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Financial Services

Triggering the tax advantage.

Tax tactics for the Global Financial Services Industry

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Foreword

Global financial services institutions are facing one of the most challenging periods in recent memory. The impact of the global credit crisis, the constant threat of new regulation, the increasing demands of customers, and the continuing pressure from competition mean that institutions must be ever more inventive in finding ways to maintain competitive advantage and boost their profitability.

In the past these challenging periods of disruption have generally been followed by a period of stability, during which financial institutions have 'caught-up', and fine-tuned their operations to the new environment. In recent years, however, this period of calm seems to have vanished, with new demands arriving before the previous challenges have been fully dealt with. Change has ceased to be a sometime event, and has instead become an ongoing process.

Through great effort, financial institutions have successfully kept pace with these challenges. They have adapted to the new regulatory demands of Sarbanes-Oxley; they have updated their risk management processes to comply with Basel II; they have invested in technology to manage customer data and accelerate transaction processing; and they have revamped recruitment and compensation strategies in order to retain their most skilled employees.

However, in this period of constant change financial institutions have seldom had the luxury to reflect on these efforts, and to ensure that no opportunities for advantage and improvement have been missed.

This is particularly true in the area of Tax.
Because it touches all areas of business, targeted improvements in Tax planning, reporting, and technology can have a major impact on a financial institution's core activities.

This joint Deloitte Touche Tohmatsu ("DTT") Global Financial Services Industry ("GFSI") and Global Tax Services (made up of DTT member firm Financial Services Industry and Tax Services practitioners) study examines several key areas of a financial institution's business – enterprise risk management, customer relationship management, information technology, regulatory compliance, human resources, and accounting & reporting – and uncovers how tax can play a role in creating competitive advantage in each area. I hope you find this study of interest and that it helps you identify and exploit some new opportunities within your existing business.

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

Enterprise Risk Management

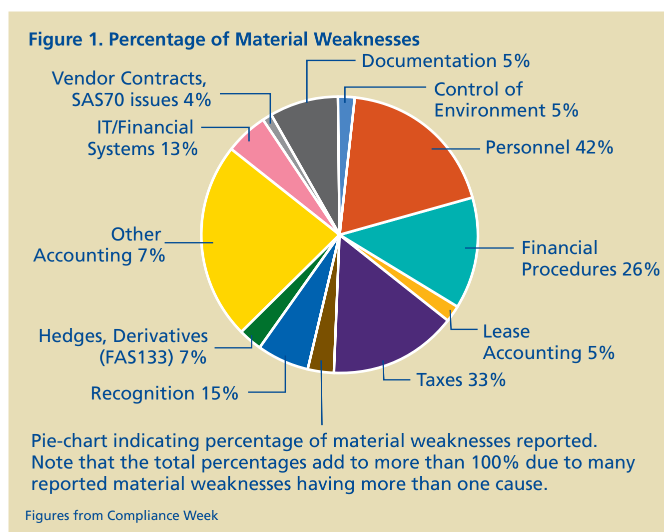
Irrespective of their listing, organisations are recognising the benefits of implementing better controls over their tax processes, as many were required to do to become compliant with Sarbanes-Oxley s404.

Even so, tax remains the number one cause of Material Weaknesses for US filers receiving an adverse opinion. Failings in tax accounting was by far the largest contributing factor to these tax Material Weaknesses.

It has been over five years since the Sarbanes-Oxley Act was signed by President Bush, and only now is the dust beginning to settle as organisations consider both the costs and the benefits of having to comply with s404. For many tax departments, the requirements of s404 were a further addition to what was already a very busy year-end reporting cycle. For others, the introduction of formalised controls and processes into what was often perceived as an autonomous and self-sufficient department was, at the very least, an uninvited distraction.

Since the passing of the Act, the evidence suggests that despite investment, some companies continue to be having trouble getting their books right. The number of financial restatements for US companies has more than quadrupled since 2001[1] while at the same time Securities and Exchange Commission (SEC) imposed fines have increased almost ten-fold since 2003[2]. More directly to tax, auditors have attributed over 30% of the reported material control weaknesses to the tax area with many of these relating to tax operations outside the United States.[3] This has naturally led to a greater emphasis on company accountability and concerns over potential SEC investigations. CFOs and tax directors are having to respond to increased stakeholder scrutiny of the financial statements and of internal processes and controls.

Figure 1. Percentage of Material Weaknesses



Pie-chart indicating percentage of material weaknesses reported. Note that the total percentages add to more than 100% due to many reported material weaknesses having more than one cause.

Figures from Compliance Week

Lessons learned: benefits realised

As overseas companies have now faced several years of s404 compliance, they should take time to consider what they have learned from going through the process. For example, one of the key learning points has been the need for an improvement in the quality and accuracy of data used in the determination of income tax provision calculations and associated tax balance sheet amounts.

To respond to this need, many organisations have undertaken a thorough review of the differences between the income tax basis and the financial reporting basis of asset and liability opening balances. Such validation of brought forward balances has provided comfort over a company's true opening position, and has led to the avoidance of errors in brought forward balances which have often resulted in material misstatements and subsequent s404 deficiencies. By adopting a tax basis balance sheet, companies can better track temporary differences to ensure the completeness and accuracy of their deferred tax balances. This offers benefits at year-end with time saved in substantiating figures and the provision of a more robust audit trail.

Non-SEC registered companies are also taking advantage of the lessons learned from Sarbanes-Oxley. Though not directly affected by s404, these companies aim to establish similarly high levels of quality, assurance, and control in their wider tax management and processes. This has been encouraged further by PCAOB's move to Auditing Standard 5 which has allowed auditors – and thus finance and tax departments – to take a more flexible risk-based approach to controls over tax reporting. Now that the SEC's requirements appear more achievable and practical, a greater number of organisations, irrespective of their listing, are making the required investment. Put simply, companies are now adopting the requirements of s404 not because they have to, but because it makes good business sense to do so.

Tax strategy

Tax can be difficult to manage and categorise – a mix of routine compliance and ad hoc transactions – the predictable and unpredictable. Tax risk is equally difficult to manage. Increasingly organisations are developing robust systems over tax risk and

[1] From 250 in 2001 to over 1,400 in 2006 (© Deloitte Research Analysis 2006)
[2] From $313m in 2003 to $3.1bn in 2006 (© Deloitte Research Analysis 2006)
[3] Compliance Week (All figures here relate to US companies)

Figure 2. "Getting By" Is no longer enough to support Enterprise Risk Management

	Failing	Get by	Best practice
Strategy	None	Informal	Endorsed
Risk	Random, uncontrolled	Annual review, static	Comprehensive, dynamic
ETR/Cash tax	Surprising	Problematic	Planned
Business	Hostile, dysfunctional	Strained, mandatory	Open, business-facing, embedded, strategic
Planning	Scattergun, poorly implemented	Reactive, inconsistent, execution	Systematic, well executed
Provisioning	Adjustments	Opaque, cumbersome	Transparent automatic
Reporting	Annual, no links with compliance, no forecasting	Interim & annual chore	Quarterly, synergies with compliance process
Knowledge	Not shared, poor training, no document management, siloed	Formal training, disjointed document management	Knowledge sharing culture, information systems
Resourcing	Ill designed, short term	Constrained	Planned, optimal blend
Technology	Low, predominance of spreadsheets	Tax calculation software	Automated, use of internal information sources
Process	Sporadic	Key tax processes documented	Fully documented, dynamic

Source: Deloitte

process management to provide assurance, not only over the completeness and accuracy of key financial data, but also over risks around compliance and planning.

