate on a portfolio of loans, given the pattern of loan losses. One conclusion from these examples is that if the loans were expected to go bad at a constant rate per year, the charge-off method would, in theory, produce the appropriate matching of income and expenses. There is an important proviso, however. These examples assume that all past due loans are ultimately worthless and there is no recognition lag between when past due payments occur and when the charge-off is allowed. The reserve method, by accelerating the tax deduction compared to the charge-off method may provide a reasonable solution for the recognition lag and take into account that all past due loans do not become worthless.

If banks are required to go to court or await the bankruptcy or death of the debtor before writing off debts that clearly are not recoverable, then the charge-off method is overly restrictive. Depending on the bankruptcy laws and court practices, the charge-off delays in some countries could be indefinitely. At the minimum, bad debts should be charged off for tax purposes in the year they are classified as worthless for regulatory purposes.

The Case for Conformity

A major advantage of having a high degree of conformity between loan loss provisioning for financial and tax purposes is that the tax authority would not have to assess the reasonableness of the provision. Instead, the tax authority could rely on the bank regulatory authority to “audit” the loan loss provision. This would provide banks with greater certainty by reducing disputes between the banks and the tax authority. However, a high degree of conformity does not necessarily require full conformity. Administrative simplification would

²² By analogy, when oil companies drill dry holes in seeking oil reserves, the cost of these unsuccessful wells could be viewed as capital costs incurred in order to find producing wells. The costs of the dry holes would be capitalized and written off over the life of the producing wells. Most countries, however, permit dry holes to be expensed for tax purposes.

still be obtained if only specific provisions are deductible for tax purposes or if the specific provision is given a “haircut,” as in Serbia.

Conformity between financial and tax accounting for loan losses also would ensure that the tax system does not provide a disincentive for banks to adequately provide for loan losses.²³ Each dollar added to the reserve for financial or regulatory purposes would reduce taxable profits by a dollar and provide a current tax benefit, so long as the bank has positive taxable income. Once a bank is in a tax loss position, additional tax deductions from additional reserving only increase the loss carry forward, and this may provide no tax benefit if the bank ultimately fails.

The tax treatment of loan loss provisioning also affects capital adequacy ratios. If a bank sets a specific provision of 100, tier I capital and profits are reduced by 100 absent taxation. As a result, stockholders’ equity is also reduced by 100. However, if the provision is deductible for tax purposes, after-tax profits, stockholders’ equity, and tier I capital are all reduced by $(1-t)100$, where t is the corporate tax rate. Thus a tax deduction for the loan loss provision cushions the effect of the provision on the amount of the bank’s tier I capital. All other things equal, this should reduce the disincentive for banks, constrained by the need to meet capital adequacy ratios, to adequately provide for loan losses.

If there is no current tax deduction for the loan loss provision (e.g., the country is on the charge-off method for tax purposes), the effect on tier I capital may still be cushioned if a deferred tax asset²⁴ is recognized for financial accounting, and this asset is counted toward tier I capital. Admittedly, this asset is a non-earning asset, and therefore not as valuable as an asset that can generate income.

²³ This may be particularly important in times of fiscal stress when banks have high rates of non-performing loans and defaults. It is somewhat ironic that during periods of fiscal stress, countries, mainly in Latin America, have often adopted bank debit taxes, which tend to encourage disintermediation (Coelho, Ebrill, and Summers, 2001).

²⁴ Some countries (e.g., the United States) determine the income tax expense for financial accounting purposes based on the reported profits for financial purposes adjusted for permanent differences between financial and taxable income (e.g., tax credits and exempt income). If financial income is greater than taxable income due to timing differences, the tax on this income, which is not currently payable, is considered a deferred tax asset on the balance sheet. Thus, even though the provision does not result in a current tax benefit, after-tax financial profits and stockholders’ equity are reduced by only $(1-t)$ times the amount of the provision. To illustrate, if financial profits are \$100 and tax rate is 20 percent, the tax expense for financial purposes would be \$20. If taxable income is \$150 due to greater provisioning allowed for financial purposes than for tax purposes, the \$10 tax liability payable now on the \$50 difference would be treated for financial purposes as a deferred tax credit. Thus the additional provision of \$50, not recognized for tax purposes, reduces the net worth of the firm by only \$40, as the \$10 future tax savings generated by the provisioning is considered an asset on the balance sheet.

