Adding value in a time of volatility
Tax Topics for the Financial Services Industry

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Foreword

As the recent financial crisis continues to reshape the global financial services industry, there are many institutions who are viewing this as an opportunity to 're-invent' the way they do business. These institutions are examining what structural changes their business will require in future, what long-standing business processes need updating to meet the new market reality, and what legacy systems are in need of an overhaul. They are also examining their strategic direction, deciding what markets they want to compete in, and even challenging the type of financial institution they should be categorized as.

One key element of this business 're-invention' is to carefully consider the tax impact of each of these market driven changes. For example, acquisitions or divestments can have a significant impact on the tax efficiency of an organization – particularly the utilization of recent tax losses at some business units – and this impact needs to be taken into account before executing any deal. Tax considerations should also be part of any operational redesign, with plenty of opportunity to update transfer pricing models to the new environment, or to further integrate tax reporting into finance transformation programs. Finally, tax issues also need to be included as institutions reshape their talent strategies, particularly in their approach to executive compensation.

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 clients to continue 'Thriving in a changing environment'.

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Regards

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Tax loss utilization

Understanding the upside of 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 plainsailing 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.

In times of falling profits and shrinking revenues tax authorities will be seeking to replenish public coffers more than ever. A UK think tank, the Centre for Economics and Business Research, recently put the loss of tax revenues for the UK Treasury from the financial sector at GBP28bn for the coming year.[1] 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.[2]

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.

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.

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; in many more jurisdictions, though, losses may expire if not used within a fixed period.

1 "Expecting the housing market to crash soon" CEBR, March 16, 2009

2 "International tax review", January 27, 2009

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. Early filing of returns may allow early repayment of taxes and tax department resources should be refocused accordingly. Helpfully, 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 finalized assessments.

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 carryforwards. 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. 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.

More recently, the size of deferred tax assets included within the regulatory capital of Fannie Mae and Freddie Mac were widely debated when the US Treasury and Federal Housing Finance Agency seized control of these entities last year. While it has always been important, tax accounting has rarely had a higher profile.

Tax vs. Book

Even assuming all tax losses may be recognized for accounting purposes, 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. 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 might impose 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.

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 utilization that should drive strategy. The rules for utilizing tax losses in the period in which they arise may be more flexible. Losses carried forward, however, may be restricted in use; they may, for example, be restricted to a percentage of profits, or expire after a specified period. In certain circumstances, it may in fact be beneficial for losses to be deferred where possible, and triggered only when they can be effectively used.

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 these 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 the 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. 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 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. Therefore client-facing management must be educated in this area and effective withholding tax management included within commercial targets.

Aligning transfer pricing

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

A thorough review of the group's transfer pricing policy now, in conjunction with commercial management, should not just protect against future challenge by tax authorities, but provide an opportunity to ensure that losses are efficiently utilized as the business recovers.

The opportunities

In the current environment, some entities will have considerable losses, and some 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.

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 (as the NOLs are not recognized 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 and can afford to make a lower pre-tax profit than a profitable company, while 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 analyzing 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.

Acquisitions and divestments
The tax impact of rapid restructuring

Given the enormous impacts of the current financial crisis many financial institutions have already begun significant restructuring programs to help restore them to profitability. However acquisitions, divestitures, and other capital raising activities can have a major impact on the tax efficiency of an organization.

In recent months we have read a great deal about how many banking groups are going through divestment and restructuring programs with a view to restoring investor confidence and enabling a return to sustainable profitable business models. Recent examples include Citigroup in the US and RBS in the UK who have both announced significant divestment and restructuring programs.[3] As a result, tax departments will be concerned with the management of these divestment and restructuring programs and ensuring that these programs are executed in a tax efficient way. Furthermore, it will also be important for banks to understand the tax issues associated with any participation in government financial stability schemes.

Acquisitions

Over the last 12 months there have been a number of high profile acquisitions involving US and European banking groups. This in itself has brought particular challenges and placed additional resource demands on bank tax departments.

Tax strategy and governance will need to be developed for the enlarged banking groups including stakeholder communication, tax risk policy, key performance indicators and tax group organizational structure. Tax departments will also need to support the business in post acquisition restructuring and integration as well as the disposal of non-core assets. This is in addition to the normal responsibilities of the tax department in supporting the business, ensuring that all statutory and compliance deadlines are met and dealing with tax accounting matters as part of the post acquisition reporting process.

Capital raising

A number of the key US and European banks have issued new capital to improve regulatory capital ratios and much of this capital has been subscribed by governments or other new investors rather than existing shareholders. This has led to a number of banking groups undergoing a change of ownership for tax purposes which has led, or may lead, to restrictions on the availability of tax losses carried forward. The definition of a change in ownership and impact of these rules will vary by jurisdiction. We understand that US banks are currently lobbying for an exemption from the US tax rules that restrict losses on a change in ownership if that change in ownership has been caused by US Government funding. Furthermore, the US has issued guidance as recently as October on the applicability of loss utilization on instruments acquired by Treasury under the Capital Purchase Program.

