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Tax Traps of Non-U.S. Issuer Debt Offerings

By Hannah Terhune (Capital Management Services Group)

Introduction

This article discusses the tax consequences to holders—U.S. and foreign alike—of non-U.S. issuer debt offerings where such issuers enter and utilize U.S. financial markets to raise capital.

Typically, non-U.S. issuers of debt seek to access U.S. capital by means of: SEC-registered offerings; unregistered Rule 144A offerings; or, private placement offerings that are exempt from SEC registration requirements. While Section 4(2) and Regulation D of the SEC’s regulatory framework have provided the basis for an issuer’s exemption from registration, Rule 144A has impacted the private offering market in the United States because Rule 144A imposes relatively few procedural hurdles. Consequently, Rule 144A, which permits the re-sale of otherwise restricted securities without imposing formal registration requirements on traders, has become a significant factor in the secondary market within the U.S. Indeed, it has served to encourage non-U.S. issuers of debt to seek to raise capital through U.S. debt offerings.

Non-U.S. Issuer Debt Offerings

Non-U.S. issuers that offer debt securities under Rule 144A typically establish a medium term note (MTN) program. The non-U.S. issuer will file either: (1) a shelf registration statement with the SEC (for registered issues), or (2) prepare a base offering memorandum (for unregistered issues). The shelf registration mechanism allows an issuer to complete registration-related procedures in advance so that the issuer can offer the debt securities quickly when market conditions are ripe. Non-U.S. issuers use a short-form registration (Form F-3). Form F-3 consists primarily of the specific transaction information and it allows incorporation by reference of certain required information about the company from documents previously furnished to the SEC. When the non-U.S. issuer makes the debt offering, it does so through a prospectus that describes the particulars of the offering.

Most foreign issued debt takes the form of standard U.S. dollar fixed or floating rate debt instruments. The shelf registration statement (or offering memorandum) allows a non-U.S. issuer to issue a wide variety of debt securities including: floating rate, zero coupon and dual or multi-currency debt with various maturities.

Taxation of Interest Income on U.S. Holders

The taxation of interest paid to U.S. holders of foreign issued debt securities depends on whether the debt security is issued with or without an original issue discount (OID), or with one or more contingent payments of interest or principal (i.e., a contingent payment debt instrument (CPDI)).

A U.S. holder of a foreign issued debt security is defined to include: (1) a citizen or resident of the U.S.; (2) a U.S. corporation; (3) an estate whose income is subject to U.S. federal income tax regardless of its source; (4) a trust subject to the jurisdiction of a U.S. court that can exercise primary supervision over the trust’s administration; or (5) where one or more U.S. persons are authorized to control all substantial decisions of the trust.

Taxation of Non-U.S. Issuer Debt Without OID

Interest paid on U.S. dollar fixed rate and floating rate non-U.S. issuer debt offerings issued without OID is taxable to a U.S. holder as ordinary interest income at the time the interest is paid or accrued, in accordance with the U.S. holder’s method of accounting. Cash basis taxpayers (i.e., individuals) include interest income in income in the taxable year received while accrual basis taxpayers (i.e., corporations) accrue interest income over the relevant accrual period. As a result, accrual basis taxpayers may include interest income in gross income prior to receiving the cash attributable to that income. The interest income included in income (by both cash

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On January 2, 2011, the United States imposed a two-percent excise tax on payments received by foreign entities for the sale of goods or services to the U.S. government. The U.S. enacted this tax through the James Zadroga 9/11 Health and Compensation Act (Act) to pay for benefits for persons affected by the September 11, 2001 attacks.1

The Act specifically levies its two percent tax on any “specified Federal procurement payment” received by a “foreign person.” A “foreign person” is any person “other than a United States person,” including a foreign business entity.2 A “specified Federal procurement payment” is any payment made under a U.S. government contract for (1) goods produced in a country that is not a party to an “international procurement agreement” with the U.S., or (2) services provided in a country that is not a party to such an agreement.

The Act does not define the term “international procurement agreement,” but legislative history suggests that it describes the World Trade Organization Government Procurement Agreement (WTO-GPA) and certain free trade agreements between the U.S. and other countries. The WTO-GPA is a “plurilateral agreement” under which signatories agree not to discriminate against suppliers of goods and services from other signatory nations in government procurement matters. Forty nations have signed the WTO-GPA, including the member states of the European Union, Canada, Japan, Korea, and Israel. Some major U.S. trading partners, including China, Brazil, India, Russia, and nations of the Middle East have not signed the WTO-GPA. Free trade agreements covered by the term “international procurement agreement” likely include the North American Free Trade Agreement, the Dominican Republic-Central America-U.S. Free Trade Agreement, and bilateral agreements between the U.S. and Australia, Bahrain, Chile, Israel, Morocco, Oman, Peru, and Singapore.3

Where a Good is Produced or a Service is Rendered

Application of the Act’s excise tax hinges on where a good is produced or a service is rendered—not on where the entity providing the good or service is based or organized. The tax thus applies to payments for goods produced or services rendered in a country that is not a party to an international procurement agreement with the U.S., even if the foreign entity producing the goods or providing the services is based in a country that is a party to such an agreement.4 This rule may have particular significance for foreign contractors producing goods or providing services to the U.S. government in Iraq or Afghanistan. Neither nation is a party to an international procurement agreement with the U.S.

The excise tax imposed by the Act applies to the gross amount of all specified procurement payments “received pursuant to contracts entered into on and after” its effective date of January 2, 2011. The tax also may apply to specified procurement payments made under contracts that are materially modified after that date.5

Unallowable Cost for Foreign Contractors

The Act states that its excise tax shall be collected in accordance with the withholding tax provisions generally applicable to payments made to foreign persons. This requirement imposes withholding liabilities on all persons, including officers and employees of the U.S., with control or custody of payments to foreign persons. If no withholding agent collects the tax, however, a payee must self-assess the tax and file a proper tax return.6

The Act provides that the head of each “executive agency” must ensure that “no funds are disbursed to any foreign contractor in order to reimburse the tax imposed under” the Act. This makes the two-percent excise tax an unallowable cost for foreign contractors.