For companies where tax is an integral part of the organisation, a well thought-out tax strategy and risk management framework creates value at all levels of the business. It also ensures that tax payments and filings happen according to a well-defined process. For some organisations, however, tax can be something that just 'happens' – where returns are filed, payments are made, and planning is undertaken, all of which is divorced from the rest of the business.

Most organisations lie somewhere in the middle where the tax department is 'getting by' – Figure 2. Unfortunately, as companies that have experienced material weaknesses will testify, 'getting by' is no longer good enough.

Regulatory compliance however is only part of the picture. Increasingly, tax departments are coming under pressure from all stakeholders in the business. Investors, tax authorities, and even not-for-profit and charitable organisations are now focusing their attention on tax departments and how they are managing their tax risk and responding to CSR issues. Internally, the Board want to know that tax is managing its risk in the same way as any other area of the business and are beginning to expect regular reports analysing key risk areas and detailing a forward-looking tax strategy.

Tax authorities are focusing their attention increasingly on risk assessment and, in the UK, businesses already have been receiving risk assessments carried out by HMRC. HMRC has highlighted specific factors that it believes will create risk in a tax system. These include inherent risk factors to the business such as complexity of corporate structures and pace of change of the business, but they are also looking at the level of openness and co-operation with HMRC, ability to deliver 'right tax at the right time' and level of tax planning and transparency of tax strategy. HMRC are looking for strong governance, clear and proper understanding of tax obligations, a culture of openness with the tax authorities and robust systems and processes.

Organisations that tax authorities categorise as higher risk businesses would expect to see systematic risk reviews with increased emphasis on significant risk areas – in particular, transactions that have little or no commercial substance and those that will result in low income falling within the their jurisdiction's tax net that is disproportionate to the economic activity taking place. However, businesses with a low risk assessment should benefit from minimum intervention from their tax authority.

Meanwhile, following on from the OECD's Forum on Tax Administration, heads of tax authorities from more than 30 countries have signed up to the 'Seoul Declaration' and agreed to work together on ways to improve tax administration and to address what has been described as **"the significant and growing problem of international non-compliance with national tax requirements."**

These developments have created what has been described as a 'perfect storm' for tax departments with separate forces coming together to push tax high up the Board's agenda – these being the increased risk-based approach by tax authorities, increased cooperation by international tax administrations, the strong tax focus coming out of the s404 filings from the US SEC and investment funds looking in detail at organisations' management of tax.

Managing tax risk

A company's risk level will vary depending on its involvement in high risk tax strategies and its overall attitude to risk management. Organisations can be viewed as being positioned on a **'risk ladder'** dependent on past transactions, general corporate complexity and the effectiveness of the management of the tax function. In effect, all entities can be benchmarked onto this ladder.

Assessing tax risk can be difficult and first it needs to be identified and described in a way that is transparent to the Board, as well as to

all areas of the business. One of the ways we can define tax risk is the possibility of suffering a loss as a result of the application of tax systems – this is a risk that is particularly prevalent in the financial services industry where organisations can be required to deal with clients' tax affairs and consequences as well as their own.

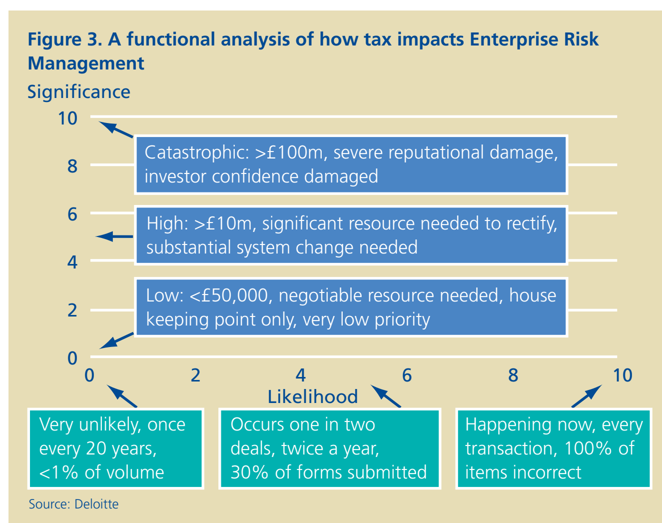
Tax risk can also arise from inadequate or failed tax management procedures during tax planning, compliance, or implementation. For example, tax risk could come from the filing of tax reclaims or from tax information reporting related to the multitude of transactions generated by the trillions of dollars flowing through the banking systems every day. In other words, any aspect of the tax process – routine compliance work, as much as one-off advisory work – can trigger tax risk.

Indirect tax risk is particularly a key issue. This is down to the prevalence of significant manual processes, decision making undertaken by staff who are not properly trained or qualified in tax and lack of visibility at a financial reporting level.

Few organisations have a robust risk framework over indirect taxes, in contrast to direct tax which tends to be more visible in the financial statements, through a tax charge, deferred tax, or the reporting of the effective tax rate.

This visibility tends to drive a degree of discipline, so that there is some confidence in the tax numbers that are being reported. Many business may be a long way from best practice, but there is at least in many cases some type of control environment from direct taxes.

Figure 3. A functional analysis of how tax impacts Enterprise Risk Management



Source: Deloitte

This environment is often entirely absent in the area of indirect tax and this fact alone contributes to the risk profile of indirect tax within an organisation. If indirect tax is not visible then this will almost certainly lead to it not being managed or being inadequate.

VAT is generally buried in the sales and cost of sales processes. Everything that passes through a business potentially has a VAT charge associated with it whether it be an output or an input.

The VAT throughput (outputs and inputs taken together) of a large business can easily dwarf its potential corporate tax liabilities and yet commonly little is done to provide a considered control environment in which to manage this tax.

Poor tax risk management may lead to losses in the business, and consequently to the investors. Just as important, it can be a risk to the reputation of the organisation as a result of the actions of the tax department. Financial services companies are particularly susceptible to this form of tax risk. In many recent, high-profile cases, tax matters have been pursued through the courts. From the perspective of corporate governance, effective tax controls and processes minimise the risk of unwelcome adverse publicity (which would arise from failing to follow the rules in the various countries), as well as helping the company achieve the "no surprises" standard often imposed by boards of directors and senior management.

How can technology help?

The effectiveness of any technology as a risk management tool relies upon the quality of its inputs. As such, the tax sensitivity contained in, as well as the ability to link with, existing financial systems is critical. While tax sensitisation of accounting numbers should be handled by the tax trained, the financial systems can be designed to organise accounting numbers into categories that Tax can interpret. In this way tax technology can be considered as a bolt-on to the financial systems.

So what can we bolt on?

Tax return software, for example, is now widely used by major organisations to produce corporation tax returns. But software is also available to complete the compliance for specialist areas such as trusts or transactional tax (e.g., VAT, GST, etc.). Using specialist software, rather than homegrown spreadsheets, has several advantages.

The compliance burden for transaction taxes, such as VAT, can be significant. Particular challenges for the tax department around VAT compliance that specialist software could address are:

- Inadequate controls – accounting systems often do not include a fully automated compliance solution, VAT returns are often supported by spreadsheets which are 'black boxes' and un-audited. Further, the VAT returns are highly dependent on manual processes, including manual cross-referencing and manual completion.

- Inadequate technology support – clever technology can be undermined by poor training and support of those using it.

- Non-standardisation – using ad hoc spreadsheets can mean that there is little consistency across different countries and different entities within the same country.

- Heavy reliance on non-tax resources – one of the common causes of material weaknesses is that many tax related processes, such as recording of VAT sensitive information into accounting systems, are often handled by staff who are not properly trained or qualified in tax.

- Systems not configured for tax – many accounting and ERP systems are set up with little input from the tax function.