Good bank/Bad bank

Against the background of acquisitions and capital raising a number of banks have started to implement restructuring and divestment strategies and the term ‘Good bank/Bad bank’ has been used in this context. In a broad sense a Good bank/Bad bank restructuring involves the separation from the Good bank of ‘toxic’ assets (or assets where there is significant uncertainty over valuation) into a separate Bad bank. This separation could be a virtual separation for internal and external reporting purposes or could involve the creation of a separate Bad bank vehicle. The assets that are separated out into the Bad bank could also include assets or businesses that are not toxic but have been identified as being non-core. In any variation it will be important for banks to understand the tax issues associated with implementing a Good bank/Bad bank reorganization strategy. For example, achieving tax neutrality on intra-group transfers to a Bad bank entity in the current environment may be more about securing effective tax relief for losses rather than deferring unrealized gains.

3 thedeal.com, December 15, 2009

In addition the ability to effectively utilize tax losses incurred by a separate Bad bank entity against profits of the Good bank will depend on the way in which the Bad bank is structured.

Asset Protection Schemes (APS)

One of the areas where new thinking will be required is in connection with assets to be covered by government financial stability schemes including the UK Government's Asset Protection Scheme. The UK Asset Protection Scheme is similar to schemes also announced in Switzerland and the Netherlands for example.

For all of these schemes it will be important to consider where the assets are currently booked and whether the assets will be placed into a special purpose vehicle or single group entity. In the case of a Good bank/Bad bank restructuring the assets to be covered by the APS are likely to be part of the Bad bank and it should be straightforward to match any guarantee or similar fee payable under the scheme with the underlying assets if the assets are in a separate Bad bank vehicle. However, if the assets to be placed into the scheme remain on the balance sheets of different entities throughout the group the analysis is less straightforward. We would expect the asset protection will be pushed down to the asset holding entities from an accounting and regulatory perspective possibly through the use of internal group back to back arrangements.[4] Where the asset protection is pushed the guarantee fee would also be expected to be pushed down. Where the fee is pushed down to subsidiaries and foreign branches there may be challenges on deductibility of the fee and the transfer pricing arrangements from the relevant tax authorities.

Transfer pricing

The change in strategic direction by the banks towards core business areas and markets, increased focus on risk management, and a change in remuneration policy to align with this strategic change should also drive change to the group's transfer pricing approach and policies. Banking groups can expect challenges from tax authorities where assets are transferred from overseas jurisdictions or where overseas activities are closed as banks move out of non-core markets given the difficulty in collecting comparable market data. Where overseas branches are closed, banks may also be challenged on the profit attribution approach on the transfer of assets from the closed branches back to head office jurisdictions.

Disposal of non-core businesses and assets

As part of the restructuring programs banks may also be looking to sell non-core businesses and asset portfolios. Instead of structuring these disposals to minimize any tax costs, such as ensuring capital gains are realized tax free (e.g., under participation exemption regimes or similar), banks will be more likely aiming to secure value for tax losses attached to loss-making businesses and write downs on asset portfolios. In this respect conventional thinking on business and asset transfers will need to be turned on its head. For example banks may look to sell assets instead of shares as a way to realize value for tax losses and write downs as buyers will be reluctant to pay for tax losses given most jurisdictions have restrictions on the use of tax losses following a change in ownership.

Tax risk management

With an increased focus on risk management we would expect there will be an increased focus on achieving certainty on tax deductions for write downs, utilization of losses, and the tax treatment on acquisitions and disposals. Recent experience in the UK has been that HM Revenue & Customs are increasingly willing to engage in discussion on transactions on a real time basis given the current market environment.

Additional focus on taxation of banks

As a result of recent events there has been an increased focus on the regulation of banks including the use of off-shore financial centers and tax havens. In the UK, HMRC are expected to publish a draft code of practice on taxation for the banking sector, so that banks can comply with not just the letter but also with the 'spirit' of the law. The code of practice is expected to be published towards the end of April. It will be interesting to see how HMRC define the spirit of the law and what effect this will have on the way banks currently operate. It is unlikely that many banks would consider themselves as operating outside of the spirit of the law. When applying a particular statutory provision the UK courts generally take a purposive construction of the provision and therefore many tax planning schemes that go through the courts and that go against the purpose of the law fail. However, not all tax law has a clear purpose embedded in it (or at least, the purpose contended in court by HMRC). Where the purpose really isn't clear, where is the spirit? Additional scrutiny on entities operating in tax havens has been a high priority under the new administration.

4 In order to minimize any accounting volatility it is expected that the guarantee fee will be structured as a guarantee fee (recognized on an accruals basis to match underlying loan assets held on an accruals basis) and a derivative (which is fair valued for accounting purposes to match the underlying assets which are also fair valued for accounting purposes).

Among the things being contemplated are the treatment of foreign corporations managed and controlled primarily within the US as domestic for income tax purposes, the imposition of new rules on transactions and entities involving "offshore secrecy jurisdictions", and a codification of the economic substance doctrine.

