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## **Banks and Corporate Income Taxation: A Review**

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# Banks and Corporate Income Taxation: A Review

Vanessa Gawehn

## ARTICLE HISTORY

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## Abstract

In this paper, I review the empirical literature in the intersection of banks and corporate income taxation that emerged over the last two decades. To structure the included studies, I use a stakeholder approach and outline how corporate income taxation plays into the relation of banks and their four main stakeholders: bank regulators, customers, investors and tax authorities. My contribution to the literature is threefold: First, I contribute by providing, to the best of my knowledge, a first comprehensive review on this topic. Second, I point to areas for future research. Third, I deduce policy implications from the studies under review. In sum, the studies show that taxes distort banks' pricing decisions, the relative attractiveness of debt and equity financing, the decision to report on or off the balance sheet and banks' investment allocations. Empirical insights on how tax rules affect banks' decision-making are helpful for policymakers to tailor suitable and sustainable tax legislation directed at banks.

## JEL CLASSIFICATION

G21, H22, H25, M41

## KEYWORDS

Corporate income taxes, banks, stakeholder approach, decision-making process

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## 1. Introduction

In the past decade tax research connected to banks has grown tremendously. Potential reasons for this trend are a greater public interest in banks due to the most recent financial crisis (e.g., OECD (2009), OECD (2010), OECD (2011)), the increased competitive environment in banking services and the call of Hanlon and Heitzman (2010) to deepen understanding of how taxes influence financial institutions.

In addition to Hanlon and Heitzman (2010), other reviews on tax research (Shackelford & Shevlin, 2001, Graham, Raedy, & Shackelford, 2012, Dharmapala, 2014, Wilde & Wilson, 2018) have emerged that, with one exception (Shackelford and Shevlin (2001)), do not explicitly systematize their results and advances in the context of banks and taxation. Hence, a general overview of what is already known in this area is lacking rendering it difficult for researchers new to and interested in this field to identify sensible contributions.

Studying how banks react to taxation is, to date, still relevant for several reasons. First, banks are an important pillar of a country's economy. They provide loans to enterprises and customers, take deposits and are able to hedge risks. A distortion would thus have negative feedback effects. Understanding how, e.g., banks set interest rates in response to taxation is therefore crucial. Second, the recent period of low interest rates makes it difficult for banks to earn profits in the classic areas of banking as lending and saving. Additional pressure stems from customers' increased use of online banking services putting classic counter services and associated jobs at risk. This development might encourage banks to reduce expenses so that they are able to report profits to stakeholders, and in particular to investors. A significant expense in this respect is a bank's tax expense, which accounting for, on average, one-fifth of pre-tax profits. Understanding how banks factor taxation into their, e.g., investment decisions, is therefore crucial for curtailing proper tax legislation and regulation. Third, banks are often in the media as a mediator for clients engaging in tax evasion or, in a milder form, establishing schemes to avoid taxes.<sup>1</sup> Banks are in an advantageous position as they possess much proprietary data for their clients, both individuals and corporations. Hence, they are able to advise customers more efficiently. For that matter, it is interesting to know whether banks generally prefer a high or low level of tax avoidance in their customers and whether they try to promote tax avoidance among them.

Although Hanlon and Heitzman (2010) ask for more insights into taxation and financial institutions, I focus on banks as they comprise the largest group of financial institutions, and they, rather than other financial institutions, are commonly the focus of empirical studies in tax accounting. To keep the literature review manageable, I limit my review to empirical studies on corporate income taxes. I therefore neglect analytical and normative studies on bank levies and optimal taxation, as they have more normative access to their topics (for an overview, refer to de Mooij and Nicodème (2014)). The studies under review broadly fall under the following research question:

Do banks incorporate corporate income taxes into their decision-making process and, if so, how?

To structure the review, I assess the effect of corporate income taxes on banks' decision-making process in the context of their major stakeholder: customers, regulators, investors, tax authorities. A key objective of banks is to maintain profitability, not only

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<sup>1</sup>E.g., UBS told to pay \$5 billion by French court in tax fraud case. <https://www.forbes.com/sites/walterpavlo/2019/02/21/ubs-told-to-pay-5-billion-by-french-court-in-tax-fraud-case/#1cb69b4d5ccb>

to please and attract new shareholders but also to comply with capital requirements. One possibility for reaching these goals is to reduce tax expenses.

In sum, the effect of corporate income taxation in the reviewed studies is displayed in the preferential tax treatment of debt and regulatory concerns, the profitability of banks and tax incidence on customers, the choice of organizational form, profit shifting, concerns about financial reporting transparency and tax enforcement, and the assessment of banks' perception of customers' tax planning.

I contribute to the literature in three ways. First, I provide, to the best of my knowledge, a first systematic review of empirical studies that assess the association between corporate income taxes and banks and that have emerged over the last two decades. Therefore, this review helps researchers to receive a comprehensive overview of this topic.

Second, I point to areas of future research. Although research in corporate income taxation and banks is growing, evidence on how banks' incorporate corporate income taxes in their decision-making is still limited. Future research might, e.g., provide more evidence on whether tax regulation impacts small banks differently than large banks, which channels banks use to decrease tax expenses, how tax aggressiveness differs across banks and in relation to non-banks and how corporate income tax rules interact with other regulatory requirements and additional taxes.

Ultimately, as banks are in the focus of a public that wants them to pay their "fair share of taxes" and be financially sound, I contribute to the debate by deducing policy implications from the studies under review. In this context, the studies under review provide cautious evidence that corporate income taxation in the context of banks leads to a distortion between debt and equity financing, a distortion between on- and off-balance sheet items, a distortion of customer prices and a distortion of investment allocations. As banks act as financial intermediators and allocate the financial resources of an economy, distortions due to taxation might cause more damage to the functioning of the economy than taxation directed at non-banks. Based on these findings, policy makers should therefore evaluate tax reform in relation to their potential to distort.

As there are ongoing debates on how tax incentives might have contributed to the latest financial crisis and whether banks should pay their fair share in taxes, a review on what is known in this research area is highly relevant for policy makers and standard setters (e.g. OECD (2009)) as well as for researchers trying to pursue this strand of research.

Section 2 presents the related literature and outlines the theoretical framework. Section 3 describes the process for selecting the reviewed studies. Sections 4 to 8 present the key results of the studies under review. Section 9 deduces the policy implications, and section 10 provides areas for future research. Section 11 concludes the paper.

## **2. Related literature and theoretical framework**

In the last two decades four reviews of tax research (Shackelford and Shevlin (2001), Hanlon and Heitzman (2010), Graham et al. (2012), Wilde and Wilson (2018)) in accounting emerged demonstrating the strong interest of scholarly researchers in how firms factor taxes into their business decisions.

Shackelford and Shevlin (2001) provide the first comprehensive review of empirical tax research in the field of accounting. They identify three major topics, the trade-off between tax and nontax considerations, taxes and asset prices and international taxation, that were excessively studied in the 15 years prior to their review. A small fraction of

the review covers studies with a specific focus on regulated industries such as banks. Shackelford and Shevlin (2001) note that regulated industries provide a suitable setting for analyzing trade-offs between book financial reporting and tax reporting. In essence, the findings in the their reviewed studies (e.g., Scholes, Wilson, and Wolfson (1990), Beatty, Chamberlain, and Magliolo (1995), Collins, Shackelford, and Wahlen (1995)) suggest that taxes play a minor role in banks' business decisions, as tax considerations are overruled by regulatory and financial reporting considerations. Shackelford and Shevlin (2001), however, note that those studies might not appropriately control for the variation in tax status across banks.

Hanlon and Heitzman (2010) expand the review of Shackelford and Shevlin (2001) by including theoretical studies and accounting-related studies in the field of finance and economics. Additionally, the included studies need to focus on taxes that accrue to businesses, as this is where most research has been undertaken. Hanlon and Heitzman (2010) identify four themes in accounting research that gained much attention: the way businesses report income taxes in their financial statements and the information content of these items for investors; the measurement, causes and consequences of corporate tax avoidance; the relation between taxes and real business decisions; and the valuation of asset prices when investor-focused taxes are present. In their review, they call for more research on the relationship between financial institutions and taxes, as the evidence on this topic was rather weak up to 2010. Many accounting studies that center on financial institutions refer to this call by Hanlon and Heitzman (2010). Although the literature on the association between taxes and banks has grown tremendously in the last decade, the latest review by Wilde and Wilson (2018) does not include this issue specifically. A potential reason is that Wilde and Wilson (2018) review tax avoidance studies according to the contribution they make in analyzing and explaining the conflicts in a principal-agency framework.

To the best of my knowledge, there is no review of studies that specifically assesses which role corporate income taxes play in banks' decision-making processes. I therefore contribute to the literature by providing a structured overview of studies that empirically look at the association between corporate income taxes and banks' decision-making processes in the last twenty years, deduce policy implications from the studies under review and demonstrate areas for future research. To structure the review, I partially rely on the idea of Wilde and Wilson (2018), but instead of using a principal-agency framework, I use a broader stakeholder approach that describes the business environment in which a bank operates and how corporate income taxes play into the relationship between banks and their stakeholders. A key objective of banks is to remain profitable, not only to please and attract new shareholders but also to comply with capital requirements.

One possible approach to reaching these goals is to reduce tax expense. Banks, however, operate in an institutional environment with various groups and interests, causing obstacles to the optimal level of tax minimization, as figure 1 shows. Like non-banks, they report to their shareholders, compete with other banks for customers and pay taxes according to the countries' tax codes. However, they are additionally subject to regulation from banking authorities.

[Figure 1 about here.]

In figure 1, the inner circle describes banks' internal considerations with respect to corporate income taxation. The outer circle shows the institutional setting that banks must take into account when planning their business operations.

Taxes affect banks' internal decision-making process in various ways, as taxes are a major expense item for banks. The actions in the inner circle (tax incidence, debt financing, profit shifting, organizational choices) mainly refer to actions that minimize corporate income tax expense. In what follows, I briefly explain the various actions and their connection to banks' stakeholders. I indicate the actions to which I refer in bold type.

When financing costs (e.g., due to an increase in the tax rate) increase, banks need to shift these costs to their customers by increasing interest rates on loans and decreasing interest rates on deposits (**tax incidence**). Customers might react to these actions by turning to other banks with more favorable conditions.

