


frontiers in tax

people thinking beyond borders in financial services
July 2010

FINANCIAL SERVICES

A full-page photograph of a person climbing a mountain peak. The person is silhouetted against a bright, hazy sky, standing on a rocky outcrop. They are wearing a dark jacket and pants, and have a large orange backpack. A blue and green rope is visible in the foreground, extending from the person down towards the bottom left. The background shows a vast, mountainous landscape with clouds and a valley below.

Exploring a new era of big government in banking
Changes abound for the financial services sector

Reshaping insurance for efficiency gains
The importance of planning ahead

Road block for fund managers
UCITS IV – significant tax complications



Hugh von Bergen
Chairman Global FS Tax

frontiers in tax – July 2010

The introductions to our last two editions highlighted the pace of change in the financial services industry – pace that is continuing this year. But, as the industry navigates its way through a new world order of regulation and oversight prompted by the financial crisis we are also seeing financial institutions looking to take their businesses successfully forward into the future.

In this edition we pick up on the two themes of changing regulation and the risks and opportunities of the future. To start, we look at the emerging theme of living wills as regulators force banks to set out how they will respond to severe financial stresses and the tax issues that flow from these plans. Governments in several major economies are also looking to drive behavioural change in the banking industry through the imposition of new taxes while raising much needed revenues. But many of the bonuses which have attracted so much media attention were paid out of profits which have now evaporated. This raises some interesting new challenges as banks try to build new transfer pricing models to reflect this new dynamic.

A discussion among four partners from KPMG's M&A tax team highlights the recovery in M&A activity in some of the larger western markets as well as the continuing focus in the Asia Pacific region. The M&A tax team highlights VAT as one of the key tax drivers in deal structuring, and the reform of VAT and GST rules for financial services is underway around the world. But a comparison of the different approaches being adopted by some of the fiscal authorities around the world suggests that financial institutions will need to remain alert to spot the risks and opportunities.

The growing focus on risk management in tax highlights the need to build a high performing tax function that strikes the right balance between risk management, and the added value of efficient compliance and tax planning. The compliance theme is developed as we look at the six golden rules of transforming a multinational organisation's compliance capabilities.

The combined drivers of greater business efficiency and the Solvency II regulatory regime have led many insurers, particularly in Europe, to look at the possibilities of migrating to single underwriting balance sheets. But European harmonization is not always what it seems as members of our investment management team look at the practical implications of the new UCITS IV directive in two articles on tax reporting and on fund structures. The investment management theme continues as we explore the transfer pricing challenges posed by the partnership structures which are commonly adopted in the industry.

India has also had a welcome liberalization of its tax code, but in our comparative analysis of its regime with Hong Kong and Singapore we argue that there is still more to do for offshore funds. Our focus on the Asia Pacific region continues with a look at the growing trend for tax authorities in the region to challenge the concepts beneficial ownership in interpreting double tax treaties and, indeed, in developing their domestic legislation. Fair value accounting has also raised some questions in the region as Singapore's decision to align the tax and accounting treatment of financial assets has thrown up some unexpected challenges for financial institutions.

We hope you find this publication informative, thought provoking and enjoyable.

A handwritten signature in black ink, appearing to read 'H. von Bergen', with a horizontal line underneath.

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Taxing the rescue



Shining a light on flawed bonus culture



The vanishing point of VAT



The perfect balance



Heading in different directions



Smoothing the passage to India

Taxing the rescue

Global regulators are promoting living wills as a method of ensuring the integrity of the financial system but the impact of tax on these new covenants is being overlooked, say **Jane McCormick** and **Victor Mendoza**.



Recent events, in particular the collapse of Lehman Brothers, have forced regulators to focus more closely on the operating and legal entity structures of financial institutions. Structural complexity (numerous entities, cross-booking, intra-group transactions, etc.) reduce transparency, make risks harder to monitor and manage, and make it more difficult to restructure or wind up in the event of a crisis.

But, on the other hand, separating businesses into different legal entities can insulate important businesses from risks elsewhere in the group, and the recognition that banks are 'international in life, but national in death' is leading some regulators to favour subsidiary structures, to protect national tax bases and financial systems. Various proposals have been put forward by regulators and governments worldwide, such as the Volcker Rule, which would restrict the activities of deposit-taking banks or the size of systemically important banks. Enforcing such rules will be difficult, but in the meantime an idea that seems to be gaining international approval is 'living wills.'

In the UK, the Financial Services Authority (FSA) has asked some banks to draft recovery and resolution plans (living wills) that spell out how the bank will act in the event of a crisis. Other regulators, such as the Bank of Spain, have followed suit, and the idea has attracted favourable comment from US Federal Reserve Chairman Ben Bernanke.

Recovery Plan

An FSA recovery plan is designed to restore a firm's capital and liquidity, and may include selling businesses or subsidiaries, or raising new capital. The FSA guidelines require a recovery plan to set out the firm's plan for responding to severe stress, and must include a capital recovery and liquidity recovery plans (a firm's existing contingency funding plans and stress-testing, as required by longstanding FSA rules, may already be adequate).

The recovery plan firm must:

- demonstrate that the firm has a plan of action.
- set out the process for deciding to execute the plan.
- describe the circumstances in which it is appropriate to execute the plan.
- itemize the information needed by the firm and/or third parties, and how that information will be obtained and disseminated.
- describe the legal, financial and operational constraints to be addressed when executing the plan.
- describe how the firm will deal with the failure of its largest counterparties.

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Resolution Plan

The resolution plan focuses on the steps the authorities must take to ensure that the firm does not damage the wider financial system. To do this, the authorities will need information, so the focus of the firm's resolution plan is on how to provide vast quantities of information in a very short time frame to allow the authorities to choose between different resolution options and execute the chosen strategy. The resolution plan must describe the different entities within the group and the relationships between them, including the legal, financial, staffing and other links between the members and the contingency plan if one member cannot meet its obligations to other group members. The FSA resolution plan should also include a detailed analysis of impediments (financial, legal, operational) that could prevent the authorities from using any of the following resolution tools:

- the bank insolvency procedure.
- a partial transfer of assets and liabilities (either to a bridge bank or private sector purchaser).
- a whole bank transfer of the assets and liabilities.
- taking the deposit-taker into temporary public ownership.
- taking any holding companies that sit above the deposit-taker into temporary public ownership.

A resolution plan must also list the market and payment systems to which the firm is connected and the plan to disconnect from them in an orderly manner.

Tax Considerations

Drafting this 'living will' involves many regulatory, legal, and operational challenges. Tax, although not the most critical issue, has an impact that needs to be considered.

First, some regulators have suggested that current complexity of group structures may be driven by tax. It is true that applying tax laws across a global group can add some complexity, but it is not, by and large, the kind of complexity the regulators are concerned about. One of the roles of a tax department may, therefore, be to help management explain the rationale for a particular structure, how it could be unwound if necessary and why it should not concern the regulators.

Second, a bank may plan in a living will to do something, in the event of a crisis, to enable recovery or resolution that has tax implications. These need to be assessed at the outset, in case the implementation of the plan creates a tax liability, or affects the recoverability of tax assets. If, for example, a restructuring led to the extinction of significant carried forward tax losses, the write-off of such assets could affect the regulatory capital ratio of the entity

concerned. A restructuring could also increase tax costs (withholding taxes, VAT, etc.) to such an extent that a part of the business became unsustainable.

In reaction to concerns about transparency and complexity (as well as the need to reduce costs) some banks are already restructuring, so the tax issues arising in the course of current restructuring will have to be taken into account in the resolution plan.

Although the tax consequences of restructuring vary from group to group, and from tax jurisdiction to tax jurisdiction, there are a number of common objectives firms will seek to achieve, including:

- recognizing and using losses from the transfer of assets at a loss and minimizing the amount of tax incurred gains (either through non-recognition, or the use of tax attributes).
- structuring liability relief to optimize the group's tax position (i.e. obtaining deductions for group lenders and minimizing income to borrowers).
- where the transaction involves new capital or a change of share ownership, preserving the favorable tax attributes of the group and group members.
- using the provisions of double-tax relief agreements to avoid multiple levels of taxation on cross-border transactions.

Taking the US, UK and the Spanish tax regimes as examples, some significant issues are:

Loss Carry Forward

Section 382 of the US Internal Revenue Code (IRC) of 1986 limits the use of net operating losses (NOLs) and built in losses (BILs) where a loss company has experienced a more than 50 percent change in ownership during a three year period. This is designed to deter acquirers from buying a company purely for its NOLs and BILs. The US Internal Revenue Service (IRS) and Treasury Department have issued guidance on how to establish whether such an ownership change has occurred. For instance, Notice 2010-2, 2010-2 I.R.B. 251 says that shares acquired by the US government do not count when measuring whether an ownership change has occurred. The notice also provides relief on the sale of shares by the US government in determining whether an ownership change has occurred.

The UK tax code contains similar provisions preventing the carry forward of losses following a 50 percent or more ownership change, but only when there is a 'major change in the nature or conduct of the trade' within three years of the change of ownership. But, in contrast to the position in the US, the acquisition of shares by the UK government does count in measuring whether there has been an ownership

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change. Given the three year time horizon, this could become significant, and should be taken into account when drafting a recovery or resolution plan.

The Spanish 'Loss Carry Forward' limitation rules would apply following an acquisition of more than 50 percent of capital or voting rights by an entity or group when – under certain circumstances – the previous participation of the acquirer was less than 25 percent, but only if the target has been dormant for at least six months prior to the acquisition date. Thus, it seems that these limitation rules may not be relevant in this context.

Bad Debt and Cancellation of Indebtedness Income (COD)

Where a group member forgives some, or all of an intercompany loan, it must demonstrate for US tax purposes, that it has met the statutory requirements for deductibility, including loss deferral rules for related-party transactions. On the borrower's side, debt forgiveness produces cancellation of indebtedness (COD) income. A number of exceptions may allow a borrower to reduce tax attributes

rather than recognize and report COD income.

In the UK cancellation of a debt between unrelated parties gives rise to taxable/deductible items, but the cancellation of related-party debt does not. The tax impact of a restructuring thus depends on the order in which transactions take place. Similar treatment applies in Spain where the cancellation of debt between related parties follows the substance over form accounting approach and would imply the recognition of a distribution of reserves, capital contribution or income/loss depending on the position of the related parties (parent, subsidiary, sister companies, etc). In certain cases a limitation on the deduction of losses would apply.

Corporate Reorganization Provisions

The transfer of all, or substantially all of the assets of a group member, or the spin/split off of member companies, may qualify for tax free treatment under the reorganization provisions of the IRC in the US and under UK and Spanish provisions.

Reorganization provisions may be internal, or involve external stakeholders as well. Whether or not the reorganization is tax-free will affect the amount of corporate gain or loss on the transaction, whether tax attributes survive the transaction, and whether shareholders recognize a gain or loss on the transaction.

Conclusion

Work has begun in some countries on living wills, and is likely to begin soon in other countries. Although tax will not be a primary focus of these projects, tax professionals should be involved in the process to ensure that the barriers imposed, and the financial and regulatory impacts of tax, are reflected in their plans.

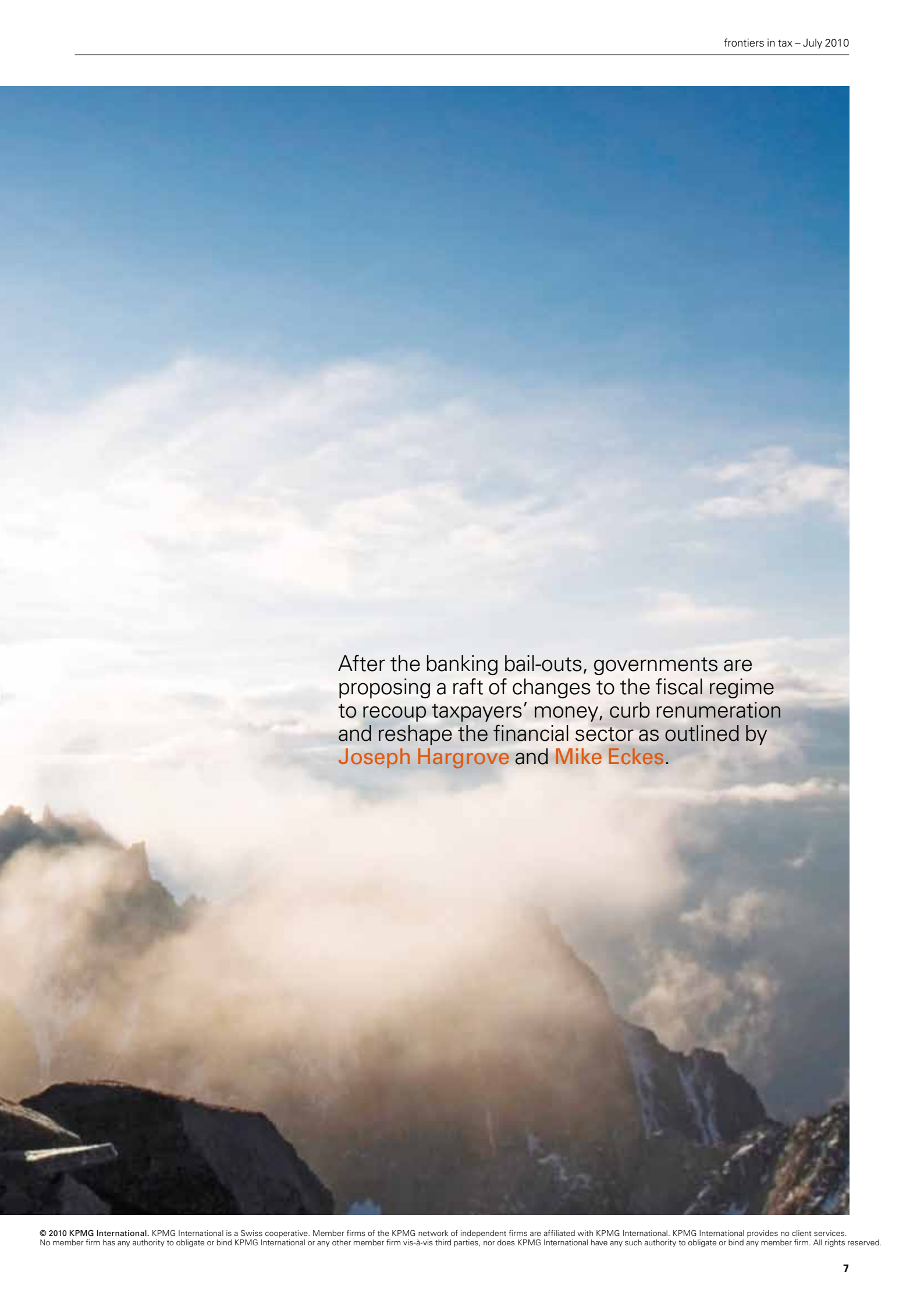
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Exploring a new era of big government in banking





After the banking bail-outs, governments are proposing a raft of changes to the fiscal regime to recoup taxpayers' money, curb remuneration and reshape the financial sector as outlined by **Joseph Hargrove** and **Mike Eckes**.

Some measures proposed in the US and Europe are inspired by public outrage at the economic effects of the crisis and reflect a wish to recoup the costs taxpayers have incurred in bailing-out the banking sector.

It would have been astonishing if the financial crisis that began at the end of 2007 had no fiscal or regulatory consequences for the financial sector. Something had to be done. How the details will all turn out remains hard to predict, but it is clear that the main areas affected will be compensation practices, the level of trading risks, and how compensation practices affect the overall level of risk of a financial institution.

Some measures proposed in the US and Europe are inspired by public outrage at the economic effects of the crisis and reflect a wish to recoup the costs taxpayers have incurred in bailing-out the banking sector. Meanwhile others have been inspired by the determination of governments to prevent another, similar crisis.

Bank Payroll Taxes

On 9 December 2009, the UK government announced a Bank Payroll Tax (BPT) designed to encourage banks to consider their capital positions and make appropriate risk adjustments when setting the level of bonus payments this year. The one-year BPT was applied to bonuses of over £25,000 made to certain employees in the period from 9 December 2009 to 5 April 2010. The tax rate was

50 percent and was to be paid by the employer, not the employees.

The tax has to be paid by 31 August, 2010. The legislation incorporates record-keeping and reporting requirements, and very wide general anti-avoidance rules to counter any 'relevant arrangements' – a main purpose being to avoid, or reduce the BPT. However even now, less that three months from when the tax needs to be paid, its scope, to whom it applies and on what it applies, etc., is still subject to discussion and debate.

Soon after the UK BPT was announced, France announced a similar tax on bonuses paid by banks and financial institutions relating to the 2009 fiscal year. The rate was also 50 percent and the tax was to be borne by employers paying bonuses in excess of €27,500. Details of the French tax and to whom it will apply, was also unclear at the time of writing.

In the US, a similar bill to impose an extra tax on bonuses paid by Troubled Asset Relief Program (TARP) beneficiaries was passed by the House of Representatives on 19 March 2009. This called for a 90 percent tax on bonuses over US\$250,000 paid in 2009 to employees of firms that received TARP assistance. The bill would have

In the UK

£25,000

50%

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In France

€27,000

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The UK's Financial Services Authority (FSA) has reminded everyone of its ultimate sanction: each bonus must comply with the regulatory guidelines, or the payer could lose its licence to operate in the City of London.

In the US

US\$250,000

90%

...90 percent tax on bonuses over US\$250,000 paid in 2009 to employees of firms that received TARP assistance.

applied to bonuses for the 2008 performance year that were paid after 1 January 2009, but it was never voted on in the Senate.