Tax capacity and tax accounting

Tax losses that become trapped as a result of a restructuring may not be available for a significant period of time or lapse entirely. Change in ownership and change in activity following a restructuring can also lead to the risk of losses carried forward being restricted. The ability to plan and manage the timing of deductions and jurisdiction in which deductions are realized is increasingly important in the current environment.

Issues around the recognition of deferred tax assets for losses have arisen particularly where activities have been discontinued as a result of business restructuring. The uncertainty over the level of further write downs and losses means that additional resources will continue to be required in forecasting tax capacity and in supporting the recognition of deferred tax assets.

Conclusion

Overall this is a very challenging time for bank tax departments, both in terms of resource requirements and the technical issues that are coming out of the current economic environment, and in particular with regard to banking divestments and restructuring.

… this is a very challenging time for bank tax departments, both in terms of resource requirements and the technical issues …

Compensation and reward
Tax tactics to help keep top talent

The public and political scrutiny of financial institution bonus structures has put pressure on organizations to reshape their approaches to compensation. Tax burdens can have a significant impact on each of these new strategies and must be considered carefully before making a change to compensation.

Nobody can doubt the seismic changes affecting major financial institutions across the globe or the fundamental impact on the quantum and structure of executive compensation.

These changes come from a combination of factors:

- Plummeting revenues, profits and share prices which reduce the capacity of major organizations to raise pay levels while fall in equity values has further undermined the total compensation being received.
- Greater governmental ownership and asset protection have created political pressures for more regulation in affected organizations.
- Legislation that has placed restrictions on the deductibility of payments and the ability to design flexible arrangements.
- A concern that the "bonus culture" has contributed to the economic crisis through encouraging and rewarding undue risk taking.

The effects on tax thinking and the related structuring of compensation will be profound and will need to be factored into the thinking of shareholders, boards and remuneration committees at an early stage.

Compensation trends

The impact on executive compensation remains to be seen, but is likely to include:

- Reduced emphasis on short term bonus reward.
- More long term awards linking the delivery of compensation to demonstrable long term value creation.
- Recognizing the cost of risk in the composition of compensation.
- Reduced acceptability of short term tax based structuring.
- Where there is government funding, ongoing controls and reductions in compensation levels until that funding is reduced.
- Greater reluctance to defer compensation on a voluntary basis.

Tax impacts

This article is concerned with the likely implications for tax structuring for executive compensation. The effects on tax thinking and the related structuring of compensation will be profound and will need to be factored into the thinking of shareholders, boards and remuneration committees at an early stage.

In this article, we will consider the likely effects in the US and the UK. It is expected that similar issues will be seen in other countries.

United States

Recent changes have impacted the US tax system for both individuals and corporations and there is an expectation that individual tax rates will increase.

Current tax features

Some headline features of the US system which are relevant to compensation include:

	US
Highest individual ordinary income tax rate	35%
Employment taxes (assessed on both the employer and employee)	1.45% Medicare (uncapped) plus 6.2% social security (capped at $106,800 of wages for 2009)
Favorable capital gains tax rates	15% for long term holding assets
Highest corporate tax rates	35%
General symmetry between the timing of corporate tax relief and the incidence of personal tax charges	Yes

Likely trends

There is already an impact on the level and delivery of compensation and further restrictions as part of the government assistance programs will force further change.

Government assistance

The Troubled Asset Relief Program (TARP) is a program of the US government to purchase or insure up to $700bn of assets and equity from financial institutions. Recent legislation enacted places new restrictions related to compensation paid to top executives of companies receiving financial assistance from TARP.

These will be applicable to the highest-paid employees and the Senior Executive Officers (Proxy Listed Officers) based on the following schedule:

For affected executives, the only incentive compensation permitted in the future will be long-term restricted stock which:

Amount of funds received	Employees affected
<$25 million	1 most highly paid
$25-$249.99 million	5 most highly paid
$250-$499.99 million	SEOs + next 10 most highly paid
$500 million +	SEOs + next 20 most highly paid

(1) Does not fully vest while the company has an "obligation arising from financial assistance" under TARP.

(2) Is capped at one-third of the employee's total annual compensation.

(3) Is subject to other terms that the Secretary of the Treasury deems to be in the public interest.

In addition, any institution participating in TARP is subject to and must certify compliance with the following provisions:

- Treasury Secretary review of all 2008 compensation paid to the SEOs and 20 next most highly paid executives ("Affected Executives") with reimbursement sought for any payments ruled to be "inconsistent with the purposes of TARP" or "otherwise contrary to the public interest".
- A $500,000 deduction limitation (instead of $1 million) for all SEOs and publicly traded entities regardless of when the compensation is paid with no exception for stock options or other performance based compensation.
- Mandatory "clawback" of any incentive compensation paid to Affected Executives based on criteria found to be "materially inaccurate"
- A prohibition on "Golden Parachute" payments to SEOs and 5 next most highly-compensated executives for departure for any reason, except for payments for services performed or benefits accrued.
- Company policy relating to approval of luxury expenditures will be required.
- An annual, non-binding, shareholder "Say-on-Pay" vote.

