



Triggering the
tax advantage
Tax tactics for the
Global Financial
Services Industry

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Foreword

The global financial services industry is experiencing a level of change not seen in recent memory. Almost every aspect of the financial services business model is being reexamined in the wake of the global credit crisis, and almost every constant that institutions have come to rely upon appears to be in flux.

It has been said that change, even when it brings improvement, does not occur without causing disruption. The change brought about by the credit crisis is certainly inconvenient, however, it does also offer a unique opportunity to freshly question all of the many business practices taken for granted in our industry, and perhaps even force institutions to develop new, more effective approaches to some of those business challenges.

Too often, tax considerations are set aside when financial services executives develop their strategies, particularly around risk management, customer relationship management, information technology, regulatory compliance, human resources, and accounting & reporting. However, because tax is embedded within all of these areas of business, targeted improvements in tax planning, reporting, and technology can have a major impact on the success of the business. In today's market that can make all the difference between just surviving, and actively 'Thriving in a Changing Environment.'

Deloitte believes that tax considerations should be a key part of any fresh approach.

This is the third year in which Deloitte has produced the 'Triggering the tax advantage' report, which features articles on how to maximize tax efficiencies across a broad range of business activities. This year, the articles have been crafted in light of the current crisis, an offer insights on how tax can create a competitive advantage in all these areas of business and, ultimately, help institutions thrive in this changing environment.

I hope you find the report of interest and that it helps you identify and exploit the opportunities for change created by the current situation.



Ellie Patsalos
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Enterprise Risk Management

Over the past 10 years, the concept of tax risk has advanced significantly with tax departments evolving their understanding of what they want to achieve by successful tax risk management.

As organisations face new challenges in the current economic climate, they are increasingly looking for new ways to gain tangible value from a renewed focus on tax risk.

There has been a strategic shift in how companies are approaching risk management and organisations are now focusing on those tax risk areas that can add value to their business.

In the past, companies have invested their efforts in identifying 'downside risks' – e.g., those risks which have resulted in money lost through overpayment of tax or penalties paid as a result of noncompliance. Progressive organisations are no longer adopting a risk averse approach in how they manage tax risk. Today, it is not so much about getting things wrong, but ensuring that things are done right. Focus is all about tax optimization and opportunities that can be realized through successful risk management.

Examples of 'upside' risks which organisations have considered significant in terms of lost value to the business include: incorrectly implemented risk planning, late involvement of tax in product development, and incongruence of commercial divisions, and tax group goals leading to missed opportunities or unexpected tax costs. Our experience is that responding to these risk areas adds tangible value to the business, enabling tax departments to clearly demonstrate the benefits of managing 'rewarded' risks. At a time of economic uncertainty, being able to demonstrate cost reduction is important, and there are increasing pressures on tax directors to treat tax like any other cost. As such, tax directors need to be able to access the right tools and methodologies to demonstrate increased efficiencies and value in their processes and tax management.

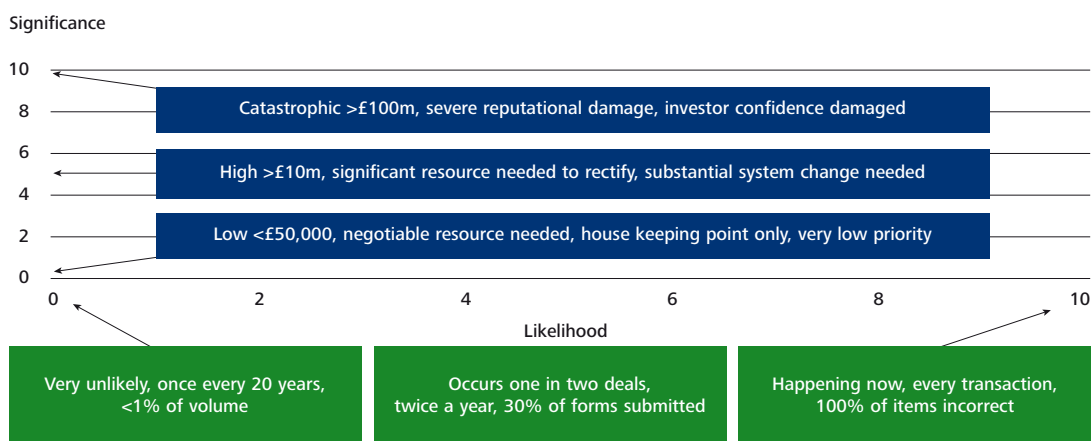
Managing tax risk

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 and demonstrating the value of tax risk can be difficult. Tax risk first 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 tangible ways in which 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.

