

frontiers in tax

People thinking beyond borders in financial services

December 2013

Featuring:

European Financial Transaction Tax (FTT)

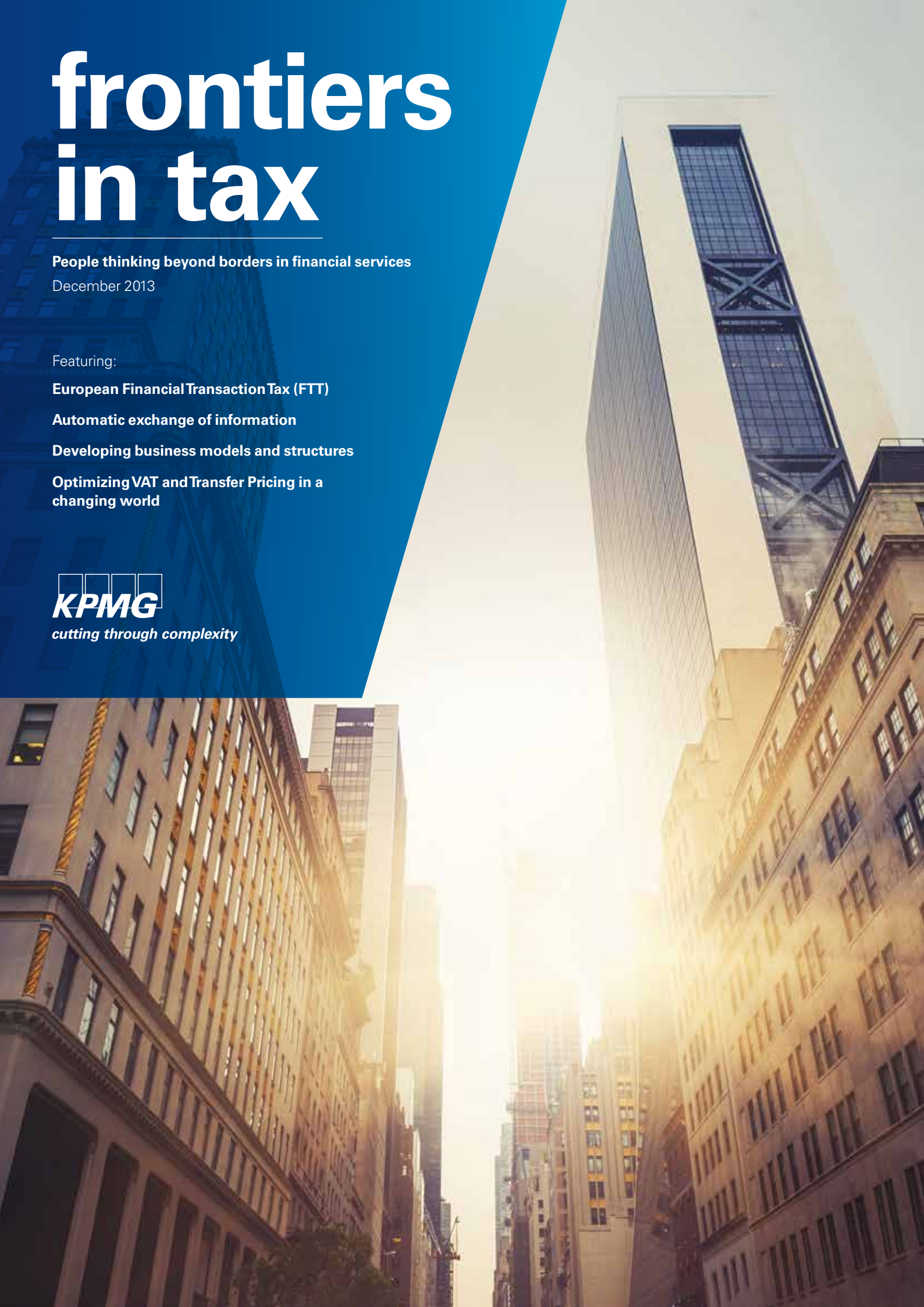
Automatic exchange of information

Developing business models and structures

**Optimizing VAT and Transfer Pricing in a
changing world**

KPMG

cutting through complexity



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Introduction: Unfinished business

There are natural cycles in public concern. However traumatic the original disaster, in due course attention moves elsewhere. In the wake of the financial crisis, we have seen acute public concern dissipate, leaving behind a vague sense of chronic unease and a lingering distrust of financial institutions.

This is partly because genuinely good news stories are emerging to offset continuing anxiety: there is an apparently real, if faltering, return to economic growth in Europe; stock markets across the world are at or near 52-week highs; the shale gas revolution in the United States is promising major economic benefits. Indeed Charles R Morris, who published a prescient analysis of the origins of the credit crisis six months before the Lehman Brothers collapse in 2008,¹ is now forecasting that the US is “on the threshold of a long-term economic boom” thanks to shale gas.²

However, major uncertainties persist. The eurozone remains fragile, with sovereign debt issues unresolved. Government deficit financing continues to drive up debt and distort economic activity across the developed world. Looming above everything is uncertainty over the ultimate inflationary impact of quantitative easing, especially in the US where a growing asset price bubble is accompanied by a stagnating real economy.

Away from the spotlight, policymakers and regulators continue their efforts to create a more stable and resilient global financial system. Once again, encouraging signs can be seen. In his recent report to G20 leaders, the Chairman of the Financial

Stability Board, Mark Carney, claimed that major progress was being made:

We are building more resilient financial institutions and more robust markets through substantially strengthened international standards. We are addressing the problem of too-big-to-fail. We are working to prevent regulatory arbitrage, so that tightening regulation in one sector or region does not lead to risky activity migrating elsewhere. And we are building a framework for robust market-based finance so that markets will remain continuously open.³

Nevertheless, much remains to be done. Away from the public eye, concerns remain and efforts continue to address the underlying causes of financial instability.

Also out of the spotlight, and largely unremarked except by professionals, is the growing impact that these regulatory developments are having in the world of tax. In some cases this is deliberate, where tax is being used as a direct instrument of public policy; in others there are collateral tax impacts of initiatives whose primary focus is elsewhere. Taken together, these trends mean that tax considerations are an increasingly significant factor in the way financial services companies seek to respond to the new regulatory environment.