- A prohibition on SEO compensation that includes incentives to take "unnecessary and excessive risks".

- A prohibition on compensation that encourages manipulation of earnings.

- The compensation committee of the board of directors must be made up solely of independent directors (although the board can act as committee for private entities and those receiving $25 million or less in funds).

Previous attempts to limit compensation paid based on tax penalties and requiring performance based compensation have had limited success. They have resulted in gross-up payments on excise taxes and companies foregoing deductions. It will prove challenging to design programs with the traditional purposes of attracting, retaining and motivating key talent. It remains to be seen whether high performers will be reluctant to seek other employment and will be willing to work for less in this difficult period of time as argued by some proponents, or if employees will seek opportunities at companies that are not subject to the restrictions.

Deferred compensation

Restrictions are placed on "nonqualified deferred compensation plans" related to the timing of elections, distributions and funding. If the plan does not comply with the requirements, then amounts deferred are included in income when deferred, or, if later, when no longer subject to a substantial risk of forfeiture, and amounts could be subject to a 20% "penalty" tax. There are some exceptions, mainly:

- Short Term Deferrals – payments made within 2½ months after the end of the year in which the compensation vested.

- Stock Rights – certain grants of stock options and stock appreciation rights.

- Restricted Property – property transfers taxable under Internal Revenue Code Section 83.

- Separation Pay – certain types of separation pay plans.

- Foreign Plans – contributions or accruals exempt from US taxation under an applicable tax treaty.

While future developments will be driven in part by the changes in the commercial design of compensation packages, it is possible to anticipate some of the tax responses.

Several factors are now influencing deferred compensation plans: (i) uncertainty regarding the financial health of companies; (ii) future tax rate increases; (iii) companies focusing on current deductions and (iv) the reduction in overall compensation levels. As a result, companies are looking to alternatives; potentially in the form of providing greater benefits through qualified plans which provide asset security or from the use of plans that would not be subject to the new rules.

Cost reduction

Companies are being forced to look at ways to increase their bottomline. This includes analyzing compensation plans and other employee benefits, including the cash funding requirements of pension plans. This could be achieved by funding plans with alternative assets which have depressed values but which have the potential for future appreciation.

United Kingdom

Tax features

Some headline features of the UK system include:

- Individual tax and social security rates combined at 41% rising to 51% for the highest earners (more than £150,000 per annum) from April 6, 2010.

- Corporate tax rates at 28%.

- General symmetry between the timing of corporate tax relief and the incidence of personal tax charges.

- Favorable capital gains tax rates (18%) with no requirement for long term holding of assets.

- Ongoing tax protections for individuals not domiciled in the UK for tax purposes.

- An increasing focus on counteracting tax avoidance.

Likely trends

While future developments will be driven in part by the changes in the commercial design of compensation packages, it is possible to anticipate some of the tax responses.

Government ownership

The UK has seen a systematic move by HMRC to counter aggressive tax avoidance. This was demonstrated by the announcement in December 2005 of power to use retrospective legislation to counter novel planning structures allied to the anti-avoidance tax disclosure rules introduced at the same time.

As a result, tax planning viewed as "unacceptable" has diminished, which is a trend which is likely to continue in organizations which have traditionally offered high compensation packages where the government has a significant level of ownership. The new high income tax rate may, however, increase the appetite for such planning in other companies.

Corporate tax losses

There is a strong link between allowing corporate tax relief and the recognition of income tax and social security charges.

Many organizations have suffered substantial commercial and therefore tax losses which will insulate them from paying corporate tax in the UK for many years. This offers more scope to deliver compensation in a form which delivers tax protection in the form of the deferral of tax payments or a capital gains tax (at 18%) rather than income tax treatment.

Long term deferral

There are several factors likely to result in executive compensation being delivered over longer term deferral periods. These include:

- For government owned organizations, pressure to defer participation in substantial remuneration until ownership has been reduced.
- Pressure to link executive returns with long term shareholder value creation.
- A resolution to delay paying remuneration until such time as any related risks have been exhausted and to claw back any related losses.

This will have implications for tax structuring. In particular:

- Where changes in tax rates are likely there will need to be detailed consideration of whether deferring tax will be optimal.
- Longer term deferral will give greater opportunities to offer capital gains tax treatment as the essence of the plans will often be to encourage the correlation of executive reward with value growth rather than current value.
- There will also be scope to deliver this remuneration within long term, tax protected deferral vehicles such as pension plans.

Risk capital

There will potential pressure for executives to "put some skin in the game" and invest their own money either through further deferral of compensation or the investment of post tax money.

Where this happens, there will be a focus on:

- Allowing the investment out of pre-tax money.
- Ensuring that relief is given for the costs of borrowing to fund the investment where this is feasible.
- Making returns subject to capital gains tax treatment.