Figure 1. A functional analysis of how tax impacts Enterprise Risk Management



Source: Deloitte

Working with tax authorities

In the U.K., one of the main drivers for pushing tax risk up the board agenda is in response to the changes in behaviour and powers by HM Revenue & Customs (HMRC) who are now assessing organisations along risk-based lines. In basic terms, those organisations that can demonstrate that their tax governance, systems, and processes are robust should expect to enjoy an enhanced relationship with their tax authorities and a 'lighter touch' in how the tax authorities deal with their tax affairs.

For companies in the financial services industry, tax authorities are likely to focus more heavily on overall tax governance in terms of ensuring robust control processes, while at the same time, staying close to other key issues, such as the substance of transactions, debt structuring, and transfer pricing arrangements.

Tax governance has been identified by HMRC as one of their key risk factors, and developing a more robust approach to governance is becoming a key focus for many of our clients. In most cases, this has involved an overhaul of control processes and underlying systems to create operational improvements for the tax department. Tied into this is a desire to improve communication and networking across the business and improved knowledge sharing and better risk management.

Tax technology plays a vital role in this and can ensure risks are better mitigated throughout the reporting cycle, and its implementation can free up resources to focus on value-added opportunities.

Transactional taxes

Indirect tax risk is particularly a key issue. This is down due 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 businesses may be a long way from best practice, but there is at least, in many cases, some type of control environment from direct taxes.

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. In the current economic climate, this is just not acceptable. Equally as important, it can be a risk to the reputation of the organisation as a result of the actions of the tax department. In many high-profile cases, tax matters have also been pursued through the courts. From the perspective of corporate governance, effective tax controls and processes minimize 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.

Effective use of tax technology

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 and GST). 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 unaudited. 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.
- Nonstandardisation – using ad hoc spreadsheets can mean that there is little consistency across different countries and different entities within the same country.
- Heavy reliance on nontax 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, e.g., 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 posttax measurement), a complete evaluation of the global tax impact of business decisions can result in permanent savings for companies. For financial institutions facing difficult economic times, reducing operational costs takes priority. Tax consequences which can make a big difference in operating efficiencies and economies will be welcome.

At the same time, 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 current economic uncertainty and need for cost efficiencies, 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 relationships. 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, nontax 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 (QI) 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. noncompliance 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.

Noncompliance 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 is 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 noncompliance.

Different regimes are enforced with different degrees of severity by relevant tax authorities. The QI regime levies significant penalties for noncompliance, 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 QI 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.

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 customer's needs are met within the parameters of the institution's commercial and ethical standards. For example, in response to the EUSD, 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 is 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 noncompliance, 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.

Key recent events

United Kingdom

HMRC information requests

In 2006, HMRC served notices on five major U.K. banks and as a result obtained information relating to offshore bank accounts held by individuals living in the U.K.. Following this, HMRC set up an Offshore Disclosure Facility to enable the banks' customers to voluntarily disclose details of relevant income and pay the U.K. 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 are in the process of issuing notices to other financial institutions.

Stock lending transactions

Institutions that enter into stock lending transactions have been impacted by the recent failure of counterparties (e.g., Lehman Brothers) and had to deal with the resultant tax issues whereby the stock loan has been terminated. In certain cases, the custodian agent acting on behalf of the lender (e.g., investment fund) has been required to consider the tax issues surrounding the replacement of securities and the treatment of any compensatory payments made to the lender as a result of the defaulting counterparty. In the recent U.K. Pre Budget Report it was confirmed that regulations would be laid in 2009 that would provide U.K. capital gains and stamp duty reliefs for lenders that would otherwise be subject to tax liabilities as a result of the failure of the counterparty to complete the lending transaction.

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 U.K.) 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. In November 2008, the European Commission adopted an amending proposal to the Directive, with a view to refining the scope of the existing Directive, increase obligations on paying agents to identify relevant customers and broadening the scope of reportable payments. The Commission proposal seeks to ensure the taxation of interest payments which are made through intermediate tax-exempted structures, in particular where the structure itself is located outside of the EU.

