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Growing in a changing environment
Understanding the Upside of Tax Losses

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Foreword

As the recent financial crisis and economic downturn continues to reshape the global financial services industry, there are many institutions who consider this disruption as the perfect opportunity to grow their business. These institutions are looking to make acquisitions while prices are attractive, collect quality talent that has been cut loose into the market, and capture customers who are fleeing struggling institutions. They are also examining ways to exploit the low price of certain structured products, utilize recent losses to reduce their future tax exposure, and re-align their cost base to position them for growth when the market recovers.

One of the most immediate sources of value is in the area of tax losses. If correctly utilized, these losses have the potential to offset tax payments on future profits, giving institutions a head start in the recovery years to come. However the complex tax codes around the world, and the rapid reorganization of many institutions, means that these tax losses can easily vanish if not carefully understood and managed. In addition many of these tax losses are time sensitive, and will require careful treatment if they are to remain of value to each institution. This Deloitte report outlines some of the key considerations that need to be taken into account during the *current* period, in order to ensure that the tax losses can be utilized for benefit in *future* period of growth.

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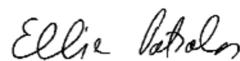
As the financial landscape continues to change, Deloitte's *Global Financial Services Industry* network is committed to providing continued thought leadership, surveys and studies on the issues most important to global financial institutions. Deloitte's aim is to help guide clients through these challenging times and provide them with insights useful in not only *surviving* the credit crisis, but essential for them to continue 'Thriving in a changing environment'.

Regards



Ellie Patsalos
Leader, Global Tax Financial Services Industry
Deloitte Touche Tohmatsu

Understanding the Upside of Tax Losses

The current global financial crisis has left many financial institutions awash with losses. However, the ability to utilize these losses against future profits requires careful consideration of local tax codes and an understanding of the time-sensitivity of many of these tax losses.

The current global financial crisis has left many banks and other financial institutions awash with losses. It might be concluded that all will be plain-sailing for the tax department in the years to come as huge losses incurred through the downturn are offset against potentially more modest profits, when the markets eventually start to recover.

This could be a costly conclusion; now is not the time to turn attention away from tax. But what action should the CFO be taking? Where should the tax department focus its resources? How should it measure its contribution and results in an environment where the Effective Tax Rate (ETR) is becoming less relevant for many companies?

No company can assume that the tax benefit of its operating losses is a foregone conclusion. The CFO and tax director should be ensuring that book losses are flowing through to the tax returns. Both permanent and temporary or timing differences should be understood and managed and all action should be taken with a view to maximizing the company's ability to efficiently utilize losses as the business recovers.

The lessons of the financial institutions in Japan during the 1990s demonstrate that large losses are no protection from tax audits and further, in times of falling profits and shrinking revenues tax authorities will be seeking to replenish public coffers more than ever. Dave Harnett, (head of HMRC) and other members of the Joint International Tax Shelter Information Center announced at the start of this year their intention to work together to prevent manipulation of tax losses by large banks and other businesses as they fear that new and innovative ways of using tax losses will deprive them of further tax revenues[1]. A UK think tank, the Centre for Economics and Business Research recently put the loss of tax revenues from the financial sector at GBP28bn for the coming year[2].

But it is not simply an awareness of risk attaching to innovative loss utilization. During this period of rapid change for many financial institutions, tax losses, which may seem assured, could be at risk as companies restructure, shareholders change and businesses refocus their strategies.

A change of shareholders in the current environment may also have a significant impact on the Board's attitude toward tax risk and perceived aggressive or innovative tax planning, especially where those shareholders, and for some banks, the controlling shareholder, are now national governments.

It is absolutely essential in this environment that tax losses and similar tax attributes are managed in real time, to minimize risk of forfeiture and maximize current and future benefits. In order to do this, tax should be considered at the start of the decision-making process throughout this defining period.

