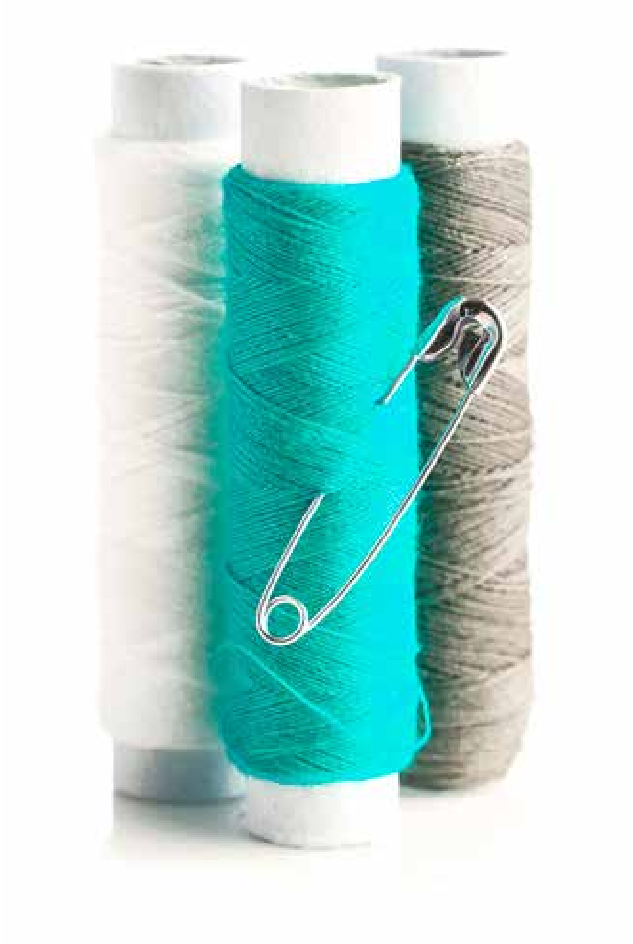

Think tax benefit, not cost

"Three lines of defense" for successful fiscal transactions

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The upside of regulatory proliferation

Global financial institutions are under intense scrutiny as they respond to high market expectations for growth and stability. Simultaneously, global tax authorities continue to issue new legislation designed to enhance certainty around jurisdictional tax revenues. While this undoubtedly increases a financial institution's tax compliance burden, the upside of a substantial, well-defined regulatory environment is an improved platform for executing tax-advantaged business transactions.

Tax efficiency is not a new concern for financial institutions. Typically, the business function makes decisions related to organizational transactions while the tax function seeks outcomes that optimize tax-efficiency. As such, basic tax planning usually falls under the direct control of the tax function. However, as regulatory models expand tax opportunities extend to virtually every business and financial transaction. As such, financial institution business models are becoming more complex and require enhanced partnering between the business, support functions and the tax function – particularly when tax opportunities arise outside normal areas of tax involvement.

This paper explores how the "three lines of defense" approach to risk can be leveraged to do the following:
- Enhance tax opportunities;
- Identify key operational areas where emerging or latent tax opportunities reside;
- Consider related tax opportunity drivers;
- Explore ways to better integrate the tax function in all tax-impacted transactions.

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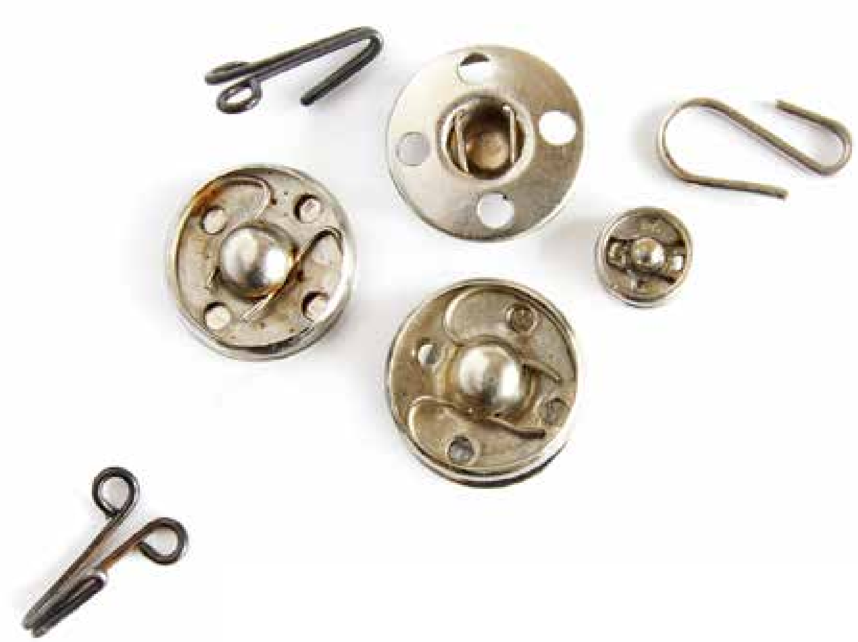