In this issue of frontiers in tax, we look at a number of these aspects: at the continuing political debate over the introduction of a financial transactions tax in the European Union; at the way the increasing global drive for financial transparency and automatic information exchange is transforming the international tax environment; and at the interaction with transfer pricing issues, business models and the specific impact on VAT. I think that together these articles shed interesting light on current developments.

In closing this, my first introduction to frontiers in tax, I should like to pay tribute to my predecessor as KPMG’s Chairman – Global Financial Services Tax, Hugh von Bergen. I hope that we can continue to sustain the standards he set for the publication, and that it will remain both interesting and relevant in a rapidly changing world.



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¹ Charles R Morris, *The Trillion Dollar Meltdown*, PublicAffairs, 2008 (subsequently revised as *The Two Trillion Dollar Meltdown*, 2009)

² Charles R Morris, *Comeback, America’s New Economic Boom*, PublicAffairs, 2013

³ Mark Carney, letter to G20 Leaders, *Progress of Financial Reforms*, 5 September 2013



European Financial Transaction Tax (FTT): Quo vadis?

The EU's proposed financial transaction tax continues to trace its tortuous path towards implementation. Some form of new, harmonized tax is likely to be agreed among core member states eventually. But its final shape and form remain uncertain. This uncertainty is casting a long shadow over how companies can plan to respond.

Financial transaction taxes (FTTs) have been proposed in a number of different circumstances; and many countries across Europe already have stamp duty regimes applied to various categories of financial and property transactions. FTTs can have a number of different objectives, but the proposals currently being advanced in the European Union (EU) are perhaps unique in the range – and potential inconsistency – of their targets. As we have outlined previously,¹ the explanatory memorandum to the European Commission's original proposal suggested that such a tax would:

- avoid fragmentation of the internal market by coordinating national FTTs
- ensure a fair contribution by the financial sector to the costs of the recent crisis
- ensure a level playing field between the financial sector and other sectors
- remove certain distortions from the financial markets
- provide a source of own revenue for the EU.

In its current form, the tax would be levied on financial institutions carrying out transactions in securities and derivatives, in general at a rate of 0.1 percent for shares and bonds and 0.01 percent for derivatives. Estimates of the potential yield vary, but a figure of Euro (€) 30-35 billion is frequently quoted.

Opposition

The Commission's proposals have divided member states. A core group of 11 states (the FTT-11), including Germany and France and accounting for more than 90 percent of eurozone GDP, are pressing ahead under a special procedure known as 'enhanced cooperation' – but in the face of opposition from other member states,

most notably the United Kingdom, from financial institutions and from large multinationals. Some alternative proposals would:

- exempt pension funds and sovereign bonds
- limit the FTT's application so that it operates more like a stamp duty (on shares only)
- introduce the FTT in phases.

In July 2013, the European Parliament (EP) approved the Commission's proposals, but also put forward a number of amendments. Among these are measures to:

- extend the FTT's scope to cover currency spots on foreign exchange markets
- introduce a legal title principle (i.e. no transfer of legal title without payment of FTT due)
- permanently reduce rates on repurchase agreements and temporarily reduce rates on trades in sovereign bonds and trades of pension funds
- provide an exemption for market makers.

Enter the lawyers

In the meantime, the UK launched a legal challenge to the proposals in April at the European Court of Justice. The core of the case may appear narrowly technical: it disputes the validity of the use of the *enhanced cooperation procedure* to allow the FTT-11 to go ahead without the agreement of the remaining member states as to its final form. In fact, this goes to the heart of the current design of the proposals, which would impose a tax on *both* financial institutions which are party to a trade even if only *one* was within the FTT-11; this is referred to as the *counter-party principle*. The UK explicitly

attacked the legality of what it claims is the 'extra-territoriality' this implies.

Supporting this challenge, the EU Council's legal service delivered a major blow to the proposals in September. The lawyers concluded that the tax would indeed:

- exceed member states' jurisdiction
- infringe the taxing competences of non-participating member states
- be discriminatory and lead to distortion of competition.

On the other hand, Algirdas Šemeta, EU Commissioner for Taxation and Customs Union, Šemeta commented on this challenge that the lawyers of his department confirmed that the procedure and the proposal are in line with the EU treaty.

Alternative scenarios

The political context remains uncertain. It has been argued that the result of the recent German elections will strengthen support for an FTT. Conversely, Christian Noyer, the governor of France's central bank, has said that the current proposals pose "an enormous risk in terms of the reduction of output in the FTT jurisdiction; increased cost of capital for governments and corporates; a significant relocation of trading activities and decreased liquidity in the markets."²

Algirdas Šemeta, continues to maintain that the measures proposed are legally sound and fully compliant with EU treaties. But it is increasingly likely that the proposals will be abandoned or seriously modified. A number of scenarios can be envisaged:

Abandonment

Neither the UK's court challenge nor the Council's legal advice can formally stop or delay the enhanced cooperation process. But in practice, the FTT-11 member states will be increasingly

¹ Euro-FTT: Politics over principle? frontiers in tax, July 2012

² France central bank chief says Robin Hood tax is 'enormous risk', Financial Times, 27 October 2013

cautious about pressing ahead with the tax in its current form. The Financial Times has reported that German officials have privately raised substantial concerns.³ More Machiavellian commentators have speculated that the recent legal opinion was actually intended to provide some cover to those states which are now looking to water down the proposals. Nevertheless complete abandonment, and the loss of face which it would entail, seems unlikely.

Alternative proposals

One alternative which has been put forward is a (low) flat rate tax imposed on financial institutions rather than on transactions – a financial activities tax (FAT). This could be applied to 'excessive' remuneration or 'excessive' profits. This approach was originally rejected by the Commission. But it could be argued that it would better achieve at least some of the economic objectives. However, like most taxes, it would in the end, be passed on to consumers; and it could still be avoided by judicious relocation of companies.

