03.12.2013

Background note on the tax treatment of deferred tax assets

The new international solvency rules (CRR and CRD IV), approved in June 2013 and due to enter into force in January 2014, provide - among many other changes - that banks' deferred tax assets (DTAs) must be deducted from regulatory capital (specifically core capital, CET1) for reasons of prudence, as there is generally no guarantee that they will retain their value in the event of the institution facing difficulties.

This deduction could have a much greater impact in Spain than in other countries subject to international solvency rules, owing to the particularly restrictive nature of Spanish tax law, which is apparent in two respects.

First, in relation to the treatment applicable in the event that a firm reports a loss on its financial statements. In some countries, when a firm reports a loss, the tax authorities refund some of the taxes it has paid in previous years (subject to a time limit). In Spain, the firm must earn profits in subsequent years in order for this offset to take place.

Second, Spanish tax law does not recognise as tax-deductible certain amounts recorded as costs in the accounts, unlike the tax legislation of other EU countries. The most salient example here is the general provisions made by Spanish banks, which are not considered to be tax-deductible costs as at the time they are set aside, but only considered as such, where appropriate, when they are converted into specific provisions relating to certain exposures; in the application of the new solvency rules in Spain a paradox arises whereby higher coverages in provisions lead to bigger deductions in regulatory capital, i.e. they would lead to situations of greater solvency translating, after the deductions of DTAs, into lower capital ratios.

The amendment of the Law on Corporate Income Tax (Royal Decree Law 4/2004 of 5 March 2004) approved by Royal Decree-Law 14/2013 of 29 November 2013 will, as far as credit institutions are concerned, enable this situation to be redressed by guaranteeing the value of a portion of the DTAs, without that foreseeably entailing a significant reduction in public revenues. This is because the mechanism for safeguarding the value of these assets, which allows their non-deductibility from banks' regulatory capital, will only be activated in cases of low probability of occurrence.

In fact, DTAs will, in principle, continue to have the same treatment as before: they will be recovered in the year in which the temporary differences are reversed (accounting expenses that initially are not tax-deductible, but which may be so in the future, as is the case with general provisions), or when tax losses are deducted from future taxable income. Only if a bank were unable to reverse those temporary differences within 18 years, or if it were wound up, became insolvent or incurred accounting losses, would the DTAs be converted into a direct claim against the tax authorities (in the case of accounting losses, they would not be converted in full, but only in a proportion equal to the ratio of losses to own funds).

The change in the tax rule included in Royal Decree-Law 14/2013 does not change the restrictiveness of Spanish tax law, which will remain strict when determining whether expenses are tax-deductible; and the practice, followed in various European countries, of refunding taxes paid in previous years when a firm reports a loss, is not adopted either. Moreover, the possibility of repayment of tax assets has a limited scope, since it does not cover all tax assets but only those that have the nature of temporary differences and have arisen from provisions for loan losses or foreclosed assets, or pension expenses.