Because the software often includes a full internal audit trail, it can help ensure that the flow of data is correctly sourced and referenced. And such software is typically updated regularly to address changes in tax law. If the reporting is in an unfamiliar jurisdiction, using specialist software can help ensure that obvious checks and balances are not overlooked. Tax return software can also be used to produce reasonable forecasts and for estimating tax provisions.

The next step: Data automation

Automating the data collection element begins, at its most basic, with sending an electronic "tax pack" to the data providers to complete and return it. Their work is then copied and pasted into the return software. At a more advanced and comprehensive level, data automation means automatically importing data from an accounting system into a processing tool, verifying the data, applying tax rules, and then importing the summarised, validated data into the return engine. This minimises the risk of incorrect numbers entering the tax calculations, while also substantially reducing compliance time and freeing staff up to pursue more value-added areas.

Beyond getting the numbers right

Getting the numbers into the tax return is, however, only the start. The tax department also has to ensure that deadlines are not missed and that the appropriate steps and procedures in the compliance process are observed. In a small tax department, handling compliance for a single jurisdiction, this is usually pretty straightforward; but when, for example, a U.K. company has compliance responsibility across the EU (or beyond), for example in relation to its VAT affairs, managing and reporting on the process can be a full-time and complicated job.

Electronic tools can be used to monitor, and report on, the compliance processes remotely. Typically web-based services, these tools contain a mix of workflow and statutory deadlines. One of the great benefits of using a web-based system is real-time information; for example, if a tax department in Germany records a payment on the system, the updated information will appear immediately on the compliance reports of the manager in the U.K.

Importantly, the process and calculation technologies can communicate with each other. This would avoid the need to enter a payment in one technology and then tell another that you've done so. In this way the link between action and report is essentially instant. Further functionality provides the ability to pick out trends from tax data contained in computations, both current and historical, thus providing intelligence upon which to generate and justify planning ideas.

This real-time responsiveness is increasingly important for financial services companies as they grapple with regulatory and statutory accounting filing deadlines. Overlaying tax deadlines helps enable the tax department to monitor, from a central base, complex global requirements and, thereby, provide assurance to senior management that tax risk (both operational and strategic) is being minimised.

The newest frontier: Tax and economic capital

For an organisation to incorporate tax in its model of economic capital, tax needs to be at the forefront of decision making in all areas of the business. In other words, tax consequences need to be understood before a course of action is pursued. For many tax departments, such visibility would constitute a significantly raised profile.

Given that a company's share valuation is based on return on equity (a post-tax measurement), a complete evaluation of the global tax impact of business decisions can result in permanent savings for companies. For financial institutions facing potentially conflicting competitive imperatives – reduce costs to create operational efficiency and introduce new products/better service – tax consequences can make a big difference in operating efficiencies and economies.

A higher profile for the tax function will help enable it to contribute more to the well-being of the organisation. The tax department can contribute a clear tax strategy that can be applied to the various business lines, while being available to discuss the tax issues with the business lines. Increased tax awareness in the business lines should help to minimise the tax exposure; if a particular course of action is likely to carry tax risk, appropriate action can be taken at an early stage.

Given the complexity and competition in today's financial services industry, the time is right for tax to step up its contribution of value to the organisation by using technology to minimise tax risks and maximising tax savings.

Customer Relationship Management

Balancing the needs of clients with those of Revenue Authorities

Global financial institutions spend a considerable amount of time and money building loyalty and trust with their customers – by developing superior customer service, delivering consistent communication and even offering financial rewards. However these efforts can be undermined through the poor management of operational taxes.

Operational taxes are those imposed on a company, with respect to its customer relationship. Why might these trigger risks for a financial institution? In short, because they are complex and touch on the sensitive issues of withholding tax and reporting customer details to Revenue Authorities. Historically, these types of tax matters may have been dealt with at an operational level within the business. As the obligations become more onerous and complicated, non-tax professionals can struggle to understand the extent of the various responsibilities. Not only do these taxes take many different forms, but their rate depends on customer-specific documentation. Accordingly, it is little surprise that operational taxes are moving to the top of management's agenda.

Governments favour operational taxes because they move the burden of the collection of taxes to financial institutions, deter global tax evasion and provide tax authorities with information that can be used to verify the completeness and accuracy of a taxpayer's return.

For financial institutions, managing operational taxes can be particularly challenging. Some are specific to a particular tax-jurisdiction, while others operate across borders, regionally or globally. The EU Savings Directive ("EUSD") covers all EU member states and certain other territories, for example, while the U.S. qualified intermediary ("Q.I.") rules have a global reach.

In theory, the cost of compliance to the financial institution should be limited to the administrative burden, although this alone can be substantial.

In reality, the costs are potentially higher for two reasons:

1) non-compliance can trigger financial risks in particular in the form of substantial fines and penalties; and

2) poor management can damage an institution's reputation and customer relationships.

Non-compliance and financial risks

The financial costs of a failure to comply with operational tax regimes can be substantial. For example, under-withholding can obligate the financial institution to settle the tax shortfall when it's unlikely that the company would make a claim for the additional tax from the customers (especially if the financial institution was at fault for the under-withholding). Tax authorities might also impose fines, depending on the regime and the degree of the non-compliance.

Different regimes are enforced with different degrees of severity by the relevant tax authorities. The Q.I. regime levies significant penalties for non-compliance, which can run into many millions of dollars. The penalties for not complying with EUSD vary according to the territory. In the U.K. for example, there is a fixed penalty of £3,000; in other jurisdictions, a penalty may be based on the amount of interest income not disclosed, which can be considerable.

Basel II requires certain financial institutions to assess and set aside capital to cover a number of risks, including operational risks, and in particular the possibility that transactions are executed incorrectly, or with an unexpected adverse impact. (In many areas of custody and clearing, operational taxes can give rise to material transaction tax liabilities). Implementing better controls and processes to address transactional issues can mitigate the required capital allocation, therefore reducing the institution's costs.

The good news is that steps can often be taken to reduce potential liabilities. When one U.K. institution implemented the Q.I. regime incorrectly, fines which initially could have totalled $50 million were reduced to less than $50,000 after the company completed significant remedial work to fix the problem. Revenue authorities and regulators generally respond positively to an institution making "best efforts" to comply – being able to demonstrate such an effort is fundamental to a successful negotiation aimed at mitigating penalties or obtaining concessions.

Key recent events

United Kingdom
In 2006, HMRC served notices on five major UK banks and as a result obtained information relating to offshore bank accounts held by individuals living in the UK. Following this, HMRC set up an Offshore Disclosure Facility to enable the banks' customers to voluntarily disclose details of relevant income and pay the UK tax which had previously not been declared in return for paying a substantially reduced penalty. HMRC has made it clear that it will continue to target holders of offshore bank accounts and HMRC have had discussions with regulatory bodies to discuss adopting a similar approach with other financial institutions.

European Union
By far the largest and most significant development within the EU with respect to tax information reporting in recent times has been the introduction of the EU Savings Directive on 1 July 2005. Since then Member States have exchanged large amounts of information and it is clear that to some extent this has enabled certain tax authorities (for example, the UK) to identify sources of income that may not have been taxed correctly.

One area that continues to be highlighted is the fact it is reasonably straightforward for institutions to minimise their obligations under the Directive by making changes to payment flows, types of products offered and the location in which relevant activities are undertaken. The EU is in discussion with Member States to address some of these issues and changes to the scope of the Directive may be expected in the next year or so. Discussions have also commenced with the aim of bringing institutions located in other non-EU jurisdictions (for example, Hong Kong and Singapore) within the scope of the Directive.