Removal of the counter-party principle

As we have seen, as currently conceived the FTT would apply to both legs of a transaction even if only one party was within the FTT-11. For example, if a bank in Frankfurt traded a listed stock with a UK-based insurance company, each party would be liable to the tax,

yielding 2×0.1 percent of the value of the deal to the German treasury. If the counter-party principle were dropped, only one party to the transaction would be caught, delivering 1×0.1 percent. Such a change would draw some of the sting from the current argument of extra-territoriality, but not entirely, as tax would still be levied on parties based outside the FTT-11 member states under the 'issuance principle' if they were party to a transaction involving securities issued in an FTT-11 member state, such as shares in a German company. Ironically this issuance principle is embedded in the UK's stamp duty system, so any arguments that the FTT would still be discriminatory and hence anti-competitive could raise issues as to the compatibility of the UK's own system with EU law.

National FTTs and/or stamp duties

A further alternative would see a formal FTT within the 11 supporting states give way to a patchwork of more limited unilateral measures, perhaps along the lines of the new French arrangements, perhaps more like enhanced stamp duty regimes. Even the UK has said it is not opposed to such taxes in principle, acknowledging its own very long-standing stamp duty on share transactions. Since a formal FTT-11 tax would itself have to be implemented by national legislation in participating states, it may be that the end result would be not very different, especially if the rates and structures of such taxes were harmonized.

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uncertain.

It has been argued that the result of the recent German elections will strengthen support for an FTT.

Implications

It is clear that the Commission's original target date for FTT implementation, 1 January 2014, is now unachievable. More likely is the formulation and negotiation of various compromise proposals during 2014, leading to a more limited regime coming into force after 2015.

Whatever the final outcome, the biggest impact on financial services firms is likely to be on systems, products and processes. For example, the FTT could affect processes such as securities settlement, intermediation functions or access to market liquidity. At best, FTT may require changes to business models. At worst, it could make them no longer viable. Compliance and reporting and payment obligations raise some of the biggest concerns. Companies need to keep up with developments and prepare for the potential impacts.

However, whether any of these measures contribute to enhancing the stability of the global financial system – the original context in which the G20 first proposed an FTT – remains debatable.

Whatever the final outcome, the biggest impact on financial services firms is likely to be on systems, products and processes.

³ Europe financial transaction tax hits legal wall, Financial Times, 10 September 2013.



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Automatic **exchange** of information:

The **emerging** framework of international tax **transparency**

Banks, insurers and other financial companies are typically obligated to report relevant information about their clients to national tax authorities. Traditionally, they have balanced their obligations against the responsibility to maintain customer confidentiality. However, an emerging international standard of automatic information exchange could significantly extend institutions' responsibilities. It would also require certain companies to implement new systems and processes to foster compliance.

One of the key themes in attempts at a coordinated reform of the global financial system since the economic crisis has been the pursuit of greater international transparency. In an increasingly globalized world, it is correspondingly easier for taxpayers to move assets into offshore financial institutions in order to potentially evade – tax.

The move to automatic exchange

A significant recent development has been the move towards automatic exchange of information between sovereign authorities, replacing the earlier standard of information exchange on request. At the Cannes Summit in 2011, the G20 agreed to consider exchanging information automatically for tax purposes on a voluntary basis. In 2012, in the context of implementing their response to the US Foreign Account Tax Compliance Act (FATCA), the so-called EU5 (France, Germany, Italy, Spain, UK) developed a model inter-governmental agreement (IGA) with the US providing for automatic information exchange.¹

In April 2013, the EU5 agreed to work towards a multilateral exchange facility between their countries as part of the creation of a new international standard. The G20 Finance Ministers and Central Bank Governors' Meeting in Washington welcomed these moves:

“More needs to be done to address the issues of international tax avoidance and evasion, in particular through tax havens, as well as non-cooperative jurisdictions... We urge all jurisdictions

to move towards exchanging information automatically with their treaty partners... We look forward to the Organisation for Economic Co-operation and Development (“OECD”) working with G20 countries ... in developing a new multilateral standard on automatic exchange of information, taking into account country-specific characteristics.”²

In May 2013 the OECD, which had previously revised its Tax Convention to bring it in line with the international standard on exchange of information, called on all jurisdictions to move towards automatic exchange of information and to “improve the availability, the quality and the accuracy of information on beneficial ownership, in order to effectively act against tax fraud and evasion.”³ Also in May, the EU Council agreed to give priority to efforts to extend automatic exchange of information at the EU and global level and welcomed the on-going efforts made by the G8, G20 and OECD to develop a global standard.⁴ At a meeting in St Petersburg in September 2013, the G20 announced that they expected to begin automatic exchange of information (AEoI) by the end of 2015.⁵

How will it work?

Different models of automatic exchange are possible, with different potential implications for systems and processes. In the FATCA context, the model IGA exists in two basic forms. Model 1 provides for financial institutions in the participating countries to transfer customer account information to their

domestic tax authorities, which in turn exchange details between themselves and third-party governments. This approach was adopted in part to ease legal and other concerns over directly revealing details of citizens' financial affairs to a third-party government. By contrast, Model 2 envisages direct automatic information exchange with the US Internal Revenue Service. This approach is also being adopted in the OECD's Treaty Relief and Compliance Enhancement package, which allows withholding tax relief at the source on portfolio investments.

The structure adopted has important implications for how institutions design and implement the relevant systems. But a number of general consequences are clear:

- there is an ever-increasing need for financial institutions to implement effective Know Your Customer regimes, not only for Anti-Money Laundering (AML) and sanctions purposes but now for tax reporting as well.
- this will include establishing:
 - where the customer is resident for tax purposes
 - whether an individual customer holds US citizenship
 - the type of business operated by corporate entities.

In particular, it should be noted that information gathered for AML purposes may not be sufficient to meet tax reporting requirements without additional due diligence. Remediation in respect of existing customers may very well be necessary in many cases.

¹ of Model Intergovernmental Agreement to Improve Tax Compliance and to Implement FATCA, US Treasury July 2012

² Para 14, Final Communiqué, 19 April 2013.

³ Chair's Summary – OECD Ministerial Council Meeting, 29-30 May 2013

⁴ Council conclusions, 22 May 2013

⁵ Tax Annex to the St Petersburg G20 Leaders' Declaration, September 2013

A new standard?