Another bonus bill, the 'Taxpayer Fairness Act', has been introduced in the US Senate. It proposes a 50 percent excise tax paid by employees on bonuses paid by TARP recipients. A similar bill, the 'Wall Street Bonus Tax Act' introduced in the House by Representative Peter Welch (Democrat, Vermont) attracted 57 Democratic co-sponsors of the bill. At the time of writing, neither bill has been voted on in the House or the Senate.

Pressure on bonuses is not confined to legislative proposals.

Media and political interest remains intense. In Sweden, local banks have felt unable to award any bonuses at all – the so-called 'do-nut' bonus – because of public hostility. A ceiling on bonuses has been imposed in the Netherlands and the chief executives of Barclays, RBS, and Lloyds in the UK felt the need to announce publicly that they are foregoing their bonuses this year. The UK's Financial Services Authority (FSA) has reminded everyone of its ultimate sanction: each bonus must comply with the regulatory guidelines,

or the payer could lose its licence to operate in the City of London.

The Financial Crisis Responsibility Fee

In its Fiscal 2011 Budget Proposal, the US administration proposed the imposition of The Financial Crisis Responsibility Fee (FCRF) to apply to banks, thrifts, bank/thrift holding companies, brokers, securities dealers and all US companies that own or control these types of entities. Companies with consolidated assets of less than US\$50 billion are exempted from the FRCF. The purpose of the fee is to recover TARP costs and deter excessive leverage at the largest firms, but the structure means large US institutions will bear the brunt of the cost.

The proposed rate is 15 basis points per dollar of liability covered by the fee. The FCRF's assessable base is the worldwide consolidated liabilities of US financial firms and the liabilities of the US subsidiaries of financial firms not based in the US. The fee base will apply to all liabilities with certain exceptions, such as Federal Deposit Insurance Corporation (FDIC)-assessed deposits, and some policy-related liabilities for insurance companies. In addition, the proposal includes adjustments to prevent avoidance, and to treat

low risk activity, such as lending against high quality collateral, appropriately.

The proposal raises a number of interesting questions.

1.

Since US firms will pay the FCRF on their world-wide consolidated liabilities, but non-US firms will only be subject to FCRF on the liabilities of their US subsidiaries, will enactment of the FCRF in its current form put US financial institutions at a competitive disadvantage? Given the global nature of financial markets, the FRCF as proposed is likely to result in the re-structuring of US and non-US institutions that could include shifting capital from low-to high-margin businesses and moving entire businesses. In addition, firms may shift to methods of financing that would not be subject to the fee (e.g., off balance sheet financing).

2.

It is proposed to use balance sheet information to calculate covered liabilities. Does this mean different standards will apply depending on the reporting standards of different regulators? And how will the foreign liabilities of US controlled subsidiaries of foreign firms be calculated?

3.

Will other countries impose similar fees? Will relief be provided to prevent duplication of similar fees on the same liabilities? Will state and local governments impose 'piggyback' fees?

4.

Will the fee be deductible for US federal income tax purposes? The Treasury Department said it would when the fee was first announced, but the Green Book explaining the Administration's 2010–11 budget is silent on this point.

Compensation Rules

A number of laws have been passed in the US that limit compensation to certain covered employees at certain financial institutions. The first was included in the 2008 Emergency Economic Stabilization Act (EESA). EESA restricts the compensation of senior executive officers (SEOs) of financial institutions that sell assets to, or accept funds from the US Treasury under the TARP. Any SEO, as defined by the federal securities law, employed by a TARP recipient who is either principal executive officer (PEO), principal financial officer (PFO) or one of the three most highly compensated executive officers is covered. The restrictions and governance standards include the following:

Limits on Compensation

Financial institutions are prohibited from compensating SEOs in ways that encourage them to take unnecessary and excessive risks that may threaten the value of the institution.

Clawback

Financial institutions will be required to clawback any compensation to SEOs that's based on earnings statements, gains or other criteria that later prove to be materially inaccurate.

Golden Parachute

Financial institutions can't include golden parachute clauses in new SEO contracts.

Deduction Limitation

Institutions that participate in the Capital Purchase Program (CPP) – a TARP program that grants funds to financial institution in return for issuing preferred shares and warrants to the US Treasury – can claim no tax deduction for SEO compensation of over US\$500,000 a year.

The American Recovery and Reinvestment Act (ARRA) imposed limits for TARP recipients on amounts

On 21 January 2010 President Obama unveiled a proposed 'Volcker Rule' on hedge funds and private equity funds. [...] It is designed to reduce risk in financial institutions and prevent the creation of more 'too big to fail' institutions.



“Firms should not be allowed to run these hedge funds and private equity funds while running a bank backed by the American people.”

President Obama

paid to CEOs and, in some cases, another 20 highly compensated employees. ARRA prohibits bonuses, retention payments and incentive compensation (other than restricted stock not exceeding a third of the total compensation of the covered employee and which cannot vest while TARP funds are outstanding) to CEOs and a number (depending on the level of financial assistance received) of other highly compensated employees. (The maximum of 20 is reached when the institution has received assistance of US\$500 million.)

The ARRA also formed the Office of Special Master for TARP Executive Compensation, who has the power to approve or review compensation to certain employees of companies receiving exceptional assistance. The EESA and ARRA restrictions apply until TARP funds are repaid.

The Volcker Rule

On 21 January 2010 President Obama unveiled a proposed ‘Volcker Rule’ on hedge funds and private equity funds. No details were divulged,

but the President said that “firms should not be allowed to run these hedge funds and private equity funds while running a bank backed by the American people.” The Volcker proposal is designed to reduce risk in financial institutions and prevent the creation of more ‘too big to fail’ institutions. The former Federal Reserve Bank Chairman, Paul Volcker, gave testimony on his proposal to the Senate Banking Committee, but legislative proposals are still being debated in the US Congress.

Future Developments

More recently international discussion of the merits of a bank tax has increased. Some countries, such as Sweden have already gone down this path on a unilateral basis. Other countries, including the UK, regard a bank tax as attractive but only if it is imposed on a global basis. Whether international consensus on this can be reached is debatable but if consensus is ever achievable, the current public sentiments are likely to provide the best conditions for this to happen.

Conclusion

Government officials and regulators throughout the world continue to examine the causes of the financial crisis and develop proposals for avoiding similar events in the future. Right now, it is unclear what specific policies and regulatory changes will emerge, but it is very clear changes will occur in the US and elsewhere. Coordinating and implementing these new policies locally, and on a global basis, will have a profound effect on the way that the global financial industry operates.

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Shining a light on flawed bonus culture

Because of the financial crisis, the accepted wisdom of how to transfer price fully integrated trading operations has come under scrutiny. Its imperfections, recognized in the past, are now flaws that must be addressed.

The payment of bonuses seemingly unconnected to value creation has provoked many tax authorities to consider overturning accepted wisdom on transfer pricing in profit splitting, write **Robert Clair, John Neighbour, Rema Serafi, Tomoko Wada and Jan Martens.**

Proper transfer pricing for a global trading operation has never been easy. It is even more difficult in today's financial environment.

At the core of the transfer pricing challenge is how to measure the contribution to the creation of value. At the centre of the answer is the use of the profit split method.

Because of the financial crisis, the accepted wisdom of how to transfer price fully integrated trading operations has come under scrutiny. Its imperfections, recognized in the past, are now flaws that must be addressed. Her Majesty's Revenue and Customs (HMRC) in the UK, in particular, has been examining the situation. This article focuses on when there is no need to separately reward the return to capital in the profit split method, because all the trading is carried on in branches of the same legal entity.

Traditional Residual Profit Splits for Global Trading

Historically, transfer pricing for fully integrated trading operations has been addressed using a residual profit split method. At a high level,

this method is usually executed as follows:

1. Identify the functions performed, assets used, and risks taken.
2. Determine the key entrepreneurial risk taking (KERT) function(s) (most commonly trading and risk management).
3. Reward the other functions (sales and marketing, risk controls, back office, acting as counterparty, etc.) with an arm's-length payment.
4. Split the residual profit among the locations performing the KERT functions using factors that correlate to the creation of value. Historically, the most common factor used – often the only factor – was total compensation including bonuses.

At the heart of using total compensation paid to traders as the most important factor in the residual profit split is the belief "that there is a good correlation between the earning of profit for the firm and the earning of compensation for the individuals performing the critical 'people' functions"¹ (part III, para 188).

¹ Report of the Attribution of Profits to Permanent Establishments, Organisation for Economic Co-operation and Development (OECD), July 17, 2008, p.157

HMRC has typically followed this approach in the UK. It is also mirrored in the proposed Global Dealing Regulations of the US regulations².

In Japan there is no specific regulation/guideline to cover global trading activities. This issue was often dealt with under a general tax/transfer pricing framework, and little guidance existed except for that spread by 'word of mouth'. However, as part of recent amendments to the transfer pricing guidelines, the Japanese National Tax Administration (NTA) released sample cases – one of which discusses the transfer pricing analysis of global trading operations³. In one case, three related parties in three jurisdictions were described:

- 1) Company A performs sales/marketing/structuring functions.
- 2) Company XA performs trading/risk management.
- 3) Company YA is the contractual counterparty to the client.

In this example, the traditional transaction methods [i.e. Comparable uncontrolled Price (CUP), Resale Price Method (RPM), or Cost Plus Method (CPLM)] are rejected⁴ by saying that comparable transactions do not exist because "transactions are highly integrated and global in nature, and functions are dispersed" between related parties that "do business together cooperatively as a single unit"⁵, and that the application of a contribution profit split method involving all three parties is generally appropriate. Although the case study does not provide further guidance on how to measure the contribution of each party, employee compensation is widely used in practice.

² Proposed § 1.482-8 Allocation of income earned in a global securities dealing operation of the US Federal Tax Regulations.

³ Case 7 in 'Reference Case Studies on Application of Transfer Pricing Taxation', which is a Supplement to 'Commissioner's Directive on the Operation of Transfer Pricing'.

⁴ Similar to the OECD Guidelines, the Japanese transfer pricing regulations prioritize the traditional methods over profit based methods.

⁵ Case 7 in 'Reference Case Studies on Application of Transfer Pricing Taxation', which is a Supplement to 'Commissioner's Directive on the Operation of Transfer Pricing'.

⁶ Report of the Attribution of Profits to Permanent Establishments, Organisation for Economic Co-operation and Development (OECD), July 17, 2008, p.158

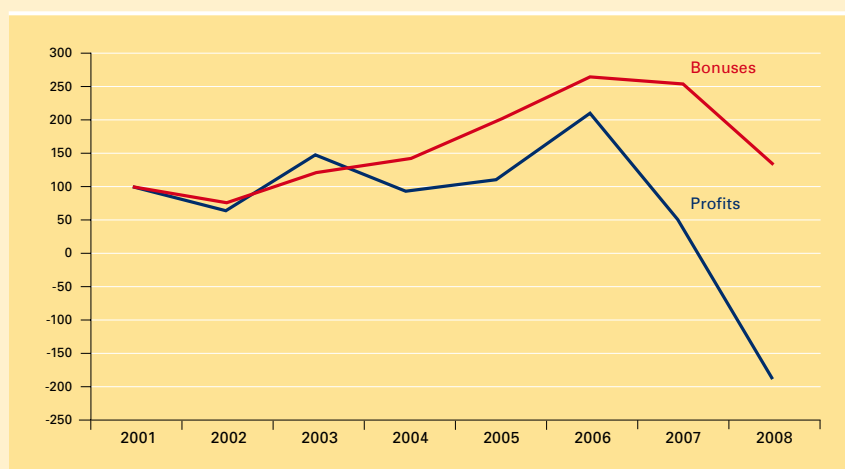
Total Compensation – Never Perfect and Getting Worse

Using total compensation has frequently raised some issues in transfer pricing because the correlation has never been perfect. One issue that has risen is geographical differences. For example, workers in cities with high costs of living are often paid more. Another issue is differences in the form of compensation – in some jurisdictions a greater portion of compensation may be in the form of benefits rather than cash compensation. It has also always been a concern that the correlation between compensation and performance is less clear in a loss year. If the smaller bonuses are paid to the employees that contributed the most to creating the loss, then allocating residual loss by total compensation might shift more of the loss to the jurisdiction that contributed the least to the creation of the loss.⁶

The recent financial crisis has raised new issues. Huge bonuses were paid in 2004 through 2007 suggesting substantial value creation that proved to be illusory by 2008. Are bonuses even less correlated to value creation than was previously thought? Thus, raising the question as to whether and how bonuses should be used in the residual profit split method.

Using total compensation has frequently raised some issues in transfer pricing because the correlation has never been perfect.

Figure 1 Wall Street Bonuses and NYSE Member Firm Profits (index 2001 = 100)



Sources: Securities Industry and Financial Markets Association, New York State Comptroller Report 14-2010



Furthermore, governments' reforms of the financial services industry that are already taking shape may not only further reduce the correlation between bonuses and value creation but also potentially distort the allocation of income across jurisdictions. The connection between bonuses and value creation is far from perfect. As shown in Figure 1, Wall Street bonuses have not always followed the pattern of Wall Street profits. From data published by the New York State Comptroller and the Securities Industry and Financial Markets Association an interesting pattern emerges:

- Bonuses were closely correlated with net income from 2001 through 2003.
- In 2004, however bonuses were rising as profits were falling.
- Both rose dramatically in the years 2005 through 2006.
- In 2007 bonuses dipped only slightly while net income fell sharply.
- In 2008 bonuses were down but not nearly as dramatically as the decline in net income.

While bonuses might follow the pattern of profitability in general, in any given year there could be substantial deviation.

Recent press reports have highlighted this disconnect. In commenting on third quarter 2009 results, The Economist reported that "(Citigroup and Bank of America) paid out a combined US\$13.7 billion in compensation during the same quarter. Taken together, on an annualized basis, employees received the equivalent of 27 percent of the core equity in the firm, whereas shareholders got a return of zero."⁷

The lack of a tight correlation between bonuses and profits at the business unit level seems supported by anecdotal evidence. In the latter part of 2009 HMRC met with KPMG in the UK, one other accountancy firm, and 10 banks to discuss profit split methodologies (PSMs). Their main focus, in light of the recent and unprecedented economic downturn, was on whether compensation is an appropriate allocation key, particularly when allocating losses. HMRC have since produced a note summarizing these discussions:⁸

- There is no uniformity within the banking community as to how or why bonuses are paid and so there are no obvious rules to adhere to for including compensation in the PSM.

- The OECD Guidance that "any solution that taxpayers adopt for dealing with losses should be consistent with the arrangements that would have been made, up front, by independent enterprises" is still relevant.
- There are strong reasons to conclude that reliance on a single allocation factor can lead to distortions in the allocation of profits which should be moderated by the use of other factors as far as this is possible.

HMRC highlighted the following key themes:

- Compensation is the most commonly used factor in a PSM – it is simple to operate, the data is reliable and readily available and it is understood by tax authorities internationally.
- The most common view is that all elements of compensation e.g. bonuses and share options, should generally be included in the PSM.

⁷ The Economist Online edition, October 16th 2009.

⁸ Discussion of profit split methodologies (PSMs) and the use of compensation as an allocation key – a summary of responses and comments received, Business International Transfer Pricing Team, Large Business Service Banking Sector, Her Majesty's Revenue and Customs (HMRC), January 2010

- The interaction between losses and the use of bonuses as an element in a PSM is complex and the particular facts and circumstances should determine whether to include bonuses.
- The impact of government intervention, both in the UK and internationally, on banks' compensation policies and the implications for the PSM will need to be considered before taking any steps to modify the use of compensation as an allocation key.

The range of behaviors exhibited by banks both in setting compensation and applying this as a factor in a PSM demonstrates that it is the particular facts and circumstances of a bank's business operations which will dictate the transfer pricing method. HMRC are not expecting banks to adopt a uniform approach to transfer pricing when the circumstances vary.

HMRC accepts that different situations mean that bonuses may or may not be included in loss splits. The key factor is whether what has been agreed would have been agreed by independent parties up front. This means that before implementing a profit split, scenario analysis should be undertaken to model the potential outputs under different circumstances. This should help create a PSM that

will be applicable in a loss making environment.

Given the less than perfect correlation between total compensation and profitability, should total compensation be used as a single factor in residual profit split models?

While the use of compensation as a key factor in a PSM is understandable because of data availability and reliability, other factors such as volume or headcount could be used as additional factors or as alternatives in a secondary 'sense check'.

The current view is that bonuses should be included but perhaps given a lower weight and other factors should also be used. The proposed Global Dealing Regulations in the US would support this position. These regulations state that a multi-factor formula may be used so long as the factors measure (or are correlated to) the functions performed or the risks assumed by the taxpayer in a given jurisdiction and that the factors be based on the factors that an unrelated party would consider.⁹ (Introduction Proposed §1.482-8 paragraph 53.)

⁹ Allocation and Sourcing of Income and Deductions Among Taxpayers Engaged in a Global Dealing Operation ¶ 151,855 Prop. Regs. 3/6/98, Fed. Reg. Vol. 63, No. 44, p.

Other proposed factors include number of transactions, volume of transactions, initial net present value of derivative contracts, headcount, and headcount weighted by seniority or position.

Impact of Financial Regulatory Reform

The regulatory reform that follows a financial crisis has already begun. One aspect is a direct impact on bonuses. These taxes and controls have the potential to create significant differences in bonuses across jurisdictions despite international efforts for coordination. The differences could result in distortions when applying residual profit splits in the future.

In the US, the Special Master for Troubled Asset Relief Program (TARP) Executive Compensation, Kenneth R. Feinberg, has determined the compensation packages for the highest executives (the top 25) for firms that received exceptional TARP assistance and established compensation rules that apply to the 26th through the 100th most highly compensated individuals in the firms receiving TARP assistance. These rules set maximum cash compensation and requirements that a minimum percentage of compensation is in

In any given year, bonuses might be limited so that in good years there is a break in the link between compensation and bonus.