Similar to non-banks, banks are allowed to deduct debt costs from their tax base (**debt financing**). Due to regulatory requirements like Basel III (e.g., minimum capital requirements or collateral for risky assets), banks are not able to excessively rely on debt financing, as this would deteriorate their capital ratio and encourage scrutiny from bank authorities.

Using international tax rate differentials, i.e., shifting profits from high-tax to low-tax jurisdictions, banks are able to decrease consolidated tax expense. To shift profits, non-banks generally exercise discretion in transfer pricing agreements. While banks generally report few intangibles, they have a comparative advantage in creating complex financial structures and choosing derivatives such that tax expense is reduced (**profit shifting**).

A more drastic approach to tax minimization was provided by the 1996 change in the U.S. tax code allowing banks to incorporate under Subchapter S where profits are taxed at the shareholder rather than at the corporate level.<sup>2</sup> Obviously, tax benefits stem from the abolishment of double taxation (corporate income taxation and personal gains taxation), and overall tax expense decreases (**organizational form choices**).

In addition to minimizing their own tax expense, banks might consider corporate income taxation in other areas of their decision-making process. This might apply when customers' tax claims for certain tax positions are weak, and tax authorities might challenge these positions, resulting in additional taxes for the customer. This would cause customers' free cash flows to decrease if they did not create a tax reserve for these cases in advance. A decline in cash flows threatens the payment of interest and the repayment of loans. As the uncertainty of repayment increases with default risk of a loan, banks might be required to hold (additional) collateral in proportion to the probability of default (**evaluation of default risk**).

Banks might factor new financial reporting rules like, e.g., the tax-motivated introduction of country-by-country reporting in Article 89 of the Capital Requirements Directive (CRD) into their decision-making process (**financial reporting transparency**). The effect of these rules might be twofold: First, financial reporting transparency for investors increases, as they now receive information on the allocation of country-specific profits and accruing taxes and might be able to better predict future tax expense and profits. Second, banks might change their group tax structure due to increased transparency to either prevent scrutiny by tax authorities or decrease the risk of reputational damage (**tax enforcement/tax compliance**).

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<sup>2</sup>The U.S. Small Business Jobs Protection Act of 1996 relaxed the incorporation rules of banks. While banks before the act were only allowed to incorporate under Subchapter C, they are afterwards allowed to switch to incorporation under Subchapter S.

### 3. Methodology and descriptive statistics

To keep the literature review tractable and focused, but as comprehensive as possible, I conduct a systematic review of the literature. I focus on empirical studies<sup>3</sup> that analyze corporate income taxes in the context of banks<sup>4</sup>. The combinations of words I use in my search are a variant of “bank\*” and “corp\* tax” and should appear either in the title, abstract or keywords of a paper<sup>5</sup>. The search engine I use to find appropriate papers is *Web of Science Core Edition*. I restrict the papers to the range of 1999 to 2019, as Shackelford and Shevlin (2001) already provide a good and comprehensive review on the early advances in the context of banks and taxation. I apply some other criteria to the search in *Web of Science*. First, the studies have to be written in English. Second, the studies need to be of document type “article”, indicating that the paper is published. Third, the papers have to fall under *Web of Science*’s section unit “Business & Economics” to ensure the papers’ proximity to accounting and economics studies. I intentionally include studies with an economic focus, as their insights also contribute to the understanding of how corporate income taxes and banks interact. Ultimately, I use two search strings to form an initial sample of relevant studies.

- (1) TI=(bank\* AND tax\* NOT bankrupt\*) AND SU=Business & Economics
- (2) TS=(bank\* AND “corp\* tax\*” NOT bankrupt\*) AND SU=Business & Economics

I settle on these combinations, as a broad search using “banks” and “tax\*” in the title, abstract and keywords (indicated by “TS”) leads to 927 papers. Adding “NOT bankrupt” takes care of two aspects. First, I am able to exclude studies that focus on bankruptcy and taxation which is not the focus of this review. Second, I am also not interested in studies dealing with the social costs of banks’ bankruptcy during the most recent financial crisis as this is not related to corporate income taxes.

Search 1 includes all those studies that explicitly use any combination of “bank\*” and “tax\*” in their title, providing some confidence that they analyze some portion of the association between banks and taxation in general. This, however, comes at the cost of search precision, as papers dealing with topics that are not the focus of this review (evaluated further below) such as, e.g., the optimal taxation of banks might be included in the search.

In comparison to Search 1, Search 2 has an advantage in that the papers in the search specifically assess corporate income taxes and banks. While search 1 limits the search to the paper’s title, search 2 is intentionally broader (topic search), as requiring “corp\* tax\*” in the title might exclude relevant studies. Naturally, studies might be included in both searches. To that end, I merge the two searches and eliminate duplicates, resulting in my baseline sample of 90 studies.

I then review the remaining papers manually with respect to method (empirical, analytical, legal/normative) and whether their topic is strongly related to corporate income taxation and banks. As I focus on empirical papers, I exclude all studies that take a mere analytical, legal or normative angle. Topic relatedness indicates

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<sup>3</sup>“Empirical” studies are all those studies that contain an empirical section. Hence, I also include papers whose predictions are derived from a formal model. It is essential that the authors test their predictions in the empirical part of the paper. I exclude analytical papers, as there are already some overview articles on this topic (e.g., de Mooij and Nicodème (2014)).

<sup>4</sup>Banks comprise the largest group among financial institutions, and empirical studies in tax accounting usually focus on them. Corporate income taxes are the largest subgroup of taxation.

<sup>5</sup>Asterixes allow a more efficient search, as the abbreviations allow a wide variety of combinations such as “banks and taxation” and “banks and tax avoidance” to be covered.



that papers whose main focus is not banks are excluded, i.e., an analysis of corporate income taxation on a subsample of banks would be excluded. Additionally, studies that consider other taxes such as capital gains taxes or taxes on deposits are excluded. However, studies that address the inclusion of specific items in the income tax base are included, as this is directly related to the calculation of corporate income tax expense. Table 1 shows the exclusion and inclusion criteria applied to the studies in the baseline sample. The final sample amounts to 31 published papers.

[Table 1 about here.]

Figure 2 shows that topic of corporate income taxation in relation to banks has gained much attention, which is reflected in the increase in published studies over the last decade. Although I claim no causality, the increase might be motivated by the latest financial crisis and, additionally, debates on whether the preferential tax treatment of debt promoted the financial crisis. In addition, many tax studies refer to Hanlon and Heitzman (2010). This is especially true for tax accounting studies whose focus is on banks and taxation.

[Figure 2 about here.]

Many of the studies in this review use the U.S. as their sample country. Other studies, especially those in the field of economics, rely on an international sample. Few studies exploit a European setting.

[Figure 3 about here.]

#### **4. Preferential tax treatment of debt and regulation**

Studying and in particular, understanding how taxation affects banks' corporate fundamentals, such as banks' capital structure or their profitability, is essential to designing a well-functioning regulatory framework that avoids negative feedback effects on the economy and promotes financial stability. This importance is also reflected in the number of studies addressing the influence of taxes on capital structure and profitability. The composition of banks' capital structures is often at the heart of regulatory discussions and interventions. The reason for this focus is a desire to monitor banks' risk-taking and prevent any instability in the financial sector caused by excessive debt financing, which might then spill over to the real economy, causing economic downturn. These concerns and probably the experience of the most recent financial crisis prompted researchers to wonder whether banks, like similar to non-banks, exploit the relative tax advantage of debt over equity. The tax benefit results from the deductibility of, e.g., interest expense from the tax base, while earnings from equity are fully taxed. Banks are, due to their business model, already highly leveraged. Researchers therefore expected to observe no reaction to taxes, as the benefit would be marginal. Studies that, however, assess whether banks incorporate taxes in their capital structure decisions are usually motivated by banks' excessive use of high-risk debt in the run-up to the recent financial crisis and whether this excessive use was partially amplified by the relative tax attractiveness of debt.

As the research and tested effects on the association between bank capital structure and corporate income taxation are rather extensive, I include figure 4 to provide an

alphabetical overview of the studies displaying their research questions, the variables of interest and the estimated effect.

[Figure 4 about here.]

[Figure 5 about here.]

#### *4.1. Association studies*

de Mooij and Keen (2016) and Heckemeyer and de Mooij (2017) are the first to analyze whether banks' leverage and capital ratio are associated with taxation. de Mooij and Keen (2016) are interested in how strong the tax distortion is in multinational banks' capital structures arising from the preferential treatment of debt. In particular, they assess how conventional debt, hybrid financial instruments, capital buffers and leverage ratios respond to differences in statutory tax rates. From a theoretical model, they derive two predictions. First, they predict a positive association between debt and the tax rate. Second, they anticipate a negative association with capital buffers, as banks with sufficiently high equity buffers are able to more flexibly decrease the buffer in exchange for further increasing debt. As predicted, de Mooij and Keen (2016) find that conventional debt and equity buffers are highly tax sensitive, while hybrid financial instruments do not seem to be associated with statutory tax rates. The reaction, however, is not homogenous across banks: Banks with low equity buffers (i.e., those closer to the regulatory minimum) are not tax responsive, suggesting that regulatory rather than tax concerns are a key driver in their investment choices. Furthermore, large banks (i.e., systematic banks) seem to be almost tax irresponsive.