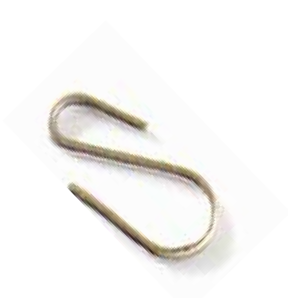

Increasing the tax function's transactional role

Financial institution taxation is complex. Industry-specific examples include the following:

- Income taxation of specified debt obligations, insurance policy reserves and loan loss reserves;
- Indirect taxation of management fees and products;
- Withholding tax obligations and related reporting on non-resident transactions.

Compounding this complexity is an intricate, often siloed business model that relies upon decision points, systems and processes that are owned and executed by the business and support functions. These functions often view Tax as a cost center focused on compliance and reporting. Accordingly, business teams often don't fully understand the value the tax function can bring to strategic and operational decisions (with the possible exception of mergers and acquisitions). By better integrating the tax function's technical acumen with overall organizational business intelligence, business transactions can be more effectively tax-optimized and transactional value increased.

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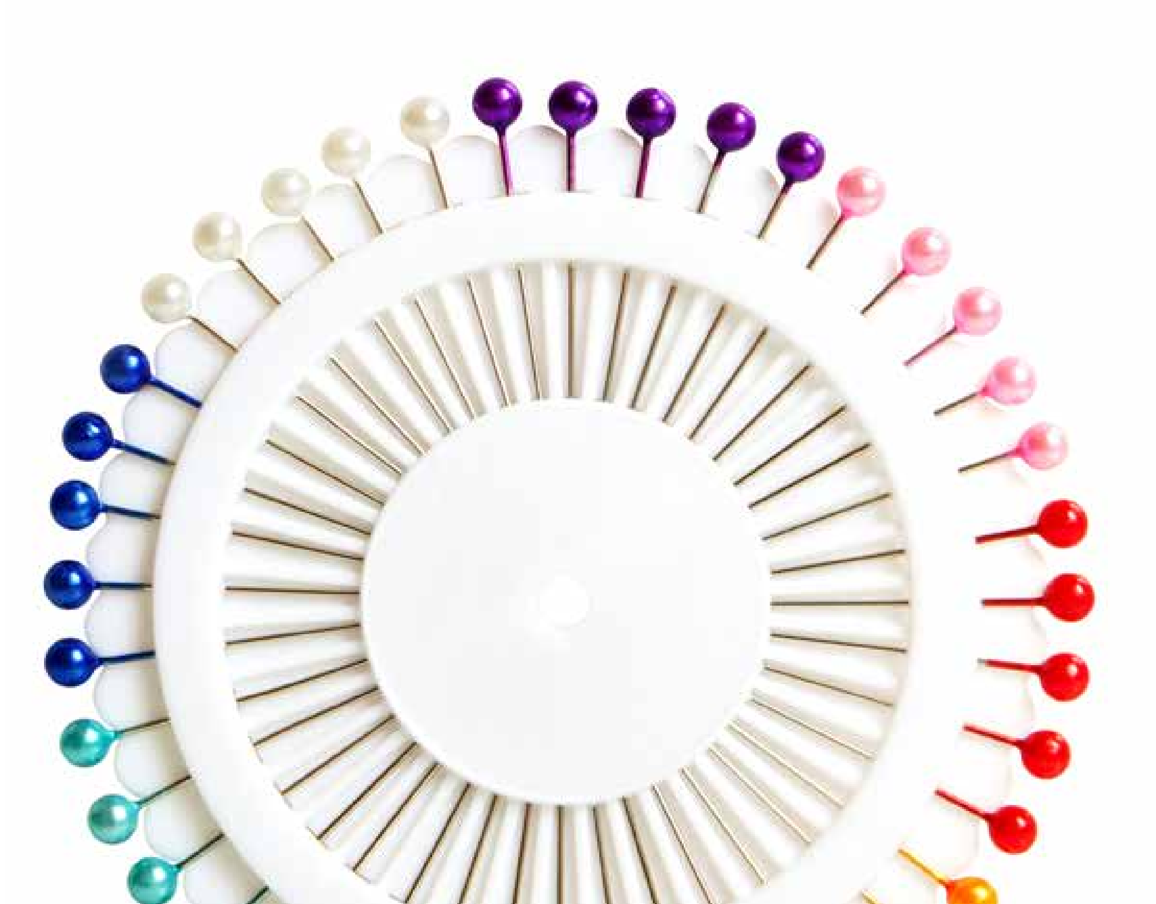