Pension provision

The tax treatment of pension provision changed fundamentally in the UK following "A day" (6th April 2006). As a result, there is greater flexibility in pension provision but also more restrictions, including new limits on tax relief for high earners with effect from April 6, 2010.

This will lead to an examination of increasing (to the extent it remains tax efficient) the pension component of overall compensation, reflecting:

- Reductions in pension values due to falls in global asset values.
- The focus on long term value creation and delivery.

In turn, the scope for allowing self-investment in pensions will be developed. Given that limitations on funding remain a feature of tax preferred UK pension plans, the ability to combine the provision of qualifying pensions with non-qualifying plans to maximize the use of the tax reliefs while linking with the wider commercial and financial objectives of the employer and the executive will increase.

Cost reduction

Focusing tax directors on cost reduction will have greater priority in corporate planning. In the UK, this usually takes one of two broad forms:

- Initiating greater disclosure and co-operation with HMRC to achieve a "low risk" HMRC rating. This has two benefits. First, the level of ongoing scrutiny by HMRC (and the related costs of management time) should be reduced. Second, where errors do occur the imposition of penalties may be less likely.

- Structuring reward to reduce employer tax costs in a manner acceptable to HMRC. An example is structuring pension provision with a direct cost borne by the employer (with no social security charges) rather than through employee funding.

Looking ahead

Executive compensation tax planning is changing in line with more fundamental shifts in global economic patterns and the approach of government, regulators and shareholders to remuneration. These changes are impacting the global economy and are resulting in a response with some degree of consistency between jurisdictions.

This will result in unpredictable changes which will evolve over time. The only certainty is that the future is uncertain. It will be critical for everyone working to stay fully abreast of developments and thinking in what will continue to be challenging times.

Finance Transformation
Tying tax into financial reorganization

As global financial institutions embark on major Finance Transformation projects, tax departments are increasingly participating in these projects with the aim of contributing cost savings, mitigating tax risk and future proofing their systems. Tax processes must be embedded into these new systems in order to realize their full potential.

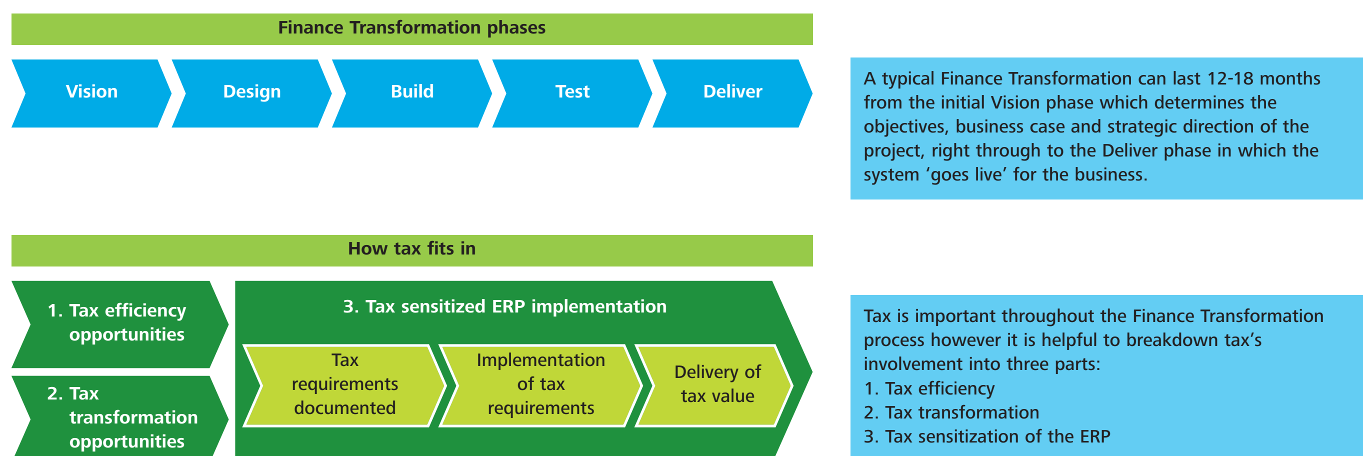
The features of Finance Transformation include implementations or upgrades of an Enterprise Resource Planning (ERP) system, the creation of shared service centers, post-acquisition integration, centralization and cost center rationalization. These create tax opportunities that can range from changing the business' operating model to the automation of the monthly VAT return process.

In the past, identifying and taking advantage of these opportunities has been difficult as they fell outside of the familiar tax department and accounting systems roles. Tax departments lacked the skills and experience to get deeply involved in Finance Transformation whilst the finance and systems teams generally had a poor understanding of tax and its importance.

Tax's recent higher profile means that companies are waking up to the benefit of extracting tax value from Finance Transformation.