It also proposes extending the Directive to cover income equivalent to interest obtained through investments in some innovative financial products, as well as some life insurance products. If enacted the proposals would require paying agents to identify products that fall within the enhanced scope from 1 December 2008 and are intended to come into force around 2012. Discussions also continue 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 nonresidents, was a restriction on the free movement of capital within the EEA. This has now been followed by the 2006 EU based decision in Denkvit 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. Other EU states have also amended (or have announced changes to) their domestic withholding regimes as a direct reaction to the outcome of these cases. 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 QI regime has been successful in raising funds for the U.S. Treasury. Now, after seven years, many financial institutions have entered into their second QI 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 U.S. 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 multimillion dollar settlements where they have applied lower levels of withholding than they can justify.

Information Technology

How companies can use tax incentives 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 Customer Relationship Management (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 incentives. Over 30 countries now provide R&D incentives for IT-related activities including Australia, Austria, Belgium, Brazil, Canada, Czech Republic, China, France, Hungary, India, Ireland, Israel, Italy, Japan, Malaysia, Mexico, The Netherlands, Singapore, Spain, the United Kingdom, and the United States. IT spending can therefore 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 forefront, since measures like Risk Adjusted Return on Capital (RAROC) require modeling on a posttax basis.



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

Whilst retrospective claims for R&D incentives are possible in some jurisdictions, the determination of whether an investment will be eligible for R&D tax credits (under various global regimes) should ideally be made during the budgeting process – in other words, before the money is spent.

Companies often have 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. Furthermore, even if there are suitable solutions in the market, they may not individually address the whole issue and combining different solutions with each other and/or with a company’s own proprietary systems can create a high degree of system uncertainty.

It is this type of complex IT development that can potentially qualify for R&D tax incentives. The following questions are typical indicators of whether an investment may be eligible for R&D benefits:

- At the outset of an initiative, is there uncertainty at a technological level over whether the solution is achievable or what form, architecturally, it may take?
- Does the company require a solution that goes beyond technology that is commercially available through off-the-shelf software packages?
- Will the development team need to experiment with packaged solutions and vendors’ products (in accordance with the company’s established software development methodology) in an attempt to address the technological uncertainties around their integration?
- If so, might 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?

Whilst it is not necessary for all of these factors to be present, the greater the number of ‘Yes’ answers, the greater the chance of obtaining R&D tax benefits.

Application to financial services

The types of IT projects within the financial services industry that may give rise to sufficiently complex issues to be eligible would include:

- Regulatory initiatives rarely specify how new requirements should be implemented and for this reason, IT uncertainty is often inherent. For example, IT developed to address the following regulations may qualify for R&D tax credits:
 - Sarbanes-Oxley: software for an adequate internal control structure, including intrusion detection/prevention systems (realtime 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 often lead to innovative development work since they give the company a chance to be a ‘first mover’. For example, 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.

In most cases, it is not the factors that drive the initiative itself, which may be purely commercial or regulatory, that is important in determining eligibility but rather it is the complexity of the developmental work required to deliver the solution.

The global picture

Not surprisingly, each country has its own set of rules although fundamental issues, such as the inclusion of costs associated with people, i.e., wages and salaries of the company's own development staff and outside contractors, and also the nature of the activities that qualify (as outlined above) are consistent. Caution is, however, needed in some jurisdictions, such as the U.S. and Australia, which have additional hurdles for software developed for 'in-house' use.

Other areas where the regimes can vary generally revolve around these questions:

- Must the activities be performed in the home country?
- Must the entity claiming tax relief bear economic risk for the activities performed?
- Must intellectual property created from the activities remain with the entity?

For example, the U.S. requires that qualified IT development activities must occur within its geographic boundaries whereas, by contrast, the U.K. will provide tax relief for activities performed anywhere, as long as those performing the activities are employees of a U.K. tax paying entity.

Whilst the Czech regime allows for the reimbursement of R&D costs by foreign related parties, Japan 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 U.K., the drive towards capitalising IT expenditure to maximise profit before tax has led to practical difficulties in establishing claims. The U.K. makes a distinction between capital expenditure, which delivers cash tax savings from accelerated tax depreciation (but no additional tax deductions), 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 the inclusion of IT development costs in its incentive claims, even where the work is performed outside its geographic boundaries, the company can claim tax relief from the home country for its foreign activities. At the same time, the company's overseas presence may be able to claim the R&D incentive in the local country. In other words, it may be 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 analysing the transfer pricing consequences. Can a taxing authority require the payment of 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 – for example, reviewing the organisation's global tax position (including foreign tax credits and transfer pricing agreements); reconsidering IT budgets in light of the tax benefits; and finally, using 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.