Leveraging the "three lines of defense"

In reaction to pressures to increase earnings, the financial sector is rethinking the way it does business. As they address evolving regulations, savvy financial institutions are also looking to better manage the after-tax impacts of business transactions. This means viewing the tax function less as a cost of doing business and more for the business value and benefits it delivers. One way to support this transformation is by leveraging existing risk management processes such as the "three lines of defense."

Regulators have long required financial institutions to have a robust risk culture. Most financial institutions satisfy this requirement by using a "three lines of defense" approach:

1st line: Risk takers/ Owners/Managers
This includes business and supporting functions (HR, finance, IT) that are responsible for establishing day-to-day controls to identify, assess, control and monitor risk.

2nd line: Risk monitors
These are financial control, compliance and risk management teams responsible for overseeing and monitoring the 1st line's processes and controls for managing specific risks. They also assist the 1st line in designing controls.

3rd line: Independent assurance
The internal audit function provides independent assurance on the effectiveness of risk governance, management and internal controls.

As the "three lines of defense" framework is well embedded in financial institutions' DNA, a real opportunity exists to educate and influence all three lines on the value of considering tax from a strategic and operational perspective.

Savvy financial institutions are also looking to better manage the after-tax impacts of business transactions.

Applying the framework

Without engagement by the tax function, new events or minor modifications to products, services or the operating model can create "unknown" incidences of missed opportunities or non-compliance. If unrecognized, these may lead to risks that impact the bottom line and impair the enterprise's ability to meet its objectives. These risks include the following:

- **Opportunity:** missed chances to proactively increase transactional tax-efficiency;
- **Regulatory:** increased scrutiny by tax authorities and regulators;
- **Financial:** increased incidence of reassessments, levies of interest and/or penalties;
- **Reputational:** public and media attention adversely impacting the brand;
- **Operational:** diversion of resources to manage and correct errors;
- **Customer:** damaged customer experience and loss of customers.

Within the complex financial institution environment, processes that are operational, business or support function-owned are often directly subject to tax legislative and regulatory requirements, making them vulnerable to one or more of the negative risk consequences noted above. Operationally-owned tax activities, for example, provide ample opportunities to convert a negative tax event into a business benefit, provided organizations are willing to move to a more fully-leveraged "three lines of defense" model that emphasizes proactive identification and management of risk.

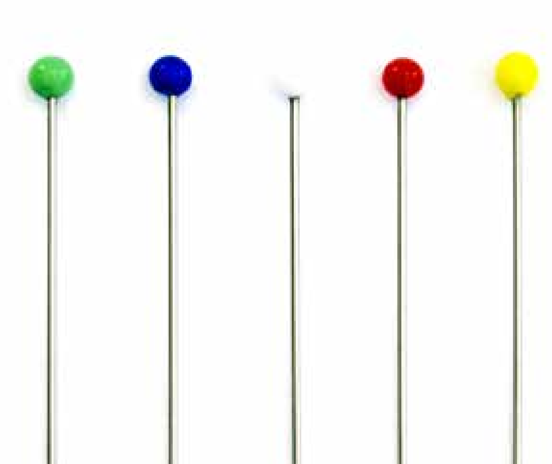
The following scenarios look at specific operational areas where tax requirements are managed or triggered. In applying our framework, we have generally highlighted the line of defense that best illustrates available benefits. These examples primarily involve leveraging the 1st and 2nd lines of defense – the 3rd line of defense can also play an important role in assisting the business to establish effective processes; however, typically this occurs less frequently and at a later stage than is required for optimal tax function engagement. Accordingly, application of the 3rd line is outside the scope of this paper.