Several questions remain unanswered regarding implementation of the Act’s excise tax, including:
• whether the tax will apply to payments made to foreign subsidiaries or subcontractors of U.S. companies;
• how a foreign person or company should determine

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whether goods are “produced” or services are “provided” in a country that is not a party to an international procurement agreement with the U.S.; and

• whether the tax applies to the full amount of a specified procurement payment to a foreign partnership if some partners are U.S. persons.

The two-percent excise tax established by the Act likely will affect a broad range of U.S. government contracts with foreign entities. Government contracting professionals should take the tax into account when pricing and performing procurement contracts, and potentially affected taxpayers should seek further guidance on application of the tax.


Brazil Unveils Tax Package
By Edwin Taylor

Tax on Short-Term Foreign Loans

Brazil raised three taxes and adjusted income tax brackets as part of a tax package issued at the end of March.

The government increased the financial operations tax (IOF) on short-term foreign loans contracted by Brazilian firms and banks. Under the new rules, the IOF on loans of up to 360 days will be 6 percent. For loans with terms in excess of 360 days, the tax will be eliminated. Previously, short-term loans of up to 90 days paid an IOF of 5.38 percent and all loans with terms of over 90 days were exempt from the tax.

The new rules represent an attempt by the government to discourage companies from taking out short-term foreign loans. Officials are concerned with a recent sharp increase in foreign indebtedness by local companies. In the first two months of the year, the foreign indebtedness of Brazilian companies and banks expanded by $16.4 billion, reaching a total of $190.3 billion.

Out of this year’s new borrowing, $10 billion of the loans were short term (due in less than a year). The loans have added to an inflow of dollars that has bid up the value of Brazil’s real and increased imports and reduced exports.

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The government also raised the IOF on credit card purchases by Brazilians traveling abroad from 2.38 percent to 6.38 percent. The strengthening of Brazil’s currency has led to a sharp increase in foreign travel by Brazilians over the last two years, causing a deterioration of Brazil’s foreign accounts.

Income tax brackets were corrected by 4.5 percent for this year and will also be corrected by the same amount each year from 2012 through 2014. The correction was set at 4.5 percent to match the government’s inflation target for 2011 and 2012. Targets have not yet been set for 2013 and 2014.

The fourth measure raised three federal taxes on beverages by a total of 15 percent. According to government officials, the tax hikes were necessary to help recover the revenues the government will lose through the bracket correction.

2Title 26, Section 7701(a)(30) of the United States Code defines “United States person” as (1) a citizen or resident of the United States, (2) a domestic partnership, (3) a domestic corporation, (4) any estate other than a foreign estate, and (5) certain trusts.


4See Joint Comm. on Taxation, Present Law and Background Information on Federal Excise Taxes, JCS-1-11, at 38 (Jan. 2011) (“If the origin of the goods or services is in a country that is not a member of the [WTO] GPA, payments made to a foreign parent located in a country that is a member of the GPA are subject to the excise tax.”).


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BRAZIL

Brazil’s Tax Department Ready for Final Stage of Tax Debt Payment Program

The final stage of Brazil’s largest tax debt payment program got underway in February after a 15-month delay.

The program was launched in 2009 and has been called by tax attorneys the most advantageous of its kind ever for Brazilian companies. Over 350,000 companies signed up for the program by the November, 2009 deadline.

Since then, however, there has been a number of delays that postponed the startup of the final stage, called the consolidation phase, in which companies will verify the debts that are being paid, explain how they will be paid and will receive a payment schedule from the tax department.

The government’s data processing service was supposed to create the software to make the payment calculations, which involve several taxes and several payment plan variables. But the service failed to meet a series of deadlines in 2010 for the completion of its software, thus delaying the final stage.

In February, the tax department finally established a timetable for the consolidation phase which will be conducted in various stages broken down by types of debts, concluding on July 29.

The program grants discounts of 60 percent to 90 percent for fines and 25 percent to 40 percent for finance charges. There is no limit on values and companies can have up to 15 years to make their payments, three times the normal period.

Brazilian Law Sets Stricter Rules on Criminal Prosecution of Company Executives for Tax Fraud

A new Brazilian law took effect in March that alters the procedure for criminal prosecution of company executives in cases of tax fraud.

Under a 2003 law, when a company owner or top executive faced criminal charges for tax fraud, the company could pay the taxes and the charges would be automatically dropped. According to the March law, however, once a prosecutor asks the court to authorize criminal prosecution, the charges cannot be dropped even if the tax is paid.

To avoid the prosecution of its owner or top executives, a company must reach a payment agreement with the tax department before charges are filed, according to the new legislation.

Tax attorneys said the law will force executives responsible for a company’s tax obligations to decide quickly whether they want to pay tax debts or run the risk of facing criminal charges. This is expected to stimulate agreements to pay tax debts. Government officials said that with the new law, they will likely be more aggressive in seeking criminal prosecutions.

GERMANY

Application of Section 1 AStG in Cases of Profit Reductions in Shareholder Loans to Related Foreign Companies

By Dr. Oliver Heinsen (KPMG Frankfurt)

There is often uncertainty about whether profit reductions related to shareholder loans are tax deductible in cases where these shareholder loans are provided cross-border between related companies.