In the UK, in addition to the bank payroll tax, the restriction on pensions benefits coupled with the forthcoming 50 percent tax rate on high earners may well distort the remuneration policies of banks in respect of their UK operations.

the form of stock that must be held for the long term and these bonuses might be clawed back if the profits prove illusory.

The efforts are, in part, designed to encourage the financial industry to take a longer term view and align the interests of executives with those of the shareholders. The unintended consequence is the program has the potential to reduce further the correlation between short-term compensation and value creation. In any given year, bonuses might be limited so that in good years there is a break in the link between compensation and bonus. In addition, since bonuses face claw-back provisions, it is possible that the bonuses that allocated the profit in one year may be claw-backed in a later year.

In the UK, the introduction of the bank payroll tax in the December 2009 Pre-Budget Report (a tax on banks that pay bonuses to bankers in excess of £25,000) is a good indication of the possible government and regulatory intervention that banks may expect to see in the future when setting their compensation policies. It is clear that activity in this area, and its implication for transfer pricing policies must be monitored carefully going forward. In the UK, in addition to the bank payroll tax, the restriction on pensions benefits coupled with the forthcoming 50 percent tax rate on high earners may well distort the remuneration policies of banks.

Similar activities are taking place in Japan. (see box on right)

The Financial Services Agency (of Japan) plans to require companies to disclose the details of executive compensation to improve corporate governance. According to its proposed revisions of a Cabinet Office ordinance, a company would be required to provide a breakdown of the pay of each executive who receives 100 million yen or more, starting with the current fiscal year ending March.

The FSA's plan is in line with moves by US and European authorities to limit executive pay at financial institutions following the global financial crisis. But business circles have already voiced strong opposition to the FSA's proposal, arguing that the level of executive pay in Japan is relatively low.

Under the FSA's plan, the breakdowns would include the amount of bonuses, stock options and other forms of compensation.

Source: Japan Today <http://www.japantoday.com/category/business/view/fsa-plans-to-require-firms-to-provide-breakdowns-of-executive-pay>

These reforms could create the potential for distortions if controls or taxation is greater in one jurisdiction than another. If one jurisdiction sets a maximum compensation that is binding and another jurisdiction does not, it is likely that the restricted location will have lower compensation and thereby earn a lower share of a residual profit split unless some type of adjustment is made. If one jurisdiction enforces a clawback provision, how will that affect the calculation of the residual profit allocation key? Would tax returns from historical years have to be refiled if bonuses are clawed back? If US

regulators address the issue with controls and limits while the UK addresses the same issue with taxation, there could be a significant distortion. How would the compensation be stated on an equal basis? Alternative factors for the residual profit split, such as headcount, start to look more appealing.

Conclusions

Given the financial crisis over the past two years, it is important to re-examine transfer pricing for trading operations. There are many fundamental changes that require the choice of method to be reconsidered and if the residual profit split is chosen, it is likely that the factors used to split the profits and the weights given to those factors should be evaluated carefully. Given the disconnect between bonuses and performance, a single factor model based on total compensation should be seriously reconsidered to determine if the addition of other factors might produce a more reasonable answer. Future transfer pricing modeling should include substantial simulations of both positive and negative outcomes to judge the fairness of solutions under a variety of potential future outcomes.

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M&A activity is showing signs of recovery, but where is activity strongest and how are prices faring? **Rob Lant**, a partner in the UK Financial Services M&A tax team, considers the taxation issues driving deals with KPMG colleagues in key markets across the world. **Kevin Moran** gives his view on the German market, **Kelly Slattery** gives the US perspective and **Charles Kinsley** adds his take on what is happening in ASPAC.

Tricks, traps and dislocations

An M&A tax Q&A about the financial sector



RL: What levels of M&A activity are you seeing, compared to a year ago?

KS: We've started to see resurgence in activity in the US, but valuations remain depressed. There is some activity in all areas by both strategic and private equity (PE) buyers, but multiples are lower. Debt restructurings and debt buy backs at a discount in the market are also common.

KM: It is a similar story in Germany. The level of leverage and the deal volume is still low, but increasing. There's more activity in the small/mid-sized end of the market. Last year, PE's share of deals was particularly low, but things seem to be picking up. Investors are still very careful when looking at transactions, seeking to avoid unnecessary transaction costs at a time when budgets are tight.

CK: We've had a different experience in Asia. Investment sentiment has remained positive. Economies, including Australia's, are continuing to grow, fuelled by the need to invest into infrastructure, growth of the middle classes, and the emerging trend of Chinese companies to expand internationally. While there were lower volumes compared to previous years, Asian transactions continued throughout 2009 in all sectors, and investors seem confident that Asia's emerging and developed markets will yield attractive opportunities in 2010, and beyond. With expectations of limited growth outside of Asia, we're expecting increased M&A activity in Asia as multinationals seek to maintain their growth.

RL: There has been much talk of the negative impact of the credit crunch and dislocations in financial markets. Are there any areas where purchasers are identifying opportunities?

KM: We're seeing targets on the market in Germany that were hardly imaginable a couple of years ago.

Large banks, for example. This is a great opportunity in particular for strategic buyers without funding constraints, given depressed prices.

CK: In Asia, buyers have tried to identify distressed assets where they expect a rebound in asset prices. Prices did drop, but they have improved over the past 12 months. I don't think the issue of valuations is as much of a driver in Asia as it is in Europe given that activity has remained reasonably stable.

KS: Prices and volumes have fallen in the US, but PE funds are actively looking at the banking sector which was rare in the past.

RL: Do you think the interest shown by, for example, the G20 in the financial services sector will develop in terms of restructuring and disposals over the next 12 months?

CK: In the last year in Asia we have seen a number of transactions involving disposals of non-core assets and operations in specific markets. There have also been some strategic acquisitions by banks to expand into new areas, or consolidate their positions in their home markets by acquiring competitors. Good signs are more capital raisings and strategic investments by banks into emerging markets.

KM: We have seen similar opportunities for financial services providers in Germany – mainly providers that have come through the crisis reasonably unscathed and are in relatively strong positions. They are looking for strategic investment opportunities at low prices.

KS: In the US, PE has shown a renewed interest in the sector and is seeking opportunities, as larger institutions try to focus their businesses and divest non-core operations, to shore up their capital. Most of the activity in banking is with the Federal Deposit Insurance Corporation's assisted failed bank acquisitions.

Minority investments in the banking sector to provide capital to distressed banks is on the rise.

KM: Forced disposals are a hot topic in Europe too, such as the EU forcing a number of large European banks to dispose of non-core assets after receiving State Aid.

RL: In forced divestments what kinds of asset are being put up for sale?

KM: In Germany, there have been sales of large portfolios of loans and financial instruments, and business divisions and subsidiaries that don't fit trimmed down, core-focused business plans. There is also growing regulatory and tax pressure on groups to quit some of their offshore locations, leading to disposals and restructuring.

KS: It is similar in the US, with a wide range of asset disposals that may increase, if a proposed fee on covered financial services organisations is introduced.

Germany: ...there have been sales of large portfolios of loans and financial instruments, and business divisions and subsidiaries that don't fit trimmed down, core-focused business plans.

Kevin Moran
KPMG in Germany

RL: There’s speculation that regulators will impose more stringent capital requirements on banks and other financial institutions, to prevent another crisis. Could this affect transaction activity?

KS: Banks are watching the evolution of the capital adequacy framework very closely and will be looking at rebalancing their business portfolios, to strengthen their capital for certain activities. The need to replenish capital in the US has already led to an increase in minority investments in the financial services sector. There is a flow-on effect across the globe.

CK: Apart from the restrictions that such changes may have on the ability to fund transactions, the changes suggested in the US on proprietary trading and hedge fund activities by banks could lead to restructuring and divestment opportunities in these areas.

RL: Are regulatory capital requirements for financial institutions playing a big part in the deal structures you use, or the level of financing?

KS: Without doubt, in the US. Regulatory capital is a big factor here. Because of their need to maintain capital, banks are seeking equity investments. Avoiding changes in control under tax rules is vital to preserving tax losses, maintaining the projected return on capital and reducing the amount of funding required.

KM: You’re right about maintaining capital. Regulatory aspects can create challenging issues anywhere. It is interesting what you said about losses. We have similar change in control rules in Germany.

CK: It is a real issue for Asia too, and can have an impact on the ability of non-banks to acquire stakes in the banking sector. The banking sector in Asia is heavily regulated. Some countries limit the equity that can be held by foreign investors. Some regulators also restrict the ability of non-financial services firms, such as PE funds, to buy stakes in certain financial services sectors.

RL: With all these regulatory restrictions who will the buyers be and how will they fund deals?

US: ...in the US private equity has shown a renewed interest in the sector and is seeking opportunities, as larger institutions try to focus their businesses and divest non-core operations, to shore up their capital.

Kelly Slattery
KPMG in the US

CK: The banking assets sold over the past 12 months have typically been acquired by other banking groups. Apart from distressed asset sales, we don’t usually see high levels of debt in Asia, because of regulatory restrictions.

KS: It is the same in the US. Strategic buyers want to strengthen a business or add to an existing platform. PE funds have shown an interest in the sector in recent months and have been applying for bank holding company charters, to compete in the auctions for bank assets or have been seeking minority investments through infusion of capital.

CK: PE houses and Sovereign Wealth Funds typically seek to acquire interests in banking and insurance operations in several countries in Asia, particularly China. During the Asian financial crisis in the late 1990s a number of PE firms invested in distressed Korean banks. This has been a favored area for them for some time, and I’d expect the trend to continue.



KM: In Germany, too, but while PE would generally try and leverage transactions in the financial services market it is often equity funding first with plans for future refinancing.

RL: Tax in the financial services industry is tricky. What are the key tax issues in deals?

CK: Asian countries have vastly different tax regimes, some being more advanced in corporate and tax laws than others, which creates complexity. One issue more peculiar to Asia is tax incentives that may have been granted to financial services groups, such as the tax holidays which are available in Singapore and India. A transfer of a business may affect the future availability of the incentive so it can be a tax cost.

KM: Many large financial institutions sustained huge losses in the financial crisis, which creates issues about the treatment of tax losses in change of control situations, and the knock-on impact on deferred tax assets. This requires particular attention in Germany given that recent rule changes have really complicated things.

KS: Same thing in the US – the treatment of tax losses and built in unrealized losses in change of control situations has been a key driver. For minority investments there's also the question of what stock issuance or changes have occurred in recent years, and the sensitivities around planned investment, and change of control testing.

ASPAC: ...the increased audit focus by tax authorities across the region, means tax indemnities and warranties are becoming even more of a concern in a share deal than they used to be.

Charles Kinsley
KPMG in Hong Kong

RL: Tax losses are a key issue in the UK as well, especially where the deferred tax asset counts for regulatory purposes. How are acquirers protecting themselves from these, and other issues we've discussed?

KM: I expect purchasers to do detailed tax due diligence, although there is tension given the associated costs. There's more focus on vendor due diligence and vendor assist work to reduce overall transaction costs when there's more than one bidder. Given lower tax revenues and increased tax authority scrutiny, suitable protection for historic tax exposure is also vital to cover for tax audit risks.

RL: How will this change in the post-crisis world? What tax issues are buyers thinking about now?

KS: In stock acquisitions buyers are focused on preserving the tax benefits from the historic deferred tax assets and are paying more attention to income taxes, especially cash taxes.

CK: Yes, we are seeing the importance of cash in Asia too, and the ability to fund acquisitions will be crucial. The increased audit focus by tax authorities across the region, means tax indemnities and warranties are becoming even more of a concern in a share deal than they used to be.

RL: Kelly, you referred to more focus on cash taxes in models, can you tell us a bit more about that?

KS: Yes, of course. One area of focus is the overall effective tax rate, including state income or franchise taxes and the method by which receipts are allocated to a particular state. In addition, to generate additional revenue, several states have enacted new or alternative forms of tax based on gross receipts or net profit.

KM: In Germany VAT's becoming more important, for example, on the treatment of transaction costs. In pure FS transactions the focus of a tax due diligence must reflect the VAT issues specific to this market.

RL: VAT recovery on transaction costs is also an issue in the UK at the moment. So to wrap up, where is the FS sector going now?

KM: We're in a different world. In a year's time I hope the market will have recovered but I doubt it will be back to the pre-crisis level. There will be new players in the M&A market, such as public bodies, which are now acquiring bank shares and assets, but in due course will need to sell them.

CK: We are also looking at a period of recovery. With expectations of limited growth outside of Asia, we are expecting increased M&A activity in Asia as multinationals look for expansion to hit their growth targets – look at Prudential's attempted acquisition of AIA, which while it has been aborted, is indicative of the interest in the region. The IPO market did pick up in the latter half of 2009 and it is expected to continue to recover.

KS: I'd agree. I think the M&A market is changing, but activity is certainly returning.

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Legislators on four different continents have been reforming VAT rules for financial services. They have similar aims but no two approaches are exactly the same, which could mean either a recipe for confusion or an opportunity for multinational organizations to exploit differences. **Nick Kallinikios, John Bain, Gert-Jan Van Norden, Peter Scott** and **Dermot Gaffney** examine the lessons that can be learned from their experiences.

The vanishing point of VAT

Tax authorities all over the world are reviewing their VAT treatment of financial services, but not all for the same reasons. This article looks at how

four jurisdictions, Australia, Canada, the European Union (EU), New Zealand and South Africa, have approached their reviews, and seeks to answer the following questions:

- What was the catalyst?
- What were the outcomes?
- What does it mean for taxpayers, revenue authorities and tax advisers and does it matter?

Taxing Financial Services

VAT taxes the value at the final stage of consumption, by taxing the 'value added' at each stage of the supply chain and allowing credits for suppliers. The main exceptions are zero-rating and exemption.

Zero-rating is generally applied when it is not considered desirable to tax a particular type of consumption, such as education or health care. A value judgment is made that the consumption of such goods is desirable and should not be taxed. By allowing credits all along the supply chain, and then applying a zero rate to the final supply, the consumption should, in theory, be relieved of any tax.

Exempting a supply removes the supplier from the credit system and taxes the supplier as if it were the final, taxable consumer when it acquires the inputs to the supply. While the supplier does not have to collect tax on the price charged, it cannot claim credit for the VAT included in the price of its input. The VAT paid on those inputs 'sticks' to the final price.

Many VAT systems default to exempting financial transactions. Unlike zero-rating, exemption does not reflect a decision that a supply should not be taxed. It recognizes the difficulty of measuring value added. This is why OECD tax jurisdictions don't tax financial services with the invoice-credit model. Tax embedded in the inputs, for which the supplier is denied a credit, becomes a proxy for the taxation of the financial service consumed.

Since the decision to exempt is based on practicalities, rather than principles, the exemption of financial services creates a range of undesirable outcomes the most significant of which are:

- **Cascading of VAT** – when the financial service is an input into another taxable supply, the VAT built into the cost of the financial service remains embedded, and is compounded when VAT is added at the next stage of supply.
- **Market distortions** – as financial suppliers are ineligible for credits, there may be a bias against outsourcing a function if some inputs can be acquired in-house without attracting VAT.
- **Classification of supplies and legal uncertainty** – the need to classify certain supplies as taxable, and others as exempt, or zero-rated, adds to compliance costs and creates uncertainty.
- **Allocation of inputs** – a need to distinguish acquisitions that relate to taxable or zero-rated supplies for which credits can be claimed, from non-creditable exempt supplies.

The EU, New Zealand, Australia, Canada and South Africa, among

other jurisdictions, have acknowledged these difficulties and examined how they affect their financial services markets.

Catalysts for the Reviews

The EU

Under EU VAT law, financial and insurance services are mainly exempt from VAT. The EU financial services industry is not entitled to deduct input VAT on costs relating to their exempt supplies.

One of the main reasons for the EU review is that the definitions of exempt financial and insurance services became outdated, leading to inconsistencies in the interpretation and application of exemptions in the EU. Stakeholders are confronted by considerable complexity in varying administrative practices, resulting in legal uncertainty for economic operators and tax authorities.

Another motivation was that hidden VAT in the cost structures of the EU financial services industry not only puts them at a competitive disadvantage, vis-à-vis those outside the EU, but also distorts competition within the EU.

In December 2004, the European Commission (EC) began to consult the EU financial services industry, and in 2007, the EC published working documents containing first drafts of the financial services VAT proposals. Finally, on 28 November 2007, the EC proposed a draft financial services VAT Directive accompanied by a draft financial services VAT Regulation.

New Zealand

When New Zealand introduced its Goods and Services Tax (GST) in

Unlike zero-rating, exemption does not reflect a decision that a supply should not be taxed. It recognizes the difficulty of measuring value added.



1985, financial services were exempted. No tax is charged on the supply of financial services and no GST refunds are allowed for input tax paid in making those supplies.

In October 2002, the government launched a review of GST and found a number of distortions had been created by the exemption of financial services, including tax cascades and 'self-supply' bias. Self-supply bias is the incentive for financial services providers to supply key services in-house, because they cannot recover the GST paid on goods and services acquired.

Australia

The Australian review of the financial supply provisions forms part of a larger review of the Australian GST system, instigated 10 years after the current law was first drafted. The Treasury department, responsible for tax legislation, raised concerns relating to the 'efficiency, equity and simplicity'¹ of exempting financial supplies.

South Africa

South Africa introduced VAT in 1991. In 1994 the government launched an independent commission, the Katz Commission, to examine various aspects of South Africa's tax regime. Between 1994 and 1999 the Katz Commission issued nine interim reports with findings and recommendations.

Canada

There has been no formal review of GST in Canada, but there has been a mini-reform of the regime as it applies to financial services with the following objectives:

- streamline the application of GST to the sector.

- strengthen the legislation in this area.
- protect the tax base, by giving the tax authority more authority to focus on audits and other controls.