As the move to a new standard of AEOI gains momentum, a number of potentially significant issues still need to be resolved, including:

- if the AEOI regime is unilateral, then what is the enforcement mechanism for foreign financial institutions?
- what is the penalty structure for non-compliance and will some countries impose stricter penalty structures based on local law?
- does the AEOI conflict with applicable data protection laws?
- is the AEOI reporting requirement fully reciprocal, partially reciprocal or non-reciprocal?
- even with OECD model agreements, how much consistency will be achieved with other bi-lateral agreements already negotiated?

It is likely that reporting may need to be directed to the local tax authority. Nevertheless, the mechanism and

structure of the reporting process needs to be fully understood and synchronised if possible with existing reporting requirements.

It is clear that these new approaches are having a significant impact, and are reshaping the international tax environment and the policies of a number of important players. In May 2013, Austria, Luxembourg and Singapore were among nine countries which signed up to the OECD Tax Convention; Switzerland, one of the world's biggest offshore financial centers, followed suit in October. José Ángel Gurría, OECD Secretary-General, commented that this "sends a clear and strong signal that Switzerland is part of the community of states which consider international tax co-operation as a necessity."⁶

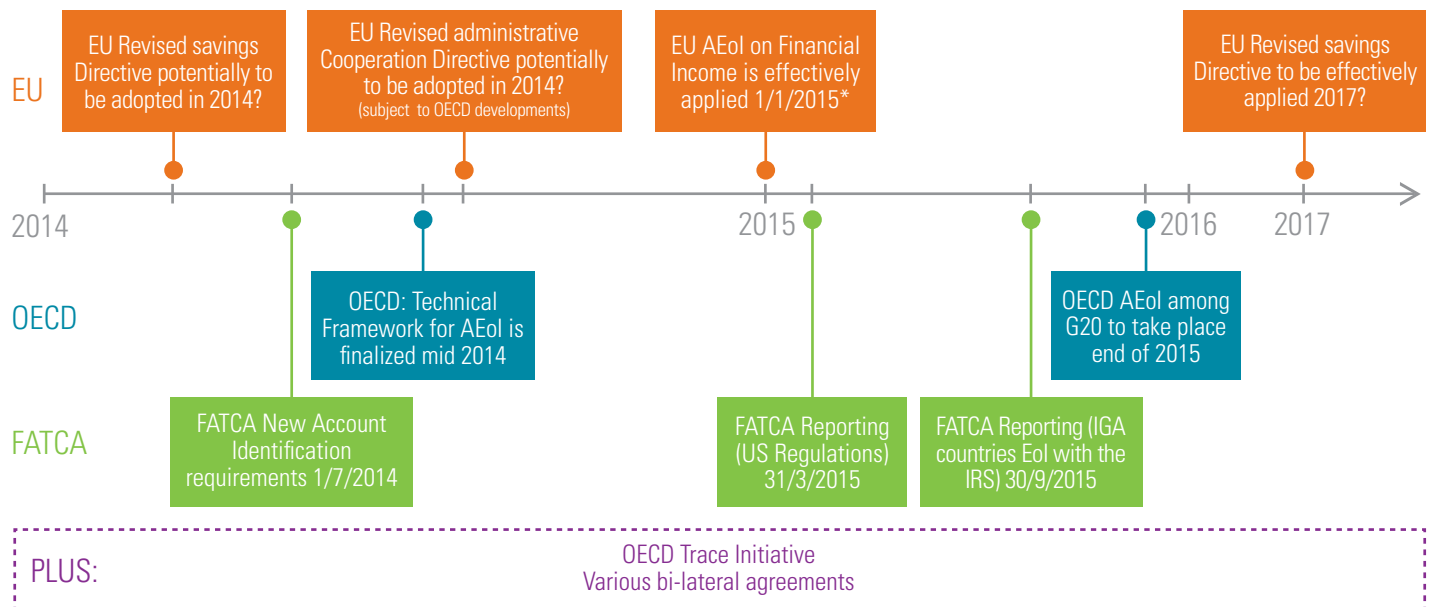
Banking secrecy, 'tax havens' and their potential use for tax evasion appear to be rapidly disappearing with these new emerging global standards. Financial institutions will be expected to play their part in facilitating the necessary AEOI.

Act now: Preparing for compliance

As specific measures continue to evolve, financial services companies will need to develop and implement appropriate responses; it is important that they maintain awareness of proposals under discussion and their potential implementation timetables (see chart) in order to formulate effective steps that may need to be taken.

Many systems and processes can be reviewed now to determine whether they can be readily modified. In particular, many financial companies are presently implementing their responses to FATCA, and it is important that any new measures to satisfy AEOI regimes are integrated with the FATCA process, to foster consistency and avoid duplication. The tax function needs to work closely with other functions such as AML and compliance to determine tax requirements are accurately interpreted and built into processes affected.

... And the timeframe



Note: * by virtue of the Administrative Cooperation Directive
Source: Illustration created by KPMG International

⁶ Switzerland signs Multilateral Convention on Mutual Administrative Assistance in Tax Matters, OECD 15 October 2013

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Key areas for review include:

- onboarding forms and policies and procedures will need to be re-designed to capture necessary data
- specific new tax forms introduced by tax authorities will need to be set up for information capture and transmission
- IT systems will need to be updated, and so should benefit from review, updating and data cleansing in readiness
- monitoring arrangements to capture changes in customer information and status can be developed alongside periodic reviews done as part of AML compliance.

An assurance and attestation framework should be designed to:

- determine that the firm is compliant with the regulations

- monitor compliance and identify instances of non-compliance
- provide a governance and reporting structure that enables divisions and legal entities to document, record and report on their compliance; and therefore
- give sufficient comfort to key stakeholders that they can attest to the firm's compliance.

Financial services companies face significantly increasing regulatory and reputational risk, and corresponding risk of financial penalties. They are also under growing scrutiny from external stakeholders. This means that boards are taking much greater interest in these areas too, a trend which we expect to continue. Consequently, it is increasingly important that companies should be developing the necessary frameworks now to facilitate the smoothest possible implementation of specific measures when they are required.

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Developing business models and structures:

The new tax and transfer pricing environment

Financial services companies are restructuring and reorganizing. This is in part a result of attempts to build sustainable long-term business models for the post-crisis environment; and it is in part also a direct result of regulatory pressures. Banks and investment managers need to develop appropriate strategies for the future. In doing so, it is vital that they ensure tax considerations are given full weight, especially given the focus on Base Erosion and Profit Shifting (BEPS).





