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November 2011

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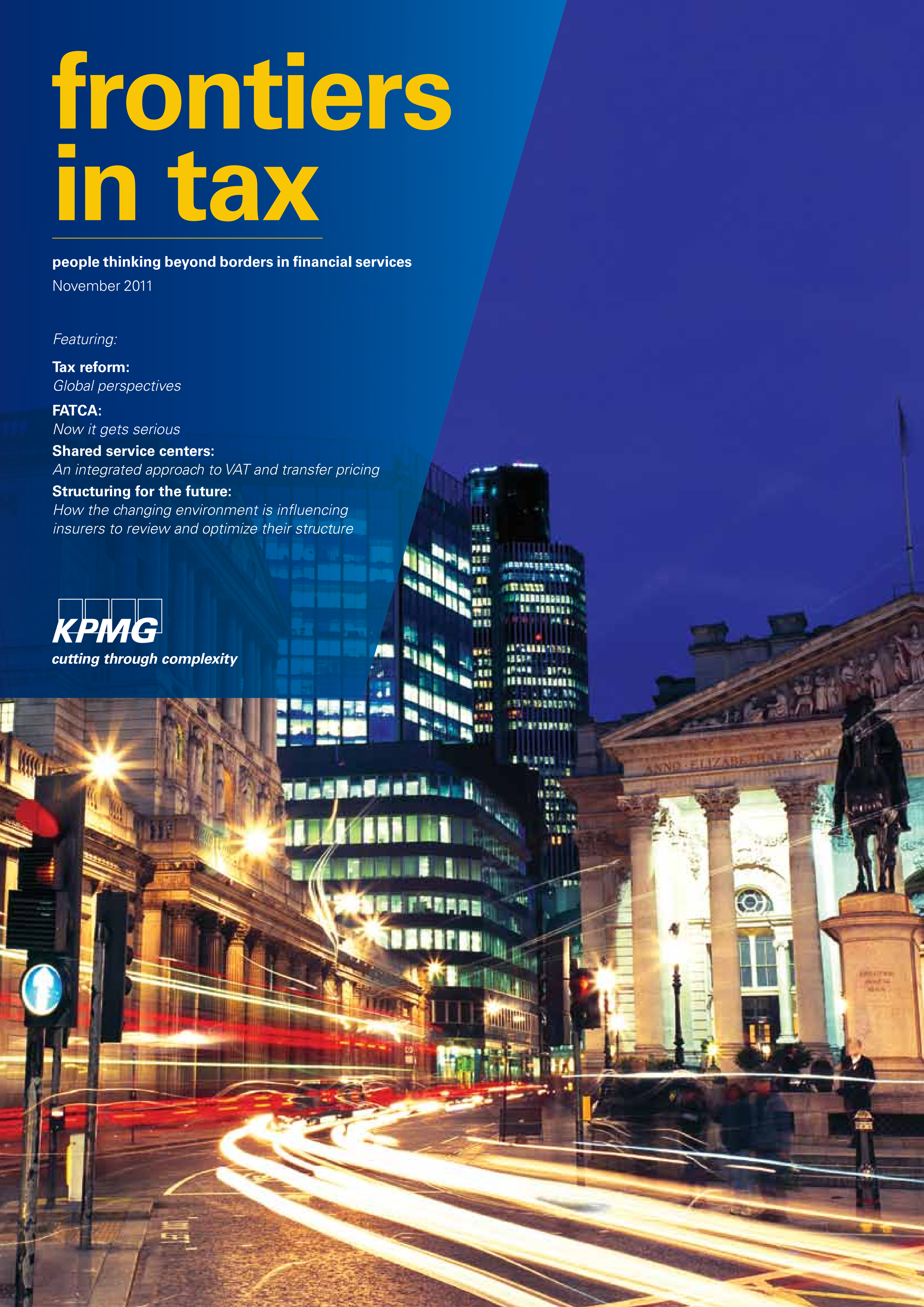

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Introduction

The financial environment doesn't feel encouraging. The eurozone crisis is now dominating the headlines; in the US, despite the administration's success in negotiating an agreement to head off paralysis and default, there is growing talk of a second recession and across the globe, policy-makers are struggling to tackle budget deficits and rein in spending.

This inevitably leads to a much closer focus on tax, one crucial factor in the national income-expenditure equation. The temptation to turn to tax rises to balance budgets is clear, but it is a quick fix only and likely to lead to future stagnation. Competitive and predatory corporate tax policy could lead to protectionism and mutual impoverishment. Getting the balance right will be critical.

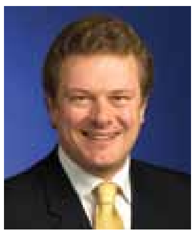
In this context, three of KPMG's global tax specialists contribute a review of emerging policy on the taxation of overseas branches and subsidiaries in three key jurisdictions. The debate over the real economic impact of different approaches is important; equally so is the pragmatic issue of what multinational companies will tolerate without rebelling in one way or another.

The US' Foreign Account Tax Compliance Act (FATCA) affords another perspective on a related issue. Unfortunately, many firms operating in the global financial services sector have as yet little appreciation of the extent to which it will impact on them. The fact is that the implications are profound. Any fund or investment manager who invests in US assets, wherever their clients are domiciled, will be potentially caught by its provisions. While the express purpose of the legislation is to drive disclosure of the details of account holders and help eliminate US tax abuse, the practical lever to achieve this will be punitive tax levies on non-compliant firms.