Marketing and legal

Marketing's role is to increase revenue and sales by developing and promoting financial products and services that differentiate the organization from its competitors. Although the marketing function has a responsibility to deliver value to its customers, it also has – in conjunction with the legal department – a duty to ensure that marketing material does not contain knowingly false information about the offering's potential tax consequences.

Consider the development of new investment vehicles such as income trusts. The nature of the income earned, assets held and other characteristics must be assessed by the product development and legal functions to ensure the vehicle has sufficient active income, assets and other required criteria that will prevent it from being caught by Passive Foreign Investment Company (PFIC) rules. Due to the complexity of these rules, the tax function can add value by performing a "translator" role – essentially interpreting the impact of the legislation on the structure of the product and working with the operational teams to accurately capture the tax impact within the prospectus. This collaboration can create an opportunity for investment in the product by U.S. citizens who would otherwise face undesirable results – such as onerous tax liabilities, severe interest charges and rigorous reporting requirements due to punitive and complex U.S. tax rules. This desirable differentiating factor would help the marketing team to target a larger market and develop additional, otherwise unavailable revenue from U.S. citizens. Due to their revenue generating responsibilities, one would expect the business leaders responsible for the 1st line of defense to be highly incentivized when it comes to product tax-efficiency. To promote this attitude and optimize potential value, organizations should develop and enforce protocols aimed at involving tax in all new product development.

While tax functions are generally consulted regarding



One would expect the business leaders responsible for the 1st line of defense to be highly incentivized when it comes to product tax-efficiency.

potential tax impacts of significant one-off transactions and events, minor modifications to product offerings by marketing and legal teams may also provide opportunities for tax function input and consultation. For example, although customers understandably desire clear, simple, streamlined contracts, removing or rephrasing key clauses may result in the loss of exempt status for certain life insurance policies, creating taxable consequences for policy holders that the financial institution may have to bear. Such events only undermine the intended benefits of the product's initial tax-efficient structure.

In the case of seemingly inconsequential modifications, the tax integration challenge may rest with the tax function itself. Since the volume of customer-centric products makes it difficult for the tax function to review all marginal amendments to each prospectus and other marketing materials, leveraging the 2nd line of defense to design a process for determining when tax function involvement is required presents a strong opportunity for competitive differentiation. For example, a "decision tree" with defined, practical criteria would help the operational team decide whether to involve the tax function in minor or routine alterations. This would also provide a framework for stakeholders unversed in tax nuances to make informed decisions regarding tax function engagement.

Treasury

The treasury function's role in cash and liquidity management frequently results in sizable lending arrangements across borders and between legal entities. These transactions may trigger exigible Canadian and foreign withholding and transaction taxes. While the general tax consequences are usually understood by the treasury team, accurately applying legislative nuances may be a challenge. Moreover, the calculation, reporting and remittance of tax liabilities are often secondary (and manual) considerations. The existence of disparate Enterprise Resource Planning (ERP) systems and transactions recorded from a management reporting perspective (rather than a legal entity perspective) further compounds the challenge.

Despite these issues, focusing on tax-efficient lending arrangements can lead to positive bottom line benefits. Having the tax function assess lending arrangement structures and financial impacts early on can lead to a more tax-efficient result. For example, financial institutions often engage in foreign exchange swaps or other similar derivative transactions in order to mitigate the risks associated with foreign exchange. Where a party to the transaction is located in a jurisdiction not covered by the Organisation for Economic Co-operation and Development (OECD), payments with respect to these financial activities could be subject to withholding taxes. Pre-emptive analysis by the tax function may provide the opportunity to restructure the lending arrangement and reduce above-the-line tax impacts.

Regulators generally require financial institutions to have legislative compliance management programs to identify, control and monitor compliance with the laws, rules and regulations of the jurisdictions in which they operate. These programs are typically enforced by the 2nd line of defense. However, since tax-related legislation is typically not well understood or is assumed to be "covered" by the tax function, there is an opportunity to more fully leverage such compliance programs. For example, an organization may expand their compliance database to capture details of lending arrangements during the early stages. This would create a type of transaction log that the tax function could access electronically in order to perform tax analysis and support the 2nd line of defense by monitoring post-transaction tax compliance and remittances.

Front office/sales

Many financial institutions use intermediaries as part of their sales channel for mortgages, securitization transactions, insurance and other products – arrangements that can generate GST/HST and QST[1] consequences. Positive business benefits may be achieved, however, if the contracts are structured such that the service is determined to be tax-exempt under the Excise Tax Act (ETA) and the Quebec Sales Tax Act. To accomplish this, organizations must mandate tax participation in assessing the nature of the service to be provided by the intermediary under the arrangement.