The scale of EU based litigation claims that arise from the imposition of withholding tax by certain Member States on outbound dividends has continued to grow. The **Fokus Bank** decision ruled that beneficial treatment of dividend distributions granted to some Norwegian resident shareholders, but not to non-residents, was a restriction on the free movement of capital within the EEA. This has now been followed by the 2006 EU based decision in **Denkavit** and **Amurta (in 2007)** that decided the imposition of withholding tax on dividends paid to EU resident investors (to which domestic investors are not subject) can in certain circumstances be contrary to the EU Treaty. As a result of these decisions France and the Netherlands amended their domestic legislation to remove withholding tax in certain instances. As can be seen these cases have wide-ranging implications for operational taxes on cross-border transactions within Europe. As a result many EU based investors have lodged claims with tax authorities on the basis they have been subject to discrimination in line with these decisions. Where successful the financial impact of such claims may be significant for Member States.

United States
Since its introduction in 2001, the Q.I. regime has been successful in raising funds for the U.S. Treasury. Now, after seven years, many financial institutions have entered into their second Q.I. agreement and the regime has matured substantially.

The IRS has proven fair but strict in their administration of the regime which broadly affects intermediaries who invest in the US on behalf of other investors. Whilst the majority of QIs have found compliance challenging and costly they have generally managed to satisfy IRS standards. However, a minority have been unable to do so and as a consequence have faced not uncommonly multi-million dollar settlements where they have applied lower levels of withholding than they can justify.

The impact on business

The regimes have impacted commercially on the way financial institutions carry out their business. Many are revisiting their product offerings and the locations where they offer or provide their services to their customers (i.e. where those institutions carry on their business) to ensure that customers needs are met within the parameters of the institutions commercial and ethical standards. For example, in response to the EU Savings Directive, as discussed above, there is evidence that some financial institutions have considered the following (if only to reject):

1) transferring funds out of the jurisdictions that enforce the Directive; and

2) transferring funds to vehicles that are specifically exempt from EUSD reporting.

Also, as customers become accustomed to operational tax regimes, they are likely to be dissatisfied with any financial institution that fails to withhold correctly or subjects them to excessive, superfluous requests for information. For financial institutions, it's a balancing act – satisfying their obligation under any withholding regime, but not exceeding the requirements since that runs the risk of driving away customers as well as regulatory sanctions.

A new focus

No longer in the dark corners of a financial institution, operational taxes are now under a bright spotlight. New tax regimes, stiffer penalties for non-compliance, and increasing risk to the financial and commercial well-being of the company – these changes have increased the importance of operational taxes and, hence, the attention being paid to them.

What needs to be at the top of management's agenda? An integrated focus. Since operational taxes can affect many teams and departments inside the financial institution, compliance can "fall through the cracks", with severe repercussions.

Information Technology

How companies can use tax credits to secure significant savings on IT and R&D investments

Over the last 20 years, financial institutions have increasingly had to invest in information technology to remain competitive – be it CRM systems, ATM, networks or data warehousing. But how many executives know that this IT spending can generate significant cash benefits under global research and development ("R&D") tax incentive regimes?

Each year, IT budgets increase as management invests in information technology to improve regulatory compliance, enhance customer relationships, protect data privacy, introduce new products, and reduce costs. Yet, as they allocate cash to IT budgets, decision makers often overlook one important piece of the puzzle: R&D tax credits. IT spending can generate real cash savings, lowering a company's effective global tax rate.

Under an ideal scenario, senior management would not approve IT development budgets based only on the needs of one entity or region. Rather, they would consider the global organisation in its entirety to help ensure that:

1) the right entities were funding IT development; and

2) resources were physically located to maximise the benefits of incentives.

Also, projects would not be approved based on anticipated ROI without including potential tax impacts. Tax incentives can often tip the ROI of a "borderline" project into an acceptable range. Indeed, the industry's move to adopt economic capital tests brings tax to the fore, since measures like Risk Adjusted Return on Capital ("RAROC") require modeling on a post-tax basis.

When does an IT investment qualify for R&D tax credit?

A company often has to develop an original, proprietary IT solution due to the lack of acceptable commercially available products or some uncertainty in what would constitute a "good" solution. It is this "original" IT development that can potentially qualify for R&D tax credits. The following questions typically indicate whether an investment may be eligible for R&D benefits:

- At the outset of an initiative, is there uncertainty about what should be the design of the software solution?

- Does the company require a solution that goes beyond technology that is commercially available through off-the-shelf software packages?

- Does the developer experiment with packaged solutions and vendors' products (in accordance with the company's established software development methodology) in an attempt to address the uncertainties?

- If so, does the vendor incorporate any of the financial institution's enhancements in the product's general release?

- Does the software development anticipate a significant reduction in cost, increase in speed, or increase in efficiency for the company?

The greater the number of "Yes" answers, the greater the chance of obtaining R&D tax benefits.

Begin at the beginning

The determination of whether the investment will be eligible for R&D tax credits (under various global regimes) should be made during the budgeting process – in other words, before the money is spent. Here are some types of IT projects that may qualify:

- Regulatory initiatives rarely specify how new requirements should be implemented; for this reason, IT uncertainty is inherent. As examples, IT developed to address the following regulations can usually qualify for R&D tax credits:

  – Sarbanes-Oxley: software for an adequate internal control structure, including intrusion detection/prevention systems (real-time threat monitoring).

  – International Financial Reporting Standard ("IFRS"): software to 1) apply different accounting rules to a given economic event; 2) store statutory, fiscal, and consolidated results separately; 3) ensure the integrity of each set of books; or 4) perform reconciliations between different accounting perspectives.

  – Basel II: analytical design and implementation to mitigate operational risk, clarify data sourcing, or establish different risk management modules.

- Market-facing initiatives are often innovative since they give the company a chance to be a "first mover." For example, customer relationship management ("CRM") systems, including large and complex projects that re-platform or integrate disparate Architectures, can consolidate technology behind multiple business lines and, in this way, enhance the organisation's ability to deliver service. New or enhanced functionality (e.g., new trading or clearing platforms) can position the company as an industry leader.

Some IT development centres on operational efficiency. For example, eBusiness initiatives can provide new ways to access legacy systems, including security infrastructures flexible enough to be compliant with all global financial regulations. Difficult and challenging intranet and internet systems can require unique software-development when the scale and complexity of design present special challenges. Innovative data warehousing techniques, as well as storage and retrieval techniques, expand transactional volume limits.

IT development also becomes R&D when it "pushes the envelope" of decision support through significant advances in calculation engines, artificial intelligence, predictive modeling, and statistical analysis. Of course, any software development that results in a patent could qualify for an R&D tax credit.

The global picture

Over 30 countries provide R&D incentives for IT-related activities including Australia, Austria, Belgium, Canada, China, France, India, Ireland, Israel, Italy, Japan, Malaysia, Mexico, The Netherlands, Singapore, Spain, the United Kingdom, and the United States. Not surprisingly, each country has its own set of rules, which generally revolve around these questions:

- Must the activities be performed in the home country?

- Must the entity claiming tax relief have economic risk for the activities performed?

- Must intellectual property created from the activities remain with the entity?

For example, the United States requires that qualified IT development activities occur within its geographic boundaries. By contrast, the United Kingdom will provide tax relief for activities performed anywhere, as long as those performing the activities are employees of a U.K. tax paying entity. Both the U.S. and the U.K. regimes allow for reimbursement of R&D costs by foreign related parties. Japan takes yet another approach. Its regime requires that a Japanese entity bear economic risk for the activities (while, nevertheless, allowing the activities to be performed anywhere). In some countries, such as the United Kingdom, the drive towards capitalising IT expenditure to maximise Profit Before Tax has led to practical difficulties in establishing claims. The United Kingdom makes a distinction between capital expenditure, which delivers cash tax savings from accelerated tax depreciation, and revenue expenditure, which potentially qualifies for 130% relief (thereby, generating permanent savings).