The transfer pricing issue is one which has traditionally exercised fiscal authorities. It is one which is intimately implicated in any decision to establish a shared service centre (SSC) in an overseas jurisdiction. However, along with associated tax issues such as corporate taxation and VAT, transfer pricing is one which is too often ignored by companies in the planning stage. Getting it right can make a huge difference to the financial benefits – or otherwise – of SSCs.

Finally, the insurance industry continues to be subject to major change, facing further rounds of fundamental regulation. The challenge to business operating models and capital and organizational structure is immense. We look at how insurers are engaging with the process of optimization under such constraints.

The world of tax is as complex and rapidly-changing as ever. We are going to continue to see the internationalization of tax issues, with consequent multiple international agreements and tensions. The articles in this issue of *frontiers in tax* explore some of the issues arising. I hope you find them stimulating and helpful.



Hugh von Bergen
Head of Global Financial Services Tax

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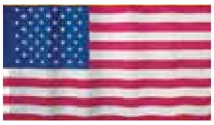
Tax reform
Global perspectives

In the wake of the financial crisis, governments across the developed world are struggling to eliminate budget deficits, restore national finances and stimulate growth and investment. Attention is naturally focusing on how best tax regimes can be reformed to serve these ends, including how the taxation of offshore earnings could be rationalized.

In considering the treatment of investments made by domestic companies in foreign operations (branches and foreign subsidiaries), a number of issues are likely to determine the taxation of foreign profits:

- How best to maintain an internationally competitive tax system?
- Whether the home country should tax some or all foreign profits?
- Of particular importance to banks, should foreign branches be taxed in the same fashion as foreign subsidiaries?

Here, we review how the debate is being pursued in three key jurisdictions, the US, UK and Japan. In each a territorial system of some sort has been adopted or is being considered for adoption.



US

In the US, the challenge of reducing the budget deficit has raised the question of how much revenue should be raised and what form taxation should take. A good part of the discussion on corporate taxation has focused on how to tax the offshore profits of US multinationals. In general, some commentators in the US tend to favor a territorial system whereby the offshore profits of US companies can be brought back to the US tax-free. Under the so-called 'capital import neutrality' theory (which supports a territorial system of taxation), the competitiveness of US multinationals is thought to be enhanced, thereby benefitting the US economy as a whole. Equally important, a territorial system would enable multinationals to move offshore profits back to the US without a tax penalty, where they could then be invested, creating additional US jobs.

Conversely, other commentators argue that the current system of taxation under which multinationals are not taxed on their active operating earnings until they are repatriated to the US encourages US companies to invest offshore where their earnings are taxed (often artificially) at a low effective rate. They argue this moves jobs out of the US. Under the so-called 'capital export neutrality' theory, investment decisions are to be made without regard to tax considerations. Under a pure version of this theory, this can only be accomplished by taxing foreign earnings currently (even before they are repatriated to the US) so that the earnings of a US group are taxed at the same rate of tax irrespective of where in the world they are earned.

A number of specific issues arise in the debate over the two approaches:

- **Transfer pricing –** Most of the world operates under the 'arm's length' standard for judging the appropriate level of charges between related taxpayers. This is the bedrock on which the OECD transfer pricing guidelines are based. Increasingly, some tax authorities are questioning whether this standard works effectively in the real world, pointing to the fact that a disproportionate amount of a group's profits often ends up in a foreign jurisdiction with a low effective rate of tax. Hence, some countries are beginning to look at allocation formulas for determining the proper distribution of profits. Purportedly, this would take subjective considerations out of the transfer pricing debate.
- **Allocation of capital –** This is of particular importance in a territorial system because capital comes free of an interest charge. Hence, a subsidiary that is funded largely with capital will be more profitable than one funded with debt. All countries address this issue in some fashion. The US government has typically thought that capital should be allocated 'fungibly' (i.e., in proportion to the assets held by different companies).
- **Taxation of offshore passive income –** No jurisdiction is willing to permit a foreign subsidiary to accumulate earnings by lending into the home country or other countries with operating subsidiaries in order to reduce the effective rate of tax on these earnings and then repatriate these earnings tax-free to the home country. The US will have some form of controlled foreign subsidiary (CFC) rules to deal with this problem.
- **Stewardship expenses –** These expenses involve supervising the operations of CFCs, but typically the benefit is purely for the shareholders of the parent company. Hence, they normally cannot be charged to foreign subsidiaries. Some countries permit these expenses to be deducted in the home country, some do not permit their deduction since they relate to tax-exempt foreign earnings, and some level an arbitrary tax of 5 percent against foreign distributed earnings to off-set this benefit. No decision has been made in the US on how to treat these expenses.

Most of the **world** operates under the **'arm's length'** standard for judging the appropriate level of **charges** between related **taxpayers.**

UK

In the UK, some of the same themes arise, in particular a concern about the budget deficit and a desire for new sources of revenue. Set against this is a desire to make the UK a competitive business location. We have already seen a significant incremental change in the tax burden on banks in the form of the UK's bank levy, but corporate tax rates continue to fall, even for banks. Despite the UK budget deficit, we are seeing sizeable reductions in the UK corporation tax rate, which will fall to 23 percent by 2014. The general approach to tax policy tends to be rather more pragmatic than driven by the intellectual debate on capital export neutrality versus capital import neutrality in the US.