For example, the ETA generally considers mortgages to be financial instruments; therefore, the supply of mortgages is characterized as tax-exempt financial services for GST/HST and QST purposes. When a financial institution purchases a mortgage portfolio from an intermediary, the contract typically includes the provision of related administrative services, such as managing the relationship with the end-mortgage holder and the collection of customer mortgage payments. Although administrative services are generally classified as a taxable supply, when bundled under a "fully-serviced" mortgage arrangement, these services may be considered to be tax-exempt as they form part of a single supply arrangement. Accordingly, the tax-exempt characterization of mortgages can extend to services if the contract is structured appropriately.

In this scenario, two opportunities exist: 1) The 1st line of defense can engage the tax function as new intermediary arrangements are contemplated and 2) The 2nd line of defense (required to perform a secondary review and approval of these transactions) can expand existing infrastructure to include experienced tax function resources – a component risk teams often lack. With these two measures, a change to tax legislation or a modification to standard contracts can be proactively assessed to increase efficiency around intermediary-involved transactions.

Regulatory affairs

Solvency II, Basel II and Basel III have created significant capital and liquidity changes for banks and insurance companies. In order to comply, financial institutions need to achieve a balanced result demonstrating regulatory compliance while continuing to take advantage of business opportunities. From a tax perspective, organizations may need to assess their legal entity and capital structures in order to meet regulatory requirements. When undertaken without consideration of potential tax implications, this can lead to inefficient capital structures and potential tax exposures. Where the solution to meet liquidity requirements results in the restructuring or disposition of deposits or loans, unintended tax consequences may arise. For instance, the migration of customer deposits from a legal entity located in one jurisdiction to another could result in the transfer of an intangible asset associated with the related goodwill. This transfer may trigger a deemed disposition, resulting in a capital gain for tax purposes. Similarly, structural changes to operations by autonomous business units, without timely participation by the local or corporate tax functions, can lead to a sub-optimal legal entity structure.

From a tax perspective, organizations may need to assess their legal entity and capital structures in order to meet regulatory requirements.

Embedding tax acumen in the strategic process

Leveraging the 1st and 2nd lines of defense to improve the tax outcomes of business decisions, as demonstrated in the examples above, can be challenging. As with any organizational change, it's important to develop a clear and concise framework for the journey. Failure to invest up-front time and energy to develop and communicate this framework will lead to false starts, reduced traction, lack of executive buy-in and suboptimal results.

Framework for integrating tax with business and support functions

Identify

A key first step is to identify opportunities across the organization where enhanced tax integration will drive value and reduce risk. The following is recommended:

- Undertake an assessment across the business and support units to identify areas that may yield the largest benefit;
- Focus on opportunities that both realize tax benefits and mitigate tax risk to achieve a holistic assessment;
- Develop an understanding of the strategic and operational objectives for each individual unit and the overall enterprise.

Assess & prioritize

Once a complete list of opportunities exists, assess and prioritize them against factors relevant to the organization. Given the size and scale of most financial institutions and the scarcity of tax function resources, focusing energies is critical. Key steps include the following:

- Identify specific tax-optimization initiatives, performing a detailed assessment of the transactions and/or processes where opportunities exist;
- Prioritize tax-optimization initiatives using the business unit and overall enterprise strategic and operational objectives, as well as the potential quantitative impact to the bottom line;
- Consider qualitative factors such as the following:
  - Cost, resources and time required to implement change;
  - Likelihood of executive buy-in;
  - Customer, reputational and regulatory implications.

Develop a roadmap

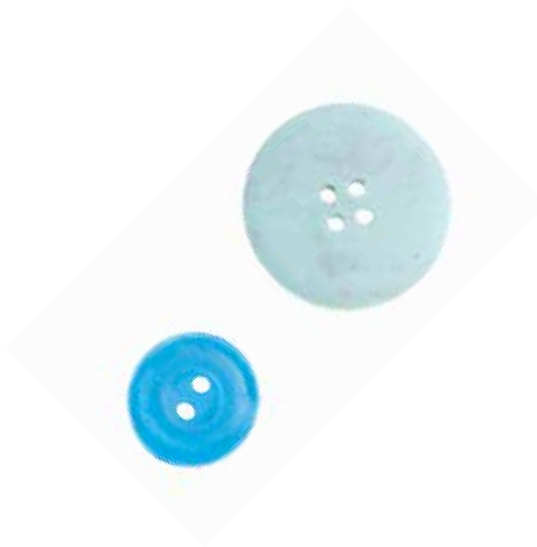
Using the prioritized list of opportunities, develop a roadmap for leveraging the existing infrastructure within your "three lines of defense" program – this should be a joint collaboration between the business, relevant support functions and the tax function. The roadmap should include defined timeframes for achieving milestones.