In a guidance dated March 29, 2011 the German Federal Ministry of Finance (BMF) states the cases in which a profit reduction in a loan granted to a foreign subsidiary may cause an adjustment pursuant to Section 1 Foreign Transactions Tax Law (AStG), so that the profit reduction would have to be reversed for tax purposes. Section 1 AStG governs income adjustments required in cases where the arm’s length principle is not complied with, and related parties maintain cross-border business relationships.

To fulfill the arm’s length principle, the loan terms, especially the interest rate and the collateralization of the loan, must be equivalent to what would usually be agreed between unrelated third parties. In the basic case at issue commented by the guidance, the BMF considers the loan granted by a domestic controlling shareholder to its related foreign subsidiary. A distinction is made according to whether (1) the loan is granted subject to an agreement on the provision of an actual collateral and whether such collateral is accounted for in the interest rate, or (2) the loan is granted without any agreement on an actual collateral and the lack of such collateral is offset by an adequate risk premium on the interest rate, or (3) the loan is granted without any agreement on an actual collateral and without any risk premium because of the
so-called “group support.” According to the BMF, not only the first two scenarios for the basic case but also the third one must be deemed consistent with the arm’s length principle, because the group support substitutes for the lack of collaterals. The subsidiary benefits from such group support as long as the controlling shareholder effectively guarantees vis-à-vis unrelated third parties (externally) the subsidiary’s (borrower) solvency and/or as long as the subsidiary fulfills its obligations vis-à-vis third parties.

Where, in the first two scenarios, the terms of the loans granted are in accordance with the arm’s length principle, a write-down to going-concern value, if allowed by tax accounting, has also to be recognized for purposes of Section 1 AStG. If in the third scenario the group support actually persists as an unimpaired collateral vis-à-vis unrelated third parties, this shall also apply to the relevant loan relationship within the group. In this case, even from a tax accounting perspective, a profit reduction is not possible, because the repayment claim is not to be deemed at risk. However, if the group support actually and demonstrably has ceased to exist at the time of a write-down to going-concern value permissible under tax accounting rules, such write-down must be recognized for lack of collateral, also pursuant to Section 1 AStG, if in the period from the grant of the loan to the write-down an unrelated third party had had neither reason nor opportunity to secure its claims.

In addition to the basic case described above the BMF guidance also covers other special cases.

In the course of the 2008 Tax Act (Jahressteuergesetz 2008) the legislator determined that, regarding assessment periods from 2008 onwards, profit reductions related to domestic and cross-border shareholder loans generally are no longer tax deductible. To the extent that Section 1 AStG does not provide for further legal consequences, the above provision generally overrides Section 1 AStG.
Recovering from the Tohoku Disaster: Managing Related Tax Issues

By Marc Lim and Ryann Thomas (Zeirishi-Hojin PricewaterhouseCoopers)

We are immensely saddened by the March 11th earthquake and tsunami in the Tohoku region and by the losses suffered by the Tohoku communities. The impact on Japan of these tragedies, which has left over 27,000 people dead or missing and has destroyed 23,600 hectares of farmland in the Tohoku and Kanto regions, will continue for some time. As Japan regroups, two guiding considerations have emerged: (1) rebuilding Japan will be a daunting and expensive task, with a potential five-year estimated horizon and a cost estimated in excess of $300 billion (US); and (2) Japan’s resilience in the face of adversity and the strong social psyche of the Japanese public are key strengths that may accelerate such rebuilding and result in an economically stronger Japan.

Corporate Japan will need to consider and address consequences far beyond Japan’s geographic and economic borders to adjust to the altered circumstances arising from the disaster. While some of the commercial changes made necessary by events (such as repairing earthquake or tsunami damage, temporarily relocating operations, addressing supply chain disruptions, etc.) have been widely discussed, less obvious but critical is the need for tax management to proactively consider and manage the tax risks arising from this type of unexpected eventualities.

The Governmental Response

The government’s response so far to the Tohoku tragedy in relation to tax matters has been consistent with its response following the 1995 Kobe earthquake:

• provisional relief to address imminent tax compliance deadlines; and
• an intent to draft more in-depth tax relief (income tax as well as payroll taxes, social security premiums and other non income taxes) without delay.

Much of the existing legislation on disaster recovery issues implemented by the government at the time of the 1995 Kobe earthquake may be directly applicable to the Tohoku disaster as well, and in any event may serve as a preview as to what type of tax relief may ultimately be issued by the government this time. A compounding concern this time is the sheer scope of the disaster and required recovery, which is not only unprecedented but is also compounded by the Fukushima nuclear situation and the global public spotlight that is being focused on in the Tohoku region as well as indirect costs incurred by companies all over Japan (and indeed, including companies overseas) due to the broader impact of these events on the Japanese and global economies. Solely from a Japanese tax viewpoint however, the following aspects should be considered:

Identification of such costs—Costs arising from the Tohoku disaster are likely to qualify for specialized treatment apart from the normal tax rules. Consequently, identification of any such costs outside of normal business expenses will be important to be able to fully take advantage of any specialized treatment offered by the government. For example, while the costs of relocation due to operations being physically destroyed in the disaster may clearly fall within such specialized treatment, the characterization of costs associated with a voluntary relocation of operations not otherwise in the Tohoku area may need to be analyzed in more detail.

Quantification of such costs—Company assets will need to be assessed for impairment and/or write off risk. Depending on the assets, the tax rules governing when...
Disaster Recovery and Taxes (from page 7)

Corporate tax relief efforts in response to Great Hanshin Earthquake

- **Jan. 17**
  - Ms 7.3 Earthquake

- **Feb. 20**
  - Passed new rules to provide special tax relief to lessen the tax burden of affected taxpayers

- **Mar. 15**
  - Issued add'l tax circular on extending due dates for tax compliance

- **Mar. 27**
  - Amended rules on general tax treatment of disaster losses in relation to the earthquake

- **Apr. 10**
  - Issued Q&A providing examples on disaster losses, treatment of account receivables, etc.