Planning makes perfect

The differences among R&D tax regimes can work in a company's favor – with planning. Consider, for example, an enterprise whose employees are performing qualified development activities in a foreign country. If the home country permits IT development to be performed outside its geographic boundaries, the company can claim tax relief from the home country for its foreign activities. At the same time, if certain structures are in place, it might also receive tax benefits in the foreign country. In other words, it is possible to obtain benefits under two tax regimes from only one cash expenditure (i.e., a double dip benefit).

Perhaps most importantly, for a company to receive maximum global R&D tax incentives, planners must start with a consideration of how such benefits can affect, and be affected by, the company's foreign tax credit positions, its international tax liabilities, and its transfer pricing arrangements. For example, there may be no benefit to pursuing global R&D incentives if the multinational is in an "excess limitation" position (i.e., it could get more, rather than fewer, foreign tax credits) in its home country. Also, a multinational financial institution should not claim intellectual property from its IT development without first analyzing the transfer pricing consequences. Can a taxing authority require the payment of

The ABCs of R&D tax credits

More than 30 countries offer some form of tax relief for R&D activities. While most regimes define R&D in a similar way, there are some differences, both substantial and subtle. For multinational financial institutions, these differences can provide savings opportunities – especially the opportunity to obtain benefits in more than one jurisdiction from a single expenditure.

R&D tax incentives come in three forms: **tax credits, supercharged deductions,** and **wage tax incentives.** For example, Canada offers a 20% federal tax credit, and the United States offers a 13% incremental tax credit. The Netherlands offers a graduated scale of payroll tax incentives related to qualifying development activities.

Tax credits are **refundable** in some jurisdictions (for example, France, Austria, and some Canadian provinces), thus providing benefits to companies operating with financial losses. Taking advantage of refundable credits can also provide additional foreign tax credit benefits to U.S.-based financial service companies.

All three types of incentives can be either **volume-based** (i.e., no minimum amount of spending is required before a benefit is earned) or **incremental** (i.e., qualified development expenditures must exceed a minimum level before they can qualify). The United States offers an incremental incentive, while Canada and the United Kingdom offer volume-based incentives. Other regimes, such as those in Australia, Japan, France, and Spain, provide incentives that have both incremental and volume-based components.

A final difference among regimes is the types of costs that can be included in a claim. For example, each regime has different requirements for allowing claims for expenditures on employees performing qualified activities, including base salaries, overtime, bonuses, stock options, pension contributions, and national insurance. In addition, supplies/consumable stores (including the purchase of software used in qualified development activities) and payments to contractors can often qualify.

Unlike direct tax, there are no specific relief's that relate to research and development costs. Therefore, research and development and/or a significant IT spend can result in significant amounts of irrecoverable VAT arising for a financial services institution such as a retail bank. In fact, VAT could be the largest tax cost when embarking on such a project. It is imperative that VAT is considered at the outset in order to limit the VAT exposure. Limiting the VAT exposure may be possible through intelligent structuring and making use of the VAT relief's that do exist.

royalties because of the exploitation of the IT activities' results? The ideal situation might be to work in countries that offer incentives without economic risk and, in effect have R&D funded by foreign affiliates in low-tax jurisdictions.

Seizing opportunities

Beyond the potential to obtain R&D credits, there are additional opportunities that shouldn't be overlooked – to review the organisation's global tax positions (including foreign tax credits and transfer pricing agreements); to reconsider IT budgets in light of the tax benefits; and finally, to use IT development strategically, as a way to secure permanent tax benefits that can lower the organisation's overall effective tax rate. For example, new companies beginning business in China, may be able to secure tax holidays for its first three to five years of operation in the country and then to supplement those tax breaks with additional R&D tax incentives. Before a financial institution invests in IT development, it pays to know – and plan for – the variety of ways to use this investment to generate tax savings. The benefits can be significant and permanent.

Mergers & Acquisitions

Why tax considerations deserve a place in the deal

In the past few years, 15 of the 17 European retail banking mergers valued above US$3 billion have taken place across borders. Like the US market before it, the European mergers and acquisitions (M&A) market has taken off again. But in the rush to seal these deals, will key tax issues get the consideration they deserve?

Although annual predictions of an impending surge in retail banking cross-border mergers have often come to nothing, there are reasons to believe that the long anticipated cross-border consolidation process has started. For example, in the last three or so years the major retail banking deals in Europe have included a cross-border element (see Exhibit 1) culminating in the huge $98.3bn takeover of ABN AMRO by the RBS, Santander and Fortis bank consortium in October 2007. This is surprising as traditionally, cross-border banking deals have been constrained by perceptions of hostility from national consumers and regulators, combined with more promising in-market growth and value creation opportunities for most banks. Deloitte believes this is changing for a number of reasons.

Date announced	Acquirer name	Acquirer nation	Target name	Target nation	Deal value ($bn)
October 2007	RBS led Consortium	UK	Abn Amro	Netherlands	98.3
June 05	Unicredito	Italy	HVB	Germany	18.2
July 04	Santander	Spain	Abbey	UK	15.8
August 2007	Banca Monte dei Paschi	Italy	Banca Antonveneta	Italy	13.2
February 2004	BNP Paribas	France	BNL	Italy	12
May 2004	RBS	UK	Charter One	USA	10.5
February 2007	BBVA	Spain	Compass Bancshares Inc	USA	9.6
September 2005	Allianz	Germany	RAS	Italy	7.1
June 2006	Resolution PLC	UK	Scottish Mutual	Spain	6.7
March 2007	HSBC	UK	Korea Exchange Bank	South Korea	6.3
May 2005	Old Mutual	South Africa	Skandia	Sweden	6
September 2004	Barclays	UK	ABSA	South Africa	5
October 2006	Credit Agricole	France	Cariparma	Italy	4.8
September 2005	Julius Baer	Switzerland	EAE	Switzerland	4.5
September 2005	ABN AMRO	Netherlands	Banca Antonventa	Italy	3.9
January 2005	Standard Chartered	UK	Korea First Bank	South Korea	3.3
June 2005	Unicredito	Italy	Bank Austria	Austria	3.3

Cross-border retail bank M&A

Source: Deloitte

Political and cultural barriers to pan-European M&A are eroding
The unspoken understanding that national bank regulators would work to frustrate the acquisitive ambitions of non-domestic banks is fast fading. The fact that cross-border retail banking deals in the Netherlands, Italy, Germany, and the UK have all been completed in the past few years indicates an openness among the continent's biggest economies that was only dreamt of in the past. This recent trend towards increased openness was given even more force by the EU's commissioner for internal markets undertaking an investigation into financial services merger barriers following the Bank of Italy's involvement in the acquisition of Banca Antonventa by Dutch bank, ABN AMRO.

These political trends become more potent when commingled with the evidence of an increased willingness on the part of consumer to purchase financial service products from non-domestic institutions. Retail bank consumers' openness to 'foreign' banks is evidenced in small ways, such as the rebadging of Barclays' Spanish subsidiary

Banco Zaragozano, with the full Barclays brand, and the increased use of Santander branding within Abbey in the UK, and is being propelled by gaping price discrepancies across different domestic markets for identical baskets of retail banking services. Taken together, we see cross-border banking mergers gathering momentum as the previously deal breaking forces of political and cultural resistance crumble, even if tax differences persist.