Like de Mooij and Keen (2016) Heckemeyer and de Mooij (2017) analyze in an international setting how leverage responds to differences in corporate statutory tax rates. While de Mooij and Keen (2016) center on a pure banking sample and assess different components of a bank's capital structure Heckemeyer and de Mooij (2017) focus on the differences in debt bias<sup>6</sup> between banks and non-banks and the different responses to debt bias across banks and non-banks in terms of leverage and size distribution. They make no prediction concerning whether banks' degree of debt bias is different from that of non-banks due to two countervailing arguments: On the one hand, banks are subject to regulation and, hence, might not have the flexibility to choose the optimal level of debt unlike non-banks resulting in a low degree of debt bias. On the other hand, well-capitalized banks are not bound in regulatory terms and are able to trade debt for equity. Additionally, large banks presume that their going concern status is backed by implicit government guarantees to prevent large and systemic banks from defaulting. Hence, they might be inclined to excessively invest in debt and exercise a larger level of debt bias. The results of Heckemeyer and de Mooij (2017) show that for both non-bank and bank samples, leverage is positively associated with statutory tax rates, indicating that there is also some type of tax sensitivity for banks. While the effect is increasing in size for non-banks, the opposite holds for banks. To answer the question of whether banks with low levels of leverage have a greater or lesser response to taxes, the authors apply quantile regression. For non-banks, the strongest (weakest) effects are found for large (small) firms with low and median (low) levels of leverage. For banks, the picture

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<sup>6</sup>Heckemeyer and de Mooij (2017) differentiate a bank's reaction to taxes into debt bias and debt shifting. Debt bias is defined as the inclination of a bank to prefer debt- over equity-financing due to its deductibility. Debt shifting occurs when a multinational bank exploits tax rate differentials and accumulates debt in a high-tax country to efficiently benefit from tax shields. They focus on debt bias as opposed to debt shifting, as the former would generate a larger welfare loss due to allocative distortions.

is reversed, as large banks' leverage always responds less strongly to taxes than that of small- and medium-sized banks.

In contrast to the aforementioned studies, Gu, de Mooij, and Poghosyan (2015) combine the assessment of debt bias and debt shifting. In an international setting, they test whether subsidiaries experience an increase in debt (leverage) when the corporate statutory tax rates increase (debt shifting) and whether subsidiaries are generally responsive to the "traditional" debt bias. They find that subsidiary banks' leverage reacts to local taxes, which is some indication of a debt bias. In economic terms, a 10 % increase in the tax rate increases a subsidiary's leverage ratio by 3 %. The authors also find significant evidence for the incentive to shift debt internationally, but the traditional debt bias exerts more impact on leverage than debt shifting. To measure reliability, the authors focus on which coefficient is more robust and find that the coefficient of debt bias is less robust in terms of its significance (i.e., after the inclusion of time-fixed effects) than that of debt shifting. In accordance with de Mooij and Keen (2016) and Heckemeyer and de Mooij (2017), the authors find the strongest effect of debt bias and debt shifting in the group with the highest capital abundance while the coefficients are smaller for the group with a relatively tight capital ratio.

In sum, there is some evidence that banks use debt in a similar fashion as non-banks to receive the benefits of tax deductibility. The effect, however, is heterogeneous across banks. In principle, large banks seem to be highly tax *irresponsive*, and banks with sufficiently high capital ratios are highly tax *responsive*.

#### *4.2. Quasi-experimental evidence*

In general, researchers are interested in testing causal relations rather than in showing associations between variables. Quasi-experimental settings in the form of, e.g., a tax reform provide tax researchers with an exogenous shock to test causal relations (Gassen (2014)). The studies below exploit this opportunity in either a one-country or an international setting.

##### *Changes in statutory tax rates across states/countries*

In contrast to the association studies above, Hemmelgarn and Teichmann (2014) use tax reforms across a cross-section of countries to obtain insights into the relative attractiveness of debt over equity financing<sup>7</sup>. Similar to prior studies, Hemmelgarn and Teichmann (2014) find a significant reaction of banks' capital structures to tax rate changes. In addition to the studies above, Hemmelgarn and Teichmann (2014) analyze the potential channels through which banks try to adjust their capital structure. After, e.g., a tax decrease, banks seize opportunities to re-gain the optimal level of capital. To achieve this goal, they might either repay debt; however, this would result in a decreased business volume with which to finance their investments. Another possibility is to increase internal equity by reducing dividends to shareholders. In line with this reasoning, the authors find that upon a tax decrease, the probability of a bank of distributing dividends and the amount of the pay-out decreases.

The research design of Schandlbauer (2017) is theoretically similar to that of Hemmelgarn and Teichmann (2014), as he assesses whether U.S. tax rate increases change the relative tax attractiveness of debt over equity for U.S. banks. In particular, Schandlbauer (2017) incorporates the level of banks' capital ratios in his research design

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<sup>7</sup>The mechanism is that upon an increase in tax rates banks increase their debt and decrease equity due to the tax incentive.

and analyzes whether this affects banks' incentive to exploit the tax advantage of debt. Schandlbauer (2017) finds evidence that better-capitalized banks substitute equity with debt, as the non-depository debt ratio increases upon a tax rate increase. No effect is found for worse-capitalized banks. However, they seem to use hybrid securities (e.g., mezzanine capital that is not tax deductible) and convert those to sub-ordinated debt (tax deductible). This shows that although the overall non-depository debt ratio does not change, the incentive to exploit the debt tax shield is also apparent under worse capitalization.

Milonas (2018) exploits the same sample of U.S. state tax reforms as Schandlbauer (2017). While Schandlbauer (2017) primarily focuses on the effect of tax rate increases, Milonas (2018) explicitly tests for the effect of tax rate increases and decreases via the inclusion of interaction terms<sup>8</sup>. With this set-up he is able to distinguish whether increases exhibit different effects on a bank's capital ratio than decreases. The effect of tax rate increases has a greater magnitude than that of tax rate decreases. This difference, however, is not significant.

In sum, the evidence seems to corroborate the findings of the association studies above that banks' capital structure is partially tax sensitive.

### *One-country tax reforms*

As the inclination to use debt depends on its relative attractiveness in comparison to equity, some countries try to increase the attractiveness of equity by introducing allowances for corporate equity (ACE).

Schepens (2016) is the first to assess whether the introduction of ACE during the Belgian tax reform of 2006 causes banks to increase their equity. Against a control group of European banks, the author finds evidence that Belgian banks increase their equity ratio by 13 %. With regard to potential policy implications, an important finding is that the increase in equity is probably caused by retained earnings and does not coincide with a decrease in lending activity. Additionally, banks with formerly low capital ratios reduce the risk mix in their asset structure suggesting that losses due to customer default now become more costly to those banks.

Building on the idea in Schepens (2016), Martin-Flores and Moussu (2019) analyze the tax effect of a notional deduction on equity (in the form a reduced tax rate rather than an actual deduction) in Italy around its introduction and a few years later around its removal. In contrast to Schepens (2016) they provide evidence on whether banks' equity reacts symmetrically to an increase/decrease in relative tax attractiveness. As expected, they find an increase in equity after the instalment of the ACE and a decrease after its removal. In line with Schepens (2016), they find no significant effect on banks' asset side, suggesting that lending activity is not affected. The change in equity is probably due to changes in retained earnings. After the removal of the ACE, the authors find evidence of an increase in the asset side, suggesting that banks increase debt, causing the capital ratio to decrease. The effect, however, is again not homogenous across banks. As in the studies above, Martin-Flores and Moussu (2019) find an effect for small but not for medium-sized or large banks. An explanation for their finding is that large banks probably have other channels for decreasing their tax expense and therefore do not react to the tax incentive of the ACE.

Overall, the studies in this section suggest that banks react to the tax incentive that

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<sup>8</sup>In the robustness section Schandlbauer (2017) uses 18 state tax decreases and does not find the decrease in leverage that theory would predict.

debt provides. The effect, however, is not homogenous across banks. Large banks appear to be the least responsive to tax incentives. The picture is mixed with respect to medium-sized banks, but small banks seem to be highly tax responsive. As the studies above note, small banks might not have access to the channels of tax minimization utilized by large banks (e.g. shifting channels).

#### ***4.3. Differential tax treatment of on- and off-balance sheet items***

While the studies above focus on how the tax advantage of debt over equity affects on-balance sheet items, Han, Park, and Pennacchi (2015) and Gong, Hu, and Lighthart (2015) analyze whether the differential tax treatment of on- and off-balance sheet items affects a bank's incentive to securitize. In particular, Han et al. (2015) analyze how the taxation of banks' corporate earnings and the competitive conditions in the loan and deposit markets that banks face affect their securitizing behavior. Banks in markets with abundant lending opportunities but limited access to deposits (whose interest expense is tax deductible) might be inclined to sell these self-originated mortgages to a) fund new loans and b) decrease the tax liability of interest income from loans. The opposite holds in markets with an abundant supply of deposits. Here, banks need to increase their equity capital ratio and hence, refrain from selling mortgages. In sum, the incentive to securitize increases with the tax rate and the shortage of deposits. In descriptive and multivariate analyses, they corroborate their theoretical findings. In U.S. states with a high state tax rate and high loan demand (i.e., a country with a rather young demographic structure), the authors find an incentive to securitize more, while they find no significant reaction in a situation with a high tax rate and high deposit supply. Gong et al. (2015) expand the U.S. setting of Han et al. (2015) to an international sample. Their idea, however, is similar, as they analyze whether headquarters of OECD banks in high tax rate countries and with constrained funding opportunities (i.e., a low supply of deposits) tend to securitize more than those with abundant funding opportunities. In accordance with Han et al. (2015), Gong et al. (2015) find that OECD banks with headquarters in high tax rate countries and a high loan-to-deposit ratio show an increased likelihood of using asset-backed securities (i.e., to securitize more). The decisive feature in both studies is that loans are sold and shifted off-balance in such a way that the generated income is not subject to taxation; this is normally done via the use of special purpose entities (SPE).

In general, both studies show that there is a distortion between on- and off-balance sheet financing. Potential policy implications are discussed further below.

### **5. Bank profitability and tax incidence on customers**

The questions of how taxation influences banks' profitability and who (the bank, the lender or the depositor) bears the additional cost of taxation are highly relevant in times of low interest margins and enhanced competition in the banking market. One measure to assess how efficiently the bank turns over its assets is the net interest margin. The higher this margin is, the more efficient the bank is in generating income from its assets. Taxes are a key expense that might drive efficiency down and distort the investment decisions of banks.

Demirgüç-Kunt and Huizinga (1999) are the first to provide multi-country evidence on how taxes, among other factors, affect the net interest margin of banks. In particular, they are interested in whether taxes are passed on to the bank's customers (either to the

lender or the depositor). They find a positive association between a bank's effective tax rate (ETR) and the net interest margin suggesting that taxes are passed on to customers via higher prices or, put differently, less favorable saving/lending conditions. The authors explain this finding by investors' focus on after-tax earnings, which would require banks to pass taxes on to customers to yield the same profit to meet investors' expectations. On these grounds, the authors assume that banks' investment decisions become distorted.