The approach is first to make the existing model work and subsequently to consider a wider reform.

The Questions Asked by the Reviews

The EU

The EC had two objectives in reforming the VAT treatment of financial and insurance services: First to increase the legal certainty for operators and tax administrations and reduce the administrative burden. And, second reduce the impact of hidden VAT on the financial industry.

The consultation looked at various proposals for achieving these two objectives:

- zero rating.
- extending the scope of exempted services.
- uniform limited input tax deduction.
- option to tax; cross-border VAT bodies.
- single legal entities and cross-border transactions.
- VAT grouping.
- cost sharing arrangements.
- reduced VAT rate for bought in services.

New Zealand

When releasing the GST and financial services discussion document in 2002, the government posed the following key questions:

- How can tax cascades and self-supply bias be avoided?
- How can the Government ensure that opportunities are not created to make GST-free supplies of financial services to final consumers?

- What is the appropriate way to balance compliance and administrative costs against the above?
- Should the scope of financial services be amended and the arrangement of financial services be excluded from the definition of financial services?

Australia

The Australian Treasury issued a consultation paper seeking views on its proposal to 'undertake a review of the financial supplies provisions, with a view to reducing their complexity and introducing more principled rules, while maintaining the existing policy.'¹ The review also sought to improve the operation of the reduced input tax credit system, under which financial suppliers are entitled to a 75 percent input tax credit for the GST included in a specific range of outsourced services.

South Africa

In 1995, VAT on financial services was reviewed and the findings and recommendations were set out in the Katz Commission's Second Report. In particular, the Katz Commission investigated the effectiveness of the financial services exemption.

Canada

The government focused on four areas: allocation of inputs, imported services, rules for pension plans and the meaning of 'arranging for'. For all of four areas the perception of tax officials was that GST legislation was not supporting the government's policy objectives in the FS sector and many of the reforms resulted from jurisprudence unfavorable to the government.

¹ Consultation Paper on the Review of the Financial Supply Provisions, 12 May 2009

Achievements

The EU

The EC concluded that most of the other systems considered, presented similar, if not more serious, complications than the current model. Consequently, in the draft Financial Services VAT Directive and Financial Services VAT Regulation of 28 November 2007, the Commission proposed the following measures:

- clarification and modernization of the rules governing the VAT exemptions for financial services.
- broadening the option to tax by transferring rights to opt out from the member states to the financial services industry itself.
- introduction of a cost-sharing group, to allow the financial services industry to pool investments and redistribute the costs exempt from VAT from the group to its members (financial services cost-sharing group).

It was originally envisaged that member states would include the new Financial Services VAT Directive in their own legislation by 31 December 2009, but it soon became clear this timetable was unrealistic. Consensus among member states on key issues such as outsourcing has proved difficult to achieve.

The EU is now focusing on clarifying and modernizing the rules on financial services exemptions, and has deferred the debates on the option to tax and financial services cost-sharing groups.

New Zealand

Following the New Zealand review changes were made to the GST Act to allow zero-rating of business-to-business supplies, effective from 1 January 2005. Financial services supplies to GST-registered persons whose taxable supplies equal, or exceed 75 percent of their total supplies, can be zero-rated if the supplier so elects.

Arranging financial services was not excluded from the definition of financial services, but certain equity and participatory investments that

give the investor management influence have been included.

Australia

The Australian review is still going on. Anecdotal evidence suggests most affected taxpayers strongly oppose replacing the existing list of financial supplies and reduced credit acquisitions, with a set of principles, and favor fine-tuning and clarification of the rules.

South Africa

The Katz Commission's Second Report recommended that the VAT base be extended to all fee-based financial services, to avoid cascading VAT and complex input tax apportionment methodologies.

Following these recommendations, from 1 October 1996 the definition of financial services was amended so that all financial services for which any fee, consideration or similar charge is payable, became subject to VAT at the standard rate. Consequently, South Africa now has very narrow financial services exemptions, mainly confined to providing credit, share transactions, derivatives, exchange of currency and long-term insurance (generally taken to be life assurance only).

As a result, financial services entities have a relatively high rate of VAT recovery on general overheads, and input tax directly attributable to taxable activities is fully recoverable.

Canada

In January 2007 the government released proposals for special rules for allocating inputs and imported taxable supplies, a requirement for financial institutions to complete annual returns out-lining all activities and steps taken in managing GST, and stated its intention to reform GST rules related to pensions. Following much uncertainty created by jurisprudence, the government announced in December 2009 its intention to narrow the 'arranging for' exemption.

Implications and Significance

The five jurisdictions featured above approached the issue of VAT

on financial services from different angles and adopted different solutions. Some chose zero-rating, others widened the VAT base, and focused on compliance. All agreed, however, that imposing VAT on financial services creates practical problems, and increases administrative costs for taxpayers and revenue authorities.

It is not easy to compare the success of the various approaches, and the solutions may create further problems for taxpayers, revenue authorities and advisers. For example, broadening the VAT base in South Africa may encourage financial services entities to structure their offerings either as fee-based or margin-based to obtain the most favorable VAT outcome for customers. All changes are compromises.

Any progress made by one jurisdiction in resolving these issues will initially offer a competitive advantage for its industry and provide a model for others.

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Leaders of successful tax departments in large financial services organizations balance the need for stringent risk management with understanding for the value creators in their organization, write **Hugh von Bergen** and **Lucy Iacovelli**.

The perfect balance

Many tax departments of large financial groups are under pressure to do more, with less; to deliver better cash management, higher capital efficiency and improved operational effectiveness, globally, in a constantly changing regulatory environment, at a time of shifting corporate ambitions and significant resource constraints.

At the same time many governments around the world are under increasing pressure to raise more revenue, and tax authorities are stepping up efforts to improve their co-operation, reduce tax leakage, and boost both the efficiency and effectiveness of their approaches to tax audits and disputes.

Tax departments must spend more time managing the additional risks inherent in this new environment, while maintaining good, balanced relationships between their companies and tax authorities.

Some companies are managing to square these circles, and achieve a balance between risk management,

and adding business value. Their ability to marry excellent risk management with responsible value creation stems from striking a balance between risk and value that matches the company's strategic approach and the development of an effective and efficient operational platform.

This focus on risk and value, and efficiency and effectiveness, is constant, but not fixed. High-performing tax functions are continuously re-balancing priorities as circumstances change and constantly improving as new industry best practices and performance improvement techniques emerge.

In this article we look at some of the things that a successful tax department might need to achieve this balance.

Strategic Alignment

To achieve commonality of purpose between the tax function and the company, the tax strategy should be aligned with the business strategy. The roles and responsibilities it imposes on the tax department and other business units must be widely





understood. The potential benefits of this common purpose are that business units can manage tax matters consistently, and thus enable clear communication with tax authorities and other stakeholders about the tax policies and practices. This will help to provide the essential clarity on issues such as the appetite for risk and who is responsible within the business for managing the various taxes.

Achieving this is not easy. In KPMG's recent survey of tax departments (Good, Better, Best – The race to set global standards in tax management), 84 percent of respondents said their tax strategies were consistent with their group's overall business strategy. However, many multinational banks and other financial institutions have undertaken fundamental reappraisals of their business models over the past two years. Losses on an unforeseen scale have transformed the fiscal dynamics of many groups. Business lines previously regarded as core have been put up for sale or closed. Apart from the tax technical challenges, this has required tax functions to adapt their priorities, as they try to reconcile their group's new business imperatives with its tax policies and requirements.

Monitor and Sustain With Embedded Processes

Embedded processes and controls over tax risk applied consistently across the business can provide more accountability, responsibility and help to minimize errors. Combined with suitable technologies, they can offer assurance to all stakeholders that taxes are being managed effectively.

84%

.....
 ...said their tax strategies were consistent with their group's overall business strategy, but many multinational banks and other financial institutions have undertaken fundamental reappraisals of their business models over the past two years.



It is not enough for processes to be written down. To be effective and provide the required level of assurance on the accuracy of the reported tax figures, they must be embedded in the daily operations of the organization.

Timely and Accurate Information

High performing tax teams understand their role, have the required level of technical, management and other skills, are appropriately trained, and well motivated and rewarded.

A significant feature of tax management in many businesses is that responsibility is dispersed through the organization. Managers and staff in many departments, including front office, product design, IT, finance, treasury, actuarial and administration all contribute materially to the end-to-end tax compliance process. We call these non-tax people involved in the tax compliance process the 'shadow tax team'. Tax authorities are requiring

financial institutions to provide data on their own tax affairs, and tax-sensitive customer information. To comply with these demands, tax functions should strive to work with their shadow tax teams to ensure an appropriate and reliable flow of data. A high-performing shadow tax team is vital, if the goal of effectively and efficiently managing taxes within an organization is to be achieved.

Ways to achieve this 'shadow' excellence will vary from company to company. Possible approaches include dispersing tax professionals throughout the company, and reorganizing the work of the central tax function to release resources and allow senior people to work more closely with colleagues elsewhere in the business.

A high-performing tax team also provides high quality training and development for tax professionals and their shadow tax team. Tax

For corporate income tax, businesses have traditionally seen their effective tax rate and cash tax rate as KPIs, which can often be benchmarked against competitors and industry standards.

professionals acquire new skills, and focus, not only on technical competence, but on soft skills, such as communication, negotiation and persuasion.

As the complexity of managing global tax compliance increases, tax teams require more advanced knowledge management systems. Such systems should provide timely access to global news and developments that may affect the business and hold knowledge acquired about the business and any associated tax issues.

Performance Measurement

There should be one, and only one, view of performance monitored by a single business-wide information system and framework. This will help to reduce the risk that different parts of the business might operate with different versions of the same information. For many in the financial sector, this is still more of an ambition than a reality. But, some tax functions have begun to build global reporting and monitoring frameworks to create a single view of tax performance, and evaluate tax risks and decisions consistently all over the business.

One common view of performance should mean clearer Key Performance Indicators (KPIs) for the tax function and the business generally. For corporate income tax, businesses have traditionally seen their effective tax rate and cash tax rate as KPIs, which can often be bench-marked against competitors and industry standards. But many financial institutions face situations where volatile asset values and large losses have rendered such KPIs more or less meaningless. Many now are having to develop new ways to measure the effectiveness of their tax functions.

There is more to timely and accurate information than an ability to meet compliance deadlines. Confidence in the underlying financial information used in the returns is also vital, because this allows a tax function to reduce time spent gathering and verifying data and allowing more time and resources to focus on creating value.

Confidence in the accuracy of the information also provides a good platform for tax authority audits. When combined with the ability to demonstrate the right embedded processes it can help assure tax authorities and other stakeholders of the accuracy of reporting. This is easier said than done, of course. It requires an agreed, business-wide process to identify tax information requirements and clear responsibilities and time-lines for preparing and delivering the information. Suitable technology can help at every stage – from the original data capture to reporting methodologies.

Automated Processes

Enabling Enterprise Resource Planning (ERP) systems to provide the necessary tax data and functionality is increasingly important for large process-driven organizations. Many insurance multinationals, for example, have undertaken finance transformation projects while they streamline their business models and embed the disciplines of Solvency II. Such projects offer tax functions great opportunities to specify and incorporate critical tax functionality into their systems. Technology can also be deployed effectively in automating tax decisions, compliance management, knowledge management, and e-learning tools.

Tax authorities the world over are also updating audit approaches and adopting standard and customized interrogation and correlation software to help in their audit work. Businesses should prepare for more sophisticated tax authority audit techniques. This requires a continuous assessment of the auditability of systems, and periodic reviews to identify potential errors, or queries that may arise in the event of a tax authority interrogation of the system.

Informing and Influencing Stakeholders

Two-way communication is required between the tax function and the key stakeholders, both internal (CFO, board, shadow tax team) and external (shareholders, regulators, tax authorities, customers and suppliers, capital markets).

A high-performing tax team also provides high quality training and development for tax professionals and their shadow tax team.

The need for more visibility and transparency in tax is now widely recognized. Internal stakeholders are more interested in tax risks and opportunities, and tax authorities are more interested in how large organizations manage tax compliance. Tax functions know that to achieve their own and the organizations' objectives, they will need more support from senior management. Good communications and political skills are required to win the confidence and manage the expectations of the key stakeholders.

The High Performance Skill Set

Tax is complicated and technical, and needs the diligent attention of well-trained professionals. But that's only part of the story. Nowadays, tax leaders should understand a fuller range of skills and attributes are needed for high performance, and should be supported by the right people, doing the right things. Those people need the right skills, the right resources, and the right rewards.

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Six golden rules for tax compliance

Tax compliance systems are set for yet another overhaul but this could prove an unexpected chance to improve efficiency for those organizations that apply the six golden rules of transformation, say **Sarah Lane** and **Graham Seymour**.

The tax compliance challenges facing large financial services (FS) groups are many. Largely because of increased scrutiny by regulators, tax authorities and executives accountable for gaps, or failures in system controls and processes. Over the next 18 months, there are likely to be:

- new responses to finance function transformation within the FS sector.
- acceptance that technology has a key role to play in compliance management.
- increased pressure to manage operational taxes with the same rigour and to the same audit trail standards as mainstream corporate taxes.

After the financial crisis many groups are trying to improve compliance and risk management processes at lower costs. This has rekindled debates on who is responsible for compliance processes and how to cut costs while maintaining or improving control and review processes.

Financial Services (FS) groups are under particular pressure to be able to update processes that take into account the changes in law and tax authority practice or interpretation in real-time.

This article sets out some key issues to address and practical guidelines, derived from our firms' experience in projects involving major change in established tax compliance processes.

Current Developments

The main change drivers in tax compliance include:

- As International Financial Reporting Standards (IFRS) make central accounting and transaction processing more attractive, assertions that tax work should automatically be done locally will be challenged. The tax function needs to engage in this debate, rather than react to challenges from finance groups grappling with radical change.
- Tax authorities are widening the scope of tax enquiries to focus on:
 - integrity of data and accounting systems (e.g. SAO in the UK and the requirement for accounts to be in eXtensible Business Reporting Language (XBRL) format).
 - tax governance (e.g. the banking code of conduct in the UK and debates on a wider tax code in Spain).
 - scrutiny of different types of transaction and how they affect tax receipts/policy, including cross-border risk assessment (e.g. German dividend trades are under scrutiny by the German tax authorities).

- KPMG's recent survey of tax departments (Good, Better, Best – The race to set global standards in tax management) indicated that resource shortage was a major headache for many tax functions. They are having to do more, with fewer, or less expensive, resources and have to consider:
 - outsourcing.
 - transferring more tax reporting and compliance to the finance function.
 - ensuring work is done at the most appropriate level.

Operational taxes have traditionally been managed outside the main compliance cycle. A compliance process review is an opportunity to ensure they are managed and controlled to the same standards as corporate and payroll taxes.

After the financial crisis many groups are trying to improve compliance and risk management processes at lower costs.

Redesigning processes can produce a better international tax map, enabling the tax team to predict rates more accurately, use tax attributes (losses, beneficial regimes) more fully and avoid reverse arbitrage. The new UK dividend exemption, for example, has led many FS groups to look at how to reduce leakage of withholding tax on dividends that are no longer creditable.

Reviewing compliance can also reveal inconsistencies between theory and practice. Many heads of tax regard themselves as the guardians of the group's tax rate, and will manage it in line with a written tax strategy and objectives – which normally includes tax efficiency. The KPMG survey found accurate and timely financial reporting was very important to 63 percent of respondents. Only 30 percent saw cash tax savings or deferral as very important. This reflects 'realpolitik' – errors or problems in financial reporting are easily spotted by executives, but there is no way to measure the cost of inefficient processes and the opportunity costs of missed cash tax savings are invisible at executive level.

On the positive side, a review can identify scope for automating repetitive processes for data extraction and adjustments, leading to cost savings and fewer errors.

Also tax department performance metrics and reward measures vary widely. An overhaul of the compliance process can provide a good springboard for dialogue about improving the alignment between metrics and value delivered.

An overhaul of the compliance process can provide a good springboard for dialogue about improving the alignment between metrics and value delivered.

Common Factors

Some rules for successful compliance process change apply whether the change is to outsourcing, transfers of key responsibilities to a shared service centre (SSC) or changes in the compliance supply chain.

In our firms' experience there are six golden rules in a compliance change project:

1.

Define scope at the outset: get stakeholder agreement on which taxes/transactions/jurisdictions are covered, and be realistic about what is achievable.

2.

Don't 'design' as you 'build': agree to objectives and identify key issues up front.

3.

Start from a candid assessment of current state: recognize not only existing strengths, but also inefficiencies or weaknesses in processes and controls.

4.

Incorporate cost-effective risk management processes with technology, co-ordination and agreed processes, particularly in outsourcing and SSC projects.

5.

Before moving from 'design' to 'build', check plans against objectives with key stakeholders and stress-test any compromises.

6.

Assess at an early stage the scope for automation to reduce manual processes, improve the risk management process, and ensure real-time access to information by in-house and SSC or outsource teams.

To Outsource or Not to Outsource?

There is no ideal approach. Each group will need to decide how to balance conflicting pressures. But for businesses considering outsourcing, or SSCs, key analysis points include:

Compliance Outsourcing

Strengths

- Frees up tax function to add value and ensure appropriate controls.
- Leverages in-country experience of outsourcer.
- Efficiencies of scale may allow cost reduction.
- Review/risk management process can be mandated to meet group needs.

Weaknesses

- Care needed to manage fit, if review/risk assessment process retained in-house.
- May make it harder to create training/development roles in-house.
- If in-house team retains responsibility for dealing with some or all correspondence with revenue authorities, timely information transfer between outsourcer and in-house team crucial.
- Needs efficient document transfer/record accessing process.