Bank executives searching for double-digit growth

Most banks CEO's are hard pressed to find organic growth opportunities of sufficient size to please investors' top line and profit growth demands. With most banks having undergone massive restructuring to strip out costs and continually scouring their operations for additional savings, the only real routes are through mergers or radical organic expansion in their range of activities into investment banking, private banking or insurance, or some combination of these, some of which as recent market evidence demonstrates can take the bank outside of its core areas of market and risk expertise. Most domestic markets, however, are too concentrated to allow a large competitor to bid for another major player. This leaves cross-border M&A as the most likely outlet for executives' growth ambition, with the ABN deal the most potent example of this to date. In recent, more challenging times for investment banking operations in particular, if anything the pressure to deliver growth has increased still further.

Market participants scrambling for supremacy

Playing the cross-border merger game will require banks to stake out new banking territory aggressively. However, banks face a very real check on their ambitions in the form of their newly assertive institutional shareholders as evidenced by some deals that have been undercut by shareholders unconvinced of the deals fundamentals – for example, Deutche Borse's bid for the London Stock Exchange. In order to gain the consent of shareholders to engage in cross-border mergers, banks need to demonstrate the following: experience of working across borders and cultures; skill in seamlessly integrating acquisitions; clearly articulated plans regarding how value will be created; regional operating and IT platforms that work.

Tax-A key consideration of any M&A transaction

During this increased periods of M&A activity it is worth remembering that tax issues need to be carefully considered as part of each transaction, whether it is in structuring the deal at the outset or in the post-merger integration phase. The benefit that tax can bring covers both 'above the line', as well as 'below the line' items.

Above the line taxes

While shareholders and senior management focus on earning per share, the tax component is little understood, and profit before tax is more often than not the typical performance measure used – internally for compensation purposes, and externally by analysts. However for Financial Institutions, taxes affecting the pre tax line are significant and often material.

The proportion of Payroll Taxes/Indirect Taxes and Operational Taxes (withholding taxes and other transactional tax costs) paid by most global financial institutions dwarfs the corporate income tax line. In M&A, especially in cross-border transactions, an effective review of these taxes can be critical in achieving successful merger integration.

Financial Institutions are facing a constant war on talent, exacerbated by the number of highly paid bankers working in the industry: No Due Diligence would be complete without an understanding of how to keep these highly paid bankers motivated in the newly managed company, so understanding the complex remuneration arrangements is essential. Often these arrangements can be upset by a change of ownership or change in corporate philosophy, potentially with fewer overall senior roles to be filled in the combined group.

Indirect Taxes are a key cost factor as financial institutions tend to be able to recover only a small proportion of the Indirect Tax costs that are charged on the services/products they receive from external suppliers. Often recovery is in low single percentage figures with the resultant irrecoverable indirect Tax costs running into the tens of millions of dollars.

Being able to understand the nature of the businesses being acquired, and the infrastructure set up to run them can often lead to the identification of financial system redundancies and procurement process improvements which can result in significant reduction in irrevocable indirect tax costs going forward. New technology tools are now available to provide diagnostic support to highlight anomalies and opportunities – if these tools are embedded into the financial system.

Operational taxes are the least understood of the three above the line costs previously mentioned.

Most financial institutions are processing transactions for millions of customers, whether institutional or retail, and the securities processing associated with this is made even more complex by the requirements imposed by tax authorities on the bank intermediaries when paying income to their customers.

Tax information reporting is complex, and can result in tens of millions of tax incorrectly reported with attendant fines. A thorough Due Diligence of this area is vital for financial institutions, and technology tools are emerging to reduce risks caused by manual or paper information flows.

'Below the line' taxes

Corporate income tax M&A is very complex for financial institutions. Cross border M&A transactions for financial Institutions will typically throw up significant tax differences in some countries in valuing complex financial instruments.

Whilst in pure accounting terms there has been a global convergence with most institutions adopting US GAAP or IFRS, themselves converging fast, there is still a huge divergence in the treatment of financial instruments between local GAAP and Group consolidated reporting.

Mark to market (known under IFRS as Fair Value) will typically apply to the Group level and published accounts to external bodies, but often at local GAAP level tax may still be applied using the imparity principle (i.e., no recognition of unrealised profits).

From a strategic point of view, Financial Institutions' effective tax rates are more often than not driven by the tax regime of the Headquarter country.

Thus companies with a Head Office tax regime based on the exemption system (foreign profits not being subject to tax in the headquarter country) will pursue a different corporate tax strategy than those companies using a credit system (where foreign taxes paid are potentially creditable against local taxes). Driving down the tax rate overseas (which is the strategy for exemption based companies) is totally different from maximising the use of foreign tax credits back at the headquarter country level.

While countries such as the UK revisit the way in which they tax overseas profits, the target of ETR management remains complex and subject to change.

There is a similar knock-on effect when considering repatriation of earnings and the financing of overseas operations.

Keeping tax issues on the table

As can be seen above, there are a wide range of Tax issues that should be considered both before and after any M&A transaction. However, these can easily be swept off the table during the intense period of Due Diligence when more high-profile issues are being considered. This would be a mistake, as overlooking any one of these many Tax issues can have a major impact on the value and success of the deal. Financial institutions should therefore build all of the above tax considerations into their M&A approaches going forward if they wish to 'trigger the tax advantage.'

Regulatory Compliance

How successful tax management and implementation of tax technology can stop deficiencies from sabotaging your Sarbanes-Oxley compliance

In 2007, over 30% of material weaknesses reported to the SEC, were related to deficiencies in tax accounting and year-end processes.

What is the matter with tax?

Tax is the number one cause of material weaknesses for US filers and there is a lot to learn from the experiences of those that have received an adverse opinion.

Failings in tax relate mainly to problems over accounting for tax (see Figure 1) – especially in relation to deferred tax. The filings that reported tax material weaknesses recorded deficiencies that included "…failing to record deferred tax balances according to FAS109 or FAS 52," "inefficient review of income tax provision calculations," "failures in adopting SFAS 123R" and "lack of expertise to determine proper tax basis". Other areas of weakness included those over significant judgements and estimates where there was "inadequate documentation and management review of tax exposure items".

Process related concerns included failures within the tax consolidation process, with "inadequate processes of oversight and review," "inefficient review of income tax provision calculations and related deferred income taxes" and importantly "ineffective or inadequate IT systems." In general, these failures lacked policies, procedures and resources needed to review complex, non-routine or non-systematic transactions.

Some financial services companies are considering the impact of these deficiencies as being a potential blessing in disguise and a real opportunity to identify and implement best practices in tax management and accounting, not just to comply with Sarbanes-Oxley, but to benefit from enhanced operating efficiencies and precision in tax management. This 'value-added' approach is best exploited with an integrated solution that includes improvement initiatives in three fundamental areas, namely, people, technology and processes.

People: Trained to succeed

People charged with calculating the tax provision should receive adequate training, especially in FAS 109 and FIN48. But which people in each jurisdiction are responsible? Sometimes, the answer is not so obvious. In fact, the "right" people can be a controllers accountants, in-house tax personnel, or even external consultants.

The training can be delivered in a variety of ways – live and local (which means traveling to non-U.S. jurisdictions or bringing those people to the United States), Web-based, self-study, or some combination. But no matter how it's delivered, training will be more effective if local country preparers and reviewers are identified early in the process and contribute to choosing new technology or designing new processes as the institution undergoes a larger tax "transformation."

Technology: Standardising for risk management

Having been through Sarbanes-Oxley Section 404 cycles, many corporate tax departments are now seeing that their tax provision technology is antiquated, that linked spreadsheets do not contain enough controls, and that their current system is not flexible enough to allow non-U.S. preparers to compute properly the tax provision for their given jurisdiction. These problems lead to others, such as the creation of several tax provision calculation files, each customised to a specific jurisdiction. The subsequent lack of standardisation forces the tax department to struggle through the year-end consolidation, manually standardising items upon receipt of the customised jurisdiction-by-jurisdiction files.