Introduction

A number of forces are making transfer pricing issues – and the organizational, structural and operational decisions which drive them – increasingly important. Since the financial crisis, fiscal agencies have focused greater attention on extracting ‘fair’ tax revenues from transfer pricing arrangements especially through the BEPS project. Rising protectionism and competition between jurisdictions are spurring more intense scrutiny by individual tax authorities.

At the same time, regulatory authorities are increasingly imposing change in the pursuit of a more stable global financial system: to shrink balance sheets, to increase capital and liquidity, to simplify structures to allow orderly resolution, to increase transparency and limit the attractions of ‘tax havens’.

All these developments carry potential implications for intra-company cross-border flows and they have the potential to attract more intensive scrutiny of transfer pricing issues by fiscal authorities. Unless the tax issues are considered thoroughly as key aspects of corporate strategy, alongside those of structure and operations, significantly adverse tax results may follow. The argument can be illustrated by considering some current issues in banking and in investment management.

Bank tax and transfer pricing issues

Political leaders and regulators are driving large, multi-national banks to hold much higher levels of capital. In December 2011, the Basel Committee on Banking Supervision published final rules to increase the quality and quantity of capital required to be held by internationally active financial institutions. Regulators in both Europe and the US require banks and certain holding companies to ‘maintain a minimum amount of contingent capital that is convertible to equity in times of financial distress’; and generally requires banks to replace certain non-equity securities with instruments that function more like equity.

As a result of these regulatory pressures, contingent convertible securities (‘CoCos’) are rapidly becoming very popular. These instruments are generally issued as long-term, subordinated debt, but automatically convert into equity – strengthening the capital base – when the bank’s capital declines to a specified level, or when the regulator deems the company’s viability is under threat. Major banks which have issued CoCos over the last couple of years include Credit Suisse (2013 & 2011); Barclays (2013, 2012 & 2011); Bank of Cyprus (2011); Bank of Ireland (2011); Lloyds Banking Group 2009); Rabobank (2010).

CoCos raise novel tax implications. Their particular attraction arises when their equity aspects make them qualify against regulatory capital requirements, while their debt characteristics mean the associated interest payments might be tax deductible. Interest on convertible debt is generally treated as deductible. However, where convertibility is fixed and predetermined, interest may not be deductible, since unlike ‘true’ debt the purchaser has no right to a definite sum on maturity. Under the US law, interest deductions are disallowed if a substantial portion of principal or interest may be paid in, converted to, or otherwise determined in reference to equity at the option of the issuer or the holder.

Where CoCos are issued in one jurisdiction (e.g. the UK) and held by investors in another (e.g. the US), they may be treated as debt in the first jurisdiction and as equity in the second, resulting in a double benefit: deductible interest and favorable capital treatment in the UK and attractive dividend yield in the US. Regulators are tending to look favourably on new forms of risk-bearing capital such as CoCos because they help strengthen bank balance sheets. However, fiscal authorities are increasingly focusing on restricting the abuse of artificial BEPS; this may lead them to change the tax rules in respect of hybrid instruments.¹ It is unclear, then, whether and to what extent CoCos may continue to enjoy the tax benefits of debt for the payer.

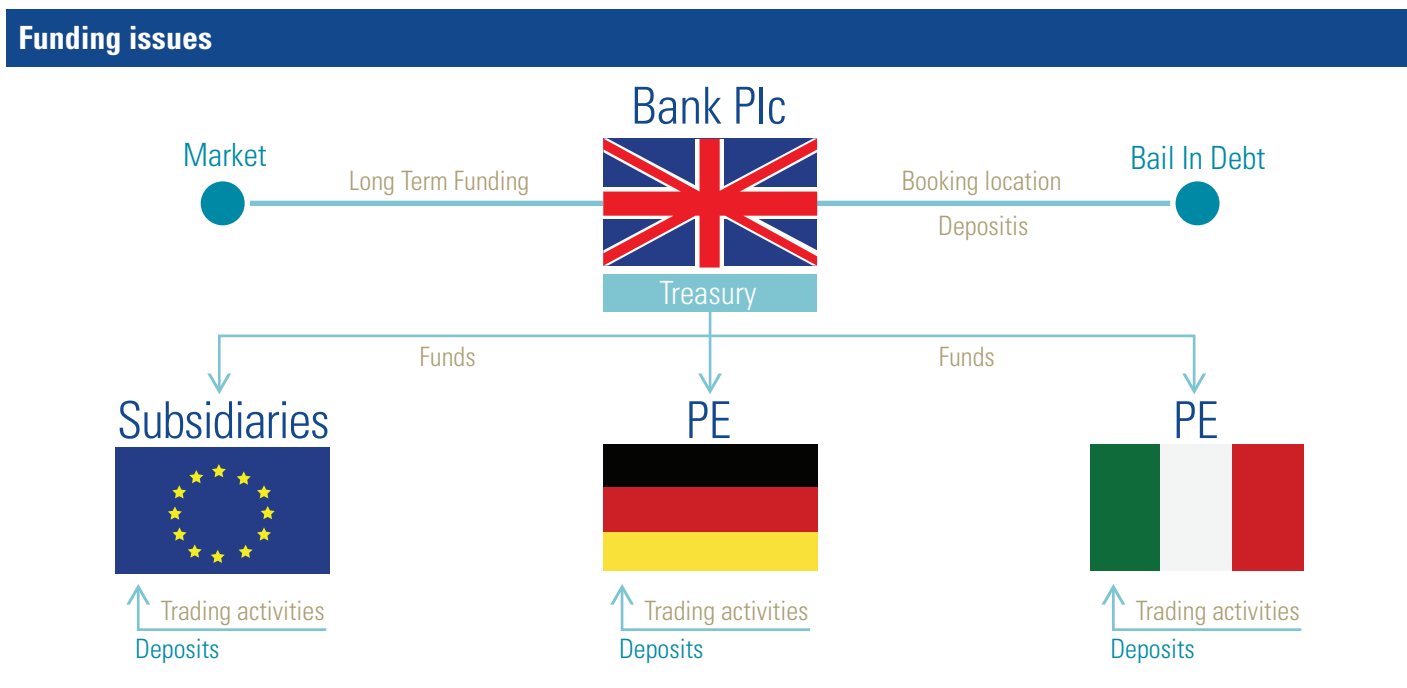
Financial services companies are responding to the new environment with a range of changes to business models and structures, for example through off-shoring, outsourcing, consolidation and rationalization.