- **Apr. 25**
  - Issued tax circular addressing on gain treatment of gain on disposal

- **Apr. 30**
  - Issued tax circular on consumption tax return filing and quantifying disaster losses for corporate tax purposes

- **Mar. 27**
  - Issued tax circular on extending due dates for tax compliance

- **Jan. 25**
  - NT A extended tax compliance deadlines for affected areas

- **Feb. 27**
  - Issued tax circular on general tax treatment of disaster losses in relation to earthquake

- **Mar. 30**
  - Issued tax circular on consumption tax return filing and quantifying disaster losses for corporate tax purposes

- **Apr. 6**
  - Issued tax circular addressing on gain treatment of gain on disposal

Where it is determined that costs are to be borne by the local Japanese entity, the classification of those costs will also be important from the transfer pricing perspective. For subsidiaries with transfer pricing policies based on net margins (such as a mark up on total costs or a target operating margin approach), it is important to classify those costs as extraordinary losses (i.e., below-the-line items), so that the costs do not distort the net margins.

The JICPA has already published guidance with respect to accounting considerations arising from the Tohoku disaster (including the scope of costs which should be classified as extraordinary losses), and Japanese companies will need to consider where the tax treatment...
Disaster Recovery and Taxes (from page 8)

differs from the accounting treatment. Where book-tax differences exist, companies may need to evaluate and record deferred tax assets in their tax provisions, which could impact bottom line earnings.

In addition to the tax issues associated with costs arising from the disaster, a second issue that will need to be considered by tax management is the immediate impact of market uncertainty on transfer pricing policies. Such impact is most obvious in the area of foreign exchange volatility, and thus more likely to have an impact on Japanese operations that are exposed to currency risk, e.g., manufacturers or distributors in Japan that purchase or sell in other than Japanese yen. The treatment of foreign exchange gains or losses arising from sudden swings in exchange rates will need to be factored into existing and future transfer pricing policies.

Less obviously, market uncertainty may also have an impact on a corporation’s access to funding (where borrowings are required to fund recovery operations or sustain the ongoing business operations), and thus may lead to an increase in the amount of financing from related parties—all of which will need to be priced on an “arm’s length” basis, i.e., as if between third parties. In the same vein, economic forecasts would tend to suggest an increased likelihood of Japanese businesses across a number of industries generating losses, at least in the short term. Whenever and wherever operating losses arise in a multinational group, they place increased stress on the ability of that group to defend its transfer pricing policies under audit, regardless of the legitimacy of the source of the losses. Taxpayers in this situation can improve their ability to manage future audits through document retention policies focused on contemporaneous evidence demonstrating the impact of the disaster on business operations. Turning from the corporate tax viewpoint for a moment, as a result of the disaster many Japanese employees may have received temporary housing or other benefits, special compensation payments for loss of work, or in the most tragic case, bereavement payments from loss of life or loved ones. Such payments could have corporate, withholding tax and individual income tax implications and should be considered as part of the overall tax management function.

In addition, companies may be raising funds to assist with the recovery efforts either by making corporate contributions to charitable or not-for-profit organizations or by pooling its funds with contributions from their employees. Companies could consider the corporate tax deductibility and effectiveness of such contributions (whether the contribution should be made directly to the Japan charity or perhaps by another affiliate through a charitable organization in its home country) and/or whether they could assist their employees in obtaining an individual income tax deduction from the funds collected.

Looking to Recovery

As Japanese companies begin to understand the immediate cost of the disaster and start their rebuilding assessment, they will face challenges unprecedented since World War II, including repairing the largest disruption...
Disaster Recovery and Taxes (from page 9)

in the global supply chain in recent years, mammoth reconstruction costs, and even decisions whether to relocate operations and/or headquarters within and without Tokyo, or perhaps even out of Japan. In addition to the commercial factors that need to be weighed when making such decisions, certain tax considerations should also be kept in the forefront of the planning effort:

1. Where “temporary” relocations create “tax nexus” and trigger filing requirements—As the troubles with the Fukushima nuclear reactors escalated, many companies (with an eye on employee safety first and foremost) relocated employees and operations from Tokyo either to another city within Japan or to another country. Even on a temporary basis, these types of relocations may trigger various filing requirements both for the relocated employees and their employers, depending upon the specific situation.

For the employer, having employees physically present and working in other locations within Japan may create “tax nexus” within that locality and require the employer to file and pay local inhabitants and/or enterprise taxes. While such may largely be viewed as more of a tax compliance management function (i.e., simply allocating local taxes that would otherwise be paid in Tokyo), certain per capita taxes may need to be paid in both locations. This could give rise to paying per capita taxes twice. For Japanese companies that have temporarily relocated large workforces, such taxes may not be immaterial.

In addition, this situation may also give rise to local payroll withholding tax requirements. As the rules are likely to differ locality by locality and based on the length of the relocation, it is recommended that companies in this position build a tax compliance assessment function within their tax management plans to address the requirements.

The rules become even more complicated where such relocations occur cross-border. Many multinational corporations have relocated expatriate staff to Hong Kong, Singapore, or other countries on a temporary basis. Companies need to ensure any necessary visa and immigration papers are obtained. In addition, such relocations may trigger local country rules with regard to creating “tax nexus” (i.e., so-called “permanent establishments” in tax terminology) and tax filing requirements in those other jurisdictions. Social security taxes in the host location may also need to be considered. Furthermore, the tax laws on reimbursements of temporary relocation costs (i.e., airfare for the employee and his family, temporary accommodations, potentially a per diem) could differ from Japan tax laws. To the extent that this results in a requirement to pay taxes (perhaps because the length and depth of the relocation is viewed to be akin to temporarily operating a business in the other country), then it must also

be considered whether those foreign taxes can be credited to reduce Japanese tax liabilities, or whether they are an additional cost of relocation.