There are three particular areas where the taxation of the world-wide income of UK groups is undergoing fundamental change:

- The UK has just introduced a branch exemption. A UK company will in future be able to make an irrevocable election to exempt the profits of all of its overseas permanent establishments from UK corporation tax, subject to various anti-avoidance rules: it will be necessary for the permanent establishments to have substance; in addition, where the branches have incurred losses in years leading up to the election it will be necessary to recoup some of the losses before electing into the regime.
- The UK is attempting to make its CFC regime more attractive to multi-national groups, following some high profile emigrations (or 'inversions') of large UK groups to overseas locations. In the future, it should be possible for a greater proportion of the income of overseas subsidiaries to be exempt from UK tax.
- Specifically for banking groups the bank levy (introduced with effect from 1 January 2011) will apply on a world-wide basis to the balance sheets of all branches and subsidiaries: this is potentially creating a significant fresh disadvantage to locating a global banking group in the UK.

Japan

The **taxation** of branch **profits** is likely to be an area of **future legislative** activity, particularly in view of the **UK decision** to introduce an exemption for **branch profits.**

Japan also has a high budget deficit that needs to be plugged through increased tax revenues. The March 11 earthquake, the tsunami and the Fukushima nuclear accident have added to the pressure to look for new sources of tax revenue. The immediate impact has been a postponement of the proposal to reduce the headline corporate tax rate from 41 percent to 35 percent and an open discussion of increasing the consumption tax from the current 5 percent to 10 percent or more. Some legislators are in favor of reducing the headline corporate tax rate to promote Japanese competitiveness with places like Hong Kong and Singapore, and introducing a 'reconstruction tax' for a temporary period; other groups favor postponing the reduction in the headline rates by a few years.

There has been no significant debate on capital export neutrality versus capital import neutrality, but Japan did introduce a foreign dividend exclusion regime in 2009 to encourage Japanese companies to repatriate their foreign earnings. These rules provide for 95 percent of dividends to be excluded from taxable income (the remaining 5 percent is taxable) for a shareholder owning more than 25 percent of a foreign corporation for six months or longer. These rules are applied in conjunction with the CFC rules. Broadly, the exemption is available to foreign corporations that have an effective tax rate of more than 20 percent or meet some of the other conditions to avoid having their earnings taxed under the CFC regime. The rules have encouraged many Japanese manufacturing groups to repatriate earnings from overseas but there have been no instances of corporate inversions yet in Japan; in practical terms, these are unlikely owing to cultural and language issues.

Currently, these foreign dividend exemption rules do not apply to foreign branches of Japanese corporations, which are taxed on worldwide income. (Japan determines the residency of corporations based on the location where the corporation has been legally established and not based on the place of their effective management, which is the standard used in many jurisdictions.) The taxation of branch profits is likely to be an area of future legislative activity, particularly in view of the UK decision to introduce an exemption for branch profits.

There is no special tax on banks like the UK's bank levy. As a practical matter most Japanese banks (and many Japanese corporations) do not actually pay any corporate tax due to tax loss carry forwards which can be used over seven years. There was a proposal to limit the use of tax losses to offset only 80 percent of taxable income but this has not yet been passed into law. As in the UK, in the medium term the burden of taxation is going to shift from corporate taxes to indirect taxes (i.e. consumption tax) and increased taxation on individuals in higher income brackets.

There was a proposal to limit the use of tax losses to offset only

80%

of taxable income but this has not yet been passed into law.

Conclusion

The fiscal pressures on national treasuries in these countries are severe. Many commentators would argue that reducing public expenditure would lead to more sustainable recovery than increasing taxes. Nevertheless, tax has a key role to play. Tax authorities in all three countries are exploring variations of measures to extract more tax revenues from their own companies' overseas operations. The challenge will be to achieve this without provoking a damaging round of beggar-thy-neighbor.

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DELL

FATCA

Now it gets serious

It appears that much of the financial services sector continues to misunderstand the implications of the US Foreign Account Tax Compliance Act (FATCA).[1] Specifically, we continue to hear potentially impacted entities claim that FATCA isn't relevant to them because they don't have any US investors. While a common myth, FATCA will impact any fund or investment manager who invests in US assets on behalf of their clients, regardless of their domicile.

[1] Passed as part of The Hiring Incentives to Restore Employment (HIRE) Act, March 18, 2010

FATCA is US legislation designed to curtail certain **offshore tax** abuse by US **taxpayers** that currently are able to avoid **disclosure** to the **IRS** by **investing** through offshore accounts and/or entities.

The specific requirements for FATCA compliance remain largely unknown. In a recent KPMG study called *FATCA and the funds Industry: Defining the Path*, 58 percent of the global fund promoters interviewed stated that their level of analysis and research of FATCA for their group is limited to general awareness, while only 10 percent state that they have conducted an impact analysis on their business. In April of this year, the US Internal Revenue Service (IRS) issued a second set of preliminary guidance, further outlining how it believes the new FATCA regime might operate[2]. While the Notice does address some industry concerns, certain unexpected provisions (e.g. the new documentation rules for pre-existing private banking customers and the expansive application of the pass thru payment concept) have been the most recent topic of debate. This is especially true given the legislation's looming effective date. Consequently, it is imperative that affected entities fully understand the implications FATCA will have on their business and operating models. Those who wait for definitive guidance are likely to find they will have inadequate time to react, even with the recently issued transition guidance[3]. In addition, and equally significant, there are still opportunities for the industry, working together, to seek clarification and perhaps influence the new regime's final requirements.