Opportunities

- Enables multinationals to use outsourcer's international network where this has deeper and wider reach than in-house.
- Add-ons from outsourcer can be leveraged – technical updates, newsletters, etc.
- Technology from outsourcer can be integrated.
- Process improvements can be built in without further time commitment from in-house team.
- Scope of outsource can be adjusted without in-house team having to build delivery capacity.

Threats

- Genuine partnership with outsourcer required for process to be effective: choice of long term partner important.
- Care needed to ensure smooth integration of outsourcer's role with retained responsibilities.
- Less visibility over costs.
- May require direct interface between outsourcer and finance team – challenging for some groups.

Transfer to a Shared Service Centre

Strengths

- As with outsourcing, allows tax function to add value and ensure appropriate controls.
- In-house SSC makes it easier to adjust scope of work undertaken at margins (but may also require more handholding by in-house tax function).
- Allows strong tie with wider finance function transformation.
- Significant cost reduction possible.

Weaknesses

- More supervision needed than with outsourcing certainly over transitional period.
- May be more difficult to attract and retain good people in tax than for other forms of SSC, especially if offshoring involved.
- No separate quality control/risk review mechanism: tax function remains wholly responsible.
- Handover of more than routine processing at outset likely to be high risk.
- Updating, training, etc. has to be bought-in or remains an in-house responsibility.
- No in-country knowledge available to supplement tax function. Updates, law changes, etc. have to be dealt with by buying advice or handling in-house.
- Technology/systems components must be created in house or bought in.

Opportunities

- More straightforward if all review/sign off functions retained in house.
- Can start with routine activities and increase scope later.
- Closer integration with finance function, and staff can be combine or be transferred between finance and tax roles.

Threats

- Delivery and staff retention issues, even if covered by a service level agreement, likely to affect in-house group.
- If technical/review roles transferred, knowledge may leave main tax function.
- Risk management and control processes must be devised and updated in house – this may be with geographically remote SSCs.
- Liaison with external auditors more complex. Clarity needed on how audit issues, queries, etc. are to be resolved.

Simply remodelling some elements of the compliance supply chain, without opting for full outsourcing or an SSC strategy can be simpler, quicker, and a good way of trying to address specific issues or concerns where the overall process works well.

Simply remodelling some elements of the compliance supply chain, without opting for full outsourcing or an SSC strategy can be simpler, quicker, and a good way of trying to address specific issues or concerns where the overall process works well. This may be particularly attractive where an approach is needed to compliance for only one particular business stream (e.g. in a divisionalized business, or where one business line involves different geographical reach from the main body of the group).

Automation and Systems Improvement

System improvements in compliance change projects are in demand in three key areas:

- Automatic data uploading (replacing manual completion of tax packs) and links with finance systems to ensure data can be cut and presented in tax-appropriate form.
- Compliance process management to help manage compliance risk and deadlines across different jurisdictions with milestones and 'red flag' early warning systems.
- Data storage and access, especially with outsourcing or SSC transfers, to facilitate real-time data sharing across multiple jurisdictions.

System changes may also include dedicated data tagging to meet tax authority requirements (e.g. the requirement in the UK for tax filings from 2011 to be accompanied by accounts in XBRL format).

Conclusion

Significant change in the compliance landscape for FS companies is likely in next two years. Many are evaluating how current compliance processes are performing and whether they are cost-effective. Others will have change thrust upon them by the finance function, or more rigorous tax authority scrutiny of compliance processes. It is time for heads of tax to address the scope for more efficient tax compliance processes, and bring compliance options and risks to the attention of senior management.

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Reshaping insurance for efficiency gains



Tightening regulation is driving the restructuring of international insurance groups but with careful planning these reshaped organisations can be more tax efficient, argue **Michael Pollard, Brian Daly** and **Bart Jimmink**.

A number of large insurance groups are investing considerable time and resources in reviewing, and in many cases amending, their legal structures. In the past many groups have operated through networks of legal entities with, for example, a company in each country in which they operate. Increasingly, however, there has been a trend towards using branches in many jurisdictions, of a small number of core companies in perhaps one jurisdiction.

Regulatory and governance issues are generally the main drivers of such changes, but a common pre-requisite is that the group's tax profile is not adversely affected. Indeed ideally the restructuring will be advantageous from a group tax perspective.

A structure that is more capital-efficient and more tax-efficient should, of course, provide a significant competitive advantage.

Capital Efficiency

A key criterion, when judging a group structure, is the efficiency with which it uses its capital, taking into account, for financial services groups, capital requirements of the impending Solvency II regime.

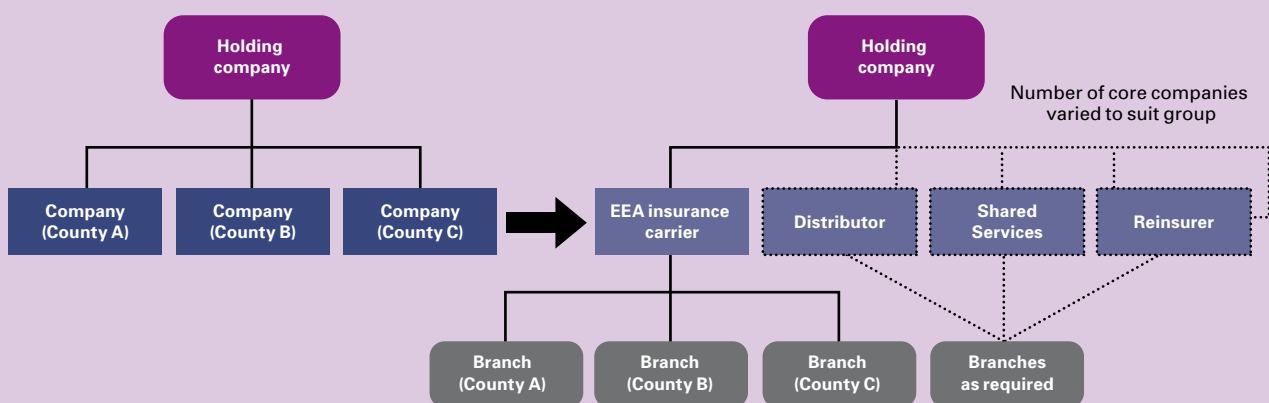
Solvency II is expected to require branches established in European Economic Area (EEA) member states to calculate capital requirements both on the early-warning basis (the Solvency Capital Requirement) and the minimum basis (the Minimum Capital Requirement). A branch is expected to only have to cover the Minimum Capital Requirement; the extra capital needed to cover the

A structure that is more capital-efficient and more tax-efficient should, of course, provide a significant competitive advantage.

Solvency Capital Requirement can be held elsewhere in the EEA. In the absence of the group support element of Solvency II, a branch structure also offers potential for diversification of risk to reduce capital requirements in comparison to multiple subsidiaries.

This suggests, based on our understanding of the Solvency II regime, that a branch structure could be advantageous from a capital efficiency point of view. See Figure 1.

Figure 1 Moving from a Subsidiary to a Branch Structure



Source: KPMG International, 2009

Other Benefits

Moving to a single or small number of corporate entities may reveal historic duplications of functions and other inefficiencies, and although it may not necessarily reduce the number of regulatory authorities involved, it may bring more transparency to the basis on which the group is regulated.

There has been speculation that some local regulators may try to impose separate capital requirements for branches in their jurisdictions. This would be a significant and potentially adverse change, but it does not yet appear to be a real possibility within the EEA.

Although tax is rarely the prime motive for a restructuring, it is usually a pre-requisite of a proposal for change that it should not result in an overall adverse tax impact for the group.

Consideration of the tax impact of a restructuring will largely include two elements:

- the tax profile of the restructured group compared to the previous position and to industry peers.
- tax costs associated with the implementation of the new arrangement.

The New Tax Profile

Replacing corporates, with branches will not, of course, by any means guarantee a better overall tax result. Each branch will remain subject to local tax and the branch parent

corporate entity will be subject to tax in its own country of residence on the profits of the whole business (e.g. Ireland and the UK), or of head office activities (e.g. Luxembourg). Branch pooling rules, generous in jurisdictions such as Ireland, can also be relevant in determining the tax payable by the head office.

Factors in Determining Head Office Location Include:

- Availability of skilled staff
- Tax regime
- Regulatory environment
- Geographic location
- Existing group arrangements

To determine the optimal structure, a jurisdiction by jurisdiction review is needed of the local taxes applicable to branches and the treatment of profits remitted to the centre.

Issues such as withholding tax must be considered and confirmation will be needed that the jurisdictions where the branches are to be established levy tax on a territorial rather than worldwide basis.

A key consideration for a hub and branch structure is the location and tax residence of the core company. It may be that the current location of a group's activities and head office means there is only one option, or it may be unclear which jurisdiction will best suit the current and planned operations of the business. In the latter case, it is common to establish

a shortlist of jurisdiction options and review the costs and benefits of each. In our firms' experience the factors that can determine the optimal approach vary significantly between groups, and location of current operations is one of various considerations, which might also include the reputation of regulators, the availability and cost of good people, proximity to markets and taxation.

The effective tax rate of the restructured group will of course depend on the balance of activities between the branches and head office. Insofar as activities are in the branch, they are likely to be subject to local taxation in addition, in many cases, to the potential for taxation as part of head office's results. It may be that as far as it is commercially and logistically possible, the most tax-efficient structure is a set of 'thin' branches, with as many activities as possible undertaken by head office.

Multiple Core Company Structures

Although a branch network may function with one core company there will often be strong arguments for more than one core company. In an insurance group, for example, one corporate could undertake the underwriting, another could act as an intermediary, another could provide shared services, and so on. From the tax perspective it is often advisable to have these 'core' companies located in a single jurisdiction to facilitate 'grouping' for loss relief and VAT, for example.



A key relieving mechanism within the EU is the Cross-Border Merger Directive, which allows companies to be merged or split into other companies.

Cross-Border Tax Consolidation

Notwithstanding the Marks & Spencer and H. Holding BV cases, which seem to have limited the possibilities for effective cross-border tax groups, a branch structure may allow cross-border loss relief in practice. In certain countries losses of the foreign permanent establishment may reduce the domestic income of the head office company. Foreign losses will often be recaptured when the branch returns to profit, but a timing advantage can perhaps be obtained.

The treatment of exchange rate differences may complicate matters, however, and will need to be addressed on a case by case basis.

Use of 'Societas Europea' (SE)

For European groups considering the nature of their main corporate entities, a very obvious commitment to a European ethos is the use of an SE, which has been available in the UK since October 2004 and in Ireland since 2007. The SE is intended by design to be capable of redomiciliation, thereby allowing (in principle) future flexibility in residence.

Therefore if a group is contemplating a change of residence, but deferring its decision for some reason, including an SE within their group structure may keep its options open.

There are however extensive non-tax requirements associated with the use of SEs particularly regarding employment law. The implications of such requirements and the time it would take to integrate an SE with a group structure need to be carefully considered.

VAT

There will often be no obligation to levy VAT on supplies that are made within a legal entity, so moving to a branch arrangement may reduce VAT. Many groups have had to reassess their VAT positions following changes in 'place of supply' rules from 1 January 2010. In some cases, restructuring could be the only long-term effective solution.

Tax Costs and Reliefs

Achieving a marginally more efficient tax solution will clearly be less attractive if substantial tax costs are incurred when making the change. Whether such costs arise will depend on the nature of the existing group and the jurisdictions in which it operates. A careful review of each proposed restructuring stage is required to establish potential tax costs, and the time it will take to obtain any necessary local clearances.

In many regimes, the European Union (EU) included, tax reliefs can be claimed to mitigate or defer potential charges. Sometimes, the establishment and use of an SE company will facilitate the use of certain reliefs. A key relieving mechanism within the EU is the Cross-Border Merger Directive, which allows companies to be merged or split into other companies. The directive can often ensure tax neutrality and perhaps allow carry-over of tax losses into the new structure. It is worth noting, however, that one requirement for relief can often be that the resulting tax base in the country concerned is not reduced as a result of the reorganisation. This could constrain how much activity can be transferred from the branch jurisdiction to the head office, at least in the short term.

New Jurisdictions

Groups increasingly seek to include as many of their jurisdictions in their group reorganisation process as possible. This can deliver significant benefits in terms of consistency and uniformity of structure, but it may also increase the scale and frequency of challenges.

For example, in some jurisdictions local tax authorities might not be

familiar with reorganisation approaches routinely used in other jurisdictions, which may reduce the speed and comprehensiveness of restructuring programs. In practice, of course, it can be very hard to predict where issues or delays may arise in all jurisdictions.

Other Factors

This article has focused on the key regulatory and tax issues that arise with large scale corporate reorganisations. Important legal issues also arise, of course, and employment matters could be very significant too.

Because of the large number of potentially conflicting factors, it may be necessary to proceed with the reorganization at a different pace, in different jurisdictions. To simplify planning, the same approach can be adopted initially in all jurisdictions, but in the knowledge that, in practice, it may need to be tailored to fit the varying jurisdictional requirements and changing circumstances. In other words, although the reorganised structure should be enhanced, it will often not be perfect or complete.

Conclusion

Some groups have found reorganisations involving a more widespread use of branches deliver regulatory and taxation efficiencies. Time and experience have shown the importance of detailed planning, and input from a wide range of specialisms from the outset.

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Heading in different directions



European tax reporting regimes for financial products are becoming increasingly complex but signs of a more coordinated approach by the major players would greatly improve product development, argue **Andreas Patzner, Nathan Hall, Alexander Cserny, and Gregoire Winckler.**

As tax authorities all over the world try to reduce enormous budget deficits, many tax reporting regimes are becoming broader and more complex. These regimes usually apply to investment funds domiciled outside the taxpayer's jurisdiction and require reports of amounts that must be declared on the taxpayer's tax return. Although the regimes have the same basic objective, to ensure taxpayers pay the correct tax at the right time, they go about it in very different ways. The Savings Directive, and the US Foreign Account Tax Compliance Act provisions both exemplify the growth in tax reporting, but the impact within Europe is even greater in terms of the proliferation of national regimes and the differences between them.

The Savings Directive and the US Foreign Account Tax Compliance Act provisions both exemplify the growth in tax reporting, but the impact within Europe is even greater in terms of the proliferation of national regimes and the differences between them.

It is clear that this trend has significant commercial implications for fund sponsors seeking to sell products in several markets. It also increases the burden on fund administrators, who have to implement the changes. The differences between the regimes are likely to become more problematic as cross-border business increases as a result of the implementation of the Undertakings for Collective Investment in Transferable Securities (UCITS IV) Directive.

This article illustrates the reporting challenges facing providers of financial products by describing the regimes in Germany and the UK, and summarizing equivalent regimes in Austria and Switzerland.

The differences between the regimes are likely to become more problematic as cross-border business increases as a result of the implementation of the Undertakings for Collective Investment in Transferable Securities (UCITS IV) Directive.



German Tax Reporting Regime

When distributing fund units into the German market it is important to distinguish between regulatory provisions (public marketing is only allowed after a notification has been lodged with the German Banking Supervisory Office) and tax provisions, which put a German investor at a tax disadvantage if reporting duties aren't complied with.

German tax compliance has two components:

1. Year end tax reporting; the calculation, certification and publication of year end tax data within four months of the fund's business year end/distribution date.
2. Daily valuation tax figures;
 - a. equity gain (Aktiengewinn).
 - b. interim profit (Zwischengewinn).
 - c. real estate gain (ImmobilienGewinn).

Dividends, interest, and other ordinary income are classified as deemed distribution income (DDI). This means it is allocated to the investor annually, even if it is not distributed. The DDI also forms part of the interim profit apart from dividend income.

Depending on the circumstances, the interim profits calculation is generally not required for hedge funds and funds-of-hedge funds.





UK Tax Reporting Regime

The recently introduced UK reporting regime has evolved from the long-standing 'distributor status' regime. Under this regime, UK investors use reports of actual and deemed distributions to arrive at total reportable income. Previously, investors simply paid tax on amounts received, so the new regime will take some getting used to. The benefit of reporting status is that investors are subject to capital gains tax on disposals of 18 percent rather than income tax of up to 50 percent.

The new rules affect fund accounting periods beginning on or after 1 December 2009. A new application is needed to enter the regime and a submission must be made to Her Majesty's Revenue and Customs (HMRC) each year demonstrating that reportable income has been calculated correctly. For managers, the filing process is similar to the distributor status process.

The move to reporting means that there is now real interest in the UK regime from hedge fund managers, although there are barriers to overcome. If the fund is not a UCITS or otherwise equivalent to UK funds, the manager must demonstrate that it is not trading. It is also likely to be difficult for funds of hedge funds to qualify for the regime.

Table 1 Contrasting the Two Regimes

	 German Reporting Regime	 UK Reporting Regime
Process	An annual report is required within four months of the year end (accumulating fund) or of a distribution (for distributing funds). This shows numerous reportable tax figures per share (distribution amount, capital repayment, DDI and fully or partially taxable, or tax exempt income components).	An annual report is required within six months of the year end. This shows reportable income per share, i.e. one number only.
Applies to Domestic and Offshore Funds?	Both.	Offshore only.
Debt Instruments	Straight line amortisation for interest coupons and the issue yield (if known). Instruments without known issue yield can qualify as so called DDI-Bonds where the capital gain qualifies for deemed distribution income upon realisation.	The effective yield method must be applied to the extent that debt is purchased at a discount or premium. In practice, straight-line amortisation should be accepted.
Derivatives	Return on derivatives qualifies as extraordinary income, not part of the DDI, which is beneficial for the investors.	Return on derivatives must be split between revenue and capital. The split is determined by the fund manager's motives in entering into the derivative contract and the circumstances of the contract. Return can be revenue, capital or a combination of the two.
Funds of Funds	Under the so called transparency principle, the various tax figures calculated by the underlying target funds need to be consolidated into the tax figures of the fund of funds.	Underlying funds must be categorised between reporting and non-reporting funds. Reported income from reporting funds is included in the fund of funds own calculation. If similar information is not provided by the non-reporting funds, the fair value movement of these funds is treated as income.
Cost Allocation	Costs (e.g. management fee, custodian fee) are to be allocated to the different income categories within the DDI whereby 10 percent of the costs cannot be offset, i.e. 90 percent of the costs are offset from the DDI-components.	The treatment is flexible. Management expenses can be offset against reportable income.
Equalisation	The possibility of recognizing equalization for German tax purposes depends on whether equalisation is adjusted for in the fund accounting system or the profit and loss figures of the yearly report.	The provisions are currently work in progress. Total reportable income can be adjusted to take account of the effect of share creations and cancellations. However, as only one number per share is reported, investors joining in the year pay the same amount of tax as investors present throughout the year.