While Demirgüç-Kunt and Huizinga (1999) assess selected determinants of bank profitability, of which taxation is one, Albertazzi and Gambacorta (2010) and Chiorazzo and Milani (2011) directly test how corporate income taxes influence banks' profitability and whether banks pass their tax burden on to customers. The motivation of Albertazzi and Gambacorta (2010) is similar to that of Demirgüç-Kunt and Huizinga (1999), as they argue that microeconomic theory advises not to tax intermediate goods (banks distribute loans and deposits and hence act as intermediaries). Taxation would hinder the efficient allocation of resources and is therefore distortive. Based on a theoretical model, Albertazzi and Gambacorta (2010) predict that the corporate income tax (CIT) rate changes the cost of equity. This change influences corporate capital accumulation and hence might decrease corporate investments. This, in turn, might decrease demand for loans, resulting in a negative correlation between the CIT rate and lending, while having no impact on deposits.

Using a sample of 10 industrial countries, they find a mixed association between the CIT rate and bank profitability. For low levels of the CIT rate, the effect on income is positive, while the relation is negative for high levels of income tax suggesting that banks partially shift tax costs to customers. Albertazzi and Gambacorta (2010) additionally disaggregate profitability into its components (net interest income, non-interest income, operating costs, provisions). The effect on interest income is similar to that found for profit before taxes: negative for high levels and positive for low levels of CIT. The association between non-interest income and CIT is always negative as predicted. The underlying assumption is that the demand for those services decreases when the CIT increases. CIT and operating costs are negatively associated as well. The association between corporate income taxes and provisions turns out to be not significant.

To test for which bank customers bear the tax incidence, they split the interest spread ( $l-d$ ) into a mark-up ( $l-r$ ) and a mark-down ( $r-d$ ) portion and regress those separately on CIT and other controls<sup>9</sup>. The relation between the mark-up and CIT is significant and negatively correlated, suggesting that a higher CIT rate coincides with a lower interest rate on loans, in line with the models' predictions. An increase in the CIT rate increases corporations' cost of equity, depressing corporate investments and, hence, demand for bank loans. Reduced demand leads to a lower interest rate on loans.

Closely related to Albertazzi and Gambacorta (2010) in terms of research question and research design, Chiorazzo and Milani (2011) assess the incidence of taxes in the banking sector. However, they focus not only on CITs but also on whether value added taxes directed at financial services are distortive. With reference to Huizinga (2004), they assume that value added taxes are not as distortive as CITs and therefore a better alternative for taxing banks. Like Albertazzi and Gambacorta (2010), they disaggregate profitability in its different components and find a positive association between profitability and CITs as well as value added taxes. Based on their findings, they presume that value added taxes are also passed on to customers, indicating that this type

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<sup>9</sup>The letter "l" refers to the interest rate on loans, "d" to the interest rate on deposits and "r" to the market rate of return.

of tax is also dissortive and that Huizinga (2004)'s assumption should therefore be rejected.

Gaganis, Pasiouras, and Tsaklanganos (2013) corroborate the findings of previous studies using a frontier technique. They also find a positive association between taxation and bank performance, indicating that banks shift taxes to customers. The effect is stronger in highly concentrated markets. The association between tax rate and performance, however, diminishes with higher levels of tax rates.

While the studies above only assess CIT's effect on the profitability of domestic banks, Huizinga, Voget, and Wagner (2014) expand the assessment by differentiating between the effect of domestic and that of foreign banks. In particular, they investigate whether international taxation puts foreign banks at a disadvantage, as they are subject to corporate income taxation at home and to withholding taxes abroad, and whether this situation hinders foreign direct investment from banks. In contrast, the pre-tax profits of home-bound banks are only subject to corporate income taxation. Dividend-double taxation might therefore lead to distortions in the international banking market. Huizinga et al. (2014) assume that the distortions cause differences in profitability/prices (interest margin) between domestic and foreign banks in the host country and in the level of foreign banks' FDI. However, they find no significant association between the host-country CIT and net interest margins, indicating that in the case of no double taxation, local taxes are not passed on to customers. The authors test explanations for this and assume that foreign banks decrease their employees' wages rather than shifting profits abroad or passing taxes on to customers. With respect to double taxation, they find a significantly positive association between double taxation and net interest margins, indicating that foreign banks that are subject to double taxation shift a large portion of their tax burden to their customers. Their estimates indicate that foreign banks bear approximately 14 % and their customers approximately 86 % of the tax burden. In addition, the FDI activity of foreign banks decreases in light of double taxation. Economically speaking, a 1 percentage point increase in double taxation results in a reduction in foreign bank FDI of 7.2 %. The authors conclude that foreign-owned banks need to increase their interest margins to counterbalance the lower amount of financial services (measured in terms of investment volume).

In sum, the evidence presented above suggests that banks generally shift parts of their tax burden to customers.

## **6. Organizational (form) choices and consequences**

Studying organizational form choices is important, as organizational form determines a firm's tax base, the structure and publication of financial reports and how investors value the firm. The U.S. Small Business Jobs Protection Act of 1996 therefore provides a fruitful setting to test whether banks re-structure their organizational form to exploit the associated tax benefit. While U.S. non-banks were already allowed to incorporate as Subchapter S corporations, banks were only granted this right after 1996. Banks incorporated under Subchapter S can pass their profits to their shareholders, where they are then taxed. Hence, Subchapter S banks are not subject to double taxation (corporate income taxation at the corporate level and dividend taxation at the shareholder level). The tax reform, therefore, allows a) investigation into the motivation of banks to convert from C corporations to S corporations and b) observations of the direct effects of this conversion on banks' stakeholders. The studies below generally assess the effect on two stakeholders: shareholders and customers.

Hodder, McAnally, and Weaver (2003) contribute to the understanding of why banks convert from Subchapter C to Subchapter S corporations. In particular, they are interested in when and why banks convert from taxable C to entity-level non-taxable S corporations. Hodder et al. (2003) assume that the bank will convert if the benefits of conversion (e.g., avoiding double taxation, alternative minimum taxation) outweigh the costs of conversion (e.g., loss of deferred tax assets decreasing regulatory capital, built-in gains, limits to external capital funding). The results are in line with their theoretical predictions: the more dividends a bank pays, the more likely conversion becomes. Factors that negatively impact conversion are, e.g., large built-in gains, the presence of tax loss carryforwards, the prohibition of conversion in specific states a bank's subsidiary operates in and late adoption. The authors assume that late adopters' tax benefit is smaller, as they experience higher costs of adaptation due to e.g. organizational re-structuring.

The three studies of Depken, Hollans, and Swidler (2010), Donohoe, Lisowsky, and Mayberry (2015), Chang, Jain, Lawrence, Edward R., and Prakash (2016) expand Hodder et al. (2003) by analyzing the effects of conversion on stakeholders. In essence, they try to understand whether Subchapter S tax benefits are transferred to banks' stakeholders. While Depken et al. (2010) focus on banks' customers, Donohoe et al. (2015) take a broader approach and assess the effect (in terms of existence and magnitude) on four stakeholders (customers, suppliers, employees and owners).

In particular, Depken et al. (2010) assess whether the tax benefit of conversion is passed on to customers via lower loan interest rates and higher deposit rates. From a theoretical point of view, shareholders might accrue all of the tax benefit. However, as S banks compete with C banks, they might be inclined to forgo some of the profit to attract/keep customers. The opposite (no transition of tax benefits) might hold as well, if banks offer customers services in a price bundle (e.g., a joint contract for a credit card and savings account). Customers, in this situation, cannot observe the individual contract components properly, and thus, they are deprived of the ability to compare. Depken et al. (2010) find no significant difference in deposit rates between Subchapter S and C banks, indicating that benefits are not transferred to customers.

Donohoe et al. (2015) corroborate the finding of Depken et al. (2010), as they also do not find a pass-on of tax benefits to customers (neither lenders nor depositors). They do, however, find a positive effect on banks' shareholders and bank employees, indicating that banks pay shareholders higher dividends and employees higher wages. Chang et al. (2016) find evidence that the benefits of conversion are neither passed on to customers nor, in contrast to Donohoe et al. (2015), passed on to employees.

Mayberry, Weaver, and Wilde (2015) are interested in a slightly different outcome of conversion. They investigate whether Subchapter S banks show differences in riskiness and risk-taking behavior compared to Subchapter C banks. They assume that differences might arise based on two mechanisms with opposing effects. First, the number of shareholders is limited for S corporations. On the one hand, this might cause managers to refrain from investing in risky assets as not to jeopardize a sustainable capital structure. On the other hand, tax savings from choosing S status might be relatively high, supplying banks with sufficient internal funds and the freedom to invest in risky assets. Second, S banks might be subject to a higher degree of shareholder scrutiny. Because profits are not taxed at the entity level, but at the shareholder level, shareholders are interested in large cash outflows. For that reason, shareholders might either constrain excessive risk-taking or foster it, as those projects yield higher returns. To test their predictions Mayberry et al. (2015) use a difference-in-difference design in which they compare the riskiness of S corporations to that of C corporations before and after the



tax reform. The findings suggest that S banks are less risky than C banks and that the risk-taking behavior of C banks decreases once they have converted.

Adopting a different perspective on banks' organizational choices than taken by the studies of the Small Business Jobs Protection Act of 1996, Smolyansky (2019) analyzes whether the effects of tax reforms in one state lead to economic consequences in other states with no tax reform. In particular, Smolyansky (2019) assesses whether U.S. banks divert lending activities to other jurisdictions after a tax rate change and, if yes, how strong the impact is on the local economy of the jurisdiction to which the bank shifts its activities. The underlying mechanism is as follows. State taxation usually calculates the tax burden according to loan receipts in a specific state (nexus) and not the actual profit of a bank subsidiary in a that state. Hence, when a customer from state B receives a loan from a bank in state A, the bank then pays taxes on the amount of loans in state B. To reduce taxation, banks can shift from offering loans in state B to increase supply in state A, where perhaps no tax accrues. Smolyansky (2019) finds that banks decrease their loan supply in those states that increased their tax rate and increased it in those states with no change. He also shows that employment and state income negatively respond to a decrease in the loan supply, suggesting real economic consequences.