Background

FATCA is US legislation designed to curtail certain offshore tax abuse by US taxpayers that currently are able to avoid disclosure to the IRS by investing through offshore accounts and/or entities. The core principle of this new regime is the requirement that a 'foreign financial institution' (FFI) will need to enter into a disclosure agreement with the IRS, agreeing to identify the direct and indirect owners of its accounts to determine whether they are 'US accounts.' To the extent they are, the FFI must disclose them to the IRS.

FFIs that refuse to enter into these disclosure agreements will suffer a 30 percent withholding tax on all US withholdable payments. The effective date for the new regime is 1 January 2013, with phased implementation over the initial years. While the US government has repeatedly stated that FATCA is not primarily intended as a revenue-raising measure, it is estimated that FATCA will generate USD800 million annually over the next 10 years[4].

As mentioned, the latest guidance (Notice 2011-53) contains much needed transition rules. The April guidance (Notice 2011-34), however contains numerous detailed definitions and clarifications, of which three themes are particularly significant:

- procedures that participating foreign financial institutions (PFFIs) are to follow in identifying US accounts among their pre-existing individual accounts;
- guidance on the definition of 'passthru payment' and the obligation of PFFIs to withhold on passthru payments; and
- guidance on certain categories of FFIs that may be deemed compliant.

Preexisting **individual** accounts

With respect to the documentation requirements for preexisting individual accounts, Notice 2011-34 introduces new rules that include a welcomed risk based approach. Specifically, instead of a need to document all pre-existing individual accounts at the end of a stated period as set forth in the first Notice, the new Notice introduces the concept of increased documentation scrutiny only where the IRS has identified a heightened risk of abuse (e.g. private banking accounts and accounts with balances exceeding US$500,000). For this new "high risk" class of accounts the PFFI is required to search all files, paper and electronic records, for indications of US status. Significantly, these expansive searches are required even where the account is documented as non-US. While we have heard the expansive due diligence requirements for these accounts explained as the toll that the PFFI must pay for the relaxed rules associated with the preexisting accounts that do not fall within these parameters, these requirements are a substantial departure from the originally stated documentation rules and will create significant administrative concerns for those PFFIs that maintain such accounts.

2 IRS Notice 2011-34, April 8, 2011
3 IRS Notice 2011-53, July 14, 2011
4 Joint Committee Report, JCX-5-10, March 4, 2010

FFIs that refuse to enter into these disclosure agreements will suffer a

30%

withholding tax on all US withholdable payments.

Passthru **payments**

A PFFI must impose FATCA's penal withholding on any passthru payment that it makes to a recalcitrant account holder (one that refuses to sign a waiver permitting an FFI to disclose account information, as well as one that does not comply with certain documentation requests in a timely manner) or a nonparticipating FFI. For this purpose, a passthru payment is a withholdable payment as well as any amount attributable to a withholdable payment. While numerous commentators asserted the need for a narrow construction of 'an amount attributable to a withholdable payment' on the grounds of both administration and notions of the proper territorial reach of a sovereign nation, Treasury and the IRS seemingly rejected those assertions and, instead, crafted an extremely expansive definition and complex methodology with respect to passthru payments. In fact, as currently drafted, the definition of passthru payment is so broad that it could pull in payments on interest rate swaps, derivative structured products (notwithstanding the fact that the underlying asset may not be related to a US security), and any other payment the PFFI is contractually obligated to make.

Pursuant to the Notice, the new regime would require every participating and deemed compliant FFI around the world to calculate and publicly post its passthru payment percentage (which is its ratio of US assets to all assets), on a quarterly basis. It has been observed that, given the complex ratios and requirements set forth in the guidance, the likelihood of a PFFI imposing withholding on the correct amount of the payment seems remote.

Deemed compliant **FFIs**

The Notice outlines a number of 'deemed compliant' FFI models, such as those for banks that limit service offerings and marketing to their local market, certain local subsidiaries of otherwise global FFI affiliated groups, and financial product distributors that do not market to US citizens. While, as above, it appears that the IRS is on the right track in adopting a risk based approach, the stated requirements that these entities must satisfy are such that few, if any, may actually benefit without significant modifications to their current business operations.

The Notice also provides that certain investment vehicles may be deemed compliant when all direct investors are either participating FFIs, deemed compliant FFIs, or exempted entities (e.g. foreign governments, central banks of issue, and those classified as such by the IRS and Treasury due to a low risk of tax evasion). To obtain this status, the fund must prohibit anyone other than those listed from acquiring an interest as well as certify that it will satisfy its requirements to calculate and publicly post its passthru payment percentage.

Finally, the Notice acknowledges that many funds utilize transfer and paying agents when making distributions. It makes clear that a fund may use these agents to carry out compliance with its FFI Agreement – although the fund will remain liable to the IRS for any compliance shortfalls.

Conclusion

The impact of FATCA will be wide-ranging. Compliance will undoubtedly be challenging for certain impacted entities and likely to force changes to these entities' core strategy and business models. It is essential that all financial services companies thoroughly review and understand the potential implications, as well as create a strategic plan in response.

