APPENDIX

TAX RELIEF ON BANKS' DOUBTFUL SOVEREIGN DEBT: RECENT U.K. MEASURES AND A POSSIBLE CANADIAN INITIATIVE

Proposal by the North–South Institute

1. In March 1990 the U.K. Chancellor of the Exchequer brought down a budget which gives U.K. banks tax incentives to sell back debt at a discount to their sovereign borrowers rather than to third parties. The mechanism is intended to encourage banks to reach debt reduction agreements with debtor countries since tax relief will be available earlier under such arrangements than if debt is sold to a third party or held on the banks' books with provisions.

2. Under the U.K. arrangements, in 1990 tax relief on provisions against doubtful sovereign debt will be limited to amounts allowable for 1989 (roughly 50 percent). In 1991 and subsequent years, total tax relief will be increased by an additional 5 percent of the debt per annum, until it is equal either to the total provisions against doubtful debt (as allowable under the Bank of England matrix), or to losses incurred through sales of debt to third parties (where losses for tax purposes equal the difference between the discount on the sale and the provision for which tax relief has already been claimed). Sales of debt to the borrower are exempted from these "phasing" arrangements. U.K. banks incurring losses through sales to their borrowers will thus obtain tax relief immediately, although the total amount of relief will eventually be the same regardless whether the loan is held or sold to a third party.

3. Under present Canadian regulations, the maximum allowable provision against sovereign debt for which tax relief can be claimed is 45 percent of gross exposure. However, in the last half of 1989 most of the major Canadian banks increased their provision to well over this level. If given, tax relief on the $3.3 billion in addditional provisions taken during 1989 could cost the Canadian treasury $1.3 billion. Unlike the new U.K. measures, Canadian banks can currently obtain tax relief if a loss (defined as the difference between the discount on the sale and provisions already claimed) is incurred through a sale to any party. Assuming the maximum allowable provision for tax purposes is kept at 45 percent, the tax system is neutral between a loss incurred through a sale to the borrower and to a third party.

4. Canada is in a position to emulate the U.K. tax measures by giving banks an incentive to engage in debt reduction for debtor countries. There are two reasons for similar measures in Canada. First, the current policy of "no discrimination" will increase tax losses to the treasury, increasing the federal deficit, more than if tax relief were restricted to