## **7. Profit shifting, financial reporting transparency and tax enforcement**

From the studies above, we have some evidence that banks try to decrease their tax burden. In addition to the actions discussed above (debt bias, tax incidence and organizational form choices), banks can also exploit the international tax rate differentials across the world to reduce their tax burden. Dharmapala (2014) provides an overview of the studies analyzing the degree of profit shifting among non-banks. He concludes that an increase of 10 percentage points in the tax rate differential between headquarter and subsidiaries increases the pre-tax income of the subsidiary by 8 %. This effect on pre-tax income is rather large. Considering that banks' income-generating assets are highly mobile and flexible, it is surprising that only recently some studies have emerged on whether banks engage in profit shifting. Profit shifting is most likely viewed ambiguously by banks' stakeholders. Various OECD reports (e.g., OECD (2009)) and the recent requirement of public country-by-country reports for EU banks suggest that tax authorities and the public view profit shifting as a tool for aggressively, and presumably improperly, reducing the tax expense. Shareholders' perceptions on this topic might be ambiguous. Some studies on tax avoidance suggest that aggressive tax avoidance is associated with manager rent extraction and intransparent financial reporting to disguise that rent extraction. In this case, shareholders would probably view profit shifting negatively. On the other hand, profit shifting means greater free cash flows and hence higher dividend yields. In this situation, shareholder should respond positively to profit shifting.

### ***7.1. Evidence of banks' profit shifting***

There is some, but small, evidence that banks actually engage in profit shifting. Demirgüç-Kunt and Huizinga (2001) provide first suggestive evidence of banks' involvement in profit shifting. Although financial markets show a large amount of integration in terms of financial asset mobility, the authors notice that a key expense, taxes, varies nationally. This might provide advantages to foreign banks, which can either use tax

rate differentials to create favorable transfer pricing agreements or offset foreign taxes against a tax credit in their home countries. A consequence of this is that international investment decisions become distorted and efficiency decreases. A first step, when investigating differences between foreign and domestic banks, is to assess the effect of taxes on their net interest margins. If the effect of taxes is positive, then banks pass taxes on to their customers. If taxes rise, domestic banks' profits need to increase as well to offset the extra expense. The effect on the interest margin for foreign banks with the option of a tax credit at home depends on the amount that can actually be offset. With a full offset, the foreign bank will be indifferent to taxation and, this indifference will decrease with the degree of the offset. For foreign banks with profit-shifting opportunities, the reaction is not clear up front. It can either be positive, indicating the need to increase profits, or negative, showing that the bank engages in profit shifting. Using the same sample and design as in Demirgüç-Kunt and Huizinga (1999), they find that banks generally pass taxes on to customers, but foreign banks to a lesser extent. To find evidence for the argument of profit shifting, they use pooled regression and show that the interaction between foreign banks and the respective tax rate is negative.

Meeks and Meeks (2014) use a small sample of UK banks to descriptively assess what causes the gap between the estimated tax revenues of fiscal authorities and those reported by UK banks. In contrast to Demirgüç-Kunt and Huizinga (2001), they systematically assess different reasons why the tax gap increased such as a decline in UK tax rates or decreases in operating profits and tax loss carryforwards due to the most recent financial crisis. Banks' reported (UK and global) ETRs show no variation across time, indicating that decreasing tax rates do not explain the discrepancy between tax revenues and reported taxes. Meeks and Meeks (2014) assume that UK banks report less profits and therefore taxes in the UK. To check this explanation, the authors use the ratio of UK assets to total assets. Surprisingly, they find no decrease in this ratio but rather a small increase, which does not suggest that UK banks engage in profit shifting. The authors, however, state that the results should be interpreted cautiously, as only some banks provide a detailed geographic segment report. As some banks do not report geographic segments, the already small sample decreases further and the generalizability of results is limited.

Using subsidiary-level data providing information on profits at the unconsolidated level, Merz and Overesch (2016) are able to close the gap of missing data in Meeks and Meeks (2014). They assess whether banks operating internationally are inclined to shift profits. In their approach, they follow Hines and Rice (1994) and use the tax rate differential to measure the elasticity of banks in response to different tax rates. In theory, they predict that banks are generally responsive to lower tax rates abroad. However, different income types might be more (e.g., non-interest income) or less (e.g., interest income) responsive to taxes. Merz and Overesch (2016) find a rather large tax elasticity of - 2.378 on overall profits compared to Heckemeyer and Overesch (2017)'s consensus estimate of - 0.8. When controlling for legal enforcement and transfer pricing strictness, the effect becomes weaker and in some specifications even nonexistent. Turning to different types of income, Merz and Overesch (2016) find that income from trading gains is highly responsive to taxes. As the potential to shift also depends on the capital ratio level a bank must sustain, Merz and Overesch (2016), similar to the studies in subsection 4, differentiate between better- and worse-capitalized banks. In contrast to the other studies, they do not find a differential effect.

In sum, there is initial suggestive evidence that banks exploit international tax rate differentials to decrease overall tax expense.

## *7.2. Public country-by-country reporting and investor perception*

The introduction of public country-by-country reporting (CbCR) for EU banks in the context of the Capital Directive Requirements IV (CDR IV) in July 2013 might cause a better supply of information and more detailed data on economic indicators (such as profits before taxes, tax expense, employees) in each country in which a bank has a subsidiary. The law change, therefore, provides a suitable setting for researchers to study banks' profit shifting and tax avoidance behavior as well as to investigate how investors react to the new information and whether the mandatory information has an effect on the banks' financial reporting. As the law became effective for fiscal years starting in 2014, the empirical literature using these data is still preliminary. To date, two published studies exploit this setting.

Dutt, Ludwig, Nicolay, Vay, and Voget (2019) assess whether investors in a bank perceive the introduction of the CbCR in the Capital Requirements Directive (CRD) IV as beneficial or damaging. The beneficial view comes from the perception that CbCR will increase financial reporting transparency, mitigate excessive risk-taking by banks and align the interests of investors and bank managers. CbCR might be viewed as damaging when investors fear a decrease in firm value due to either a decrease in tax planning activities or the revelation of aggressive and not sustainable tax planning. The latter might cause reputational damage and decrease firm value. To exploit whether benefits or costs prevail, Dutt et al. (2019) analyze the reaction of investors around the first public announcement (27<sup>th</sup> February 2013) that CbCR for EU banks will be mandatory. Unlike similar studies, they surprisingly do not find a significant investor reaction, as measured by the three-day cumulative average abnormal return. Using additional event dates and sample splits such as banks with a high connection to individual customers or banks with a high portion of institutional investors, the authors again do not find evidence of significant reactions. An explanation for their findings is that some portion of investors view the introduction of CbCR as beneficial, while the other portion views it as damaging. On average, those two effects counteract each other, leading to no effect on average.

Brown, Jorgensen, and Pope (2019) assess whether the mandatory disclosure of CbCR causes banks to adjust their geographic segment reporting pursuant to IFRS 8. They also test whether banks that are active in tax havens use a higher aggregation level to obfuscate this fact. The motivation results from the idea that banks must file two different sets of disclosures, the CbC report and the geographic segments. Brown et al. (2019) wonder whether important countries as identified in the CbC report are disclosed similar to those disclosed in the geographic segments. They do not find a significant change in the quantity of reported items in the geographic segment report after the introduction of CbCR. However, they find an association between the degree of aggregation and tax haven intensity which supports the idea that banks try to hide this tax haven activity.

Not directly related to the studies above, Andries, Gallemore, and Jacob (2017) wonder whether the rules of the corporate tax system exhibit positive effects, especially in the area of a bank's financial reporting and, hence, for investors. In particular, they are interested in whether there is an association between the corporate tax system and loan loss provisioning (LLP), and whether this association is driven by the timely recognition of losses or by excessive risk-taking. To test their research question, they use a cross-section of countries and regress LLPs on statutory tax rates and a variable indicating the tax deductibility of general LLPs. They predict and find a positive and significant coefficient on the interaction, indicating that there is an association between

LLPs and the tax system in general. To test whether the relation is driven by timely loan loss recognition, they regress LLPs on the interaction between a variable indicating whether the bank suffers from a high change in non-performing loans, the statutory tax rate and the general deductibility of LLPs and find a positive and significant coefficient, as predicted. They are not able to establish a link between LLPs and increased risk-taking. Andries et al. (2017) conclude that the corporate tax system fosters timely loss recognition when LLPs are tax deductible.

## 8. Evaluation of associated default risk and customers' tax avoidance

In addition to banks' actions to minimize their own tax expense, it is relevant to know how banks perceive and value the tax planning and tax avoidance (practices) of their clients. Theoretically, there are two views banks might have on this subject, both with different implications for regulators and investors. On the one hand, banks might value a high degree of tax avoidance, as this generates cash that can then be used to pay interest and repay loans. On the other hand, a high degree of tax avoidance might be indicative of risky tax planning. Risky tax planning, such as exhausting the discretion in transfer prices or advanced tax rulings (subject to illegal state aid), might lead to substantial back payments if the company is not able to sustain the tax position following a tax audit<sup>10</sup>,<sup>11</sup>. Therefore, a tax dispute might be a threat to the financial stability of firms and banks if the corporation is not able to service its loans. If banks favor a high degree of tax avoidance and encourage risky tax planning, then regulators might become concerned with banks' financial soundness. Investors, in anticipation of increased risk, should charge banks a higher risk premium. If banks, however, view tax avoidance negatively, banks might exercise their stakes in companies to mitigate risky tax planning by charging higher premia in loan contracts. In that case, banks act as a disciplining power to minimize excessive tax planning.

This topic presumably received much attention due to the vast media coverage of banks helping their clients evade taxes. Although there are banks that have assisted their clients in tax evasion, it is not clear to what extent banks themselves engage in tax avoidance and favor a low degree of avoidance in their clients.