At this same time, it is imperative that these entities also understand that the guidance, to date, remains fluid. Specifically, the IRS has repeated stated that it remains open to further representations by the industry, especially where current proposals may cause practical difficulties in implementation. Reasoned arguments, substantiated by specific illustrations of adverse consequences, can still lead to the IRS adopting operationally workable rules without undermining its core purpose – yet another reason why each member of industry needs to engage in a detailed analysis and assessment of FATCA's impact on its business as a matter of urgency.

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Shared service centers

An integrated **approach to VAT** and transfer pricing

Among large multi-national companies, the establishment of in-house shared service centers (SSCs) is probably now more the rule than the exception. An SSC allows centralized processing of back-office functions in one central location (or a small number of them) with clear potential for rationalization, concentration of expertise and minimization of cost. Administrative and support operations typically transferred to SSCs include a range of finance and personnel functions (payroll, accounts receivable, accounts payable, tax compliance and other accounting related services).

In all cases, determining the '**right**' transfer **price approach** and, in particular, mounting and **documenting** a case which will convince tax authorities, can be a **major challenge**. The **implications** need to be fully considered in the planning stage of an **SSC transition**.

Although many large European and US companies choose to locate SSCs in lower-cost environments such as the Asian sub-continent or the Philippines, this is by no means a universal trend. There are downsides to such remote operations, especially when regular contact with 'home'-based staff or employees – or the general public – is required and the headline cost advantages may prove to be transitory. Many multinational companies recognize the prospect of securing significant operational efficiencies and cost savings even if they establish an SSC in a comparatively high-cost location such as the UK or continental Europe.

Not just a **practical matter**

The potential benefits of establishing an SSC are often so obvious that the exercise is treated primarily as a management and operational challenge. A location must be identified, and the range of functions to be centralized determined. Consultation and negotiation will be necessary where jobs are to be lost at the home locations, or perhaps opened to transfer. Training schedules are required. Communications programs need to be drawn up to ensure that internal and external stakeholders are aware of and ready for the change.

While these are essential practical matters whose effective management can be key to the success of an SSC venture, there is a danger that they can distract the parent company from other fundamental decisions such as transfer pricing policy and other taxes such as VAT. Getting these wrong can lead to excess costs, poor cash flow and lost tax advantages. In the extreme, disputes with tax authorities, fines and penalties may be triggered. All of these detriments can make a significant dent in the economic benefits of an SSC.

Conversely, careful advance planning and analysis can not only avoid the worst of these adverse impacts, but in fact maximize the economic benefits.

Transfer pricing

Where related parties, such as an SSC and the operating companies it serves within the same multinational company, provide or take services, the appropriate price or cost at which those services should be accounted for inevitably becomes a non-trivial issue. In an ideal world of no tax, no externalities and completely free markets, the transfer pricing decision would have few if any implications outside the company. In the real world, however, with different tax regimes, different regulations and different tax rates in different jurisdictions, transfer pricing decisions can have a significant impact on both the total level of tax liability and where those liabilities fall due. Even in the absence of an aggressive and overt tax minimization strategy, transfer pricing decisions in relation to an SSC can have significantly variable economic impacts.

The transfer pricing issue has been a focus of concern for tax authorities in developed countries for many decades. Multinational companies in the main retain the freedom to set prices provided they are in line with the arms length in principal.

In general, tax authorities regard the open market as the best source of independent, appropriate pricing information. Where transactions take place between related parties, this principle implies that the transfer pricing decision is appropriate if it broadly reflects the price and terms and conditions at which the service would be provided in the open market between two unconnected principals. This arm's length principle is also economically sound, and is likely to produce what is perceived to be a 'fair' division of profit and taxation and to deal with international double taxation treaties in a similarly 'fair' manner.

The arm's length principle is endorsed by the OECD, which comments: "Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions." Most OECD members adopt domestic transfer pricing policy and practice based on the OECD guidance[5]. In the specific case of SSCs, the guidance is set out in Chapter VII, *Special Considerations for Intra-Group Services.*

However, establishing an appropriate arm's length price is itself a decidedly non-trivial issue. HMRC in the UK comment:

"The complexities of applying the arm's length principle in practice should not be underestimated. Because of the closeness of the relationship between the parties there can be genuine difficulties in determining what arm's length terms would have been – especially where it is not possible to find wholly comparable transactions between unconnected parties. There are many factors to take into account. Consequently, the exercise can be as much an art as a science."

The **'right'** price

A number of alternative approaches may be used in the attempt to determine a comparable price – or in practice, a price range for comparable arm's length transactions. These methods fall into two categories: "traditional transaction methods" and "transactional profit methods."

Generally, traditional transaction methods – such as determining a comparable uncontrolled price, or cost plus/gross margin approaches – are the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are at arm's length. However, the complexities of real life business situations may put practical difficulties in the way of these methods. Where there are no data available or the available data are not of sufficient quality to rely on the traditional transactional methods, it may become necessary to consider transactional profit methods, such as those based on comparable profitability or transactional net margin.

In all cases, determining the 'right' transfer price approach and, in particular, mounting and documenting a case which will convince tax authorities, can be a major challenge. The implications need to be fully considered in the planning stage of an SSC transition.