Early consideration of the tax issues and engagement of the tax team will help ensure that the tax value is maximized within a Finance Transformation. Figure 1 illustrates how tax fits into the phases of a Finance Transformation project. Tax impacts the whole Finance Transformation and managing this can be made easier by focusing tax's involvement on three parts: 'tax efficiency opportunities', 'tax transformation opportunities' and 'tax sensitization of the ERP system'.

Figure 1. How tax fits into a typical Finance Transformation project



Tax efficiency opportunities

A Finance Transformation brings with it the opportunity to reconsider whether the current organizational model strikes the right balance between the demands of the business and the global/local tax requirements.

Using the opportunity for organizational change to generate value is perhaps the most familiar area of tax consideration but this has been brought into fresh focus by the challenges faced by the global financial services industry.

Traditionally the location of a shared service center, the structure for cross charging for VAT and corporate tax as well as ensuring the level of analysis in the systems effectively support the tax requirements were the points of consideration. Now, other points of issue are vying for attention:

- The structure of tax reporting on a global basis.
- The measure of profits used in performance management i.e. should bonuses be measured on a pre or post tax profits basis?
- The increasing importance of tax forecasting and the need to reconcile differences between forecasts, actual results and tax return submissions.

These issues cover a wide spectrum of interests, from finance to human resources and will have impacts throughout the business' locations.

Tax transformation opportunities

Transforming tax activity should be an important component of the overall Finance Transformation, as it is an invaluable opportunity to review and redefine the current model. This is the best chance to not only contribute the tax compliance and reporting requirements into the project but also to exploit the wider Finance Transformation's push towards automation and centralization. As a business generates strategies for reducing costs and changing the shape of the finance function, leadership should make sure that tax activities are seriously considered within this agenda.

This approach is well illustrated by the example of financial Shared Service Center's (SSCs). Leading companies now see the set up or expansion of an SSC as an opportunity to include their tax processes as this opens up the opportunity to standardize and automate the activities. Their aim is to reduce the costs and increase the process controls within their tax departments.

An SSC is no longer just the domain of the routine or basic finance activities. Increasingly sophisticated tax calculation tools that interact directly with ERP solutions have facilitated a shift of both the indirect tax and Corporate Income tax return preparation work into SSC environments. There are no compelling arguments against a business considering moving at least some of their tax activities into a SSC.

A company recently successfully moved the VAT compliance for 12 countries into its SSC and so reduced the time spent on compliance and eliminated a costly outsource contract. They accelerated the VAT compliance process (from closing the books to filing the VAT return) by over 30% and generated 50% year on year savings compared to the cost of outsourcing the compliance.

In the above example, the benefits of adopting a specific indirect tax compliance solution extend beyond cost reduction alone. Compared to using spreadsheets, their solution mitigates the risk of exposure to material tax errors and penalties. It also provides full audit trails, cross referencing to the source ERP data, VAT to General Ledger reconciliations, detailed partial exemption calculations and even supports electronic filing of the tax return to the relevant authorities.

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Another area of increasing interest within Finance Transformation is how to manage corporate income tax reporting. This is not only to ensure that the current process is supported, but so that the implemented solution reduces the cost of integrating between Tax and Financial reporting.

Global tax accounting solutions are now becoming the choice of many companies in the global financial services industry: especially those with a wide reach or complex organizational structure. As their cost saving benefits become clear, they will become as prevalent globally as they are currently in the US.

A company implementing a global tax accounting solution recently reduced the group tax effort at year end from 200 man days to 60 man days. They are expecting to cut that reduced time by a further 50% once the accounting structures in the ERP and tax accounting system are fully aligned.

Tax sensitization of the ERP system

It is the tax department's responsibility to ensure that the business' tax compliance and reporting obligations are met after a Finance Transformation project is completed. All too often, the complexity of each country's tax requirements is underestimated by the implementers of ERP solutions and this results in a less than perfect solution being rolled out.

Underestimating the importance of tax within the system will lead to process inefficiencies, inadequate reporting and errors in the data. This all pushes up costs and sorting it out entails a difficult post-implementation 'remediation' project to configure the ERP solution more appropriately for tax.

A better approach is to consider the business' tax requirements properly during the process of implementing or upgrading the ERP solution.

A recent example of best practice was a multi-national company aiming to deliver a world-class financial information solution to its businesses in Europe, North and South America and Asia Pacific.

They were motivated to ensure that tax was dealt with correctly because of consistently losing millions of US dollars globally through not being able to defend their positions robustly during tax audits. As such, tax was a key value driver for the project overall.

To deliver maximum value within each region's implementation, tax was managed as its own work stream alongside key teams such as general ledger, accounts payable, accounts receivable, asset management, controls and change management. This ensured that not only were all the tax requirements captured and documented during the project's early stages, but that they were then closely managed through to fruition.

The result is the company now has assurance that the tax requirements are completely addressed in the ERP solution and more importantly, that they have fully realized the tax value held within the business' systems.

Future proofing

The pace of change within Finance is ever increasing and a business' systems need to be set up in the right way to enable them to flexibly adapt to future tax challenges.