Increasing bail-in capital through convertible securities also raises significant cross-border transfer pricing issues. If interest-bearing instruments are raised at the group parent level, and retained there, this will permanently depress the parent's profitability. Retaining a permanent structural loss-maker at group level distorts

assessments of value and performance: rational economics as well as fiscal pressures imply that the cost of the additional regulatory capital should be transferred through the group. However, this raises critical issues of how risks and benefits should be priced and transferred across borders and between jurisdictions. For example, should

differential credit ratings be applied between a parent and subsidiary? Should subsidiaries in territories with weaker – and riskier – economies, where capital raising is more expensive, pay an additional country risk premium?

The diagram below illustrates in simplified form some of the structural and cross-border implications.



Source: Illustration created by KPMG International

Fiscal authorities everywhere are seeking to maximise tax revenues. Those in weaker economies, in particular, are likely to resist the imposition of additional inward cost transfers which reduce their domestic tax takes. The potential for competition between national authorities is clear, and disputes are likely to increase.

Banks are unlikely to find a solution which suits all parties. Instead, they will come under increasing and

contradictory pressures. It will be important to develop a clear strategy in full awareness of the regulatory, tax and operational implications. The aim should be to get ahead of the game by making the necessary structural changes when raising the additional bail-in capital and other longer term debt for liquidity purposes.

The broad direction of current developments is clear: regulators are increasingly focusing on each legal

entity carrying its own liquidity and capital. The key strategic challenge therefore is to determine a clear position – whether separate legal entities, permanent establishments or branch structures – and create a defensible case for capital structures, interest charges and the associated results. Tax and Transfer Pricing considerations need to be at the heart of these decisions over the coming period.

¹ cf: Action Plan on Base Erosion and Profit Shifting, OECD 2013

Investment management: Substance not form increasingly important

Regulatory pressures are imposing increasing change on the investment management sector in the wake of the financial crisis. Concerns over global financial stability are less acute than they are in the banking sector; however, the transparency and consumer protection agendas are equally as significant. And the investment management industry is also subject to general public and political concerns over what is perceived as improper tax avoidance and use of tax havens like the Cayman Islands.

In Europe, a key measure is the Alternative Investment Fund Managers Directive (AIFMD).² This came into force in July 2011, giving Member States two years to transpose in local law. Under the Directive, all alternative investment fund managers (AIFM) established in the EU or which manage EU alternative funds or which market AIFs into the EU are subject to a new authorizing and monitoring regime. Fund managers will have to apply for authorization in order to manage an Alternative Investment Fund if the amount of assets under management exceeds certain thresholds. Managers authorized in one EU jurisdiction will be eligible for 'passports' which will allow them to offer management and marketing services throughout the EU.

AIFMD will drive a number of changes in corporate structure, either directly or because companies will find them desirable in the new environment. For example, the passporting provisions create an opportunity for groups to

simplify their corporate structures – using one legal entity to perform roles in all jurisdictions through branches. Marketing and investment management activities can be performed in any European jurisdiction, exploiting regulatory approval in the 'host' EU nation.

The Directive also places greater emphasis on the risk management role: risk management needs to be undertaken directly by the AIFM, and must be organizationally separate from portfolio management. Identified staff such as individuals who are able to influence significant risks assumed by the fund will have to have part of their remuneration deferred. The administration of this deferral may be more easily achieved if all employees are employed by one legal (AIFM) entity, rather than many entities seeking to administer the regulatory requirement individually.

Portfolio management can still be delegated. However, the fund manager needs to retain overall responsibility, sufficient seniority and control to be able to oversee the functions delegated.

These issues are focusing closer attention on the different components of the investment management value chain, and on ensuring that the form and substance of organizational structures are more closely aligned, more effectively regulated and appropriately taxed. The OECD Action Plan on BEPS³ is likely to lead to greater scrutiny of the substance underlying offshore structures and individual functions such as management, marketing and ownership of brands and intellectual property. Country by country reporting will shine a spotlight where profits are located in low tax jurisdictions with

minimal substance. Tax authorities are likely to require that profits be more closely aligned with the relevant components of the value chain.

Where AIFMD stresses new or enhanced functions, as we have seen in the case of risk management, it is appropriate that firms attach an economic value to the function and ensure that it is charged out accordingly. However, the principle is easier to state than to translate into transfer pricing arrangements which will hold water in a BEPS environment.

These considerations mean that investment management companies face a series of novel challenges:

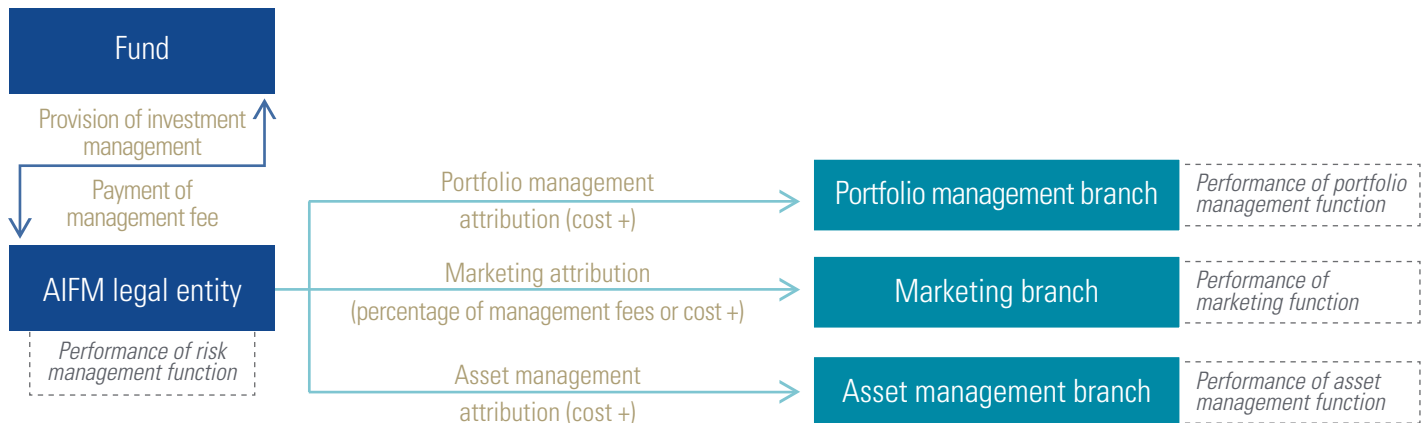
- reconfiguring organizational structure and the location of functions such as marketing and management
- reflecting the changes to the value chain which follow from regulators' stronger focus on functions such as risk management
- aligning the substance of organizational functions with the theoretical structure to ensure that profits are correctly located
- determining the transfer prices for various functions across the organization in a defensible manner so that fees charged for marketing or management reflect services delivered.