VAT

An associated issue, and one which in our experience is even more likely to considered only as an afterthought, is that of VAT. The VAT implications of transfer pricing between an SSC and the operating companies it serves can be at least as significant as the corporation tax consequences. Getting it wrong can lead to 'stranded' VAT costs which are unrecoverable for the enterprise and incorrect VAT charges being applied to external customers.

One of the key technical issues arises from the principle underlying European VAT regulation that the provision of services is liable to VAT only if it falls within the category of *supply* for a *consideration*. Neither the provision of a service by an SSC, nor a financial flow in the opposite direction, necessarily implies that the transaction falls under the VAT regime. Conversely, a supply of services may exist even when there is apparently no financial consideration.

In practice we find that most tax authorities seek to tax services supplied by SSCs to in house recipients. This is further complicated by the lack of symmetry between VAT systems, especially outside the EU, and the absence of double tax treaties. In this hostile environment, double tax is a constantly lurking peril. Especially in the financial services arena this can lead to significant above the line costs for business which may wipe out the fundamental economics of the SSC business case.

Alongside the core transfer pricing decisions which need to be considered in relation to an SSC, then, the issue of VAT on those prices is also critical.

Early planning, **coherent approach**

SSCs can bring clear operational and financial benefits to multinational companies. But their establishment is not simply a matter of practicality and implementation. An SSC raises complex issues of transfer pricing and tax liability which need to be considered in depth, and in a coherent, integrated manner, if the financial benefits to the group are to be maximized and financial penalties avoided.

KPMG's joint Transfer Pricing and Indirect Tax teams can address the issues at an early stage to maximize value, minimize cost and control risk.

[5] OECD Transfer Pricing Guidelines, OECD 2010

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Structuring for the future

How the changing environment is influencing insurers to review and optimize their structure

Structure in context

Many insurers, including both international groups and domestic operations, have legal entity, operating and capital structures that have evolved organically over time, partly as a result of mergers and acquisitions and partly from piecemeal initiatives, often driven by considerations of tax efficiency. As a consequence, the results can be complex and unwieldy involving multiple underwriting platforms, administration and service companies, and out-dated holding and finance structures which themselves lead to inefficiencies. Such inefficiencies include dividend traps, additional regulatory and compliance burdens, fragmented reporting and increased operating costs.

Typically, a complex group will reconsider its structure only every few years, or when a major acquisition or divestment stimulates a review. A program of simplification and reorganization may follow, with legal entities being rationalized and the group structure being re-cast to match contemporary tax and regulatory requirements more closely. However, in light of the current unprecedented pace of regulatory change the world over, and the fiscal and market environment facing insurers, all three key characteristics of this pattern are now out-of-date:

- it is no longer appropriate for structure to be dictated by narrow technical considerations, or primarily by tax; it is essential that structure reflects the commercial and operating realities
- the key structural issues facing insurers are no longer simply those of legal entity structure but also those of regulatory and capital structure, the target operating model and the risk and control infrastructure
- such issues cannot be put on one side for review once every few years; instead, they need to be matters of constant concern and attention at board level.

In a nutshell then, insurers need to ensure that, as their businesses evolve to accommodate changes in the market environment, their corporate structure is aligned to the business strategy, so as to optimize the overall effectiveness and competitive positioning of the business.

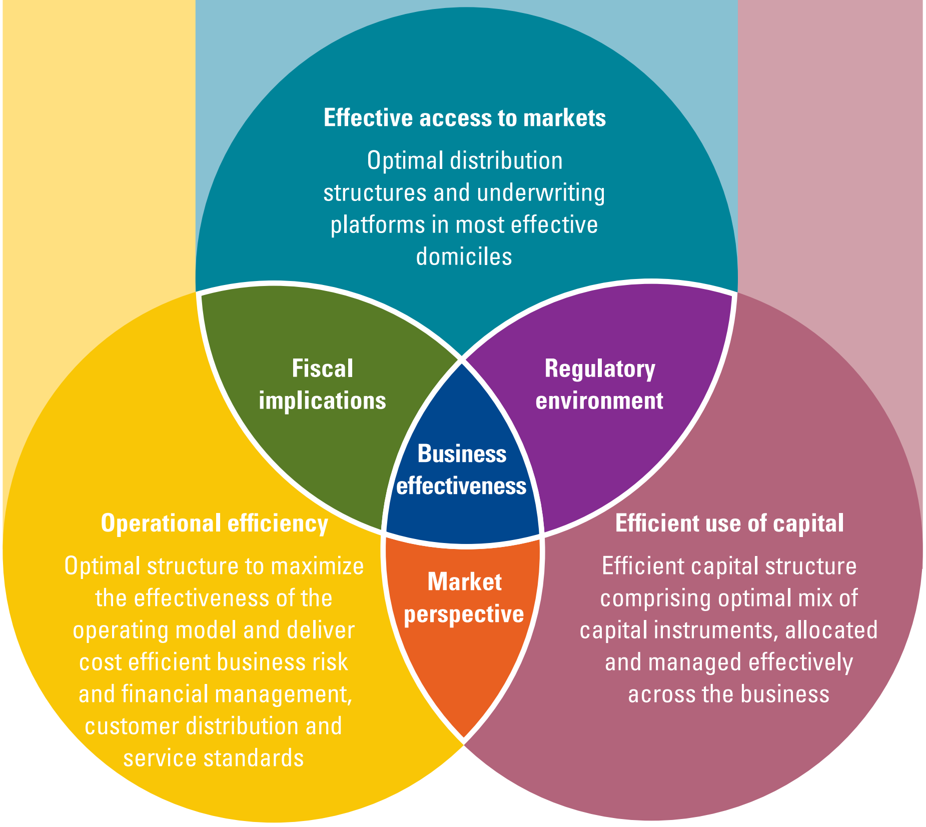
Broad structural **drivers**

The key drivers of broad structural change currently impacting on the insurance industry (see diagram on next page) are:

- efficient use of capital
- effective access to markets
- operational efficiency.