Execute

Using the roadmap, it's now time to realize the benefits. This may involve developing new controls and implementing new processes, however it is critical to leverage your existing "three lines of defense" infrastructure as your baseline, applying enhancements as needed to increase and improve tax function engagement. It's also important to develop an accountability matrix to monitor specific tax-optimization opportunity drivers and measure tangible benefits and results.

Improving tax function engagement: A business imperative

The business transactions financial institutions live and die by are significant and complex. Equally complex is the myriad of global tax rules and regulations that constrain these transactions. By leveraging the “three lines of defense” to enhance business and support function and tax function integration, organizations can optimize tax across the board and consistently achieve tax-efficient outcomes to business-driven decisions.



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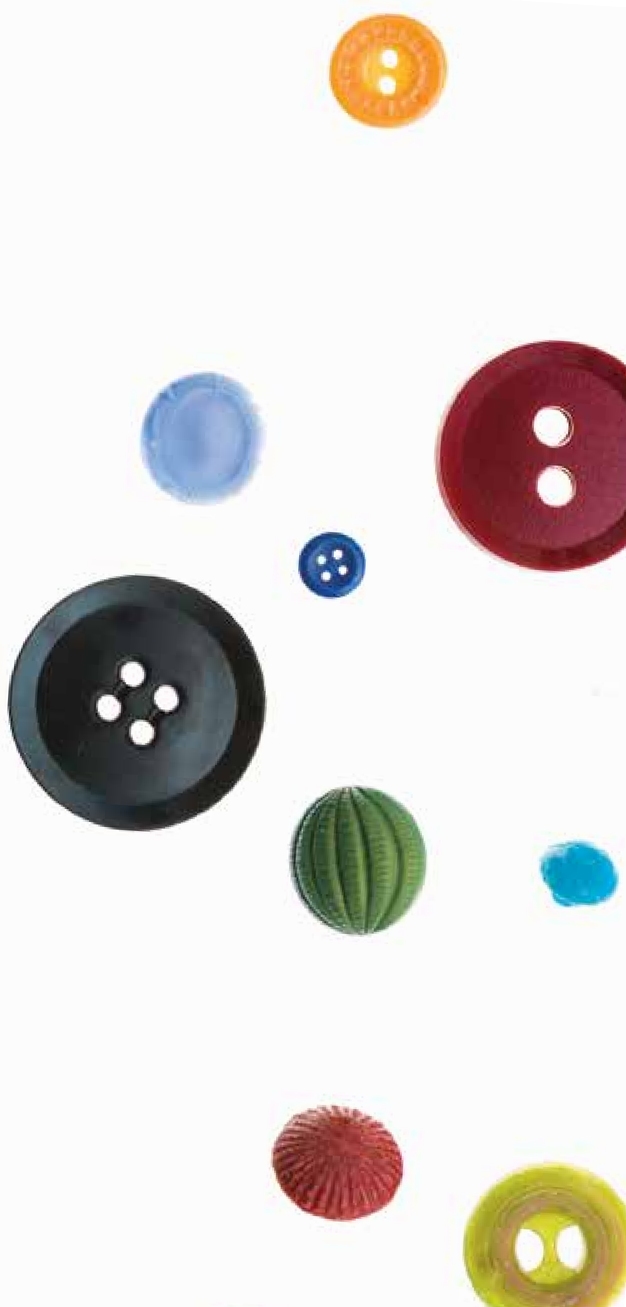

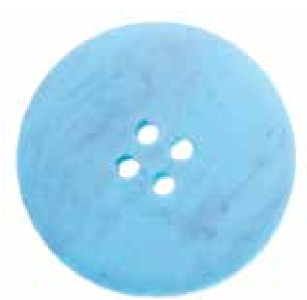

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Endnotes

1. Since January 1st 2013, financial services are considered to be exempt supplies for QST purposes (prior to that date, they were considered to be zero-rated supplies).