Restructuring the business

Many companies are re-examining the way they do business, determining the core successful business and restructuring to focus on these areas. A takeover or a major change in shareholders (say, arising through a merger of businesses) may limit a corporation's ability to utilize losses incurred prior to the transaction. Moreover, internal restructuring alone may be sufficient to threaten available tax losses in some jurisdictions or across multi-jurisdiction operations. At the simplest level, the future use of losses arising in respect of a specific business may be lost or badly limited in certain jurisdictions if that business is terminated, even if the group as a whole continues to trade. Consolidation of businesses, intended to reduce costs, may also put tax losses at risk.

1 "Expecting the housing market to crash soon" CEBR, March 16, 2009
2 "International tax review", January 27, 2009

In profitable periods, loss restriction rules may not have been considered in any depth in internal reorganizations, but during periods of large losses – precisely the time when groups are now likely to undertake major restructuring – these rules must be considered carefully within the cost/benefit analysis of any business model. The CFO will need to ensure that tax is considered in the early stages of any reorganization.

That is not to say loss restrictions are the only possible outcome of restructuring. Tax legislation in some jurisdictions is intended to assist companies in trouble and additional flexibility may be available on termination of a business such as loss carry-back (indeed some, such as Norway are looking to extend these benefits in the current climate). But the capacity to benefit from these rules may be limited where a company's losses are far in excess of the previous year's profit. Loss carry back is, however, one of the most effective ways of unlocking the benefit of tax losses as it can give an immediate cash repayment of tax at a time when cash is scarce.

Efficient loss utilization

To fully understand the impact on losses, the CFO must ensure that the tax department is involved in business planning and forecasting. It is all very well to protect a loss from inadvertent forfeiture at the time of a restructure, but if significant losses become trapped in an entity or jurisdiction where the business has been restructured to limit future risk and therefore future profit, it may be years before the benefit of these losses can be fully realized. In a few jurisdictions, losses do not have a shelf life (the UK being one such exception); in many more jurisdictions, though, losses may expire if not used within a fixed period.

One of the most effective ways to obtain a benefit from tax losses is through carry-back against prior year profits, if available. This may give certainty of use and result in a tax repayment rather than a benefit at some time in the future. Such a strategy may require a rethink of priorities and change in tax department behavior. Where previously tax returns may have been filed close to the filing deadline as a matter of course, it may now be beneficial to file returns considerably earlier, and resource focused on this area, if repayment of tax cannot be obtained until the tax return for the loss period is submitted with the tax authorities.

Some tax authorities are acting to assist early repayment of taxes. The 2009 Singapore Budget, for example, includes temporary enhancements to the loss carry back regime, including allowing provisional claims for tax refunds to be based on estimated losses rather than finalised assessments.

There are a number of other strategies the tax department of a loss-making business will be considering to maximize the benefit of tax losses, including deferring these losses where there is a risk they may expire. However, this can only be efficiently planned if the tax department is working with the latest information regarding the future direction of the business.

Where tax losses cannot be immediately utilized, businesses need to consider the extent to which losses carried forward can be recognized for accounting purposes, as well as the value that regulators might put on deferred tax assets representing loss carry-forwards. The lessons of the Japanese banks in the "lost decade" should be remembered. A stark example of the risk attaching to losses was the government rescue of Resona Bank in May 2003, following the bank's auditors refusing to recognize more than three years of deferred tax assets. This resulted in the FSA declaring that the bank was undercapitalized as the capital adequacy ratio would consequently have fallen well below the minimum 4% required, to around 2%. Corporations cannot afford to risk a challenge from auditors who must consider these assets with ever more caution and banks and other similar institutions might evaluate if there are transactions pursuant to which deferred tax assets might be replaced with other assets.

Much has also been made of the very significant amounts of deferred tax assets included within the regulatory capital of Fannie Mae and Freddie Mac when the US Treasury and Federal Housing Finance Agency seized control of these entities last year. While the key issue is a regulatory one – to what extent should such assets be recognized within regulatory capital? – it does highlight the fact that, while tax accounting has always been important, it has rarely had a higher profile.