The force of these drivers is being felt against the backdrop of evolving regulatory and fiscal regimes and market developments, including changing consumer demands and the emergence of new/growth markets, government intervention and investor demands. Shareholders, members and policyholders continue to demand enhanced value, whilst at the same time insurers both across the globe and in Europe must cope with increasing regulatory intensity, extra tax complexity and competition. For European businesses this competition arises internally within European markets and also from overseas.

Typically, a **complex group** will reconsider its **structure** only every few years, or when a major **acquisition or divestment** stimulates a review.



Many insurers are also concerned to improve their group risk governance, and to address constraints in their ability to attract business – for example due to insufficient capital in insurance operations, and fragmented distribution and product offerings. All of these issues point to the need to use capital efficiently, a topic that is high on the executive agenda. Insurers are seeking to optimize the quantum, allocation and profile of their capital structure with a view to reducing the cost of capital, satisfying stakeholder demands and financing new business initiatives.

Regulatory **framework**

Within Europe, despite a common framework for insurance regulation underpinned by European Directives, a wide array of different national practices and policies has emerged. Furthermore, additional prudential capital rules are imposed in many instances, from simplistic asset admissibility restrictions to sophisticated risk-based capital overlays, and supervisory approaches and practices vary greatly from country to country. Thus insurers active in the European market currently have a wide range of options in terms of how their business should be capitalized, structured and controlled.

The existing framework will change radically under the Solvency II regime which is now expected to be introduced in 2014. Solvency II will significantly impact insurance capital requirements across Europe, and fundamentally change the way in which insurance businesses with a European presence are organized, managed and reported. The Solvency II regime is already prompting insurance groups to engage in large-scale projects that will bring about major restructuring to take advantage of opportunities such as diversification and group capital fungibility, and to minimize the potential and expected burdens of the more sophisticated regulatory environment. It is also driving mergers and acquisitions, as well as divestment.

Under the Solvency II regime, insurance groups with European subsidiaries will be subject to group supervision. This is a major step change in regulatory approach and is aimed at addressing group risk. It means that groups will need to meet the Solvency II requirements for the entire European group (considering all entities, insurance and otherwise) or, in the case of non-European groups, for the European sub group. Furthermore, non-European groups potentially need to comply with Solvency II at worldwide level too. A single group-wide lead supervisor will be appointed to oversee the supervision of the European business. Group supervision will have significant implications for group structures, in fact structure significantly influences how the regime bites, and the commercial implications should not be underestimated. Groups will benefit where they are able to use the group requirements and related changes to capital components to adopt a much more flexible and efficient structure. This will allow them greater freedom to respond to changes in market conditions and to take advantage of emerging market opportunities.

In other regions, for example jurisdictions in the emerging and growth markets of the Americas and across Asia, enhanced regulation promoted by the International Association of Insurance Supervisors (IAIS) that comes into force later this year is expected to drive changes in solvency capital requirements and wider risk management practices, on a jurisdiction-by-jurisdiction basis. In many cases the future shape of regulation in these regions is uncertain – the lack of formal mandate on the part of the IAIS means that organizations will likely face varying levels of change under different timescales in each jurisdiction – and the added layer of group supervision requirements means that the impact and future regulatory landscape in these regions is difficult to predict.

All this means that instead of complex structures driven for example, by narrow considerations of tax efficiency – which in any case fiscal authorities are increasingly penetrating – structure in

Retaining unwieldy **group** structures and **inflexible capital** profiles is **potentially** highly **damaging** to performance.

the broader sense needs to reflect and support the realities of the business within a more sophisticated and challenging environment. It should now be a core responsibility of boards and chief executives to ensure that this is so.

Continual review

Retaining unwieldy group structures and inflexible capital profiles is potentially highly damaging to performance. While in the past insurers and their stakeholders may have tolerated inefficiency, perhaps in the group structure, its capital or operations, competitive forces are unlikely to allow this to continue. Further, the extensive disclosure under Solvency II and related regimes will lead to significantly greater transparency concerning the efficiency of insurer structures. Taking a strategic view of the group organization and capital structure can offer significant competitive advantages; restructuring of this type is becoming increasingly common.

Restructuring is not a one-off, once-a-decade activity. A regular reappraisal of company and group structure should be part of insurers' business as usual strategy. For insurers to maintain their performance and competitive edge, it should become an iterative process. Insurers that act now to improve their structures can expect to generate both immediate rewards, such as improved returns and market value, and opportunities for the future. These opportunities include the ability to respond to changing market conditions, and to self-fund new investment. These combine with the benefit of a simpler structure through which to implement enhanced risk management and solvency capital change, and to cope with other regulatory, accounting and fiscal changes.