The ABCs of R&D tax credits

In summary, more than 30 countries offer some form of tax relief for R&D activities and taking time to understand the potential benefit can reap significant rewards. While most regimes define R&D and administer their regimes in a similar way, there are some differences, both substantial and subtle. For multinational financial institutions, these differences can provide significant 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 U.S. offers a 13% incremental tax credit. The Netherlands offers a graduated scale of payroll tax incentives related to qualifying development activities, whilst the U.K. and Australia offer enhanced tax deductions. Tax credits are refundable in some jurisdictions (for example, France, Austria, and some Canadian provinces), thus providing benefits to companies operating with financial losses and potentially allowing above the line recognition. Taking advantage of refundable credits can also provide additional foreign tax credit benefits to U.S.-based financial services companies as the incentives do not always reduce foreign tax credits.

All three types of incentives can be either volume-based (i.e., applicable to the total spend in each year) or incremental (i.e., qualified development expenditures must exceed a minimum level based on prior years before they can qualify). The U.S. offers an incremental incentive, while Canada and the U.K. offer volume-based incentives. Other regimes, such as those in Australia, Japan, and Spain, provide incentives that have both incremental and volume-based components.

Unlike direct tax, there are no specific indirect tax reliefs 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 and it is imperative that VAT is considered at the outset in order to limit the exposure. Limiting the VAT exposure may be possible through intelligent structuring and making careful use of existing reliefs approach to financial reporting and management.

Mergers & Acquisitions

The new world order for financial services – tax considerations.

The long awaited European banking consolidation has arrived, but not in a way that could have been believed just a year ago. The sheer scale of the change being wrought within financial services is breathtaking – and the longer term regulatory and fiscal implications have scarcely started. But amongst the turmoil of bail outs, G20 communiqués and recrimination, cool heads must reign and no more so than in considering tax and group tax policy.

International policy response

The immediate crisis may have abated – leaving behind a world of nationalised banks, government stakes and forced take overs – but the long-term issues of improving regulation and competition remain. The G20 gives us some idea of where we are headed: according to their communiqué of 15 November 2008, the root causes of the crisis were market participants chasing ever higher yields, procyclical regulation, complex and opaque financial products, and weak risk management practices – not forgetting the *bete noir*, rating agencies. Some commentators would add governments themselves to the list as national self-interest engendered a culture of national champions, light touch regulation and regulatory arbitrage. Any international coordination that did take place took far too long to negotiate – Basel II is dead on arrival.

However, you apportion blame, what cannot be disputed is that these factors combined to generate excessive leverage and made the financial systems increasingly vulnerable. The global deleveraging process will continue even as the policy response ramps up – twin strategic drivers that need to be considered by institutions in formulating how to reshape their businesses.

Excess leverage

Excess leverage generating excess profits – and now excess losses. Everyone agrees that levels of debt were too high and policy setters will want to make sure that this situation does not happen again any time soon.

As well as broader and tougher regulation – to cover the shadow banking world and to increase capital requirements in the good times – might there be a tax policy response to the issue of excess leverage? Changes to the tax advantages of issuing debt have been mooted before – Germany already has interest cap rules and the U.K. is likely to follow with some limited restrictions (prompted by existing concerns that foreign groups were loading U.K. operations with too much debt). In the circumstances, combating excessive leverage through limiting deductions for interest might be very tempting: tax neutrality between debt and equity above a certain level of gearing would arguably make issuers and investors focus more on the economic risks inherent in the capital structure. Such change of course makes little sense on a unilateral basis and might be difficult to implement fairly, but at this stage should not be ruled out.

Compensation culture

The U.K. regulator, the Financial Services Authority, has issued an open letter to CEOs (Remuneration Policies, 13 October 2008) expressing concern that inappropriate remuneration schemes may have contributed to the crisis. The letter is not formal guidance but sets out some initial thoughts as to what the regulator believes is best practice. Remuneration schemes that do not appropriately take into account risk or that incentivise staff to pursue risky policies will not be acceptable. Schemes should be structured to defer a major proportion of bonuses and if things later turn sour, the reward should not vest.

Any sense that risk taking is being unfairly rewarded by the tax system is also unlikely to be tolerated. Could there be a return to the debate around capital treatment in private equity and hedge funds, or possibly a harsher tax treatment for both employer and employee where a scheme does not represent good practice?

As governments coordinate action across a number of fronts – regulatory reform, risk management practices, and accounting standards to name but three – the extent that tax policies may be used to encourage best practice and avoid the mistakes of the past remains to be seen. National self-interest will militate against this to some extent particularly in view of continued tax competition across Europe and the substantial national interests that bank bail outs have created.