Similarly, the relocated employees will need to consider whether the length of such relocation triggers individual income tax filing requirements. For example, U.S. citizen expatriates relocated to Singapore on a temporary basis would need to consider whether under Singapore tax rules the relocation triggers local filing requirements and/or tax payments. If so, those individuals would need to work through the foreign tax credit rules to see whether the Singapore taxes could be offset against their Japan taxes (if they are permanent residents of Japan) and/or their U.S. taxes that would otherwise be due on their income.

2. Relocating more permanently—the choice to change base of operations—Recent media reports have discussed whether the Tohoku triple disaster would prompt companies to consider relocating operations out of Tokyo, or even out of Japan, on a permanent basis. Although many commercial factors will undoubtedly factor into any such decision, this thought process also requires a number of tax considerations to be weighed, some of which are discussed below.

Certainly, any such analysis should be based on a thorough understanding of the overall tax picture of the existing operations. For example, do the existing operations have significant tax losses that could shelter business profits, which would otherwise be taxed if the business operations were moved out of Japan? Moreover, if those losses gave rise to deferred tax assets in Japan for accounting purposes, would an inability to utilize the losses in the future (due to decreased profitability in the remaining Japan-based operations) require the company to write-off the deferred tax assets? On a similar issue, should expenses be capitalized (versus currently deducted) so as to defer recognition of the deduction until the future, when profitability has hopefully recovered?

In addition to understanding the overall tax picture of the existing operations, the tax treatment of the relocation would also need to be considered.

From the individual perspective, in addition to the relocation issues identified above in the temporary

The treatment of foreign exchange gains or losses arising from sudden swings in exchange rates will need to be factored into existing and future transfer pricing policies.

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Relocation section, companies considering permanently relocating may also need to consider that not all employees may be able to or desire to permanently relocate with the company. If these employees leave the company then retirement/separation payments may need to be made and potentially taxes would need to be withheld.

Relocating operations within Japan—Relocating operations within Japan permanently will give rise to the same tax considerations mentioned above in relation to temporary relocations within Japan.

Relocating operations to another country—For companies considering relocating operations to another country on a permanent basis, the taxation of the business migration out of Japan needs to be considered. As a general principle, the transfer of business assets outside of Japan will trigger a taxation of any built-in gain in such assets (as well as allow any built-in losses to be recognized) for Japanese tax purposes. Where the entire business operations are transferred, the goodwill associated with such operations is generally viewed as an asset for this purpose and taxed. Accordingly, companies considering migrating their businesses will need to value such operations and may incur a significant tax cost to move the operations out, depending on the results of the valuation.

Beyond the immediate taxation of the business migration, the relocation of the business will also directly impact the transfer pricing policies in place to govern intercompany transactions among group companies. Relocating a manufacturing function from Japan to China, for example, would require an assessment of whether Chinese transfer pricing rules support the same policy to remunerate the manufacturing function as that applied in Japan, or whether the policy will need to be adapted—or even completely changed—to ensure compliance with Chinese law. Particularly within Asia, where there is significant variety both in terms of transfer pricing practice, it is unlikely that the same transfer pricing policy will be able to be applied exactly as it was in Japan—even, for example, for a business as simple as a limited risk service provider. It will also be important for tax management to check if there are any transfer pricing filing requirements in the relocated jurisdiction, such as contemporaneous documentation requirements, as Japan has a far less onerous compliance burden in this regard than many other countries.

Relocating only part of the business (the raw materials processing part of the manufacturing operations only, for example) creates other transfer pricing issues to consider. In such cases, a new intercompany transaction—between the part of the business remaining in Japan and that relocated overseas—would be created, requiring establishment of a completely new transfer pricing policy. The consequences of a partial relocation are particularly relevant where they result in the conversion of the Japanese business from an entrepreneur to some form of limited risk entity. This will inevitably cause a reduction in the "arm's length" profit margins that should be recorded by the Japanese entity in the future, as well as an assessment of whether any intangible assets have been transferred outside of Japan. These aspects will certainly require careful consideration, and are likely to increase audit risks going forward. Again, documentation of the changes to the business as a result of the permanent relocation will be critical to managing that risk.

The permutations of any such potential relocation are varied (e.g., moving an entire headquarters, moving a division, solely moving a workforce, moving management, etc.), with an equally wide range of tax issues arising in each case. Thus, the tax consequences of any form of relocation should be carefully considered as part of management’s relocation decision making process.

Comment

Addressing the tax function as part of the broader business recovery plan may hopefully ensure that tax risks are identified early and mitigated as far as possible. In turn, this should allow Japanese companies to financially account for the economic consequences of the Tohoku disaster as efficiently as possible.

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Submission of Articles

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Guidance Issued on New Corporate Income Tax—The Timing of Profit Remittance and VAT Documentation

By Richard Irwin (PricewaterhouseCoopers)

**Guidance on New Corporate Income Tax**


**Notable Changes**

**Deductible and Non-deductible Expenses**

- Costs of damaged goods due to expiration or natural spoilage are tax deductible. Conditions include (i) the costs are within the limit established by the company (Circular 18 is silent on whether such limit must be registered with the tax authorities), and (ii) supporting documents as stipulated in Circular 18 are in place.
- Circular 18 stipulates specific documents required to claim a tax deduction for damaged assets and goods due to natural disasters and fires.
- A tax deduction is allowed for depreciation of fixed assets during production suspension periods of less than nine months (if due to seasonal production) and 12 months (if due to repairs, maintenance or relocation).
- Indefinite-term land use rights are not tax depreciable.
- The condition for tax deductibility of bonuses that they are of “salary nature” is abolished. The condition remains that the bonuses and the entitlement criteria must be set out in employment contracts, collective labor agreements of internal policies.
- The tax deductible cap applicable to clothing benefits (cash and/or non-cash) increases from VND1.5 million to VND5 million.
- A tax deduction is allowed for year-end salary accruals of not more than 17 percent of the actual salary costs of the year, provided that the company is not in a loss position.
- Various rules on the 2009 and 2010 CIT finalization, which were previously not stipulated in the CIT Circular 130, have now been incorporated in Circular 18. These include the treatment of:
  - foreign exchange gains/losses;
  - interest income;
  - commercial penalty income; and
  - income from sales of scrap.