Ensuring the right result

It is critical to approach a potential restructuring of a group in a logical and considered manner, ensuring the involvement and engagement at the appropriate time(s) of all relevant parties in the organization, in addition to external stakeholders such as the range of regulators of the group and rating agencies. But since structure needs to reflect the specific realties of the individual business, there can be no one solution or special formula to determine the most appropriate structure: each organization will have its own set of circumstances driving its optimal structure. But the key message for tax professionals is that it is vitally important that account is taken of the business aims and the drivers, and that any constraints and deal breakers are identified at the outset and used as a reference point in benchmarking any restructuring options. The key is to ensure that the correct decisions are taken and the implications understood.

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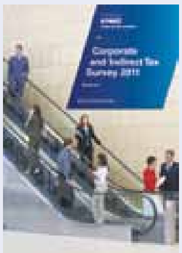


Corporate and Indirect Tax Rate Survey October 2011

The 2011 story of the world's corporate and indirect tax rates continues that of the one told in previous years. According to KPMG International's annual Corporate and Indirect Tax Survey, corporate tax rates have been steadily falling for a decade, while value added tax and goods and services tax (VAT/GST) systems have been introduced across the globe, rising to higher rates and applying to more items as indirect tax systems mature. The survey provides a detailed comparison of corporate and indirect tax rates from over 125 countries.

Also see KPMG International's new online interactive tax rate tool www.kpmg.com/taxrates.

Global FS Indirect Tax Brief – special feature on Financial Services – October 2011

This special feature on the financial services sector, addresses some of the latest trends and developments in indirect tax around the world. Professionals from KPMG member firms analyze some of these changes and offer insights into both the impacts and responses as multi-national financial services organisations need to continue to adapt their operating models to service this rapidly evolving environment.

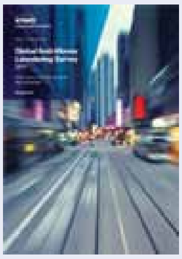
EU Tax Newsflash – European Commission issues proposal for a Financial Transactions Tax October 2011

On the 28 September the European Commission published a proposed Directive for a tax on financial transactions. The European Parliament has already declared its support for such a tax, but the European Council seems divided. The proposal requires unanimity in the European Council to be adopted as EU legislation. According to the Commission, current indications are that the directive is likely to generate revenues of around 57 billion Euros annually at EU level.

Solving Tax for Solvency II – October 2011

The solvency capital requirement is defined as an amount equal to a 1 in 200 year loss. Crucially, this loss is net of any tax relief and so this tax relief is a key driver of the overall capital requirement. Tax can potentially reduce capital requirements by a third* in some markets.

** The size of the credit is likely to be limited to the statutory tax rate in the relevant jurisdiction.*



Global Anti-Money Laundering Survey 2011: *How banks are facing up to the challenge* August 2011

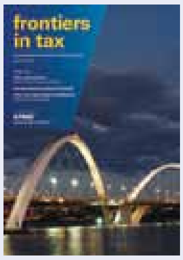
AML remains a critical compliance area for all financial sector firms, especially banks, but it is more than just about compliance. What part does AML play in the changing regulatory world? How much does it cost, both now and in the future? What areas are particularly challenging? How helpful are the regulators' approaches? This survey explores the changing landscape, summarising the views of 200 of the top 1000 global banks.

FATCA and the Funds Industry – defining the path June 2011

KPMG surveyed the leading fund promoters in 12 countries around the world to examine the investment managements industry's readiness for the US Foreign Account Tax Compliance Act (FATCA). The report raises the urgent need for fund promoters to understand the implications of this legislation and begin developing their strategy if they expect to maintain their status and customers in the immediate aftermath of FATCA.

Evolving Investment Management Regulation: Meeting the challenge June 2011

The investment management industry is grappling with wide-ranging regulatory reform addressing issues from systemic risk to investor protection, transparency, governance, and taxation. Balancing the competing demands of various regulatory agencies is a huge challenge. How will you meet the challenge? Understanding the totality of regulatory requirements and the strategic implications for your business is key to putting you ahead of the curve.



frontiers in tax: *people thinking beyond borders in financial services* May 2010

The pace of change in the financial services industry shows no sign of slackening. Three years after the financial crisis, governments and regulators are still trying to implement new control regimes which will ensure stability and sustainable growth. This edition looks at some of the more acute developments revolving around the imposition of special taxes or levies on financial services companies with a particular focus on Brazil.

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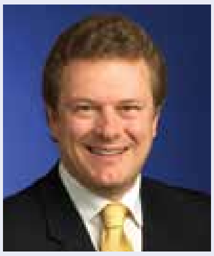

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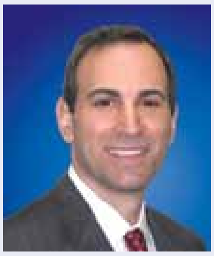

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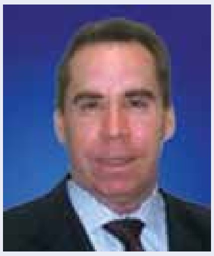

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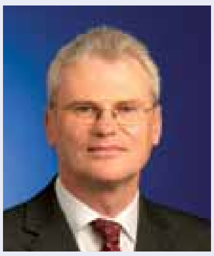

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