The EU passporting provisions offer some flexibility. For example, opportunities around the new emphasis on risk management, but impose an additional layer of complexity when tax considerations are taken into account. Effective arrangements for group domicile and the location of different functions can help minimize the overall tax burden, avoid double taxation and in a number of cases limit liability to VAT.

² cf AIFMD: Beware the tax impacts, *Frontiers in Tax*, December 2012

³ *ibid*

A typical passported AIFM structure



Key tax aspects

- Location of AIFM in the tax effective jurisdiction will help minimize overall tax burden on the Group
- Profits of the branches would not be doubly taxed when AIFM is located in the UK, the Netherlands or Ireland
- Currently, attributions between a branch and the legal entity of which it is part are not treated as a VAT-able supplies

Source: Illustration created by KPMG International

Conclusion

The lesson is clear: tax considerations specifically the impact of BEPS, need to play an integral role in the development of strategy in responding to current regulatory developments.

There are risks unless existing structures are adapted to the new environment:

- for banks especially in the areas of Transfer Pricing models for capital and liquidity; and
- for Investment Managers, the transparency brought by country by country reporting, where profits are allocated to countries with insufficient substance.

However, taking tax, transfer pricing and VAT into account in the design stage should enable business models to be constructed that meet regulatory requirements but are still efficient from a tax perspective.

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Optimizing VAT and Transfer Pricing in a changing world

As we have seen elsewhere in this issue, banks and other financial services companies are restructuring and reorganizing. Regulatory developments are largely driving this significant structural change. Political leaders are committed to creating a more resilient, stable, and competitive banking sector; reducing the severity of a potential future financial crisis; and protecting taxpayers in the event of such a crisis.¹ There are significant tax issues associated with these regulatory changes, with some of the key impacts arising from the potential VAT and Transfer Pricing implications of the related restructurings. Four important current developments are outlined below which companies should think carefully about and how then to respond and mitigate any potential tax implications.

Ring-fencing retail banks

One of the key measures being pursued in many jurisdictions is the separation of retail banking from investment and wholesale banking activities. In the UK, the Financial Services (Banking Reform) Bill is designed

to implement the recommendations of the Independent Commission on Banking (ICB) to this effect.²

The separation and ring-fencing of retail banking activities carries a number of implications from a VAT perspective. By way of background, banks typically operate as a VAT group. Supplies between UK VAT

group members are disregarded for VAT purposes with no VAT being chargeable thereon. Further, as confirmed in the FCE Bank case,³ supplies between head-office and overseas branches also do not constitute supplies for VAT purposes. In the UK, VAT grouping extends to allowing an overseas entity with an establishment in the UK to be a member of a UK VAT group.

¹ cf. Cm 8660, Banking reform: draft secondary legislation, UK Treasury July 2013

² Independent Commission on Banking, Final Report, September 2011

³ Services rendered by a head office to a branch in another Member State are not taxable services for VAT, even if the cost of such services is allocated to the branch, Advocate General opinion, Case C-210/04, September 2005



Given that financial services entities are generally not in a position to recover all the input VAT they incur, VAT grouping (and branch structures) represent avenues for reducing the amount of input VAT within a corporate group. Clearly, removal of a member from a VAT group or the transfer of activities for an existing member to a separate company outside the VAT group

could impose significant additional VAT costs on services provided between corporate group members. It may also result in the need to consider transfer pricing on intra-group transactions that previously did not exist. In its most recent consultation on the draft legislation for introducing ring fencing in the UK, the only reference to VAT is in para 57 of

the explanatory notes where it states that the impact of removing ring-fenced banks from their VAT groups would have to be considered. In this regard, the UK government recognizes that its proposals may imply major additional operational costs, suggesting a figure of up to British Pound (£) 105 million per bank per year.

Once again, issues of VAT and of corporate structure are closely intertwined in the development of appropriate responses to regulatory change.

Although, it may in principle appear perverse to manufacture additional tax cost as a side-effect of measures to improve financial stability, this is nonetheless a potential fallout of the ICB proposal. Where banks continue to share functions and capabilities (e.g. IT) in a post separation environment, there will be considerable challenges in structuring to mitigate the VAT consequences. Maximizing available VAT exemptions and maximizing input VAT recovery through the use of appropriate partial exemption methodologies, in addition to optimized VAT group structures, will be necessary. In addition, consideration of appropriate transfer pricing policies and methodologies will be required.

AIFMD

Elsewhere in this issue we consider how the European Alternative Investment Fund Managers Directive (AIFMD) is creating a radically new environment for the investment management sector.⁴ The introduction of AIFMD brings with it significant potential VAT implications which need to be reflected upon. The first issue relates to the VAT liability of services provided to Alternative Investment Funds (“AIFs”) and, whether similar to traditional fund vehicles (e.g. UICs funds), those supplies would fall to be VAT exempt. This particular point has not yet been bottomed out with no specific guidance coming from HMRC in relation to the VAT liability of the types of funds caught by AIFMD. Secondly, AIFMD provides Alternative

Investment Fund Managers (“AIFM’s”) with a “marketing passport” for EU AIFs, in addition to a “management passport” providing a legal basis for AIFM’s to manage fund vehicles cross-border. The introduction of these passporting functionalities will increase the amount of cross-border activity – this will create opportunities to structure in VAT-efficient ways, for example by taking advantage of VAT group arrangements in relevant Member States or by taking advantage of the Member States’ non-harmonised practical approach regarding the scope of the VAT exemptions. It may additionally provide Corporate Tax benefits through the use of branches and any exemptions on taxing non-domestic income. Transfer Pricing will however be necessary when determining how to value either intra-group transactions, or the attribution of profits to branches.