Institutional response

Putting aside speculation on policy response, what should tax directors focus on as the new market reality takes shape.

Institutions caught up in the swathe of consolidation forced through by governments will by now be in the midst of integration planning. More generally, business units will be trimmed, sold off or combined, head count reduced and legal entities rationalised. The scale of change will inevitably give rise to tax risk that needs to be carefully managed – and the numbers are likely to be significant. It is more important than ever for the tax function to stay close to the business and for advisors and in house professionals alike to be aware of business drivers. Equally advice to business units should factor in corporate issues, such as loss preservation, capital requirements, and revised legal entity structure.

There will be intense pressure to identify, prioritise, and execute tax policy and strategies in a greatly expedited timeframe. Internal departments resourced adequately in quieter times may feel the strain. Targeted, short-term external resources can pay dividends and help reduce the risk of a major misstep. Good, pragmatic tax advice as always is essential.

Some of the specific corporate tax issues surfacing from the crisis are outlined below.

Loss preservation

The crisis may have started in the U.S. but is now global and so are the tax losses. As a valuable asset in their own right these should be handled with due care. Most jurisdictions have restrictions on utilising losses where the ownership or nature of the business changes and forfeiture may not be avoidable in some cases. Tax directors should liaise closely with integration and restructuring teams so that opportunities to preserve losses are not missed.

Tax capacity

Tax capacity is now a scarce resource and tax planning needs to adjust accordingly. The value of some avoidance transactions will be reduced, but transactions to refresh losses or defer deductions into future years will remain popular. Structured product business units that compete for capacity will find life tough and may be asked to justify transactions based on the return on capacity generated compared to other planning initiatives. For some institutions, aggressive planning may be more difficult when the government is a significant shareholder.

Regulatory capital

Institutions are living by the mantra 'capital is king'. External capital raising will seek to replace depleted core capital and in many cases this will involve public funds. Tax deductible hybrids may no longer be worth the effort when there are no profits to shelter and replacing core tier 1 is the overriding priority. Capital may be freed up by selling noncore assets and balance sheet deleveraging. The pressure to allocate capital efficiently and repatriate surplus or trapped capital will add to the burdens on group tax functions.

Antiavoidance

The plethora of antiavoidance rules that have been legislated over the past few years, particularly in the U.K., could now interfere with commercial restructuring and catch the unwary. Situations that could not have been sensibly anticipated at the time of a transaction – a securitisation vehicle becoming a related party, for instance, are creating unexpected tax problems. These can often be worked around given sufficient lead time and fiscal authorities may be minded to take a more lenient view in the absence of an avoidance motive.

Liaison with fiscal authorities

A proactive approach in dealing with the tax authorities is critical. The sums involved may be very large as businesses are completely reshaped for the new market reality – not something that should be left to an audit several years down the line. An early and open dialogue with tax authorities should be considered – after all in this environment any chance of some certainty should be grabbed with both hands, thereby ensuring no unpleasant surprises when it is too late.

Please do not hesitate to contact your local Deloitte Financial Services Tax contact as we navigate these extraordinary times.

The crisis may have started in the U.S. but is now global and so are the tax losses.

Regulatory Compliance

How successful tax management and implementation of tax technology can stop deficiencies from sabotaging your Sarbanes-Oxley compliance, even with reduced tax resources.

Auditors attribute over 30% of all reported material control weaknesses to issues with tax accounting and year-end processes.

The benefits of increased regulation

It has been over six years since President George W. Bush signed the Sarbanes-Oxley Act, but only recently have organisations had the opportunity to step back and review both the costs and benefits of compliance. Despite widespread investment, the evidence suggests that companies continue to find it difficult to get their books right, with 40% of reported tax material weaknesses in the first quarter of 2008 being by repeat offenders.

Auditors are attributing over 30% of all reported material control weaknesses to tax, and this has unsurprisingly led to a greater emphasis on company accountability and concerns over potential SEC investigations. In response to this, CFOs and tax directors are having to react to increased stakeholder scrutiny of their tax numbers in the financial statements, as well as ensuring greater assurance over their internal processes and controls.

Many organisations, however, are reporting the benefits of this investment. Companies that have responded positively to the regulatory changes are realising the benefits of their investment. In the words of one of our clients, 'the visibility and communication of tax has increased across the wider finance community as a result of formalising the controls and processes over financial reporting and tax management during adoption of section 404.' It is our view that these organisations will be best placed to ensure continued regulatory compliance and effective tax management even where their tax resources are reduced as a consequence of the economic down-turn.