At first glance, it seems that the findings in the literature are somewhat mixed. In a U.S. setting Hasan et al. (2014), find that banks charge higher loan spreads on firms with a high level of tax avoidance. An explanation for this finding is that banks do not directly benefit from customers' appetite for risk but only bear the costs (i.e., default risk of loans). On these grounds, they charge higher premia to compensate for the risk of default. Beladi, Chao, and Hu (2018) find similar evidence, but in a Chinese setting. Similar to Hasan et al. (2014), they assume that the costs of tax avoidance outweigh the benefits to creditors. For that matter, they predict and find that Chinese banks charge higher loan costs and provide loans with shorter maturity. Kovermann (2018)

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<sup>10</sup>Hasan, Hoi, Wu, and Zhang (2014) provide some examples of the direct cost of an IRS audit. A more recent example is the legal proceedings between the IRS and Amazon.com Inc. The IRS claims that, in tax terms, Amazon undervalued the inputs provided by the U.S. headquarters when setting up a cost sharing agreement with its Luxembourg subsidiary. Additional taxes in the amount of \$230 million would be due if Amazon was to be convicted. <https://news.bloombergtax.com/transfer-pricing/amazon-irs-return-to-court-for-2-billion-tax-case-appeal> last accessed on 2019-10-02.

<sup>11</sup>Advanced tax rulings attracted a vast amount of public attention after the leakage of papers showing that Luxembourg and other EU states have set up special tax arrangements with corporations. Those arrangements are now subject to the EU investigations for illegal state aid. <https://www.wsj.com/articles/eu-court-sides-with-starbucks-in-tax-case-11569314810> last accessed 2019-10-02.

distinguishes between the perception of tax avoidance and tax risk. Contrary to Hasan et al. (2014), he finds that banks view tax avoidance positively. Although Hasan et al. (2014) do not directly test this relation, the positive association between tax avoidance and loan spread might be driven by the concept of tax risk, rather than tax avoidance. In line with this argument, Kovermann (2018) provides evidence that tax risk and the cost of debt are positively correlated, suggesting that banks price the potential risk resulting from unsustainable tax positions. He further shows that the relation between tax avoidance and the cost of debt is moderated by tax risk.

Gallemore, Gipper, and Maydew (2019) implicitly assume that banks generally prefer a low level of tax avoidance. In particular, they are interested in whether and which banks help their clients to form tax planning strategies. To test their hypotheses, they use different approaches. First, they show an association between a firm's level of tax avoidance and the average tax avoidance level of that bank's clients. The degree of assistance, however, differs across banks. Therefore, in a second step, they assess new lending relationships and find that the firm's degree of tax avoidance increases when entering into a new loan contract with a tax-intermediary bank<sup>12</sup>, suggesting that banks specialising in that area actually help firms with tax planning. A natural follow-up question is which characteristics a tax-intermediary bank has. On average, a tax-intermediary bank focuses on non-lending income and has industrial expertise measured in terms of lending market share in the respective industry. Gallemore et al. (2019) additionally show that assistance in tax planning is more pronounced in longer lending relationships and relationships with a higher lending volume. An interesting finding is that firms providing some foreign income when entering into a lending contract seem to have a higher degree of tax avoidance than those who do not. In contrast to Hasan et al. (2014), they find that banks give firms with a low credit rating more assistance, probably to bolster their after-tax cash flows and increase the probability of debt repayment.

Partially linked to Gallemore et al. (2019), Chernykh and Mityakov (2017) assess whether the degree of tax evasion of banks with offshore activities and the firms that conduct business with these banks is higher than that of banks with no offshore activities. In a unique Russian setting, they show that there is an association between the degree of banks' engagement in offshore financial activities and tax evasion. The authors predict that offshore-active banks and their customers try to evade taxes through reporting lower income and through the underreporting of employee compensation, as the latter is also taxed at the entity and not at the individual level. To determine whether employee expense is underreported, they compare the car value of employees working for firms that conduct business with offshore banks to the car value of employees working in firms that conduct business with banks with no offshore relations. The assumption is that while the salary of employees can be underreported, the car that an employee drives is visible and can be determined accurately. The authors predict that if offshore-related banks underreport their employee expense, there should not be a significant association between the car value of an employee who works in a bank that is active in tax havens and the car value of employees in banks with no stakes in offshore activities. They find evidence in line with their predictions.

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<sup>12</sup>Gallemore et al. (2019) define a bank as a tax intermediary if its clients' average tax rate is above the median across all banks in the three years prior to the new loan contract.

## 9. Policy implications

There are no fewer than three OECD studies (OECD (2009, 2010, 2011)) directly dealing with the role banks play in the tax system. This is not surprising as “banks play a significant role in the global economy” (OECD (2009)). Due to their special role and knowledge, policymakers are highly concerned with banks’ tax compliance. Partially in contrast to that, theory suggests not taxing intermediate goods, arguing that this might result in distortions and welfare losses, as banks provide intermediate financial goods, in the sense that they try to efficiently allocate financial resources of an economy. From a theoretical point of view, taxes directed at banks should therefore be evaluated carefully in the light of unintended consequences and feedback loops. The studies under review provide some empirical insights that inform the debate about tax policy issues in the banking sector raised by politicians and experts. Empirical studies provide the advantage that their evidence, due to their research design, is based on actual conditions and might help shaping evidence-based policy making.

For the policy implications, I categorize the studies above according to the distortions that taxes cause.

### *9.1. Distortion between debt and equity*

One frequently raised point in tax policy is that corporate income taxation distorts the allocation of debt and equity. A central argument in this debate is that the preferential tax treatment of debt partially caused the financial crisis, as banks are incentivized to hold more and riskier debt. In contrast to the studies under review by Shackelford and Shevlin (2001), the studies above generally find an effect of taxes on the capital structure of banks. The effect, however, is heterogeneous across banks. It seems that on average, large banks’ leverage is almost tax insensitive, while small- and medium-sized banks’ leverage is strongly associated with taxation. As Heckemeyer and de Mooij (2017) show, the effect is reversed for non-banks. Although the evidence in the studies above suggests that large banks are less inclined towards conventional debt tax bias, the leverage ratio of other banks still responds to taxation. For policy implications, the fact that large banks are probably better able to hedge the risk emerging from loans than small- and medium-sized banks should be considered. To mitigate the tax advantage of debt, some countries have introduced a deduction of equity interest. As there is no international evidence on this issue, conclusions from those studies might not be generalizable to other countries. However, both studies (Schepens (2016), Martin-Flores and Moussu (2019)) find that banks react to this deduction with an increase in equity capital. Schepens (2016) shows that the increase in equity comes from retained earnings rather than from decreased lending activity. While there is an effect on average, Martin-Flores and Moussu (2019) provide evidence that large banks again do not seem to react to an introduction of ACE. In sum, there is some empirical evidence for banks’ tax incentives to accumulate debt. Tax policy in this area should especially be concerned with the effects on small- and medium-sized banks, as large banks do not seem to react. With respect to the latter, other policy tools might be considered to decrease excessive leverage.

### *9.2. Distortion between on- and off-balance sheet financing*

Another issue that has recently gained attention in the empirical banking literature on taxes is the issue of on- and off-balance sheet financing. In terms of policy implications, this issue is highly relevant, as the studies show that the additional taxation of banks increases the problem of off-balance sheet financing. This is especially true for banks in constrained funding environments (i.e., environments with a low supply of deposits), as banks need to raise funds elsewhere to serve loan supply. Banks usually use the tool of securitization which grants two benefits. First, selling loans generates free investment funds. Second, the transactions are structured such that the profit from selling is tax-exempt. These two conditions raise various policy concerns. As the buyer of securities is normally a large vehicle, receives a large amount of loans and directly hedges those loans, monitoring the quality of the received loans decreases on the side of the seller. This means, in turn, that the riskiness of the sold loans increases. The higher the tax rate and the lower the supply of internal funds, the more probable is the securitization of loans. A higher supply of internal funds is equal to more tax-deductible internal debt. Banks faced with a high supply of deposits have a lower incentive to securitize. Policy makers should therefore carefully evaluate whether additional taxes exacerbate the distortion between on- and off-balance sheet items.

While the results show that there is a tax distortion between on- and off-balance sheet financing, the results also have far-reaching policy implications. In a situation with high loan demand and low deposit supply, banks will sell more loans, as the on-balance sheet financing of loans (via self-originated equity) is more costly than the off-balance sheet financing (selling to a tax-exempt special purpose entity) due to the tax disadvantage of equity. While banks in these situations have a high incentive to sell loans, they are less inclined to monitor these loans properly, as the default risk is transferred to the new owner. Increasing capital requirements in combination with tax reforms increasing tax rates might therefore lead to the excessive selling of riskier, i.e., unmonitored, loans, jeopardizing financial stability. To weaken the tax disadvantage between on- and off-balance sheet financing, Gong et al. (2015) suggest the introduction of ACE.

### *9.3. Distortion of prices*

Studies on the association between CITs and bank profitability suggest that customers bear the tax burden by paying higher prices or receiving lower interest on their deposits. They conclude that taxes distort efficient price setting, and hence, banks should not be subject to corporate income taxation. The Small Business Job Protection Act of 1996 provides a suitable setting to test whether abolishing taxes on corporate income leads to more favorable conditions for customers. The studies above, however, show only weak evidence that this is the case. Instead, they find that shareholders of the bank profit from tax reform via higher cash outflows.

### *9.4. Distortion of investment allocations*

A central issue in the recent tax policy debate is the exploitation of international tax rate differentials by multinationals. From an economic point of view, differences in statutory tax rates might divert foreign investments in countries due to their tax attractiveness and not due to business concerns, potentially leading to inefficient allocations of investments. From a fairness angle, countries have the sovereignty to tax the profits of firms that were generated therein. Countries spend a large amount of tax

revenues on social security, national security and the maintenance of transport infrastructure. Heckemeyer and Overesch (2017) suggest a tax elasticity of -0.8 (consensus estimate) for non-bank multinationals, while Merz and Overesch (2016) find evidence for an even stronger elasticity of -2.378 for multinational banks. Although the average reaction of banks to international tax differentials is large, empirical evidence, with the exception of Merz and Overesch (2016) and some preliminary studies (e.g., Langenmayr and Reiter (2017)), on how and whether banks exploit these differentials is scarce and generally anecdotal<sup>13</sup>. Governmental organisations such as the OECD suspect that banks exploit international loss offsetting rules, resulting in loss shifting or the use of financial derivatives across borders to decrease group tax expense. As the methods used are very complex, it is difficult for tax revenue bodies to keep track. While aggressive loss shifting is presumably available for non-bank multinationals as well, structuring tax-motivated financial transactions with the help of financial derivatives is rather specific to banks due to a comparative advantage in financial knowledge. The difficulty is in differentiating between merely tax-motivated transactions and business-related transactions. While the first fall under the area of aggressive tax planning, interfering in the latter would result in large investment distortions and welfare losses. Countries granting zero tax rates to businesses, normally referred to as “tax havens”, are of major concern to and under special scrutiny by tax authorities, as a large number of multinationals install SPEs. SPEs might be installed not only for tax reasons but also because the country grants other favorable conditions to businesses or banks. There is a small but emerging empirical literature to detect whether banks actually physically operate in the locations they have subsidiaries in or whether these subsidiaries only serve as a pass-through entity. The literature, and hence, the empirical evidence is growing due to the passage of Article 89 in the EU CRD IV, forcing multinational banks of a certain size to disclose business items such as profits before taxes, tax expense, and employees on a country-basis. As time elapses, it will become clearer if banks actually shift away from certain tax havens, cautiously indicating that those subsidiaries might have been tax-motivated. However, preliminary evidence on this topic is mixed and does not yet provide a clear implication for policymakers on whether disclosure rules prevent banks from exploiting aggressive tax planning.