Relatively new "shrink-wrapped" tax provision software and custom-designed spreadsheet/database solutions are addressing these problems. For example, they can improve controls by including password protection, certification, and sign-off protocols. Some companies are choosing to enhance their homegrown technology, for example, by standardising temporary and permanent difference categories (including local tax calculation columns to handle all tax jurisdictions) and building out "return to" provision worksheets or database tools. This standardisation allows for an efficient and controlled worldwide tax provision consolidation, while keeping the technology flexible enough to handle the most difficult tax jurisdiction computation anomalies.

Process: Getting rid of bad habits

There is also much to be done in resolving a variety of process-driven problems. Consider the "bad habit" of misaligning currency conversion methodologies between the tax provision calculation and the company's financial systems. Typically, tax provision calculations are performed quarterly or annually in functional currency. The functional currency amounts are often translated to U.S. dollars using the average rate for the period in question. By contrast, tax expense may be recorded in a company's general ledger in functional currency on a monthly basis and translated to U.S. dollars using the average rate for the month. These two different methodologies, under certain circumstances, can produce materially different results. But without transformed processes and technology, the differences can go undetected.

Another example is the use of blended or effective tax rates to calculate current or deferred tax expense. Most homegrown systems include space for only one current and deferred tax rate. This single tax rate often is applied to both the current taxable income (to compute the current tax provision) and to gross temporary differences (to arrive at the deferred provision). In this case, the limitations in the technology drive a poor process. When there are graduated rates or separate rates for ordinary income versus capital gains in a given jurisdiction, preparers are left to compute those amounts offline and enter the blended rate into the tax provision package. This single tax rate approach ignores the fact that a separate assessment needs to be made for each gross temporary difference, based on the enacted tax rate for the period in which each temporary difference is expected to reverse. Often, little attention is paid to the enacted tax rate requirement until new software is installed that requests a separate tax rate for each gross temporary difference.

The first step is the biggest

Clearly, the "transformation" required of tax accounting elevates the issue to senior management's attention – which is just where it belongs. Sarbanes-Oxley tightens the connection between a company's financial statements and effective oversight. The SEC has made one thing clear: the CEO and CFO have to be close to the tax numbers – confident that those numbers are accurate and reliable; secure in the knowledge that those numbers are determined by people with the right skills, using the most appropriate technology, working within efficient and effective processes. SOX has brought tax accounting out in the open; now, it's up to the financial company's leadership to make sure it can withstand scrutiny in today's new environment.

Key features of a tax technology platform

Financial services companies seeking a world-class technology platform for their tax provision processes would be wise to consider the following features and functions:

- Tax reconciliation schedules that track payments by month and year.
- Automation to reduce the risk of human error and increase efficiency in these activities: rollover of data from period-to-period; calculation of book-to-tax differences based on programming rules; download of separate company and consolidation of book financial information; posting and tracking of late adjustments "top side"' in the consolidation process.
- Use of multiple tax rates to calculate current tax to account for special tax regimes (e.g., when capital gains are taxed at a rate different from that for ordinary income); application of different tax rates to each gross temporary difference to account for phased-in tax rate changes and tax holidays (including the ability to schedule out reversals and set tax rates by year).
- Flexibility to handle purchase accounting, including the ability to reverse valuation allowances against goodwill rather than tax expense.
- Sophisticated currency conversion algorithms that align with the conversion methodology used in the financial consolidation process.

Human Resources

Why international assignments are key to retaining your top performers

In today's volatile labour markets, global financial institutions are being challenged to find replacements in the highly competitive market for next generation talent. One key motivator for this new generation is the opportunity to travel and work abroad. However careful tax planning is critical to helping ensure this attractive benefit does not become an unexpected financial burden for your top performers.

Deloitte Research on offshoring in the financial services industry revealed that the majority of institutions suffer from "offshoring fatigue" after three years in operations. The report suggests that performance begins to fade as the first wave of managers return home from assignment. As a result, many institutions are searching urgently for effective ways to encourage their best young managers to undertake international assignments and to support them abroad. To meet this challenge, financial services leaders should understand that this fatigue is a manifestation of a larger issue that all companies face – the looming talent crisis caused by seismic changes in the demographics at home and abroad which means that global businesses face a huge management talent gap, one which has already begun to take its toll.

This occurs at a time when relentless margin pressure and intense competition are forcing financial services companies to offshore more of their operations. As a result, offshoring fatigue could soon change from a pressing problem to a critical one. The situation is complicated by the fact that countries such as China and India, which provide management and offshore talent pools could fill the gap, are themselves facing talent gaps as they experience rapid economic growth. Some overseas companies are now actively luring their expatriates working back to their home countries.

In sum, financial institutions that want to cure offshoring fatigue must move young talent into the management ranks much more quickly and pay close attention to their needs and desires. This needs to be achieved with a new generation of executives focussed more on achieving a work/life balance with greater emphasis on out of work satisfaction than at any time previously. The days when building a career came first and building a family was second, are disappearing. The new generation are different from this in several ways. First, members of this generation tend to be much more family-oriented than their parents and more concerned about keeping work, family and friends in balance. In fact, for many of them, friends, and family override their devotion to work.

In addition, they are less willing than baby-boomers to devote themselves early in their careers to a single specialisation. Instead, they are more interested in developing a portfolio of experience –

Leveraging short-term assignments while minimising overseas tax liability

Sending employees on short-term travel to other countries instead of relying on traditional long-term expatriate assignments can create complications, not the least of which can be huge tax penalties.

Until now, many corporate professionals relied heavily on what is known as the "183-day rule," believing that as long as an employee spends fewer than 183 days in a foreign country, their earned income is not taxable in that jurisdiction. However, in countries with no applicable tax treaty, expatriates may become subject to taxation immediately upon performing services. Even when a treaty does apply, there still could be corporate tax and reputational risk exposure.

To minimise overseas tax liabilities, employers should confirm not only at what point an individual's income tax obligations begin, but also whether any particular visa types could lead to a reduced rate of, or exemption from, taxation.

For treaty countries, this information and corresponding limitations are found in their respective treaties. Analysing the tax situation on non-treaty combinations can be more complicated. Employers should explore whether employees may be able to utilise a preferential tax status and make sure that each compensation item is being delivered in the most tax-efficient manner.

In practice, the main challenge employers face in managing their business travellers is often simply identifying them. It is critical therefore, for companies to establish a process for tracking their short-term business travellers and to ingrain compliance into the organisation's culture.

The bottom line is that before embarking on a short-term travel strategy, a company should assess the many hidden costs that may be involved. The internal HR and accounting departments, as well as external immigration and tax providers, should be involved. Only then can the organisation determine if the savings are worth the administrative baggage.

moving from IT to auditing to human resource management, for example. While such rapid changes can be frustrating to companies that invest in training, managing these career aspirations is key to retaining and developing the new generation.

What do these characteristics mean for financial institutions that want to encourage the best young executives to manage an offshore operation? Clearly, financial institutions must find ways to manage a delicate balancing act – creating programs that satisfy young managers' desires for variety in their careers, while still making it possible for them to keep work and life in balance.

One solution is for financial services firms to use long-term rotational assignments. That is, companies give young managers a series of 18-month overseas assignments, each in a different country, interspersed with year-and-a-half assignments in their home country.

A young executive might start with a year and half in China, come back for 18 months, and then go to Switzerland. This approach allows the managers to experience a variety of work experiences without being away from home so long that ties to family and friends are undermined. Such long term rotational assignments can supplant the practices of many companies in which managers are assigned to a single country for between three and five years, then bring them back home for just six months before the next lengthy international assignment. Another possible solution is even shorter-term assignments – six months or less. Short-term assignments allow young managers to keep their ties to family and friends strong, while exposing them to a wide range of experiences. Although a growing number of companies are taking this approach, a number of issues – including the tax implications for the company and the individual manager – should be taken into account.