Source: KPMG, April 2010

Contrasting the Two Regimes

Both regimes distinguish between income and capital to ensure that investors are always taxed at appropriate rates. The aim is to tax the fund investor at the same rates and, as much as possible, at the same time as direct investors in the fund's assets. But German and UK definitions of income and capital were developed independently over many years, so it is not surprising they differ significantly.

The main differences between the regimes are shown in Table 1.

The Challenge for Product Developers

Financial product developers must also take these differences into

account, because tax nuances can have a significant impact on fund performance.

For example, if a class of share has German and UK investors, it is likely that distribution policy will be driven by, and tailored to meet the requirements of the larger investor group. This means that, insofar as the measure of income in each country differs, a distribution calculated under German rules may be disadvantageous for UK investors and vice versa. Ironically, given that one aim of the new UK regime was to reduce share classes, this asymmetry has led some companies to consider creating more share classes.

Index-linked funds are another problem area. Funds holding baskets

German and UK definitions of income and capital were developed independently over many years, so it is not surprising they differ significantly.

of equities generating dividend yields that are reportable income for German investors often use a total return swap to exchange the return on this basket of assets for the total return on a chosen index. Germany's derivative rules provide a tax efficient capital return in such cases, but the treatment is not straightforward for UK investors. UK derivative rules look to the substance rather than form of the return. If the index is a total return index, the reported income must include the revenue element of the return.



Reporting in Austria

Investment funds are not subject to tax in Austria – they are deemed to be transparent. The income of the fund is taxed on the level of the investor, depending on his/her personal situation and the type of income. The taxation of income does not depend on the domicile of the fund or on whether the income is distributed. There are two types of reporting:

1. The income tax treatment of resident investors in foreign funds depends on whether the fund has an official tax representative in Austria, who calculates the deemed income, and files a return with the Austrian Ministry of Finance. The Ministry will publish the figures for investors if the return is filed on time.
2. Alternatively, managers of foreign investment funds can provide regular information to the Austrian clearing house (OeKB) on interest income earned, including the equalization amount on interest and taxable income per share, as defined in the Council Directive 2003/48/EC (EUSD).

Although not mandatory for foreign funds the OeKB reporting system has tax advantages for individual investors, because taxation is on the same level as domestic funds. Any other tax status produces a higher tax burden for the investor.



Reporting in Switzerland

Funds structured as contractual funds, 'société d'investissement à capital variable' (SICAVs), or partnerships are considered partially transparent for Swiss income tax purposes. As a result, a Swiss resident holding a unit, share, or interest in a fund as a private investment will pay income tax on the net income component generated by the fund. The net capital gain of the fund is tax free, and the net capital loss is non-tax deductible for a Swiss resident individual holding the share for private investment purposes. This treatment applies to both Swiss and foreign funds.

Funds and fund promoters are not obliged to report their Swiss tax information to the Swiss Tax Authority (STA) or to Swiss investors in the funds. Swiss funds used to provide some tax information to the STA, but few foreign funds did. It was, therefore, not unusual for Swiss individuals to hold shares in foreign funds, and receive no information on the fund's taxable income. The investor had to assume the fund had earned no taxable income, and complete his/her tax return accordingly.

The STA has recently issued guidelines for calculating the taxable net income component of funds and indicated that it will tax Swiss individual investors on a lump sum basis, if the fund or the fund promoters, do not provide Swiss tax information. Most foreign funds now provide this information to avoid Swiss tax disadvantages for their individual investors.

There are two main practical difficulties in Swiss tax reporting:

1. The fund's financial statements are often unavailable when Swiss individual investors file their tax returns.
2. Because they are not drawn up for Swiss income tax purposes, the financial statements of foreign funds may not include information needed to identify the net income components.

These difficulties are particularly troublesome for funds of funds structures, because each of the funds is partially transparent for Swiss income tax purposes.

Conclusion

The main tax lessons for a fund promoter wishing to distribute in more than one market are that they must understand the reporting rules in all relevant markets, and that a structure that is tax-efficient in one jurisdiction may not be in others.

Given the likely increase in cross-border business following UCITS IV, any signs that reporting regimes are converging would be very welcome. However, there are no such signs and no reason to believe that many national tax authorities have any interest in harmonizing reporting rules.

The EU funds industry must, therefore, continue to pay the cost of the complexity, if it is to reap the potential scale benefits from increased cross-border distribution.

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Fund managers: Sharing the rewards

The partnership structure of fund management groups raises unique transfer pricing problems that are focusing the minds of global tax authorities, warn **Kari Pahlman**, **Lucia Fedina** and **Erica Howard**.

The partnership structure is very common in many industries. For example, in the financial advisory and professional services industries. Typically it is used in areas where human capital plays a significant role in the business and where the partners create and embody the predominant values of the business.

Partnerships are also very common in the fund management industry, where the fund itself (a private equity fund or hedge fund) is typically structured as a limited partnership. Often the fund manager entity is also operated as a partnership. The founders and other senior professionals are typically the partners of the fund manager entity, participating through their ownership in the upside of the business (which will typically materialize in a form of performance fees paid by the fund).

It is common for a fund management partnership to involve an operating subsidiary or partnership (employee vehicle) in another jurisdiction to provide various types of advisory, sub-advisory or consulting services to the fund manager entity. This employee vehicle usually employs a number of investment professionals and other personnel working for the benefit of the fund manager. In many cases, one or more of the partners are employed by the employee vehicle.

The existence of partnerships within a fund manager group often raises unique transfer pricing and tax problems and, thus, is one of the areas tax authorities in many jurisdictions are increasingly focusing on. This article discusses some of the remuneration structures used in the fund management industry, their related transfer pricing implications and the potential risks arising from these structures.



Alternative Remuneration Policies for Related Employee Companies

The diagram in Figure 1 depicts a common situation where the fund manager entity engages one or more of its employee vehicle affiliates to provide investment advisory or trading services in relation to the fund's investments, e.g. for a particular class of assets or for particular markets. The services performed may also relate to sales and distribution functions.

With transfer pricing principles, the employee vehicle should be compensated for its activities depending on the functions performed and the associated risks. When assessing the appropriate transfer pricing method in a fund management context, the functions in the value chain and their relative contributions vary depending on the type of fund, asset class, investment strategy and market. Different value may be placed on advisory, decision making, and trading functions with conventional, index-tracking funds as opposed to where the fund manager entity operates, for example, an alternative investment fund. The extent of the employee vehicle's routine and/or non-routine functions and the specific risks it controls has to be determined on a case-by-case basis.

The fund manager entity will typically compensate an employee vehicle

using one of the following four transfer pricing methods:

- Cost only.
- Cost plus.
- Profit or revenue (fee) split.
- Other methods (e.g. Comparable Uncontrolled Price (CUP) method).

Difficulties in the Application of the Transfer Pricing Method

With the cost and cost plus method, the difficulty in applying transfer pricing methods arises when some of the partners perform some of the functions because it is difficult to define cost. The partners have contributed value that needs to be rewarded. However, they receive a share of the profits rather than a salary or bonuses. Therefore, it is necessary to determine an arm's length amount for their contribution, before a transfer pricing method can be applied.

Similar issues arise with the cost plus method if the employees are rewarded with an Employee Benefit Trust (EBT) or share options. In these cases, the cost of the benefit that is reflected in the statutory accounts of the employee vehicle is spread over the vesting period rather than determined when the service is provided or received. This gives a mismatch between when the cost is accounted for and when the revenue for the service is received. The

determination of the arm's length cost base is difficult and needs careful consideration.

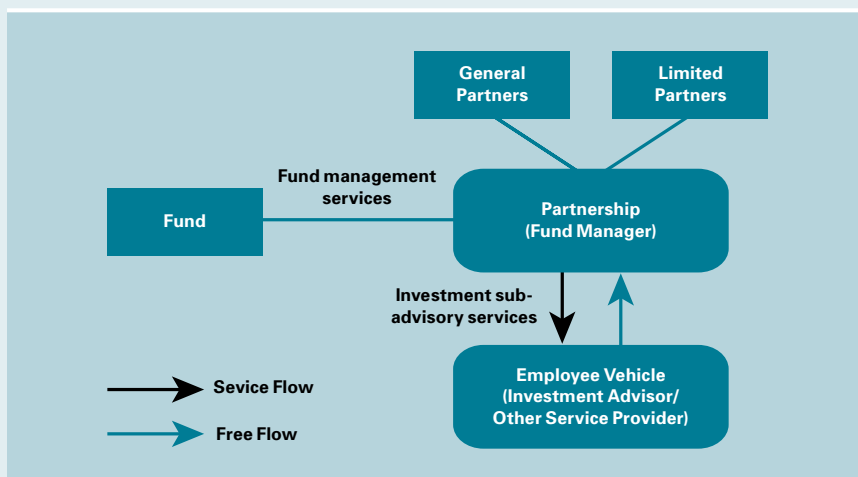
Under a profit or revenue (fee) split model, the aggregate profit or revenue generated by the relevant related parties is combined and split between the participants. The split is based on the relative value of contributions of each of the entities to the combined profit or revenue. Because the remuneration of employees/partners is often a key indicator of value contributed by either party, it can be used as a metric to split the revenue or profit. Again, it is necessary to determine an arm's length level of contribution for the partners in order to be able to apply the profit or fee split method.

Other transfer pricing methods, such as the CUP method, are also occasionally adopted by fund managers in determining an arm's length fee between the related parties. This is particularly true when the fund manager also relies on comparable, third party service providers or operates in a fund segment (typically mutual funds), or where it is possible to obtain public information on fees paid by fund managers for advisory or distribution related services. Because the CUP method looks at the price of the transaction, the cost base does not factor in the application of the method. Therefore, the CUP method is not affected by partner profit or employee remuneration.

Other Transfer Pricing Implications

The compensation payable by the fund manager entity to the employee vehicle directly affects the level of profit retained by the fund manager partnership and the tax liability of the partners. This impact on partners is direct in cases where the fund manager partnership is considered transparent for tax purposes (i.e. partners are taxed directly on their share on respective partnership income). Where individuals are both partners of the fund manager partnership and employees of an employee vehicle in another

Figure 1 Alternative Remuneration Policies for Related Employee Companies



Source: KPMG, June 2010

As many countries have extended their transfer pricing provisions to cover domestic related party transactions, transfer pricing provisions could challenge payments even between two onshore entities.

jurisdiction, and the fund manager partnerships subcontracts activities such as marketing to the employee vehicle, tax authorities are minded to attach the payments to the offshore employee vehicle as a diversion of partnership profits.

A cost only or cost plus remuneration model is generally defensible in an environment where the activities of the employee vehicle are of low value or otherwise considered routine in nature. In the fund management industry, this would normally require that the employee vehicle is operating, for example, as a mere information provider, researcher, or client liaison function without any significant, independent influence over the identification, analysis and processing of the investment opportunities. If compensated as a routine entity, the advisor should not have decision making capability or any material influence over the actual investment decisions.

Cost only reimbursement models are acceptable from a transfer pricing perspective only on rare occasions. Even information provision or pure administrative functions performed by an employee vehicle within the context of a fund management business should generally attract a profit component. Potential exceptions are situations where the employee vehicle relies primarily on other parties to perform its functions and acts as a pass-through of third party costs (in which case it would be expected to have only a limited

number of employees). Also, where the entire fund manager group is at loss – a situation which has become increasingly common during the current economic downturn – it may be possible to justify a cost only based compensation for a routine employee vehicle. Even where the employee vehicle provides only staff and not services, it should make a small profit to compensate it for its employment/HR functions, and risk of employment.

It is also necessary to consider whether the fact that the employee vehicle is structured as a partnership implies it is performing more than a routine function. While looking at base compensation levels may superficially support a claim that the employee vehicle is a routine entity, the reality is that often the employed partner will typically perform critical functions for the fund manager and receive substantial upside through the fund manager partnership structure. This raises the issue in which capacity the partner performs those critical functions – in the capacity of partner or in the capacity of an employee of the employee vehicle.

Partnership structures in the fund management industry have recently come under attack in the UK and other jurisdictions and are increasingly perceived by many tax authorities as arrangements designed to limit the tax liabilities arising from the operation. The partners/partnership may be taxed at a different rate to a corporate entity. Therefore, there can be a tax advantage in the way that a partnership compensates an employing company for the provision of staff or services. As many countries have extended their transfer pricing provisions to cover domestic related party transactions, transfer pricing provisions could challenge payments even between two onshore entities.

Lastly, some of these arrangements can also lead to reassessments from an employee taxation perspective. All these can potentially lead to costly additional tax liabilities and penalties.

Conclusion

The compensation for services by employee vehicles acting for example, as investment advisors to the fund manager partnership, can cause difficulties in the application of the transfer pricing method used, and may be seen as a way of gaining tax advantages by moving profits. These structures have been recently targeted by tax authorities in the fund management industry and continue to be vulnerable to transfer pricing, anti-avoidance and personal taxation.

The payment arrangements between the fund management entity and an employee vehicle should be carefully planned and managed to ensure that the compensation structures are aligned with the actual substance of operations. They should also be monitored to ensure that they are compliant with all applicable transfer pricing and tax regulations, particularly where partners are involved in the employee vehicle.

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Road block for fund managers

The UCITS IV directive from the EU appears to offer greater freedom for cross border fund management houses, but **Georges Bock, Hans-Jürgen Feyerabend, and Seamus Hand** warn unexpected tax consequences for investors could negate the benefits.

With the new Undertakings for Collective Investment in Transferable Securities (UCITS IV) Directive, the European Union (EU) has taken a decisive step towards realizing a single European fund market. The directive's cornerstones are a pan-European management company passport, the facilitation of cross-border mergers and a framework for cross-border master-feeder structures.

At first sight, the Directive appears to have lowered considerably the regulatory barriers between fund management companies and fund structures within Europe and has the potential to reduce costs and increase efficiency. But appearances can be deceiving. The political decision to focus on the regulatory side of the cross-border fund landscape has led to the neglect of the tax side, which could mean tax legislation in many member states will render the new possibilities offered by the UCITS IV Directive inoperable and, in some cases, even frustrate an otherwise sensible change of business.

Might it be possible to build a tax-efficient structure with these uneven blocks?

This article outlines tax aspects to be considered when evaluating possibilities for restructuring existing business models.

Single Management Company

A key feature of the UCITS IV Directive is that EU-wide management company passport, which allows management companies established in one member state to manage funds in other member states.

The investment management industry appears to value low cost, good infrastructure and a well-established regulatory regime, more than tax efficiency when deciding where to establish a central management company. When assessing tax efficiency it is not just the headline tax rate that matters. It is also necessary to consider rules that determine the basis on which tax is levied, and any special income or capital gains tax rates. The cost of tax compliance, tax audits and the stability of a local tax regime are also important. These different components of attraction make comparisons of tax regimes complex.

Unexpected Tax Consequences for UCITS Investors

To make things even more complicated, the single management company passport can produce adverse cross-border tax consequences for the UCITS fund they manage. Where the management company and the funds it manages are located in different jurisdictions, there is a risk that the tax residency of the funds could shift from their place of registration to the place of incorporation of the management company, if it is deemed that the effective management of the

Fund promoters who have set up in traditional fund centres, specializing in cross-border distribution, appear to have little appetite to relocate their management companies.

fund has moved to the jurisdiction of the single management company.

Such a shift of residency could lead to an unexpected and material foreign income tax burden, which could result in double taxation and an unexpected withholding levy. It is unacceptable, of course, for the fund's promoters to optimize their own tax position at the expense of the tax positions of fund investors.

Single Management Passport Incentive for Strong Consolidation

One size does not fit all. Each set of circumstances has different solutions. Fund promoters who have set up in traditional fund centres, specializing in cross-border distribution, appear to have little appetite to relocate their management companies.

Moreover, depending on the regulatory practice and acceptance cost minimization, process rationalization seems to have been achieved by classical outsourcing. Some funds have domestic operations

in markets where they have critical mass, and operate a cross-border platform in parallel, in one fund centre. They say that such an arrangement makes sense and there is no reason to fuse the operations. Players with three or more platforms, each with its own decision-making, may want to take advantage of the single management passport. This is often in connection with a possible merger of their fund range.

An important consideration when deciding whether or not to have a fund and the management company in two different EU countries is distribution into non-EU markets, such as Asia or South America. In the past, these regulators have limited regulatory co-operation to one country, when accepting distribution of EU funds into their markets. The new models involving triangular regulatory acceptance could increase time to market, or make the distribution into these countries more burdensome.

Fund Mergers

The second key pillar of the UCITS IV Directive is the possibility that it provides for cross-border fund mergers. The idea is that larger funds may have better return expense ratios, and thus make the EU industry more competitive. One of the problems in fund mergers is the possibility that they will lead to tax charges for investors. UCITS IV should allow all types of funds, contractual, corporate or unit trusts, to merge freely, cross-border, within the EU. Here too, however, tax issues impose practical restrictions.