Tax v Book

The amount of a tax loss that may be recognized for accounting purposes is one concern. Even assuming all such tax losses may be recognized, there may be significant differences between book and tax losses. The Board needs to be aware that a loss that has crystallized in the books of the business, may not necessarily be triggered for tax purposes in the same period and therefore may not be available for utilization. No tax director relishes the prospect of explaining to their CFO why a corporation making a sizeable loss for book purposes is still in a taxpaying position. However, it is possible for such a scenario to occur. Many countries will not allow a tax deduction for provisions or reserves, it is only when the loss is realized that the deduction may be taken and even then some countries impose further onerous restrictions before write offs are allowed. This may result in material book tax differences. CFOs and tax directors should be making sure that their Board knows exactly the type and size of book losses that will not result in a tax loss and at what point a tax loss may be triggered. This should not come as an unpleasant surprise during financial reporting, or worse, when cutting a cheque for the taxman.

There has been a trend in recent years towards the alignment of tax treatment with accounting principles where possible in many territories, which should help to reduce book and tax differences. However, tax legislation is often more than one step behind. Given the current crisis, the SEC and IASB are allowing mark-to-market rules to be relaxed, with this method of valuation now considered by many to be fundamentally flawed. In territories where the tax treatment does not follow book, there may be significant differences.

As accounting methods change, how is this likely to affect the recognition of tax losses as compared to accounting losses, or will the two diverge? The tax department needs to have good systems in place to monitor differences between book and tax losses and changes in the accounting and tax treatment of these losses in different territories. Maximizing tax losses may be too simplistic a target, it is efficient utilisation that should drive strategy. The rules for utilizing tax losses in the period in which they arise may be more flexible. Losses carried forward, may be more restricted in use; they may only be carried forward against profits of the same company, or may be restricted to a percentage of profits, or expire after a specified period, or only be available for set off against certain types of income. In certain circumstances therefore, it may in fact be beneficial for losses to be deferred where possible, and triggered when they can be effectively used.

The tax director's target should be to maximize efficient use of losses and understand how this will be achieved, rather than simply to minimize the differences between book and tax losses. Those tax losses that cannot be recognized for accounting purposes should not necessarily be forgotten. A corporation's unprovided losses may yet be available for use as forecasts change, and protection of these losses should be no less closely monitored. Some companies are actively compiling potential tax planning strategies and techniques to increase the benefit of losses sustained but not recorded. As the review and analysis of those transactions is completed, it might be possible to increase the benefits recognized for financial statement purposes.

Tax credits … or are they?

Although the discussion so far has focused on taxes on profit, it is important to remember taxes withheld at source. These will often continue to be levied, regardless of a business being in a loss-making position, as they are calculated and withheld on gross income (interest, dividends), rather than profit. Previously, withholding taxes may only have been considered a cash flow disadvantage for many profitable businesses, as these taxes could generally be credited against the main corporate tax liability. Or, even if they were not creditable, the withholding taxes might have had a reduced cost because they might have been tax deductible. However, where there is no corporate tax liability, due to losses, there may be a real and full tax cost arising from withholding taxes. Businesses should therefore be examining taxes withheld at source and ensuring these are minimized where possible.

Efficiency in this area cannot be achieved by the tax department alone. Whether tax is deductible at source will depend on the exact nature of the contract or transaction entered into. A product structured so as to achieve a return by way of interest income may be subject to withholding tax, whereas a product providing a gain or loss on maturity may not.

At the most basic level, withholding tax rates may often be reduced under tax treaties between the two countries of the respective parties. However, in order to apply these lower rates, it may be necessary to obtain advance tax authority clearance, or ensure certain documentation between contracting parties is in place at commencement.