## 10. Areas for future research

The motivation for many studies stems from the fact that banks are an important pillar in a country’s economy and that actions directed at banks might have unwanted feedback effects. Evidence on whether changes in tax preferences actually spill over is weak or preliminary. Smolyansky (2019) is the first to show that changes in U.S. state taxes incentivize banks to shift their credit supply to other states that offer more favorable conditions. A preliminary study by Biswas, Horváth, and Zhai (2019) uses the Belgian introduction of ACE to show that banks use freed reserves to increase the credit supply to specific borrower groups. Investigating real outcomes of changes in banks’ tax preferences is important, as customers partially bear the tax burden as the studies above note. This means that borrowers’ costs increase, and the cash otherwise directed to new investments is now needed to service interest expense. This theoretical

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<sup>13</sup>In their 2013 report on base erosion and profit shifting (BEPS), the OECD refers to this point as well and admits that it is difficult to “reach solid conclusions about how much BEPS actually occurs [since] most of the writing is inconclusive although there is abundant circumstantial evidence that BEPS behaviours are widespread”. Prior studies (e.g. OECD (2009)) report on the potential of aggressive tax planning.



example shows that tax reforms might harm economic growth. For that matter, more empirical evidence on this topic is needed to help shape appropriate tax reforms.

A thus far neglected topic is the interaction of corporate income taxation with other types of taxes (direct or implicit) and levies (most recently, the EU bank levy on the amount of banks' liabilities) that should contain banks' risk-taking. So far, only one preliminary study (Bremus, Schmidt, and Tonzer (2018)) examines the different incentives for banks under corporate income taxation and bank levies. While the latter promotes less risky capital structures, the first incentivizes increases in debt due to its tax deductibility. As other additional taxes, such as the financial transaction tax, are still under discussion, more empirical evidence is needed to test how already installed additional taxes influence banks' business behavior.

Little is known about the channels banks use to decrease their tax expense and how banks' level of tax avoidance (measured in terms of ETR) differs from that of non-banks. The reason we know so little about these topics is the constant exclusion of banks in tax avoidance and profit shifting studies. As often outlined in this review, banks are a crucial pillar in the economy, and knowledge on how their tax burden corresponds to that of non-banks is of interest to shape adequate tax reforms. It is also important to disentangle tax- from business-motivated structures, as an intervention to reduce, e.g., profit shifting, might have negative effects on the economy if banks' business operations accidentally become targeted.

While we know that the response to taxation is heterogeneous across banks, we do not know whether small, medium-sized or large banks engage in different degrees of tax avoidance. Could it be possible that small banks pay a lower amount of taxes than large banks? The mechanisms for decreasing income tax expense might also differ between those groups. An effective tax policy would need to take these effects into account.

The results on how banks perceive customers' tax avoidance are mixed. Kovermann (2018) outlines that banks might respond differently to customers' tax planning when it consists of risky positions. For that matter, further research is necessary to disentangle banks' reactions to tax avoidance from their tax risk.

## 11. Conclusion

In this review, I systematize studies in the intersection of banks and corporate income taxation. To structure the review, I apply a stakeholder approach. I group studies according to the effect corporate income taxation has on banks and how this effect transfers to their main stakeholders (customers, regulators, investors and tax authorities).

Not surprisingly, banks incorporate corporate income taxation into their decision-making process. The evidence shows that corporate income taxes seem to foster banks' debt-financing, incentivize them to shift part of their tax burden to customers, leads them to exploit international tax rate differentials and incentivizes them to change their organizational form when the expected benefits outweigh the costs.

Although the empirical literature on banks and corporate income taxation has grown in the past decade, there are still many areas to assess. Future research should provide more evidence on whether tax regulation impacts small banks differently than large banks, which channels banks use to decrease tax expense, how tax aggressiveness differs across banks and in relation to non-banks and how corporate income tax rules interact with other regulatory requirements and additional taxes.

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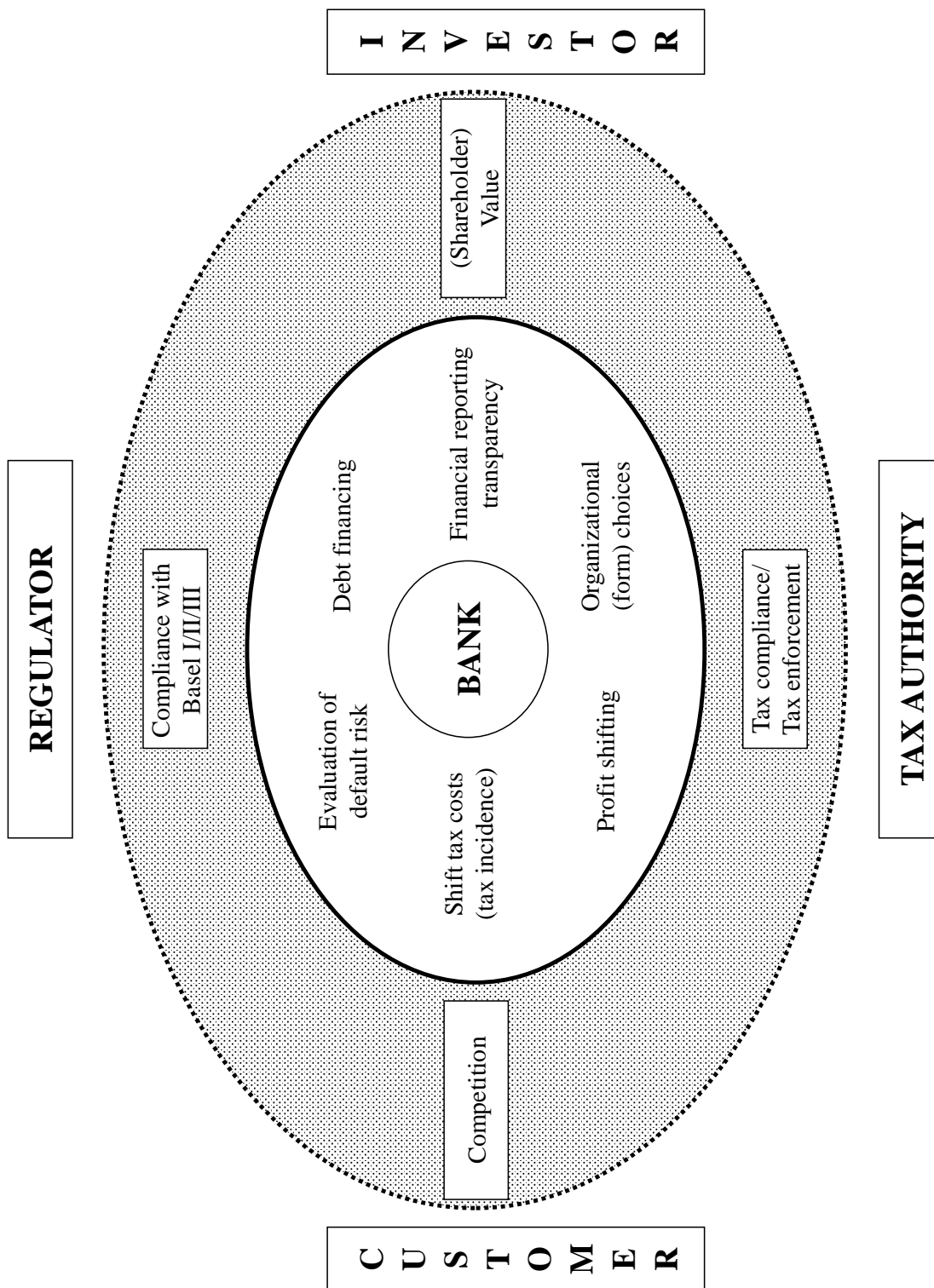


Figure 1.: This figure describes the relation between corporate income taxes, banks' internal actions of minimizing tax expense (inner circle), the institutional setting that is driving banks' actions (outer circle) and the part banks' main stakeholders have in this. Partially modified I use this approach to show how taxes influence or mediate the association between banks and the institutional surroundings.