Finally, in recent years, many financial services institutions have tried to stay competitive by focusing on cost containment through their HR policies in general and their approach to international assignments in particular. Faced with a looming shortage of talented executives, and growing competition for their services, institutions may well need to consider increasing spending on rewards and compensation while developing innovative policies that give young executives the flexibility and balance they seek. In this way, financial institutions should be able to bridge the looming gap, while performing the delicate balancing act that will help them quickly develop strong performers into the much needed next wave of managers.

Integrating tax in IFRS

The time is right to take the next step

Now that many financial institutions have had a few years of applying the International Financial Reporting Standards ("IFRS") behind them, it's time to revisit a tough, strategically important question: What are the long-term impacts of tax reporting under IFRS?

Certainly a lot has changed for global companies following IFRS in their published financial statements of performance. And more change is coming, as the International Accounting Standards Board ("IASB") and U.S. Financial Accounting Standards Board continue to align their standards or at least narrow their differences.

While companies have put all their energy into complying with the new reporting requirements, at most financial institutions management is still coming to terms with the fundamental tax consequences of IFRS. This has recently led to the SEC dropping its requirement to reconcile IFRS figures to US GAAP for IFRS-compliant entities listed on US exchanges.

Deferred tax

The principal impact is in the area of deferred tax. As part of preparing financial statements under IFRS, companies have had to consider the tax effect of book adjustments (to financial instruments, pension costs, and stock option costs) arising from changes in accounting policies. In addition, they've needed to identify ways that the accounting policy itself has changed. Executives have had to ask themselves such questions as: Where must deferred tax be provided? When is it appropriate to recognise deferred tax assets? What exceptions are allowed? In turn, book adjustments have raised a big question: Can potentially large deferred tax assets – for example, pensions, fair value adjustments, or impairments – be recognised? Under IFRS there are generally fewer exceptions from deferred tax accounting. Extra provision is needed for tax on revaluations, tax on profits made offshore which cannot demonstrably be retained there, and tax on temporary differences arising in business combinations. The result has been potentially significant increases in deferred tax provisions, with potential impact on a financial institution's regulatory capital requirements and its ability to pay dividends.

By now companies have realised that there are fewer ways to reduce the reported tax rate, other than by permanently reducing the cash taxes payable. Deferral doesn't work; strategies, such as retaining profits offshore or deferring capital gains may save cash tax but would require deferred tax planning also to reduce the rate. Also, many benefits to the tax charge previously enjoyed under many domestic GAAPs – such as tax relief for tax-deductible equity or employee share option gains – are no longer available.

Cash tax liabilities

The impact of IFRS on cash tax liabilities depends on two considerations:

1) **The extent to which IFRS is implemented at a solo company, as well as at a consolidated level** (since in most jurisdictions tax liabilities are usually computed by reference to solo company numbers). The main focus for IFRS (like US GAAP) is reporting to the capital markets, where consolidated numbers are of the greatest interest. The adoption of IFRS globally has been fuelled by the European Union ("EU") requirement that companies issuing shares or securities in the EU must report under IFRS – a consolidated requirement. Yet, many countries have either allowed or mandated similar reporting at solo-company level. Moreover, many national GAAPs are evolving toward harmony with IFRS. When companies have a choice, they are sometimes adopting IFRS (or an IFRS-harmonized version of GAAP) to avoid the need for multiple internal accounting systems.

2) **The extent to which the calculation of taxable profit follows GAAP in each jurisdiction**. There is a wide range of national practices as regards how closely tax follows accounts, but in many countries there is at least a strong influence in accounting practice on computation of taxable profit, at least over many areas of business taxation.

By far the most experience with the issues raised here can be found in the U.K. While the U.K. has allowed companies a choice of IFRS or U.K. GAAP for solo company accounts, the two are being harmonized relatively quickly. And the U.K. explicitly recognises, for tax purposes, the validity of GAAP across many aspects of the tax computation, most particularly in the area of debt and derivatives. The IFRS accounting standard in this area follows a so-called "mixed valuation" model – some items are fair valued, whereas others are accounted for at "amortized cost" (broadly, an accruals basis). The result is volatility of profit since matching assets, liabilities, and derivatives have mismatching accounting treatments.

If tax follows accounting, this leads to volatility of cash tax. In the U.K., this has been exacerbated by a tax rule which recognises reserve movements (or amounts "taken to equity") as components of taxable profits. To mitigate this, the U.K. has given corporations

the choice of following what is essentially a "tax GAAP" in respect of most hedging arrangements (recreating, for tax purposes, the old, pre-IFRS, U.K. GAAP rules) or of following the new accounting. The choice is essentially between additional compliance (the burden of, in effect, two accounting systems) or cash tax volatility. Similar issues have arisen in other areas, including embedded derivatives (where complex tax rules overlay the already difficult accounting); functional currency (where more prescriptive rules threaten to affect tax-hedged results); and non-regular amortization of goodwill and recognition of a wider range of intangibles under IFRS. An entirely new tax regime has been introduced for securitisation vehicle companies, where the tightly matched cashflows depend on matching tax treatment. Other problems – less relevant in the U.K., but potentially important in other countries – touch upon property revaluations, pension liabilities, and share remuneration.

The harmonisation of accounting standards achieved with IFRS has also inspired the European Commission to propose a "Common Consolidated Corporate Tax Base" throughout the EU. Although still subject to political discussion, it seems likely to be adopted in some form in due course, giving multinationals a choice of a harmonised, partially IFRS-inspired tax system (with maybe fewer planning possibilities but lower compliance costs) across several European jurisdictions.

Looking forward

As financial institutions anticipate reporting their performance for 2007 and beyond, it's time to start putting taxes in the picture. Here are three areas ripe with opportunity to achieve a tax advantage:

Compliance and systems

Having proven that teamwork can meet the demands of financial reporting (including disclosures) under IFRS, why not create teams to find ways of improving the data collection and calculations by automating, as far as practical, the tax reporting process? This is even more important now that companies have to do business in the Sarbanes-Oxley world of high standards of corporate governance and internal controls.

Automation can help in many ways, such as tracking and calculating tax on share options, revaluations, derivatives, and profits retained offshore. In addition, as noted above, each jurisdiction will have its own book/tax differences, depending on the GAAP used and specific tax rules in that territory; the right systems can reconcile these books, as well as ensuring that tax is correctly booked to income statement or equity. At the same time, transfer pricing documentation can be reviewed and updated.

Tax forecasting and effective tax rate management

To forecast taxes payable and reported tax charges – and to deliver meaningful data in real time – requires an investment in systems (or headcount) above and beyond simple business tools and structures. The new tax accounting rules, combined with the impact of cash tax rules in different jurisdictions and the need for robust forecasts by territory, make inevitable a new and better way of "crunching" numbers.

Because of limited exceptions to recognising deferred tax, it will generally be much harder to achieve a lower effective tax rate under IFRS. Here, new key performance indicators can help. Companies need to focus on their effective tax rate to get a clear understanding of post-tax profits and, hence, earnings per share.

M&A

The greater transparency and comparability arising from the wide use of IFRS is expected to fuel further M&A activity once the impact of the "credit crunch" is assimilated. Not surprisingly, new accounting issues will come along; for example, due diligence will have to take into account the way the target has applied IFRS and calculated its cash taxes payable, and the buyer will have to recognise tax assets not readily apparent (e.g., intangibles).

The bottom line is: now, if not before, the time is right to integrate IFRS and tax into a coordinated approach to financial reporting and management.

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