The Case Against Full Conformity

Financial vs. tax accounting

Both financial and tax accounting are based upon the premise of measuring income, but their goals are somewhat different. Financial accounting, particularly prudential rules, are based on conservatism, that is, to delay recognition of income as long as possible and to anticipate expenses and losses as soon as possible. Notwithstanding the bankruptcy of Enron, such a system is designed to ensure that the profits and the net worth of the company are not overstated.

The objective of tax accounting is the opposite, that is, to ensure that income is not understated. Therefore, income is taxed as soon as it belongs to the taxpayer. Thus, it would be normal to tax prepayments of rent as soon as received, regardless of the fact that they relate to a period beyond the tax year. Similarly, tax accounting defers deductions until it is clear that the liability will actually be incurred. Various reserves allowed for financial accounting generally are not allowed for tax accounting.²⁵

General reserves

From the tax accounting point of view, the general reserve for loan losses looks quite suspect. Although the general reserve is for “present” or “latent” losses, it is, by its nature, “speculative,” and involves a great deal of judgement by bank managers (World Bank, 2002). The fact that the general reserve is often included as part of tier II capital suggests that this reserve may be for future losses. At the very least, it is for current losses that have not yet been identified. Consistent with tax accounting, generally, a liability should not be recognized for tax purposes until it is certain (i.e., it can be identified) and can be reasonably estimated. Moreover, recognizing general provisions for tax purposes can be very expensive in terms of foregone tax revenue, as many banks would have general provisions that are larger than their specific provisions.²⁶ It is not surprising, therefore, that tax authorities are wary of allowing banks to deduct general reserves for unidentified, but arguably “present” losses.

²⁵ The two exceptions would be loan loss provisions for banks—the focus of this paper—and the required reserves of insurance companies. In both cases, the tax authority can rely on the regulatory authority for banks and insurance companies to determine the reasonableness of the reserve.

²⁶ For example, if a bank had classified loans equal to 3 percent of total loans and had set specific reserves averaging 40 percent of the classified loans, the specific provision would be only 1.2 percent of total loans—less than a general provision of 1.25 percent applying to the other 97 percent of loans.

Specific reserves

There is also a suspicion, at least among tax officials, that the specific reserves are set on the high side to be conservative, to protect the capital of the banks, and to reduce overly risky behavior.²⁷ If the bank regulator fears that banks may not properly classify loans, the required provisions for each category may be set at a higher rate in order to partially offset the tendency to misclassify loans. Moreover, required reserves for regulatory purposes are minimums, as the bank regulatory authority wants to make certain that banks do not understate their losses.²⁸ The tax authority, however, wants to ensure that banks do not overstate reserves. Instead of being minimums, the regulatory reserves should be maximums, if allowed for tax purposes.

To counteract the bias that regulatory reserves are too conservative, it may be appropriate to reduce the provision level for tax purposes—say to 80 or 90 percent of the regulatory rate. If the loans actually do go bad, they will ultimately be completely written off—this is therefore a timing issue.

Tax treatment of borrowers vs. bank lenders

From the tax policy perspective there is an additional concern regarding a reserve method for accounting for loan losses; namely, the asymmetric treatment of banks and their business borrowers. In general, when interest is an expense of the borrower, it is at the same time income of the lender, just as when a business pays wages and deducts the expense, the worker is taxable on the wage income. Similarly, when a bank has a loan loss, the borrower has income—forgiveness-of-indebtedness income. However, this income is recognized only when the debt is forgiven; that is, written off. If a bank recognizes the loan loss through provisioning, it may be able to claim the loss in an earlier tax year than when the borrower must recognize income. This timing difference between the expense of the bank and the income of the borrower works to the disadvantage of the fisc. This is probably more of a theoretical problem than a real one, however. When borrowers are unable to make the debt payments, they likely are in economic difficulty and have tax losses. In this situation, it may not matter in which year the forgiveness-of-indebtedness income is recognized for tax purposes, as no tax liability will accrue in any event.