Finance Transformations are an excellent time to anticipate and prepare for the future statutory and business needs of the tax department such as:

- The convergence of Accounting Standards globally.
- Common Consolidated Corporate Tax Base (CCCTB) in Europe.
- Wider adoption of electronic filing globally.

An obvious example of this which is occupying companies currently is the new Business to Business (B2B) 'Place of Supply' rules which come in across the European Union on 1 January 2010. These will bring changes to the way VAT is paid for the financial services industry.

The EU is implementing changes designed to ensure that VAT accrues to the member state where the services are used. This will require VAT to be charged on B2B supplies of services at the place where the customer is situated. Suppliers will be required to include the services supplied to business customers in other member states on their European Community Sales Lists (ESL) while customers will need to ensure they've correctly accounted for VAT on the reverse charge.

Affected businesses who are currently involved in Finance Transformations should be using this as their opportunity to make the necessary changes to their billing systems, accounting systems and current ESL reporting.

The things to remember

In conclusion, there are significant benefits to be gained from a timely intervention by tax in the Finance Transformation process. If your business is about to embark on a Finance Transformation then there are five things that you should always remember to ensure that the transformation is a positive experience and the business' tax requirements are fully accommodated at the end.

1. **Don't wait to be asked:** Early engagement in a Finance Transformation is essential to avoid real problems further down the line.
2. **You're an asset to the business:** Tax can contribute real value to a Finance Transformation project – whether it's through process efficiencies, the mitigation of tax risk or the implementation of tax efficiencies. It is a mistake to view tax as burden on a Finance Transformation.
3. **Stay ahead of the curve:** Tax efficiency and transformation opportunities need to be thought about and discussed before design and build of phases of a program get underway.
4. **Now's your chance:** Finance Transformation brings the opportunity to enhance tax systems, processes and controls, and save costs within a central project budget.
5. **Keep engaged:** Decisions that directly affect tax will be made throughout life of a Finance Transformation. It is vital that tax's interests are represented at every stage and tax leadership should be looking to provide dedicated resource to the project.

Updating transfer pricing models
Increasing the focus on intellectual property

From increased documentation to attribution of profits, transfer pricing continues to be top of mind at global financial institutions. All forms of intra-group transactions need to be considered from a transfer pricing perspective, but one significant area that has traditionally been given less attention in the financial services industry is intellectual property. However the pressure to update transfer pricing models to the new environment provides an opportunity to fix that.

Transfer pricing is an issue with which most CFOs will be familiar. All forms of intra-group transaction need to be considered from a transfer pricing perspective, but one significant area that has traditionally been given less attention in the financial services industry is intellectual property. The IP used within the financial services industry generally falls under (but is not limited to) the categories of software/IT platforms and brand.

There are many reasons which might explain the relative lack of focus on IP transactions. For one, the *sine qua non* of financial services companies is the provision of potentially high value services to customers and the assumption of risk. While brand may have value and software may have an important – though ancillary – function, the view of many within this industry is that it is people functions and capital that are the primary value drivers for the industry. Accordingly, the transfer pricing of transactions involving services and capital have gotten the lion's share of attention and focus.

A second reason is that the tax authorities in the major financial centers have, in general not yet paid as much attention to the transfer pricing of IP in the financial services sector as they have in other industries. However, with the recent release of the OECD draft report on business restructurings, and the new US transfer pricing regulations on cost sharing (i.e., the transfer pricing of jointly developed intangibles) tax authorities around the world appear to have sent a signal that IP will be an increasing area of focus.

Increasing compliance focus

From what has been observed outside the financial services sector in recent years, IP transactions have arguably become the single largest area of transfer pricing challenge globally. Given the increasing awareness tax authorities have of such transactions in the wider economy and the increasing pressure to generate tax revenues in the current economic environment, there would seem to be a distinct possibility that going forward, tax authorities will seek to focus greater attention on IP transactions in the financial services industry. Indeed, we have already observed a greater number of instances of the IRS, HMRC and other tax authorities enquiring into financial services IP transfer pricing issues.

For example, it has been noticed that the IRS is increasingly challenged the pricing of software and platform development within the industry. For the most part, financial institutions have tended to recharge software development costs under either a cost allocation arrangement or a cost-plus pricing methodology. In the context of the new US cost-sharing regulations, the IRS is providing itself with more tools to assert that US entities have developed valuable IP for which they should be rewarded with a greater share of the operating profits generated by the businesses in which this technology is deployed. Such a charge might for example, take the form of a sales-based royalty. The technical arguments in this area are complicated and the risk of such a challenge will vary significantly depending upon the facts and circumstances of the technology and the use to which it is being put.

However, this emerging trend quite clearly points towards an increasing need for taxpayers to consider whether their IP transfer pricing transactions are arm's length. As with many transfer pricing issues, there is a first mover advantage. It is better to set the narrative yourself than to allow tax authorities wide latitude to interpret your facts with the benefit of hindsight.