The tax department may become involved only after contracts are signed and transactions completed, when withholding tax has already been deducted and paid. Minimization of withholding taxes must therefore involve client-facing management. Front office staff must be educated in effective withholding tax management. Generally, withholding taxes on income flows do not impact front office staff compensation – staff are generally compensated on a pre-tax basis. There may be a strong argument now to deduct un-creditable withholding taxes from front-office P&Ls. And if this is put in place, how would the tax department ensure they are able to maintain sufficient control over tax risks?

Tax capacity usage transactions may also have been entered into during tax-paying times, effectively allowing corporations to utilize excess tax credits. However, such transactions assume a certain level of tax capacity going forward and may be economically unprofitable pre-tax. The ability to execute such transactions needs to be reviewed in the new environment and the tax department should ensure that the tax profile of the group allows for tax capacity transactions.

Aligning transfer pricing

Tax losses within the current environment must also be considered from a transfer pricing perspective. Transfer pricing is not just a stick for tax authorities to beat businesses with in times of profit, it can also be used to challenge losses, both in absolute terms or in the relative allocation of losses on a given transaction amongst group participants. With the unprecedented speed with which markets are changing, it is vital that transfer pricing models are re-examined to ensure they are aligned with the current environment and are not based on pricing models that are no longer relevant. The CFO and tax director must ensure that the group's transfer pricing keeps pace with developments in the market or either risk lengthy disputes with tax authorities further down the line or risk missing out on opportunities to ensure tax efficiency today.

In recent years, transfer pricing models may only have needed minor annual adjustment; now they may require wholesale review.

A transfer pricing policy that has not been adjusted to reflect changes in economic risk between group companies, has a greater risk of losses stranded in jurisdictions that may never have sufficient profits to absorb the loss. Data previously used to benchmark transactions and results, or transactions previously considered comparable, may be unreliable and out of date. Moreover, with increased potential regulation may come new increased disclosures about financial transactions and results, so tax directors may have to consider data from new sources to evaluate the arm's length result.

It is crucial that the CFO supports the tax department to drive changes in transfer pricing policy to ensure internal pricing keeps pace with external. As external pricing changes in the current environment, does the transfer pricing policy still reflect deals with third parties? Is the return to capital still sufficient, given the increased risk evident in the market today? Should banking groups which are increasingly charging significant fees to external customers be replicating this with group entities? Should interest rates be aligned to ratings of individual borrowers, or should guarantee fees be considered? There are many new questions to be answered about intercompany funding and treasury functions.

In recent years, transfer pricing models may only have needed minor annual adjustment; now they may require wholesale review. Pricing between group companies may not have great visibility at Board level where the consolidated results of the group and more importantly the external losses of the group are priority. However, tax authorities may later come to question whether sizeable intra-group balances would have arisen to such an extent between unrelated parties. Is restructuring of old debt or provision of new debt to a struggling subsidiary something that may be challenged by the tax authorities as a capital injection and interest expense deductions denied?

A loss or expense denied by the tax authority in one jurisdiction will not automatically mean a matching adjustment is available in the other jurisdiction and double taxation may arise.

The tax department should be thoroughly reviewing the group's transfer pricing policy in conjunction with commercial management to identify potentially out-of-date pricing and allow swift adjustment. This should not just protect against future challenge by tax authorities, but provide an best opportunity to ensure that losses are efficiently utilized as the business recovers.