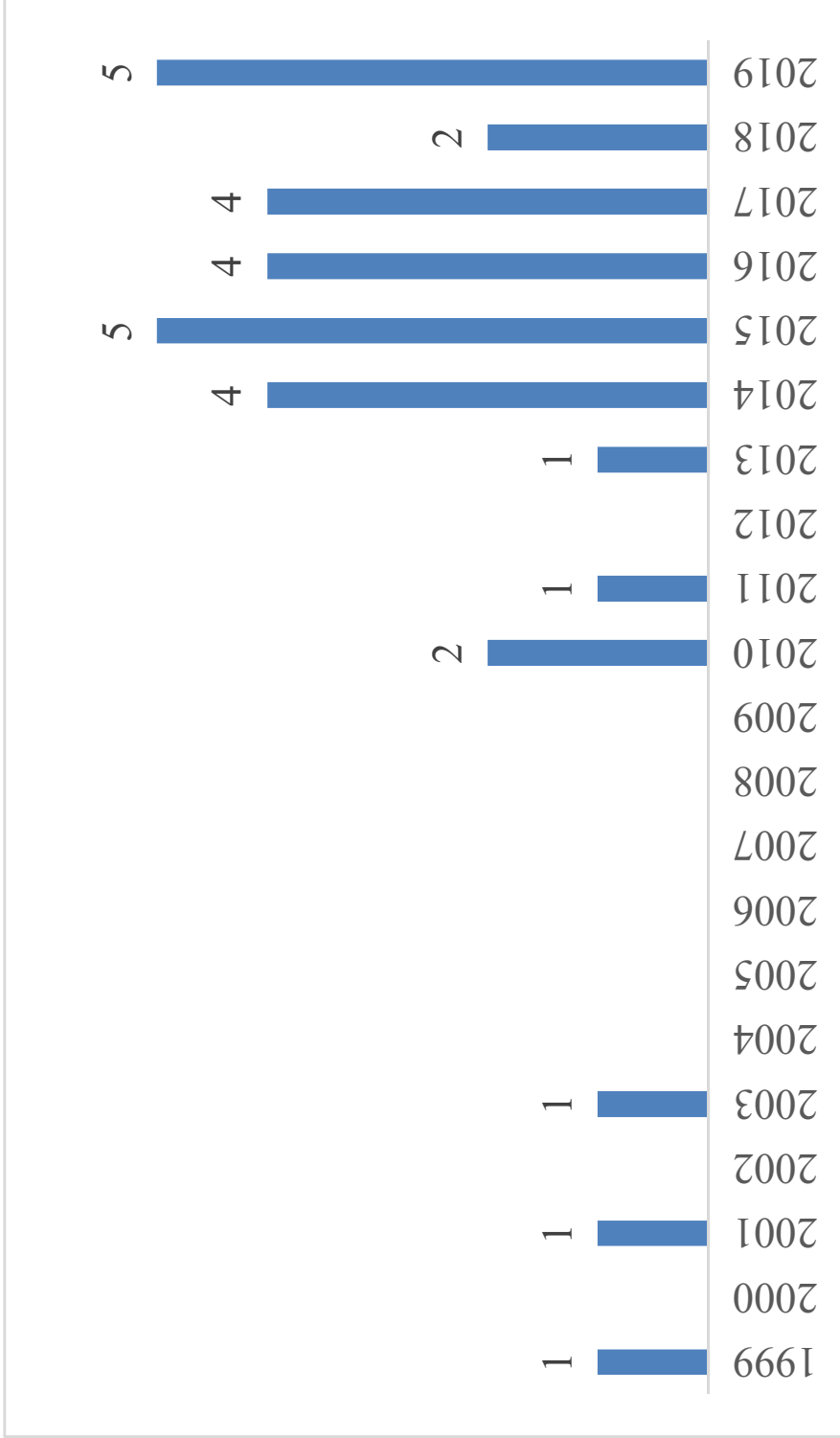


Figure 2.: This figure shows the distribution of published papers per year. The selection process is described in table .

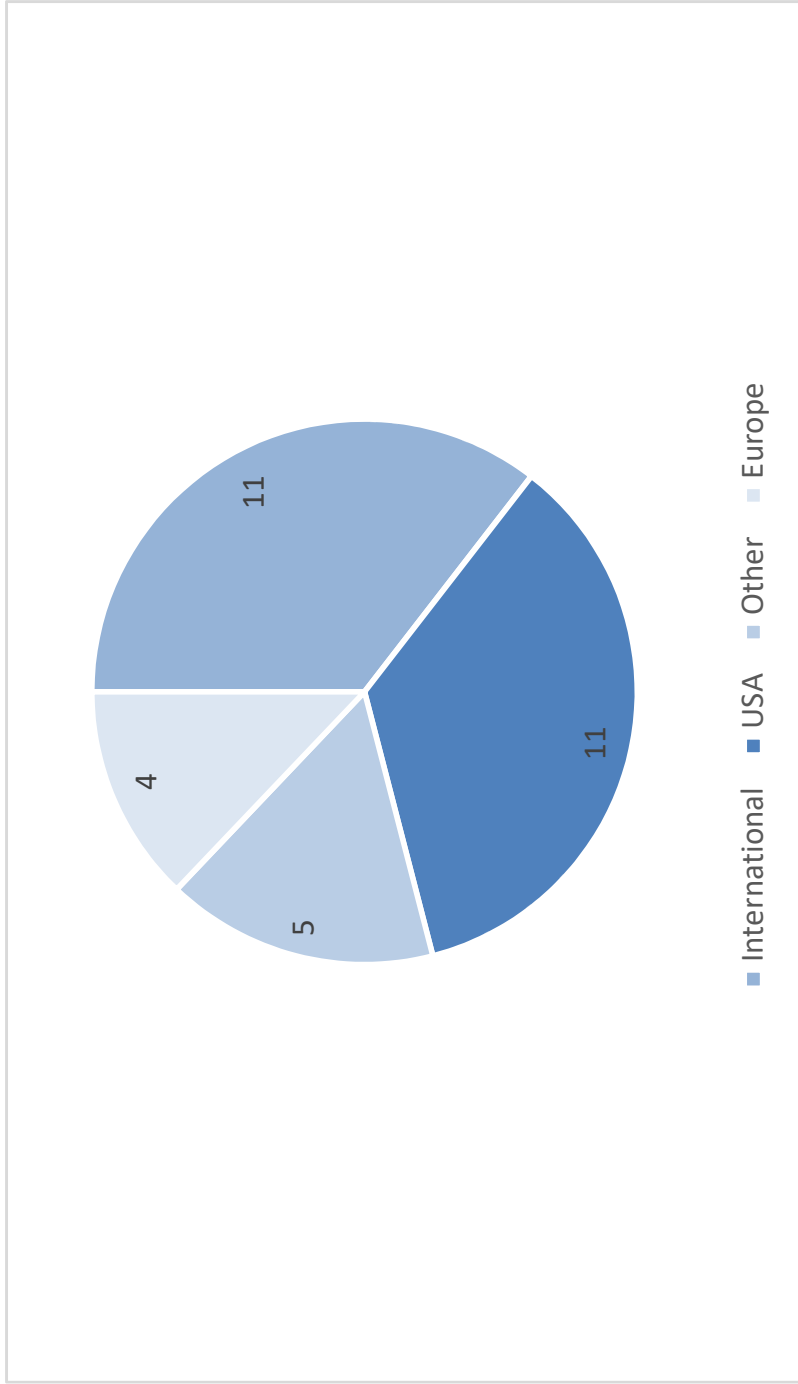


Figure 3.: This figure gives an overview of the countries that papers use as their sample countries. **Europe** denotes papers that use a cross-section of European countries. Single-country studies that only look at one specific EU country (like e.g. Schepens (2016) whose sample country is Belgium) fall under the category **Other** and are therefore not included in **Europe**. **International** refers to those studies that use a wide range of countries not specific to certain continents. The category **USA** includes all studies with a U.S. sample.

Author	Year	Research question	Capital structure item	Tax variable	Sample split	Effect
de Mooij/Keen	2016	How strong is the tax distortion in banks' capital structures arising from the preferential treatment of debt against equity?	leverage ratio	corporate income tax (CIT) rate	all observations	+
			conventional debt hybrids			+
Gu/ de Mooij/ Poghosyan	2015	How do corporate taxes affect the capital structure of multinational banks? Does the corporate tax rate induce subsidiary banks to raise their leverage?	risk-weighted leverage ratio	CIT rate of host country (debt bias)	capital abundant banks	+
			equity buffer			no effect
			leverage ratio	Δ CIT rate home and CIT rate host (debt shifting)	capital tight banks	no effect
						strong +
Heckemeyer/ de Mooij	2017	How do banks and nonbanks react to debt bias? Are the reactions different with varying degrees of firm size?	leverage ratio	debt bias + debt shifting	capital abundant banks	strong +
						debt bias: weak +
Hemmelgarn/ Teichmann	2014	Do banks confronted with a tax rate change adjust their capital structure differently compared to banks that were not affected by a tax change?	leverage ratio	CIT rate	capital tight banks	debt shifting: weak -
						strong +
				CIT rate	non-banks banks	+
				CIT rate*Size	non-banks banks	+
				CIT rate	medium/ small banks	strong +
					large bank	weak +
					medium/ small nonbanks	weak +
					large nonbank	strong +
				Δ tax rate + lags of Δ tax rate	all observations	+/- general adjustment to tax rate changes

Figure 4.: This figure provides an overview in alphabetical order of those studies that assess the tax attractiveness of debt and its implications for bank capital structure.



Author	Year	Research question	Capital structure item	Tax variable	Sample split	Effect	
Martin-Flores/Moussu	2019	How do banks react to an allowance on equity (ACE) in Italy? Do banks react symmetrically to the introduction and removal of that allowance?	equity ratio	interaction ACE (treated)*post	all observations (introduction ACE)	+	
			total bank assets			no effect	
			retained earnings	binary variable post	treated banks (introduction ACE)	+	
			equity ratio	interaction ACE (treated)*post	all observations (removal ACE)	-	
			total bank assets			+	
			retained earnings	binary variable post	treated banks (removal ACE)	no effect	
Schandlbauer	2017	Do financial institutions adjust their capital structure/leverage upon a tax increase?	non-depository debt ratio	interaction tax increase*BC interaction tax increase*WC	better-capitalized banks worse-capitalized banks	+	
			conversion of hybrid instruments (mezzanine items, subordinated debt)	interaction tax increase*BC interaction tax increase*WC	better-capitalized banks worse-capitalized banks	no effect	
			equity ratio				
			total assets				
			total loans				
			retained earnings				
Schepens	2016	Is reducing the relative attractiveness of debt-financing by the introduction of an ACE a suitable addition to bank capital regulation?	equity ratio	interaction Belgian banks*post	all observations	+	
			total assets			no effect	
			total loans			no effect	
			retained earnings			+	
			other equity			no effect	
			equity reserves			no effect	

Figure 5.: Figure 4 continued

Baseline sample from Web of Science search	92
- Analytical studies	14
- Normative or legal approach	9
- Individuals' taxation and bank deposits	4
- Taxes other than corporate income taxes	7
- No explicit focus on banks	14
- Others	13
Final sample of published papers	31

Table 1.: This table shows the sample selection process. I start with a sample of 92 published papers. I lose papers due to their methodological focus, due to a focus on other business-related taxes, and when papers do not explicitly focus on banks.

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