There are usually no immediate tax charges in a merger of domestic funds – tax can often be deferred until gains arising are realized. But

these provisions are not consistently applied across Europe to all forms of UCITS (incorporated, contractual, or trusts) domestic or cross-border. There is a risk, therefore, that investors will have to pay tax on unrealized gains.

Fund Mergers: A Discriminatory Landscape

Since different treatments of domestic and cross-border mergers are a restriction on the free movement of capital, legislators should repeal the discriminatory legislation and allow tax neutrality for all mergers. If they don't, the EU Commission could, in theory launch an infringement procedure, and take the case to the European Court of Justice (ECJ).

But, in practice, eliminating discriminatory tax treatment through infringement procedures is a long, difficult and expensive process that delivers no immediate benefit. In our view a merger directive for the re-organization of funds is the only efficient way to deal with this issue.

Fund managers can adopt new business models, redesign organizational structures and extend product ranges, by merging funds in different jurisdictions. But, if the adverse tax consequences for shareholders are not taken in account, they could prove overwhelming obstacles to achieving a tax-effective outcome.

Master-Feeder Structures

A third important change in the new Directive is the provision for establishing cross-border, master-feeder structures. The objective here is to facilitate access to new markets by setting up a new or

streamlining an existing fund range by having a single master fund in one jurisdiction with feeder funds in other jurisdictions.

In the absence of effective tax rules for mergers, a master-feeder structure in which a master fund converts into a feeder fund of a fund in another jurisdiction may be a way to create a central pool of assets without a merger.

In many EU countries, disclosure of hidden capital gains on the transformation of a fund into a feeder fund is not required as long as the investor retains his or her original investment. This strategy could solve in the short-term the problem of streamlining funds in jurisdictions where tax-neutral fund mergers cannot be achieved.

Tax Optimization Strategies

Master-feeder structures may offer optimization opportunities with respect to double tax treaty benefits. There are two possible ways to capture such benefits.

The first is to identify a master fund location that will optimize treaty access between investee countries, and the master's country of residence.

The second is to use a tax-transparent master and country specific feeder, because it should be easier to gain treaty access for the investors through double tax treaties between the investee country and the residence country of the feeder. In its working papers the Organisation for Economic Co-operation and Development (OECD) has recently recommended that treaty protection tests should be based on whether an appropriate number of treaty-entitled

The investment management industry appears to value low cost, good infrastructure and a well-established regulatory regime more than tax-efficiency when deciding where to establish a central management company.



investors are involved, rather than on the status and residence of the fund. The industry cannot adequately document treaty protection based on the tax residency of investors, at present. Country feeders might make the documentary proof less burdensome and more reliable.

Currently many fund promoters do not appear to be focusing on the double tax treaty when considering master-feeder structures. But it is not clear whether this is because they are content with the double tax treaty coverage in their current arrangements, or because they have yet to identify the new potential.

Care should be taken, of course, to reduce tax leakage in the form of withholding or capital gains taxes between master and feeder.

Transfer Pricing

The new rules permit structures that involve service supplies from various jurisdictions (for example, a management company in Germany, administration in Luxembourg, portfolio management in London). If all entities belong to one group transfer pricing issues will have to be carefully considered.

VAT

VAT is another key factor. While the management of UCITS is exempt from VAT, a number of services

rendered to UCITS are VATable, with either no or minimal recovery. Moreover, although VAT is levied on the basis of directives applicable to all member states, there are differences in interpretation and definition of exempt services. The VAT treatment of these services could depend upon how they are bundled or structured. If cost reduction is a priority, a low VAT charge is crucial.

Major problems areas include the limitation of the investment fund management exemption to locally established funds, differences in definitions of investment management services, and multiple cross-border intra-group service contracts that might trigger additional VAT costs.

Since UCITS IV extends the range of services that can be delivered to include cross-border supplies, the place of taxation for VAT is of prime importance. It is still debatable in some member states whether funds qualify as businesses, for VAT purposes. If they do not and the fund management VAT exemption only applies to domestic funds, VAT would be applied on services supplied to foreign funds. This leaves a single management company applying the VAT exemption to services to its local fund, but taxing the same services delivered to funds in other countries – an obvious case of unequal treatment.

UCITS IV should allow all types of funds, contractual, corporate or unit trusts, to merge freely, cross-border, within the EU.

Moreover, a master-feeder system could require additional services between the management companies of feeder and master, if they are not serviced by a single management company. It is hard to say how it will turn out, because the day-to-day operational requirements have yet to be decided. However, it is clearly desirable that services supplied between two management companies, both serving the master fund and the feeder, should be VAT-exempt.

Conclusion

Although designing new business models for UCITS IV appears fairly straightforward from the regulatory perspective, taking account of tax is much more complicated. There are significant opportunities, but one size does not fit all. Promoters should develop a set of possible structures and stress-test each of them for tax.

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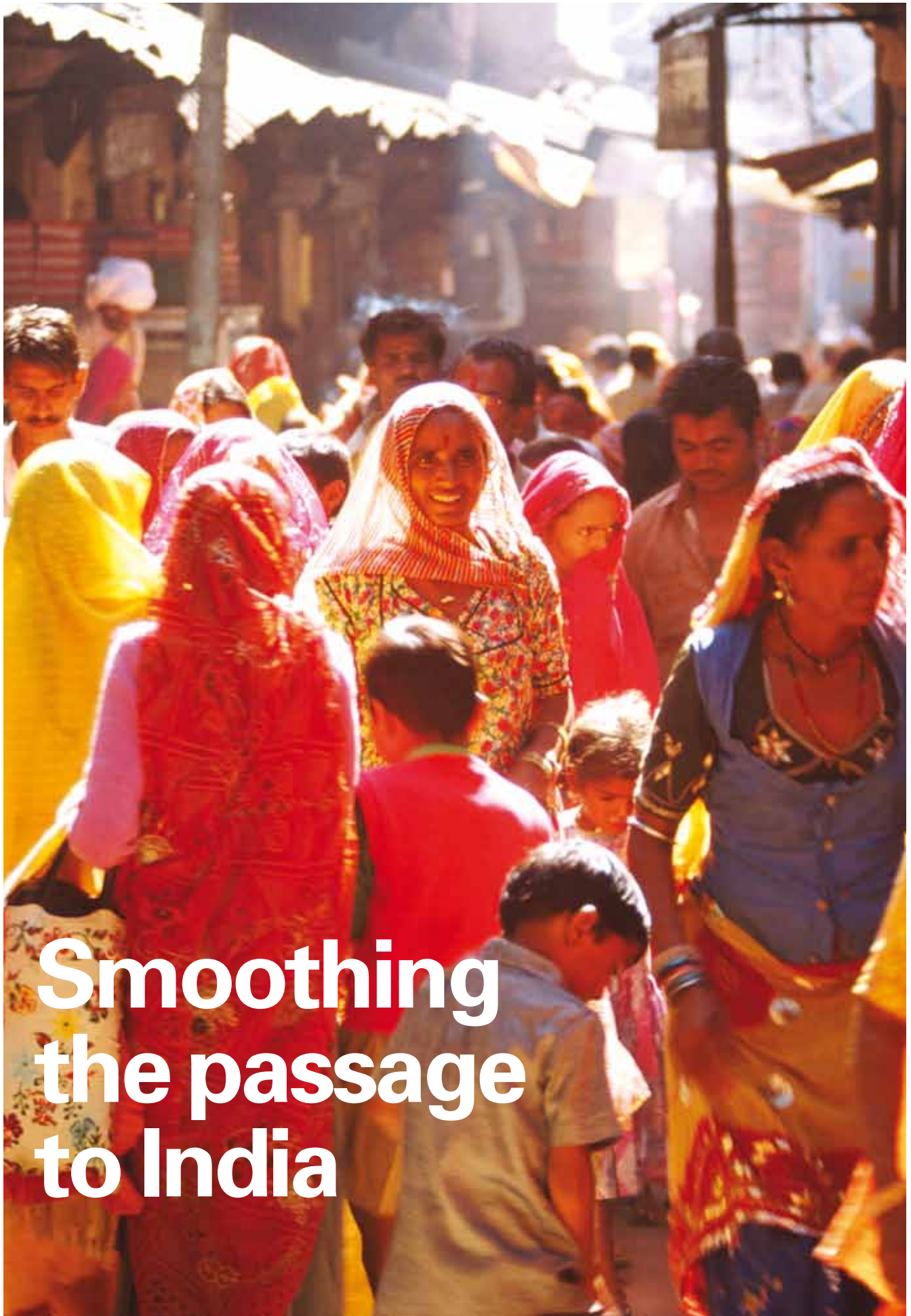
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Smoothing the passage to India

The welcome liberalization of India's tax code has helped to create a thriving investment market for foreign institutions. Delhi authorities should now exempt offshore funds from domestic taxation in line with other Asian markets, argue **Naresh Makhijani**, **Ivor Morris** and **Chee Sin An**.

In 1993, India amended its foreign investment regulations to allow recognized Foreign Institutional Investors¹ (FIIs) to invest in securities listed on Indian stock exchanges. Since then, FIIs have contributed significantly to India's economic growth. It took five years to double net cumulative FII inflows from 30 billion rupees (US\$652 million) in 1997, to 59 billion rupees (US\$1.3 billion) in 2002, but only three years to triple net inflows to 177 billion rupees (US\$3.8 billion), and another four to double that again to 346 billion rupees (US\$7.5 billion). The current FII investment² inflow is roughly 357 billion rupees (US\$7.8 billion) a year – 11 times the 1997 figure.

In addition to the inherent attractions of India to investors, the relatively benign tax and regulatory environments have also helped to boost FII investment – as they also have in Singapore and Hong Kong. This article reviews the current and proposed taxation regimes for FIIs and fund managers in India, compares them with those in other countries, and suggests further changes that the Indian government could consider to take FII investment to the next level.

Taxation of FIIs and Fund Managers in India

Under India's Income-Tax Act (1961) long-term capital gains³ earned by FIIs on sales of specified securities⁴ are exempt from tax, but short-term gains⁵ are taxed at 15 percent. In addition a Securities Transaction Tax (STT) is levied by Indian stock

exchanges on sales and purchases of securities.

Many FIIs invest in India from more favorable jurisdictions and so benefit from the Indian domestic law that allows taxpayers to opt for either the tax treaty regime or domestic law, whichever is more beneficial. These FIIs pay minimal taxes even on short-term gains, and gains made on sales of securities that do not enjoy beneficial tax treatment under domestic law.

The proposed Direct Taxes Code (DTC), intended to replace the 1961 Income-Tax Act, includes no concessionary tax regime for FIIs and hence gains (both short-and long-term) earned by FIIs will be taxed under the DTC at 30 percent.

One of the key reasons why so many FII funds are managed from outside India is that the domestic law stipulates that not only management fees earned by the fund manager, but also the fund's income, would be taxable in India if its finances are managed in India. This is due to the fact that in this case, it could be deemed to have a permanent establishment (PE) in India.

The lack of a PE in India will cease to be beneficial when the DTC comes into effect, because unless agreed

otherwise in a subsequent treaty, the DTC regime will prevail over treaty regimes. Moreover, the inclusion of a General Anti Avoidance Rule (GAAR) in the DTC gives the Tax Commissioner considerable power to combat aggressive tax planning. These measures will create uncertainty about the tax treatment of the income of FIIs, and run counter to the FIIs' wish for a settled, simple and beneficial tax system. In the long-run, they could reduce the growth of the investment and fund management industry in India.

Net Cumulative FII Inflows

1997

30 billion rupees
(US\$652 million)

2002

59 billion rupees
(US\$1.3 billion)

2005

177 billion rupees
(US\$3.8 billion)

2009

346 billion rupees
(US\$7.5 billion)

2010

357 billion rupees
(US\$7.8 billion)

¹ FII investment primarily covers portfolio institutional investment in the Indian stock exchanges.

² Feb 2010

³ Capital gains earned on sale of listed securities held for a period exceeding 12 months are treated as long-term capital gains.

⁴ Specified securities covers equity shares and units of an equity oriented mutual fund.

⁵ Gains other than long-term capital gains are short-term capital gains.

Fund Regimes In Other Countries

Countries with successful fund regimes either have an explicit tax exemption for offshore funds (e.g. the US, UK, Singapore and Hong Kong) or have refrained from taxing the funds even if the funds are managed from other countries. Many countries have rules that can exempt fund managers from creating a taxable presence for the offshore funds, including the US, UK, Hong Kong, Singapore and, most recently, Japan.

Taxing offshore funds poses practical difficulties – for example, gathering the relevant information. And, in any event, an offshore fund could only be taxed once because, once taxed, a rational fund manager would subsequently leave that jurisdiction.

Taxing offshore funds poses practical difficulties – for example, gathering the relevant information. And, in any event, an offshore fund could only be taxed once because, once taxed, a rational fund manager would subsequently leave that jurisdiction.



Singapore

One of the more important tax incentives introduced by the Singapore Government is the Offshore Fund Incentive. Under this incentive, specified income⁶ derived by offshore funds managed in Singapore, by any fund manager in respect of designated investments, is exempted from Singapore income tax. These offshore funds could be in the form of trusts (with non-resident trustee) or non-resident foreign companies.

For a trust fund whose trustee is resident in Singapore, a permanent establishment (PE) in Singapore or a Singapore citizen, the Prescribed Trust Fund Incentive could also provide tax exemption coverage to foreign investors. Under this incentive, specified income⁶, derived by a trustee of a trust fund managed in Singapore, by any fund manager in respect of designated investments, is exempted from Singapore income tax. This is on the condition that the trust fund does not have more than 20 percent of its value beneficially held directly or indirectly by Singapore investors (including a PE in Singapore).

In addition, to encourage foreign investors to invest through onshore funds set up in Singapore, the Resident Fund Exemption Incentive was introduced in 2006. Under this incentive, amongst other conditions, the onshore funds have to be tax residents and incorporated companies in Singapore. For a company approved under the incentive, the specified income⁶ tax exemption is at the fund level. An added advantage is that companies could also enjoy preferred tax treatments accorded under tax treaties Singapore has concluded with other countries.

Under all mentioned incentives, restrictions disallow funds from being fully held by Singapore investors to ensure that the incentives are not abused for tax avoidance purposes.

The Enhanced Tier Fund Incentive (ETF) was introduced in 2009 to provide fund managers in Singapore with greater flexibility to source for investment mandates. This incentive has the following enhancements:

- no restriction on the residence status of the fund vehicles and investors.
- applicable to funds constituted as limited partnerships, trusts or incorporated as companies.
- lifting of the investment limit imposed on resident non-individual investors.

Under the ETF incentive, specified income⁶ derived by funds approved during the period from 1 April 2009 to 31 March 2014 from designated investments would be granted tax exemption at the fund level.

With these incentives in place, fund management firms are attracted to use Singapore as a base to secure mandates regionally with more than 80 percent of funds sourced from outside.

In the 2008 Singapore Asset Management Industry Survey, conducted by the Monetary Authority of Singapore, the Assets Under Management (AUM) of the Singapore asset management industry grew at an average of 16 percent per annum over a five year period to 2008. Given the global financial crisis, the AUM in 2008 was S\$864 billion compared to S\$1173 billion in 2007. Prior to the crisis, the average per annum growth rate over a five year period to 2007 was 28 percent. As highlighted in the survey, the decline in 2008 was less than general market declines, underscoring the resilience of the industry in Singapore.



Hong Kong

Prior to 2005–06, there was no law in Hong Kong exempting from tax offshore funds that were, in practice, managed from Hong Kong. However, some funds could claim exemption under other provisions of the Tax Ordinance. Following extensive lobbying by, and discussion with, the funds management industry, Hong Kong introduced an offshore funds exemption in 2005, and a provision in domestic law specifying that qualifying offshore funds would not be taxed in Hong Kong, even if they were managed from Hong Kong (the Offshore Funds Exemption).

The exemption applied retrospectively, from the year of assessment 1996–97 onwards. The Inland Revenue further issued a practice note on the application of the exemption. The rules exempt non-resident funds from profits tax if the following conditions are met:

- The non-resident fund carries on no business in Hong Kong other than ‘specified transactions’ (in securities, including certain equity, debt and derivative instruments, but excluding equity in private companies), futures and foreign exchange contracts, foreign currencies and exchange-traded commodities, and making deposits (other than by way of a money-lending business) or transactions incidental to these activities (provided the profits from ‘incidental transactions’ do not exceed 5 percent of the fund’s total trading receipts)⁷.
- Those transactions are arranged by or carried out through a ‘specified person’ licensed under the Securities and Futures Ordinance.

- For anti-avoidance purposes, certain provisions may apply to deem a Hong Kong resident investor taxable on its share of the exempt offshore fund’s Hong Kong sourced profits if the resident investor, together with its ‘associates’:
 - holds directly or indirectly a beneficial interest of 30 percent or more in the exempt non-resident fund; or
 - holds any direct or indirect interest in an associated exempt non-resident fund.

The Offshore Funds Exemption provides the non-resident fund relief from Hong Kong profits tax, even if it is managed by Hong Kong fund managers. The deeming provisions are designed to prevent abuse and ‘round tripping’ by residents.

According to reports in the Fund Management Activities Survey 2007 issued by the Hong Kong Securities and Futures Commission (SFC), AUM of Hong Kong fund managers in the year to 31 December 2007 increased by 57 percent, to HK\$9,000 billion after the implementation of the Offshore Funds Exemption on 1 March 2006⁸. Over 60 percent of the funds came from non-Hong Kong investors.

While many economic factors in the region, including strong growth in the Chinese economy and bullish financial markets throughout the year, help to account for the level of growth in 2007, the offshore funds exemption played an important part in enabling Hong Kong to remain the leading fund management centre in Asia.