The opportunities

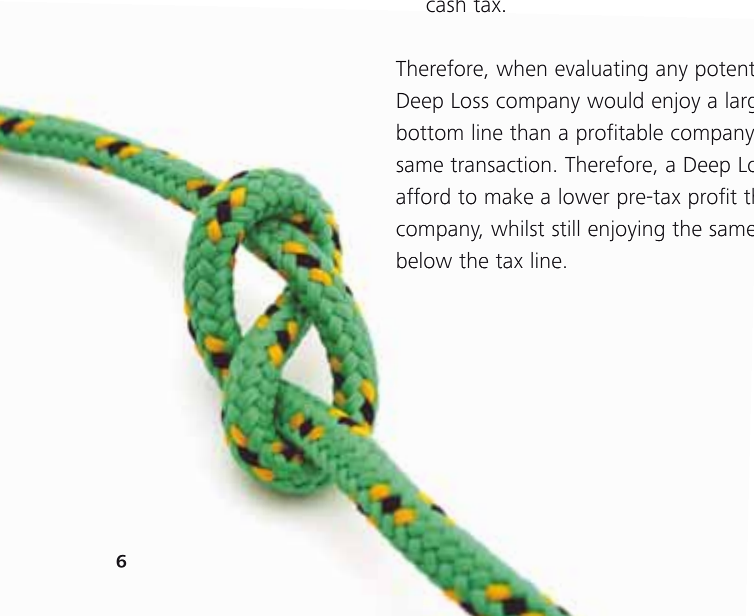
In the current environment, there are some entities that will have considerable losses, and some that will have losses so substantial that they will have significant valuation allowances raised against those losses. Therefore, the profit on a transaction will be treated in one of three ways:

1. Profitable companies will recognize a tax expense in their financial statements and pay cash tax to the relevant tax authorities.

2. Loss companies that do not have any valuation allowance will still recognize a tax expense in their financial statements (reducing NOLs), but will not pay any cash tax.

3. Loss companies with a large valuation allowance (a "Deep Loss company") will neither recognize any tax expense in the financial statements (as the NOLs are not recognised as assets), nor will they pay any cash tax.

Therefore, when evaluating any potential transactions, a Deep Loss company would enjoy a larger gain on the bottom line than a profitable company assessing the same transaction. Therefore, a Deep Loss company can afford to make a lower pre-tax profit than a profitable company, whilst still enjoying the same, or better return below the tax line.



In general, most front offices are compensated on a pre-tax basis, and as such, the potential benefit highlighted above may be missed. However, analysts use post-tax numbers in analysing performance, and as such, any benefits that can be received through exploiting the above should have a positive impact on the share price.

Now may also be the time to consider the internal restructuring that was commercially desirable, but previously considered tax inefficient. Transactions to achieve internal efficiencies that may previously have been put on hold due to potential for triggering taxable gains or profits on fair market value transfers, should now be revisited. These gains may be significantly reduced or eliminated in the current environment and now may be the time to reconsider the corporate structure.

Conclusion

Although ETR has been a useful tool for monitoring whether tax was being efficiently managed, it should never be the only measurement. Other key performance indicators that have perhaps been considered less important should now be re-examined. Effective tax management for a loss making business must be measured over an extended period to determine effectiveness. It is not simply a matter of making sure tax and book losses match, and in fact this may not always be efficient. Quick wins such as loss carry-back, should be implemented swiftly where possible, thus providing a more immediate cash benefit.

The eventual ability to use tax losses is key, and the importance of minimizing the risk of future challenge by tax authorities cannot be underestimated. Tax risk is as great an issue now as during high tax-paying periods.

Finally, the tax opportunities available to businesses during a loss period, such as the potential to implement stalled internal restructure plans, should not be missed. As such, it remains as vital as ever today that tax departments ensure that they keep the focus of their CFOs, and that CFOs consider how best to monitor and evaluate their tax departments.

Contributors

Ellie Patsalos
Leader, Global Tax Financial Services Industry
Deloitte Touche Tohmatsu
44 20 7007 1844
epatsalos@deloite.co.uk

Clare Stobbs
Deloitte Touche Tohmatsu
Japan
81 3 6213 3772
clare.stobbs@tohmatsu.co.jp

Nick Walters
Tohmatsu Tax Co.
Japan
81 3 4218 4933
nicholas.walters@tohmatsu.co.jp

Richard Standing
Deloitte & Touche LLP
Singapore
65 6216 3157
rstanding@deloitte.com

Leonard Khaw
Deloitte Touche Tohmatsu
China
86 21 6141 1498
LKhaw@deloitte.com.cn