**Income**

- Refunds of import duty or export duty (ID/ED) related to the current year should be offset against deductible expenses. A refund of ID/ED paid in previous years shall be treated as other income. However, if the

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**Foreign investors will be permitted to remit their profits annually at the end of the financial year or upon termination of the investment in Vietnam.**

ID/ED relates directly to incentivized activities, the refund should be included in the profits eligible for such incentives.

- Various rules on 2009 and 2010 finalization that were previously not stipulated in CIT Circular 130 are now incorporated into Circular 18. These include the treatment of:
  - personal income tax for employees on “net” contracts;
  - accommodation costs of employees and school fees for children of expatriate employees; and
  - foreign contractor withholding tax in the case of “net” contract.

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**Tax Losses Carried Forward**

Losses incurred in a quarter are now allowed to be carried forward to the following quarters of the same tax year for CIT provisional payment purposes.

**CIT Incentive**

Circular 18 appears to confirm that “other income” can be offset by losses arising from CIT incentivized main operations.

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**Guidance on Profit Remittance**

The Ministry of Finance has issued Circular 186/2010/TT-BTC replacing Circular 124/2004/TT-BTC to provide detailed guidance on profit remittance by foreign organizations and individuals directly investing in Vietnam. Circular 186 is effective from

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January 2, 2011.

Key changes under Circular 186 are as follows:

**Timing of Remittances**
Circular 186 specifically provides that foreign investors will be permitted to remit their profits annually at the end of the financial year or upon termination of the investment in Vietnam. No reference is made to provisional remittances of profits, which is a deviation from Circular 124 which had provisions dealing with this. Accordingly, Circular 186 suggests that provisional remittances of profits are not permitted.

**Determination of Profits Entitled to Remittance**
Circular 186 formalizes the guidance under previously issued official letters, i.e., foreign investors are not permitted to remit profits if the investee company has accumulated losses. However, Circular 186 provides confusing references to both tax and accounting concepts and this provides some uncertainty as to conditions to be satisfied for profit remittances to be made.

**Notification Prior to Remitting Profits**
Circular 186 changes from an approval to a notification process. Either the foreign investor or the investee company will directly notify the tax authorities of the plan to remit profits at least seven working days prior to the scheduled remittance. The notification format is attached in the circular.

**Substitute Supporting Documents for Input VAT Claim in Relation to Exported Goods**
The Ministry of Finance issued Official Letter 16053/BTC-CST providing further guidance on substitute supporting documents for claiming input VAT refund of exported products where payment vouchers via banks are not available in the following situations:
- the foreign purchaser is insolvent;
- the defective exported goods are destroyed overseas; and
- the exported goods are damaged overseas.

Supporting documents to prove the above situations could include a court application filed in the foreign country, a document confirming the insolvency or bankruptcy of the importer issued by the foreign competent authorities, confirmation of destroyed goods issued by the entity undertaking the destroy or certificate of loss/damage issued by the foreign competent authorities.

**U.S.**

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and accrual basis taxpayers) also includes any foreign tax withheld by the issuer.

**Foreign Withholding Tax**
Foreign withholding tax may apply to non-U.S. issuer debt interest payments. Generally, debt securities of non-U.S. issuers provide that the issuer will pay interest without deducting any withholding tax or, if withholding tax does apply, the issuer will pay additional amounts so that the holder receives the full amount of any interest payment, irrespective of any withholding tax (i.e., a tax gross-up). As a result, a U.S. holder of foreign issued non-U.S. issuer debt may be taxed on more income than it actually receives. A U.S. holder may be able to claim a foreign tax credit or claim a deduction for any foreign tax withheld, subject to applicable limitations under U.S. tax law.

**Variable Rate Non-U.S. Issuer Debt Instruments**
The tax treatment described above applies whether the debt is a variable rate debt instrument (VRDI), or one that pays interest at a single floating rate (i.e., a rate determined using a single fixed point of reference). Plain vanilla floating rate debt (i.e., debt with an interest rate tied to LIBOR) is treated as a VRDI. In addition, commercial paper rate notes, prime rate notes, treasury rate notes, CD rate notes, and federal funds rate notes generally qualify as VRDIs.

More complicated debt securities (such as certain range accrual notes) may be subject to the more complex tax rules that apply to Contingent Payment Debt Instruments (CPDIs), depending on the particular terms of the debt. As a result, non-U.S. issuers of debt instruments seek to avoid classification of debt as CPDI. Purchasers of non-U.S. issuer debt offerings with U.S. tax nexus are prudent to avoid acquisition of CPDI.

**Purchasers of non-U.S. issuer debt offerings with U.S. tax nexus are prudent to avoid acquisition of CPDI.**

**Taxation of Non-U.S. Issuer Debt Issued with OID**
U.S. holders of non-U.S. issuer debt subject to the original issue debt (OID) rules include the OID in income over the term of the note on a constant yield basis based on a compounded yield to maturity. Even cash basis taxpayers (i.e., individuals) must include OID

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in income before receiving the cash attributable to that income. OID is the excess of a debt instrument’s stated redemption price at maturity (i.e., the amount payable at maturity) and the debt instrument’s issue price. The issue price is the first price at which a substantial amount of the debt instruments is sold. Debt issued with more than a de minimis amount of OID is subject to the OID rules. OID is de minimis if it is less than 0.25 percent of the debt’s stated redemption price at maturity multiplied by the years to maturity. All payments on a debt security, other than “qualified stated interest,” are treated as part of the debt’s stated redemption price at maturity. Qualified stated interest is stated interest that is unconditionally payable at least annually in cash or property at a single fixed rate (or at a single qualified floating rate or “objective rate”), other than in additional debt securities of the issuer. Payment-in-kind (PIK) debt securities are subject to the OID rules.