What is the matter with tax?

Failings in tax continue to relate to problems over accounting for tax – 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, nonroutine or nonsystematic 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.

Let's look at these in turn.

People

People charged with calculating the tax provision should receive adequate training, especially in FAS 109 (Accounting for Income Taxes under U.S. GAAP) and FIN48 (Accounting for Uncertainty in Income Taxes). But which people in each jurisdiction are responsible? Sometimes, the answer is not so obvious. In fact, the 'right' people can be a controller's 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 U.S.), Web-based, self-study, or some combination. But no matter how it is 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.

Tax balance sheet approach

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 has been a key lesson learned from reported tax deficiencies. An example of this is that many organisations have been asked by their auditors to undertake a thorough review of the differences between the income tax basis and the financial reporting basis of asset and liability opening balances. Such a validation of brought-forward balances has given greater assurance over a company's true opening position. Similarly, the adoption of a tax-basis balance sheet approach has enabled organisations to better track temporary differences and thereby provide more comfort over the completeness and accuracy of their deferred tax balances. This in turn has saved time and resource at year-end in substantiating figures, as well as providing a more robust audit trail.

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, and working within efficient and effective processes.

Sarbanes-Oxley has brought tax accounting out in the open; now, it is up to the company’s leadership to make sure it can withstand scrutiny in today’s new environment. Forward looking organisations that are aiming to respond to this new environment are building on their investment in regulatory compliance by setting up overarching systems that benefit multiple tax processes. The first step on this journey is often the formalisation of a tax strategy or key tax objectives around how they would like their function to operate. These objectives cover all aspects of the management of tax, and often focus on tax accounting and reporting. Examples include:

- reducing the resources spent on compliance by 20% by 2010;
- focusing more resources on tax-effective business planning;
- delivering an improved level of standardisation and consistency across all tax activities;
- cutting the tax financial close process by one week.

These objectives would sit well within the wider finance function, and this is representative of how many tax functions are placing themselves within the wider business’s strategic plan.

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Key features of a tax technology platform

Financial services companies seeking to fulfill their objectives of 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; calculating of book-to-tax differences based on programming rules; download of separate company and consolidating of book financial information; and 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.

Next steps

Optimised tax management requires fully integrated tax solutions. Progressive organisations are reaching this goal by seeking to align their tax and financial systems to provide standardised tax processes on a group-wide level. This can be achieved by use of global data warehouses, tax 'dashboards' for at-a-glance progress reports and enhanced data analysis for tax planning. For many companies, particularly those most heavily impacted by the current economic climate, achieving this is still an aspiration. For them, the journey to a fully-optimised tax reporting process may begin with smaller steps. To move tax forward, these organisations should decide where tax wants to be in the future. Understanding their current position and creating a set of key objectives to add value to their tax function is a step in the right direction.

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 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 which 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 focused more on achieving a work/life balance with greater emphasis on out of work satisfaction than at any time previously.

Within this context, the changing expectations of today's graduates need to be recognized. 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 – 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. With the current focus on short-term cost reduction in the light of the credit crunch, there is a risk that organisations lose sight of the longer term strategic imperatives and developing underlying problems.

If this happens, problems with the development of executive talent and experience will grow to become a potential crisis when the economic cycle has turned and the balance has shifted back to talent shortages.

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. This is becoming more marked as financial institutions respond to the drastic economic implications of the financial and market turmoil seen over the last six months and expected to continue. Despite this, institutions with a longer-term view 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 gap, while performing the delicate balancing act that will help them quickly develop strong performers into the next wave of managers.

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.

Integrating tax in IFRS

The time is right to take the next step.

Now that many financial institutions have had a few years' experience of applying IFRS, it is 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. Some U.S. groups are also looking at adopting IFRS as their primary reporting method.

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.

Tax accounting

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: When 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.

Further complexities arise in tax reporting: When can assets and liabilities be offset? When does tax need to be reported in equity rather than the income statement? What disclosures are required e.g., expiry of deferred tax assets?

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 further 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 U.S. 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 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.

If tax follows accounting, this leads to volatility of cash tax. In the U.K., this has been exacerbated by a tax rule which recognizes 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 accruals basis) 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 2008 and beyond, it is 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 team work 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 statements 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 posttax profits and, hence, regulatory capital and 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 liabilities on acquisitions not readily apparent (e.g., on 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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