Deloitte member firm country tax contacts

Asia Pacific

Leonard Khaw
Regional Leader, Asia Pacific
Tax Financial Services Industry
Deloitte Touche Tohmatsu
China
86 21 6141 1498
lkhaw@deloitte.com.cn

Australia
Neil Ward
Deloitte Touche Tohmatsu Ltd
61 3 9208 7444
nward@deloitte.com.au

India
Virendra Mittal
Deloitte Haskins & Sells
91 22 6619 8410
virmittal@deloitte.com

Japan
Yang Ho Kim
Tohmatsu Tax Co.
81 3 6213 3841
yangho.kim@tohmatsu.co.jp

Singapore/South East Asia
Richard Standing
Deloitte & Touche LLP
65 6216 3157
rstanding@deloitte.com

Taiwan
Cheli Liaw
Deloitte & Touche
886 2 2545 9988 x3943
cheliliaw@deloitte.com.tw

EMEA

Nigel McCrea
Regional Leader, EMEA Tax
Financial Services Industry
Deloitte LLP
United Kingdom
44 20 7007 3652
nmccrea@deloitte.co.uk

Austria
Josef Schuch
Deloitte Consulting
GmbH
43 153 7000
jschuch@deloitte.com

Belgium
Johan Van Der Paal
D Belastingconsulenten
32 2 600 66 39
jvanderpaal@deloitte.com

Central Europe
Peter Wright
Deloitte Central Europe
420 246 042 888
pewright@deloitte.ce.com

Denmark
Jacques Peronard
Deloitte Statsautoriseret
Revisionsaktieselskab
45 36103346
jperonard@deloitte.dk

France
Gianmarco Monsellato
Taj – Société d'avocats
33 1 55 61 63 46
gmonsellato@taj.fr

Germany
Marion Farnschläder
Deloitte & Touche GmbH
49 69 75695 6303
mfarnschlaeder@deloitte.de

Ireland
Paul Reck
Deloitte & Touche
353 1 417 2470
preck@deloitte.ie

Italy
Mauro Lagnese
Studio Tributario E Societario
39 0283 324097
mlagnese@deloitte.it

Luxembourg
Pascal Noel
Deloitte SA
352 45145 2571
pnoel@deloitte.lu

Netherlands
Caroline Zegers
Deloitte Belastingadviseurs B.V.
310 10 880 1400
czegers@deloitte.nl

Russia
Maxim Lubomudrov
RepOffice of Deloitte &
Touche RCS Ltd
7 495 7870600 x3093
mlubomudrov@deloitte.ru

Saudi Arabia
Nauman Ahmed
Deloitte & Touche Bakr
Abulkhair & Co.
966 3 887 3937
nahmed@deloitte.com

South Africa
Nazrien Kader
Deloitte & Touche
27 11 209 6030
nkader@deloitte.co.za

Spain
Luis Fernando Guerra
Deloitte Asesores Tributarios,
S.L.
34 915820900 x1932
luguerra@deloitte.es

Switzerland
Irene Salvi
Deloitte AG
41 44 421 6386
isalvi@deloitte.ch

Turkey
Sebahattin Erdogan
DRT YMM Bağımsız Denetim A.
90 212 366 60 93
serdogan@deloitte.com

The Americas

William Rogers
Regional Leader,
The Americas Tax Financial
Services Industry
Deloitte Tax LLP
United States
1 212 436 4305
wrogers@deloitte.com

Argentina
Pablo Tonina
Deloitte & Co. S.R.L.
54 11 432 02776
ptonina@deloitte.com

Brazil
J. Camilo Santos
Deloitte Touche Tohmatsu
Consultoria Contabil e
Tributaria Ltda
5511 5186 1003
jcsantos@deloitte.com

Canada
Jocelyn Blanchet
Deloitte & Touche LLP
1 416 601 6405
jblanchet@deloitte.ca

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