Debt may be issued with OID if it is fixed rate or floating rate debt and is sold at a discount. In addition, zero coupon bonds (which do not pay current interest) are subject to the OID rules. Special rules that apply to VRDIs may also cause a debt instrument to be treated as issued with OID if it provides for interest payments at more than one qualified floating rate or objective rate (e.g., if 20-year debt provides for interest based on LIBOR for the first 10 years, then for interest based on a Treasury Bill rate for the final 10 years).

Contingent Payment Debt Instruments

CPDI rules apply to debt securities that provide for one or more contingent payments of interest or principal. Even a cash method U.S. holder of a CPDI is “forced” to accrue interest income and include it in income based on a projected payment schedule. The projected payment schedule is based on the issuer’s “comparable yield” (i.e., the rate at which the issuer could issue a fixed rate debt instrument with similar terms, ignoring the contingencies). Therefore, a U.S. holder includes in income an estimated yield on the debt that may be substantially in excess of cash payments actually received. Positive or negative adjustments to previous interest income inclusions are required if actual contingent payments differ from projected payments.

Non-U.S. issuers of publicly-issued OID debt instruments must file Internal Revenue Service Form 8281, and list the comparable yield and projected payment schedule. For this reason, foreign debt issuers are prudent to structure debt to avoid the CPDI rules because of the complicated interest accrual rules and the reporting obligations. Again, purchasers of non-U.S. issuer debt offerings with U.S. tax nexus are prudent to avoid acquisition of CPDI.

Taxation of Interest Income on Non-U.S. Holders

A non-U.S. holder is subject to U.S. income tax on interest paid or OID accrued on non-U.S. issuer debt offerings when the non-U.S. holder is engaged in a U.S. trade or business and the interest or OID is effectively connected with that U.S. trade or business (Section 882(a)(1)), and when a relevant tax treaty deems that the interest is attributable to a U.S. permanent establishment.

Generally, foreign source interest income is not treated as effectively connected with the conduct of a United States trade or business. (Section 864(c)(4)(A).) Foreign source interest income of a foreign corporation derived from the active conduct of a banking, financing, or similar business within the United States, however, is treated as effectively connected with the conduct of a United States trade or business “if such person has an office or other fixed place of business within the United States to which such income, gain, or loss is attributable.” (Section 864(c)(4)(B).)

For purposes of section 864(c)(4)(B), when determining whether a foreign corporation has an office or other fixed place of business, the office or other fixed place of business of an agent will be disregarded unless the agent: (1) has the authority to negotiate and conclude contracts in the name of the foreign corporation and regularly exercises such authority; and (2) is not a general commission agent, broker or other independent agent acting in the ordinary course of business. (Section 864(c)(5)(A).) In addition, a foreign corporation’s income, gain or loss will not be attributable to an office or fixed place of business in the United States unless such office or fixed place of business “is a material factor in the production of such income, gain, or loss” and the office or fixed place of business regularly carries on the type of activities from which such income, gain or loss was derived. (See Section 864(c)(5)(B).) Treas. Reg. § 1.864-5 provides rules for determining when a foreign corporation’s foreign source income will be treated as effectively connected with a U.S. trade or business. Treas. Reg. § 1.864-6 also provides rules for determining when a foreign corporation that is engaged in a U.S. trade or business has an office or fixed place of business in the U.S. With respect to a foreign corporation that is engaged in a U.S. trade or business, Treas. Reg. § 1.864-7 defines

A U.S. holder may recognize foreign currency gain or loss with respect to interest income and on the sale, disposition or retirement of foreign currency debt.
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the term “office or other fixed place of business” for the purposes of Section 864(c)(4)(B), Treas. Reg. § 1.864-6, and Treas. Reg. § 1.864-5(b), all of which are provisions relating to foreign source effectively connected income. (See Treas. Reg. § 1.875-7(a)(1). See also IRS AM2009-010 (September 22, 2009).)

Taxation on the Disposition of Debt for U.S. Holders

On the sale, exchange or retirement of a U.S. dollar debt instrument (other than a CPDI), a U.S. holder generally recognizes gain or loss equal to the difference between the amount realized on the sale, exchange, or retirement (less any accrued interest), and the U.S. holder’s adjusted basis in the debt. A U.S. holder’s adjusted basis in a debt security equals the cost of the debt adjusted by: adding any amounts included in income as OID and market discount and subtracting any payments that are not qualified stated interest payments and any amortizable bond premium applied to reduce interest. If the debt was held for more than one year, a non-corporate U.S. holder recognizes long-term capital gain or loss. Long-term capital gain of a non-corporate U.S. holder currently is treated as capital loss. The capital loss is recognized long-term capital gain or loss on sale, disposition or retirement (less any accrued interest), and the U.S. holder’s adjusted basis in the debt. A U.S. holder’s adjusted basis in a debt security equals the cost of the debt adjusted by: adding any amounts included in income as OID and market discount and subtracting any payments that are not qualified stated interest payments and any amortizable bond premium applied to reduce interest. If the debt was held for more than one year, a non-corporate U.S. holder recognizes long-term capital gain or loss. Long-term capital gain of a non-corporate U.S. holder currently is treated as capital loss. The capital loss is recognized on the receipt of interest denominated in a foreign currency.