²⁷ Even if this is so, bank managers (with the concurrence of regulators) may under provide for reserves at times of distress, whether or not additions to reserves are tax deductible. Tax policy probably cannot correct this.

²⁸ The regulatory authority is also concerned that banks do not have “hidden reserves” in order to smooth income. Any reserve for future losses should be accounted for as an allocation of retained earnings; that is, below the line.

Transition Rules

If a country is going to switch from the charge-off to the reserve method, one needs to be concerned about how the transition is handled. Suppose, for example, the effective date of the switch is January 1, 2003. Suppose further that for a particular bank the beginning of the year reserve is \$100, and the required end of year reserve is \$120. If the country had always been on the reserve method, the tax deduction for 2003 would be \$20, ignoring any write-offs and recoveries. However, the beginning of the year reserve of \$100 has never been allowed as a tax deduction. How should this \$100 be treated for tax purposes?

One possibility would be to allow an additional deduction of \$100 in 2003 on the grounds that \$100 would have been an expense in earlier years if the country had been on the reserve method. This could be quite expensive in terms of foregone tax revenues. Also, a special rule (e.g., a longer loss carryover period) may be needed to cover the situation where the one-time deduction creates a large loss carryover that likely will not be used during the carryover period.

An alternative and the preferred approach for handling the transition would be to treat the switch from the charge-off to the reserve method as a change in the method of accounting. The effect of the change—an additional deduction of \$100—would be spread over three to five years.²⁹ For countries that are very concerned about the revenue cost of switching to the reserve method, the allowable deduction could be further limited in the first year to, say, 25 percent of taxable income before the reserve deduction. This percentage would increase to 100 percent over several years. Any amount disallowed in one year as a result of this limit would be carried over to subsequent years until allowed.

Conclusions and Recommendations

There is no standard international practice as the treatment of bank loan losses for tax purposes. Some countries use the charge-off method; other countries allow provisions for loan losses along the lines of the provisions required for regulatory accounting. Only rarely do countries have full conformity between book and tax provisions for loan losses. It is much more common for countries to disallow general provisions for performing loans.

The widespread practice of underprovisioning in many developing countries, and the importance of ensuring that tax rules do not unduly discourage the establishment of needed provisions means that there is much to be said for ensuring an adequate tax deductibility for loan-loss provisions. Some conclude that all provisions should be tax deductible. But, on the

²⁹ Spreading the effect of a change in the method of accounting is quite common practice when a business switches from cash to accrual accounting or changes its method of accounting for inventories. When the United States went from a reserve method to the charge-off method for large banks, the existing reserve at the end of 1986 was brought back into income over four years.

assumption that banks are following prudent provisioning practice, the position taken in this paper is that the tax rules for loan losses should be closely tied to (but not necessarily the same as) the prudential rules for provisioning. However, no tax deduction should be allowed for a general provision for performing loans. Also, it may be appropriate to reduce the specific provisioning allowed for tax purposes to 80 or 90 percent of the regulatory rate, in order to reflect the real income of banks as accurately as possible. When countries using the charge-off method for tax purposes switch to a reserve method, this change should be treated as a change in the method of accounting and the effect of the change spread over 3 to 5 years.

Soviet-style Accounting

Whether or not loan losses should be an allowable expense was an issue under Soviet-style accounting, which was developed to provide fiscal data to the state, rather than information for shareholders, creditors, and managers. In practice, an enterprise was required to *offset* all of its expenses with revenues it earned from the sale of its products and services (Ash and Strittmatter, 1992).