Does your company have significant IP? How can you assess this? Beyond a qualitative assessment of your company's marketing materials – which may over emphasize the value of your IP in an effort to impress customers or investors – it may be useful to consider quantitative indicators of IP. As an example, consider the table below, which shows the level of annual R&D expenditure by software companies, averaged over the last three years. While cost is not necessarily an indicator of intangible value, the table below might help you assess whether your software spend is sufficiently large that a closer investigation of your IP transfer pricing is warranted.

Interquartile range of annual R&D expenditure for sample of 20 major US software companies – (figures are averages based on 2005-2007 data, quoted US dollars).[5]

Lower Quartile	Median	Upper Quartile
$149m	$232m	$422m

The importance of branding within the financial services industry should not be overlooked either. Branding is a tricky issue for financial services firms. Does use of a brand name help a company to earn higher profits or to operate at lower costs? Does a brand's value in one tax jurisdiction translate to similar (or any) value in a different tax jurisdiction? How quickly does a brand's value deteriorate? In short, determining whether an unrelated party would pay for the use of a company's brand and if so, the amount that they would pay, is very sensitive to the facts and circumstances under which a company operates. As with software, it is probably prudent for taxpayers to investigate and address the transfer pricing of brand and similar intangibles before tax authorities start asking questions about these types of related party transactions.

Running in parallel to the trend of increasing tax authority scrutiny, are the obligations arising from FIN 48. In assessing whether the benefit taken in the accounts is appropriate, auditors will generally expect to see some form of documentary support for the transfer pricing policies adopted. This will often apply even if the policy is that no charge for the use of IP is appropriate and the support exists merely to demonstrate that such a policy is appropriate. Taken together with the increased focus of the tax authorities in this area, it would appear that the transfer pricing of IP should get more attention than it has in the past.

Strategic opportunities

Consideration of transfer pricing should not of course be restricted simply to compliance and documentation. As traditional tax planning opportunities are restricted, principles-based transfer pricing is an increasingly important tool for legitimately increasing tax efficiency within multi-national groups. This is of particular relevance within the financial services sector given the significant tax losses generated in recent times.

As companies reconsider (or perhaps consider) the transfer pricing of their IP transactions, the changing rules and increased levels of guidance on the pricing of intellectual property may provide taxpayers with the opportunity to make a virtue of necessity. Some companies may find that they should charge their affiliates more for IP in the future than they have in the past. To the extent that IP owners are also residual risk takers, this may provide taxpayers with the ability to use transfer pricing principles to bring income into entities that have net operating losses, while simultaneously increasing compliance with the most recent transfer pricing guidance regarding IP.

There is a range of issues and approaches that companies may want to consider in their IP transfer pricing. At the more basic end of the spectrum, careful thought should be given to ensuring that any new IP is developed and owned from a tax-optimal location. A more complex variant on this option might involve shifting the functionality associated with developing and maintaining IP, such that the location of ownership is gradually migrated over time with no exit charge being triggered.

5 'Transfer Pricing Architect was used to analyze financial statement information for this set of 20 companies with sales in excess of $1 billion and which sell/license software to third parties. While these types of companies might reasonably be expected to own software or other information technology products with intangible value, Deloitte Tax has not separately evaluated any intangible property which these companies may own. Moreover inclusion in/exclusion from the set of companies is not intended to imply that Deloitte Tax has a definitive view on the value of intangible property owned by these or other companies.'

At the more complex end of the spectrum, companies may want to consider an immediate migration of IP to an entity in a different tax jurisdiction (perhaps because the existing IP owner is not the entity with significant trading losses available for utilization or maybe because the desire is to quickly get the IP into a lower tax jurisdiction). The current environment may make this an attractive option, particularly given that asset values are currently relatively low and there may be the possibility of sheltering any gains against capital losses. However, it should be recognized that any such migration would need to be accompanied by real and significant transfers of functionality, along with detailed consideration of the implications of the recent OECD business restructuring draft and US cost-sharing rules.

A point worth emphasizing is that whilst indirect tax considerations are of critical importance in the context of charging for the use of IP, the added complications which arise are by no means insurmountable. By working closely with indirect tax experts to define intra-group pricing policies, it is often possible to devise arrangements which are efficient from both a transfer pricing and indirect tax perspective.

Conclusion

The transfer pricing of IP is an area which has not traditionally been the focus of either the tax departments of financial institutions or tax authorities. However, Deloitte member firm experience in the marketplace indicates that this is starting to change. Coupled with the need to comply with FIN 48, there is an increasing need for companies to consider whether they are adequately addressing their IP transfer pricing policies.

The compliance obligation to address the transfer pricing of IP may also coincide with opportunities to align the company's transfer pricing policies with its strategic tax objectives. In short, there may be opportunities to do well by doing good. There may be a number of alternative options available with varying degrees of complexity, but these opportunities should not be missed.

The compliance obligation to address the transfer pricing of IP may also coincide with opportunities to align the company's transfer pricing policies with its strategic tax objectives. In short, there may be opportunities to do well by doing good.

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