Implications for India

Hong Kong’s experiences show tax and regulatory concessions can play an important role in attracting FII investment. It suggests that, in view of India’s attraction on fundamental grounds to FIIs, similar concessions would have comparable effects in India. The Indian government should, therefore, consider the following policy changes:

Under the Current Tax Law

A provision can be inserted in the domestic law exempting offshore funds from taxation in India, even

if their funds are managed from India. This could be done by amendments or additions to Section 9 and other relevant sections of the 1961 Income tax Act. The Indian entity managing the funds would be taxable on the management fees.

In addition, a circular or guideline could be issued clarifying the government’s intent and resolving possible ambiguities. This would provide certainty for the investor community and could also ensure the exemption is restricted to the fund management industry.

Under the Direct Tax Code

The Tax Code could contain a specific provision exempting offshore funds from taxation in India even if they are managed from India. Again, the Indian fund manager would still be liable to income tax on the management fees earned.

Conclusion

India, as an investment destination, appears to be high on the list of many major institutional investors. Ironing out tax and regulatory hitches, as discussed, would help to make India an even more attractive investment jurisdiction.

⁶ Examples of specified income include gains or profits from the disposal of securities, interest and foreign dividends received in Singapore.

⁷ DIPN43 para 22–24 and 45.

http://www.ird.gov.hk/eng/pdf/e_dipn43.pdf

⁸ Fund Management Activities Survey 2007 page 1: http://www.sfc.hk/sfc/doc/EN/speeches/public/surveys/08/fmas_080724.pdf

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An end to treaty shopping in Asia

Tax authorities in Asia Pacific are taking a much harder line on what constitutes beneficial ownership which **James Dodds, Lewis Lu, Keyur Shah, Graham Garven, and Jae Won Lee** warn, will force investment funds to consider structural changes to secure tax benefits.

Waves of foreign capital have flooded into Asia Pacific (ASPAC) and India in recent years, particularly from private equity and real estate funds. Since many of the investors are tax-exempt or tax-advantaged, structuring investments tax efficiently has been a key objective. However, tax authorities have not made this easy. While various steps have been taken to prevent the erosion of tax bases, a common target for tax authorities is 'treaty shopping'. Many regulators have looked closely at beneficial ownership and 'substance' tests for obtaining treaty benefits.

These have been issues for investors in Japan and South Korea for years. For instance, Japan's tax authority successfully challenged the use of tax treaty exemptions for certain investors in Japanese silent partnership arrangements. Initially, these challenges arose during tax audits, but the Japanese government has recently updated its tax treaties

to make clear that silent partnership income is taxable in Japan. To clearly identify who is entitled to treaty benefits, Japan has introduced Limitation on Benefits (LOB) clauses into their tax treaties. Furthermore, at the time of writing, Japan has announced, but not yet issued, the details on the new treaties with the Netherlands and Hong Kong. Both are expected to include LOB conditions.

The situation in South Korea is similar. The tax authorities have challenged the use of tax treaties by private equity funds to earn tax free gains. Following high-profile cases where investments in South Korea were made through a treaty country, and no tax was paid in Korea on the gains, the Korean government took various steps. The steps included renegotiating tax treaties and introducing domestic anti-avoidance legislation to override treaties. The latter requires entities in designated tax havens (currently only Labuan in Malaysia) to provide evidence of substance. Other ASPAC countries also require additional evidence to support treaty applications.

India



Arguments about beneficial ownership of shares and rights to claim treaty benefits remain a large cause of litigation in India. Indications are that the courts broadly continue to respect investments made from favorable treaty jurisdictions such as Mauritius, was shown by the recent Advance Ruling in the E*Trade Mauritius Limited case. The Authority for Advance Rulings in India (AAR) held that a Mauritius entity earning capital gains from sale of Indian securities could claim benefits of the Double Taxation Avoidance Agreement between India and Mauritius, and as a result was not liable to pay capital gains tax in India. The AAR ruling relied on:

- the Circular issued by the Central Board of Direct Taxes that stipulated that a Tax Residence Certificate issued by the Mauritian authorities would be sufficient to claim tax treaty benefits.

Direct Taxes Code (DTC) is in draft form and open for public debate. It is expected to become effective, as amended, from 1 April 2011.

- the ruling of the Supreme Court of India in the case of Azadi Bachao Andolan, which upheld the validity of that circular.

This ruling was issued after the Revenue Authorities had held that E*Trade Mauritius was not, prima facie, entitled to India Mauritius Tax Treaty benefits.

Another important development is the inclusion of the Direct Taxes Code (DTC), which will replace India's existing Income Tax Act of General Anti Avoidance Regulations (GAARs). This gives wide powers to the Commissioner of Income Tax to question any step in, or part or whole of an arrangement, where the main purpose is to obtain tax benefits. This may mean questions of beneficial ownership will become significant again. The DTC is in draft form and open for public debate. It is expected to become effective, as amended, from 1 April 2011.

Looking Ahead

Approaches to beneficial ownership and substance questions vary in ASPAC and India. They are changing as tax authorities learn more about the structures used. Investment funds should carefully consider their structures, and how to meet the substance tests of different tax authorities. Current structures should be reviewed to ensure they meet the new requirements and are adaptable enough to take account of future changes.

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The fair value tax treatment of trading financial assets, designed in the wake of the Enron collapse in the US, has made tax efficiency harder to achieve in the burgeoning markets of Asia Pacific, write **Tay Hong Beng, Graeme Reid** and **Caley Mac**.

When being fair can be costly

Almost a decade after Enron and the introduction of fair value accounting, tax authorities are still adjusting to Financial Reporting Standard (FRS) 39.

This article examines the FRS 39 consequences of trading financial assets at fair value through the profit or loss (FVTPL) account in Singapore and elsewhere in Asia Pacific.

As its name suggests, the key objective of fair value accounting is to respond to investor calls for greater transparency in financial statements by valuing certain financial assets and liabilities at their market values. However, tax inefficiencies will arise if unrealized profits are taxed, and there are restrictions on the use of losses in later years.

After the adoption of fair value accounting in Singapore, the Inland Revenue Authority of Singapore (IRAS) adopted FRS 39 in section 34A of the Singapore Income Tax Act (SITA), effective from 1 January 2005. To minimize the need for adjustments, the tax treatment of financial assets and liabilities was changed to align it with the accounting treatment under fair value accounting.

For trading financial assets at FVTPL, the FRS 39 treatment requires complete alignment with the accounting treatment. FVTPL financial assets are on a revenue-account for trading purposes and all gains or losses recognized in the profit and loss account are taxed or allowed a tax deduction, even if unrealized. This mirrors the concession the IRAS had long extended to banks on the mark-to-market accounting treatment of most derivatives and investments.

Taxpayers can opt out of FRS 39 treatment if they provide details on how the pre-FRS 39 tax adjustments are determined and maintain the relevant documents to support the pre-FRS 39 adjustments. However, once they have adopted FRS 39 they must stay with it.

FRS 39 tax treatment is thus a significant departure from the long tradition of only taxing realized gains and allowing deductions on realized losses. It is important to note that even before the new tax treatment was introduced, a provision for reduced value of financial assets on revenue accounts was allowed as a deduction and any write-back of the amount previously

...the key objective of fair value accounting is to respond to investor calls for greater transparency in financial statements by valuing certain financial assets and liabilities at their market values.

claimed as a deduction was subject to tax.

FRS 39 treatment lessens the pain of preparing tax returns. It also seems that taxing unrealized gains and allowing deductions for unrealized losses merely results in a difference in timing from the traditional tax treatment. But the Singapore tax system is not simply a matter of pluses and minuses. The tax a corporate taxpayer pays on unrealized gains may, in certain circumstances, never find its way back as a tax deduction if the financial assets subsequently fall in value.

The differences between FRS 39 and pre-FRS tax treatment are shown in Table 1.

Table 1 The Differences Between FRS 39 and Pre-FRS Tax Treatment**Background Facts:**

In 2007, Company A with financial year ended 31 December, acquires a FVTPL financial asset for S\$1.0 million.

The fair value of the FVTPL financial asset is:

As at 31 December 2007: S\$1.4 million

As at 31 December 2008: S\$0.7 million

Illustration I**Tax Impact of FRS 39 Tax Treatment for FVTPL Financial Asset****Assumptions:**

- In the Year of Assessment (YA) 2009, Company A has no taxable profits to set against current year trade losses.
- Company A can satisfy all the conditions to carryback current year unabsorbed losses to YA 2008 (financial year ended 31 December 2007) as allowed under the SITA (loss carryback is restricted to S\$0.2 million).

Tax Impacts:**YA 2008:**

The unrealized gain of S\$0.4 million is subject to tax.

YA 2009:

The unrealized loss of S\$0.7 million is claimed as a deduction. But since Company A has no taxable profits to set-off against the current year trade losses, the current year unabsorbed losses of S\$0.2 million (as allowed for in the loss carryback provisions) is carried back to YA 2008 to set off against the taxable gain of S\$0.4 million. The balance of the current year unabsorbed losses of S\$0.5 million is available for carry forward to set off against future years' profits subject to meeting the shareholders' continuity test.

	S\$ (in millions)	Taxable Gain/ (Loss)	(Loss)
Acquisition cost in 2007	1.00		
Fair value as at 31 Dec 2007 (YA 2008)	1.40	0.40	
Fair value as at 31 Dec 2008 (YA 2009)	0.70		(0.70)
Carryback of losses	-	(0.20)	0.20
Total		0.20	(0.50)

Tax Calculations:

Under the **FRS 39** tax treatment, Company A pays tax on the net unrealized gain of S\$0.2 million for YA 2008.

Illustration II**Tax Impact of Pre-FRS 39 Tax Treatment for FVTPL Financial Asset****Assumptions:**

- In YA 2009, Company A has no taxable profits to set-off against the deduction claim for impairment for reduction in value of the FVTPL financial asset.

Tax Impacts:**YA 2008:**

The unrealized gain of S\$0.4 million is not subject to tax.

YA 2009:

Impairment for reduction in value of S\$0.3 million is claimed as a deduction. Since Company A has no taxable profits to set-off against the deduction claim, the unused losses of S\$0.3 million in the year ended 31 December 2008 is available for carry forward to set off against future years' profits subject to meeting the shareholders' continuity test.

	S\$ (in millions)	Taxable Gain/ (Loss)	(Loss)
Acquisition cost in 2007	1.00		
Fair value as at 31 Dec 2007 (YA 2008)	1.40	-	
Fair value as at 31 Dec 2008 (YA 2009)	0.70		(0.30)
Carryback of losses	-	-	-
Total		-	(0.30)

Tax Calculations:

Under the **pre-FRS 39** tax treatment, the unrealized gain of S\$0.4 million is not subject to tax in YA 2008.

Source: KPMG, June 2010

Table 2 The Regional Context

	Australia	Hong Kong	Japan	Republic of Korea	Malaysia	Singapore
Fair value accounting (FVA)	Yes	Yes	Yes	Yes	Yes	Yes
Taxability of unrealized gains or loss under FVA	Yes	Yes	Yes	Yes	Yes	Yes
Carry forward of trade losses (7/10yrs/indefinitely)	Indefinitely	Indefinitely	7	10	Indefinitely	Indefinitely
Carry back of losses	No	No	No	No	No	Yes
Shareholders' continuity test	Yes	No	Yes	No	No	Yes

Source: KPMG, June 2010

Singapore's FRS 39 tax treatment is more disadvantageous for taxpayers than other Asia-Pacific countries.

Australia: ...if the shareholders' continuity test is failed, unabsorbed losses may still be used to offset taxable income of future years if the same business test is met.

Japan: ...only certain specified events occurring within five years of a change of ownership would trigger the forfeiture.

The claim for impairment in the value of the FVTPL financial asset of S\$0.3 million in YA 2009 is available as unabsorbed losses for carry forward to set-off against future years' profits subject to meeting the shareholders' continuity test.

The losses may be used to reduce the taxpayer's tax liabilities in future under the FRS 39 tax treatment, but the timing of such use depends on the company having sufficient profits. Furthermore, for companies that have adopted the FRS 39 tax treatment, the timing of a subsequent restructuring is critical. For instance, if they had paid tax on large unrealized gains from FVTPL assets up to YA 2008, they may need to recognize unrealized losses on FVTPL assets in YA 2009 in respect of the same FVTPL assets during a severe downturn in financial markets.

If a restructuring creates a substantial change in shareholdings, tax losses not used in YA 2009 may be forfeited, because under current tax rules, losses can only be carried forward for set-off against future profits if at least 50 percent of the ownership is continuous, unless a waiver of the continuity test is granted.

Although simple to apply, the FRS 39 tax treatment for FVTPL assets has drawbacks. The pre-FRS 39 tax treatment has its drawbacks too, mainly because of the shareholders' continuity test, but it is not as disadvantageous as FRS 39,

particularly in a difficult economic environment. It is not only cash flow. There are another two major disadvantages:

- Unrealized gains are immediately taxable, but unrealized losses only translate to tax savings if there are sufficient profits to use the losses.
- Unabsorbed losses can be carried forward indefinitely, but are forfeited if there are substantial changes in a company's ultimate shareholders and their respective shareholdings, unless a waiver for the shareholders' continuity test is obtained from the IRAS, on the basis that the change is not motivated by tax benefits or advantages.

The Regional Context

As Table 2 shows, Singapore's FRS 39 tax treatment is more disadvantageous for taxpayers than other Asia-Pacific countries.

In general, Australia, Hong Kong, Japan, the Republic of Korea and Malaysia have taken the same approach as Singapore. All six countries, gains or losses on trading financial assets at FVTPL account are taxed, or allowed a tax deduction, whether or not they are realized.

But although only Singapore allows loss carry-backs, the other five have mechanisms that mitigate some potential adverse consequences of taxing unrealized gains from trading



financial assets at FVTPL account; namely that they either have no shareholders' continuity test to limit the preservation of unabsorbed losses or have less restrictive tests than in Singapore. In Australia, for example, if the shareholders' continuity test is failed, unabsorbed losses may still be used to offset taxable income of future years if the same business test is met. In Japan only certain specified events occurring within five years of a change of ownership would trigger the forfeiture of unabsorbed losses.

The Singapore tax regime does have certain features to cushion the adverse tax consequences associated with taxing unrealized gains in trading financial assets at FVTPL account, but they are quite limited. For instance, the carry-backs of unabsorbed trade losses and unabsorbed capital

allowances are capped at S\$200,000, for the preceding three assessment years (only for assessment years 2009 and 2010).

FRS 39 tax treatment has been operating in Singapore for over five years and there is no sign from the government that the rules will be reviewed. It remains to be seen, for example, if the government will allow the direct matching of taxed unrealized gains against subsequent losses on an asset by asset basis. This may prove to be too administratively cumbersome, but the government could consider relaxing the rules on the preservation of unrealized loss, to make them consistent with the treatment in Asia Pacific countries.

In the other five Asia Pacific countries the tax regimes appear to have addressed some of the disadvantages

...the Singapore government should change its tax treatment, to ensure taxpayers are not unduly disadvantaged, and so help maintain Singapore's competitive position as a location for commerce in the Asia Pacific region.

of taxing unrealized gains on trading financial assets at FVTPL account. It is uncertain if they will take further steps to address, for example, the issue of funding tax liabilities on unrealized gains, and restrictions on using tax losses, particularly after changes in shareholders, which have become increasingly common in the wake of the financial crisis.

Fair value tax treatment is here to stay. However, the Singapore government should change its tax treatment, to ensure taxpayers are not unduly disadvantaged, and so help maintain Singapore's competitive position as a location for commerce in the Asia Pacific region.

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Produced by KPMG's Global Financial Services Tax Practice in the UK

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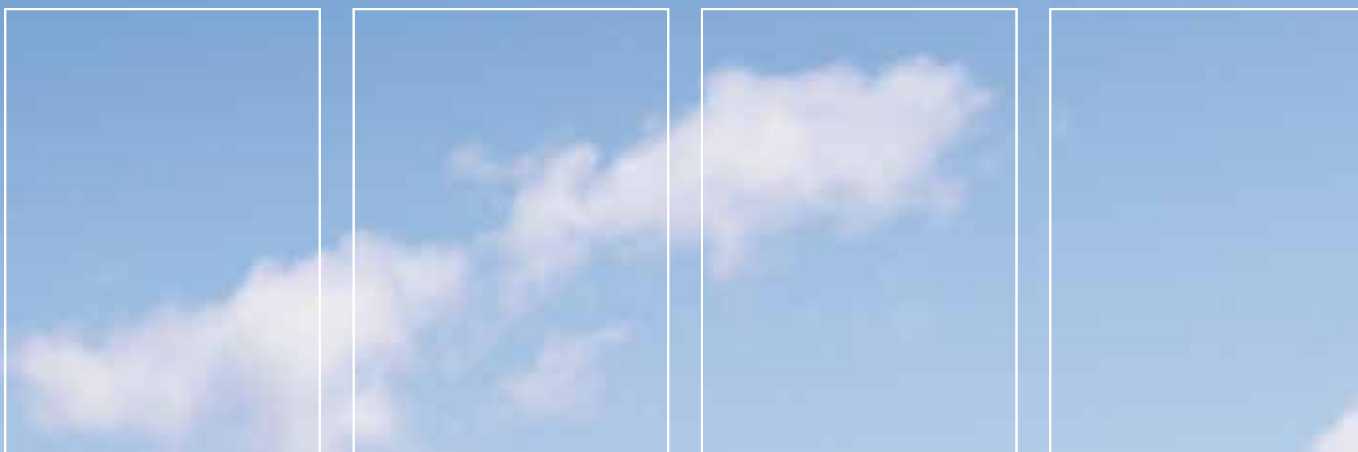
Publication name: Frontiers in Tax

Publication no: 314404

Publication date: July 2010

Printed on recycled material

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