There were no private banks in the Soviet economy prior to a transition period just before the break-up of the Soviet Union. All enterprise loans (or cash transfers) came from the State Bank (Gosbank), after the Ministry of Finance had approved the budget, which contained a breakdown by individual enterprise. State-owned companies did not go bankrupt, in part, because the plan for each enterprise was set to ensure that revenues (including transfers from the State Bank) offset expenses. Once private banks appeared, loans were guaranteed by the state. If a business defaulted on its loan, the guarantee would be called. Bank bad debts generally were unknown.

The income taxes first adopted by various states of the former Soviet Union reflected Soviet-style accounting—revenue offsetting allowable expenses. Thus private banks were not allowed to claim a tax deduction for loan losses, which were not considered an allowable expense. Instead, these costs were accounted for as direct charges against the bank's equity.

Western-style accounting for the earnings of an enterprise is premised on a *matching* of expenses to the revenues to which they relate. With respect to the accounting treatment of bad debts, it is recognized that when a bank originates a portfolio of loans, it is not known which loans in the portfolio will default, but some inevitably will. A loan loss is considered a cost that a bank incurs in order to earn income on performing loans. Loan losses therefore should be a deductible expense.

The various states of the former Soviet Union have all adopted income tax laws that now recognize bad debts as costs of earning income. For these countries, the major policy issue—and the primary focus of this paper—is when and how the cost of loan losses should be recognized for tax purposes.

Insurance Reserves and Investment Income

The financial and tax treatment of insurance companies has also been a contentious issue in a number of developing and transition countries. If the regular corporate income tax is going to apply, there are two major policy issues that need to be addressed: (i) the appropriate reserves to allow for tax purposes and (ii) the allocation of investment income.³⁰

Insurance companies operating in a country are usually subject to regulation by an insurance authority that requires the maintenance of reserves against the contingent liabilities that are insured. These contingent liabilities may require expenditures to be made in the current year or in future years. In determining the appropriate reserve, the regulatory authority should require discounting of expected future expenditures, using a pre-tax discount rate, in order to reflect the time value of money.

The reserves appear to be an ordinary and necessary cost of doing insurance business, and additions to these required reserves are commonly allowed as deductions in determining taxable income. These reserves involve quite complex actuarial computations (which cannot be effectively audited by the tax authority in most countries), and they may exaggerate the contingent liabilities (e.g., assuming high mortality or accident rates or low discount rates), reflecting the concern of the insurance regulators to give policyholders confidence in the company's solvency.

If the reserves are too conservative, then allowing a tax deduction for the full amount of the addition to reserves results in an understatement of the company's income. One possible counteraction would be to give the reserves required for regulatory purposes a "haircut" before allowing them as a deductible expense for tax purposes.

In developing and transition countries, insurance policies are often written by international companies. The accumulated reserves may be invested offshore as the domestic capital market is quite limited. The associated investment income, however, would normally be foreign source income and thus not taxable in the country in which the policies are written. This mismatching of income and expenses can lead to insurance companies reporting little or no taxable income in the country where the policies are written. A possible counteraction

³⁰ There are also important issues related to how policyholders and beneficiaries should be treated. Generally, businesses should deduct premiums accrued or paid to insure business risks. Any benefits paid under the insurance policies to businesses would be included in taxable income. If the benefits are paid to employees or other persons, they generally are not taxable. However, if the benefit payment replaces income which otherwise would have been taxed (e.g., lost earnings), the benefit probably should be taxable. In the case of life insurance provided by an employer, it would be unseemly to tax life insurance proceeds but it would be appropriate to tax employees on the value of company provided insurance. In the United States, for example, employees are required to include in income the cost of company provided group life insurance in excess of \$50,000 of such insurance.

would be to require that the investment income of an insurance company operating across international borders be allocated based upon liabilities insured in each country.

Because of the complexity of determining income of an insurance company and the appropriateness of its reserves, some authorities recommend a gross premium tax in lieu of imposing the regular income tax on insurance companies (Hussey and Lubick, 1996). Non-insurance activities (e.g., financial leasing) would be treated as conducted in a separate entity subject to the regular corporate income tax.

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