Any gain realized on the sale, exchange, or retirement of a debt instrument subject to the CPDI rules is generally treated as ordinary income. Any loss realized is treated as ordinary loss to the extent of the prior net interest income inclusions with respect to the debt (under the special CPDI interest inclusion rules), and any loss in excess of that amount is treated as capital loss. The capital loss is long-term capital loss for a U.S. holder that held the debt for more than one year.

For purposes of determining any gain or loss on a CPDI, a U.S. holder’s adjusted basis equals its cost adjusted by adding any amounts previously included as interest income under the projected payment schedule and subtracting the amount of any noncontingent payments and the projected amount of any contingent payments previously made on the debt.

Taxation on the Disposition of Debt for Non-U.S. Holders

A non-U.S. holder is subject to U.S. federal income tax on gain realized on the sale, exchange, or retirement of debt when the gain is effectively connected with a U.S. trade or business (see above), and when a relevant tax treaty deems that the interest is attributable to a U.S. permanent establishment. In addition, a non-U.S. holder is subject to U.S. federal income tax on gain realized on the sale, exchange or retirement of debt when such individual is present in the U.S. for 183 days or more in the taxable year of the sale, exchange, or retirement, and other requirements are met.

Foreign Currency Debt for U.S. Holders

If a U.S. holder acquires a debt security denominated in a foreign currency, it must determine its interest income and any gain or loss on sale, disposition or retirement of the debt by translating amounts received in a foreign currency into U.S. dollars. U.S. taxpayers are required to determine their U.S. tax liability in U.S. dollars. A U.S. holder may recognize foreign currency gain or loss with respect to interest income and on the sale, disposition or retirement of foreign currency debt. Foreign currency gain or loss is treated as ordinary income or loss.

Taxation of Foreign Currency Debt Issued without OID on U.S. Holders

If interest payments on a debt security issued without OID are denominated in a single foreign currency, the calculation of interest income differs for cash basis taxpayers and accrual basis taxpayers. A cash basis taxpayer recognizes interest income in the amount of the U.S. dollar value of the interest payment based on the spot currency exchange rate on the date of receipt of the interest income, regardless of whether the interest payment is in fact converted into U.S. dollars.

An accrual basis taxpayer accrues interest income in the specified foreign currency and translates that amount into U.S. dollars using either: the average currency exchange rate for the interest accrual period, or the spot currency exchange rate either on the last day of the interest accrual period (or the date of receipt if that date is within five business days of the last day of the interest accrual period). An accrual basis U.S. holder may recognize foreign currency gain or loss (treated as ordinary income or loss) on the receipt of interest denominated in a foreign currency if the spot currency rate of exchange on the date of receipt differs from the rate used to determine a prior accrual of the interest income.

Taxation of Foreign Currency Debt Issued with OID on U.S. Holders

If debt issued with OID is denominated in a single foreign currency, a U.S. holder determines the U.S. dollar amount includible in income as OID by calculating the amount of OID includible in each accrual period in the relevant foreign currency, and translating that amount into U.S. dollars in the same manner that

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An accrual basis taxpayer accrues interest income. When a U.S. holder receives a cash payment relating to OID previously included in income (including on a disposition or retirement of the debt), the U.S. holder may recognize ordinary income or loss in an amount equal to the difference between the U.S. dollar value of the amount received and the U.S. dollar value of the accrued OID.

Foreign Currency CPDIs

Special rules apply to CPDI debt denominated in a foreign currency or CPDI debt that has principal or interest payments determined by reference to a foreign currency. Under these rules, the comparable yield and projected payment schedule are determined in the relevant foreign currency, and positive and negative adjustments (based on the actual amounts received), are also determined in the relevant foreign currency. The foreign income inclusion is then translated into U.S. dollars at the average exchange rate in effect during the accrual period, or if the taxpayer elects, at the appropriate spot currency exchange rate. Positive adjustments are translated into U.S. dollars at the relevant spot currency exchange rate. Negative adjustments are subject to special rules depending on whether the negative adjustment reduces interest income for the current taxable year or previous years.

Taxation on the Disposition of Foreign Currency Debt for U.S. Holders

A U.S. holder must determine gain or loss on foreign currency debt in U.S. dollars. Gain or loss generally is ordinary income or loss under the rules that apply to foreign currency debt instruments to the extent gain or loss is attributable to changes in exchange rates during the period that the U.S. holder owned the debt. A U.S. holder’s initial basis in foreign currency debt is the U.S. dollar value of the foreign currency purchase price on the date of acquisition (or settlement date for debt traded on an established securities market). If a U.S. holder receives a currency other than the U.S. dollar in connection with the disposition of a debt security, the amount realized will be the U.S. dollar value of the payment on the date of disposition (or settlement date for debt traded on an established securities market).

Planning Note: Non-U.S. banks often issue debt securities out of their U.S. branches. Although the issuer is technically a non-U.S. person, the U.S. branch is treated as a U.S. person for tax purposes. As a result, the tax consequences of owning debt issued by a U.S. branch of a non-U.S. bank are generally the same as the tax consequences of owning debt of a U.S. issuer. Therefore, any interest is treated as U.S. source interest and the issuer must receive proper tax certifications from non-U.S. holders to be able to pay interest to those holders free of U.S. withholding tax. It is also important to check that interest can be received free of any withholding tax imposed by the issuer’s country of tax residence or incorporation.

Conclusion

Non-U.S. issuers of debt typically access U.S. capital markets using SEC-registered offerings, unregistered Rule 144A offerings, or private placements that are unregistered pursuant to SEC exemptions. This article is intended to present an overview of the various U.S. tax consequences to both U.S. holders and non-U.S. holders of non-U.S. issuer debt offerings, and address the issue of non-U.S. issuer debt offerings that generate U.S. income tax costs.