Once again, issues of VAT and of corporate structure are closely intertwined in the development of appropriate responses to regulatory change.

VAT group benefit under threat?

Where the regulatory environment is developing in a number of directions at once, from a pure VAT perspective, one of the key uncertainties currently is over the future of the VAT group provisions themselves as they apply to the treatment of branches.

As we have noted, the present interpretation of VAT law in the EU allows that transactions between parts of the same corporate entity – for example between head office and branch – carry no liability to tax. However, a current referral by Sweden to the EU Court of Justice (CJEU) questions whether this is valid where the branch receiving a charge passed on from its headquarters outside the EU is itself within a VAT group. Specifically, the CJEU has been asked:

“Do supplies of externally purchased services from a company’s main establishment in a third country to its branch in a Member State, with an allocation of costs for the purchase to the branch, constitute taxable transactions if the branch belongs to a VAT group in the Member State?”⁵

The Court has yet to give an opinion. However, the analysis previously advanced by the Commission was that there was a taxable transaction in these circumstances. Consequently, if the CJEU sustain the Commission’s view it would imply that VAT would become chargeable on such supplies. The Commission argues that a VAT group is a legal fiction in which all members lose any individual identity and, crucially, any possibility of remaining part of any other legal entity. They state:

“by joining a VAT group, the taxable person becomes part of a new taxable person, the VAT group and, consequently, dissolves itself for VAT purposes from its fixed establishment located abroad.”⁶

If the CJEU concludes that the supply in the Swedish case is indeed liable to VAT, the implications could be profound for financial services and other VAT exempt companies. The impact could be especially severe in the UK, with its large financial sector and extensive VAT group provisions with their extra-territorial reach. Transfer Pricing would continue to be applied in the same way, irrespective of whether VAT grouping continues or not. However, its impact will clearly have a significant indirect tax impact if grouping provisions disappear.

Interestingly, the recent CJEU decision in *Credit Lyonnais* could be viewed as providing a signal to how the European judiciaries currently view VAT group member status for VAT purposes. In that case a head-office and branch were effectively viewed as separate persons for VAT purposes for the purpose of determining recovery of input tax in different jurisdictions.

⁴ Developing business models and structures: the new tax and transfer pricing environment

⁵ The *Skandia America Corporation USA* case, C-7/13

⁶ *ibid*

OECD VAT/GST guidelines

The OECD has become concerned in recent years that the development of VAT and other forms of goods and services tax (GST) regimes has increased the potential for double taxation and unintended non-taxation. In 2006, the organization began to develop guidance for governments on applying VAT to cross-border trade.⁷ In February 2013 it published for comment a draft consolidated version of these guidelines, which build on two core principles:⁸

- the *neutrality principle*, whereby VAT is a tax on final consumption that should be neutral for business
- the *destination principle*, whereby internationally traded services and

intangibles should be taxed in their jurisdiction of consumption.

If generally adopted, the destination principle could have major implications for the taxability of services acquired by a headquarter and supplied onward to multiple branches.

Currently, where there is a single *supply* deliverable to a number of branches under a global contract, the entirety of the service is taxed according to the location of the branch most closely connected to the *supply* and the onward branch-to-branch allocations are not subject to VAT. The OECD guidelines would mean that internationally traded services would be taxed according to the rules of the jurisdiction of the place of *consumption*. When a supply is made to a legal entity that has establishments in more than one jurisdiction, the OECD

proposes a two-step method (the 'recharge method') to allocate taxing rights to the jurisdictions where the customer establishments using the service are located.

The effect for multinational financial institutions with branches in the EU and other jurisdictions with EU Model and VAT systems would be to bring relevant services within the scope of VAT, with potentially substantial costs. This could represent significant additional VAT cost for financial services entities if not considered properly. Companies will have to review the structure, location and direction of services provided, with potentially profound consequences for operating models. Transfer Pricing will again have an impact on how the attribution of this expense is made to the branches and therefore will in part determine the VAT cost.

Conclusion

Financial institutions face a raft of new regulatory requirements which will drive widespread changes to corporate structures and operating models. Many of the necessary responses will have the collateral transfer pricing and VAT consequences even if these are not immediately apparent. Companies will need to ensure that their evolving strategies take account of the tax consequences to minimize any unanticipated tax costs.



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⁷ The OECD International VAT/GST Guidelines, 2006

⁸ OECD International VAT/GST Guidelines, Draft Consolidated Version, Invitation For Comments, February 2013

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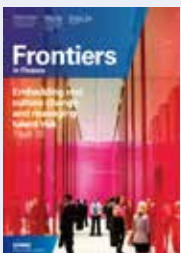
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To learn more about the impact that regulation is having on the hedge fund sector, KPMG partnered with the Alternative Investment Management Association (AIMA) and the Managed Funds Association (MFA) to conduct a comprehensive, global survey of hedge fund managers around the world.



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Today's economic bright spot, as ever, seems to be the Asia Pacific region. It has escaped relatively unscathed from the global economic crisis and continues to offer evidence of growth. In this edition we focus our attention on key tax issues in this dynamic region.



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The on-going turmoil in the financial markets is driving major change tax regimes around the world and much structural change in the fund and hedge fund industry. It will be critical for these types of companies to keep on top the changes and ensure that their systems and processes are keeping in line. KPMG International has once again collaborated across our member firms to provide you with the annual International Funds and Fund Management Survey and International hedge funds survey that can help you navigate the changing environments in which we work.



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In this publication we provide an overview of the AIFMD (Level I and Level 2) legal and regulatory framework that governs the alternative investment fund industry in the EU that has, since July 2013, reshaped the operations of managers and the alternative funds they manage.



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Designed by Evalueserve.

Publication name: Frontiers in Tax – December 2013

Publication number: 130834

Publication date: December 2013