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IRS Provides Transitional Relief for FATCA Implementation
Examination of New Release on Foreign Banks

By Alan Winston Granwell (DLA Piper)

On July 14, 2011, the Internal Revenue Service (IRS) issued Notice 2011-53 (Notice) announcing plans to phase in the requirements of the Foreign Account Tax Compliance Act (FATCA), which enters into force January 1, 2013.1 (See chart on page 16 for phase-in dates.)

Why Notice Was Issued

In response to numerous comments concerning the practical difficulties in implementing FATCA by January 1, 2013, the Notice provides a phase-in for the implementation of FATCA. Commentators had requested transitional relief because of the lack of definitive guidance and the significant lead-time (18 to 24 months) that foreign financial institutions (FFIs) require to revise their IT systems once final guidance is issued. The Notice also acknowledges the reality that the effective implementation of FATCA will require coordination with foreign governments to resolve (if possible) the potential conflicts between FATCA and foreign laws. FATCA is a U.S.-centric law that imposes expansive extraterritorial obligations, particularly on FFIs. A number of these U.S. obligations may conflict with local law prohibitions with respect to privacy, data protection, anti-discrimination and withholding “foreign” taxes, generally if the account holder or member does not otherwise consent, thereby exposing FFIs to potential regulatory sanctions, civil lawsuits and possible criminal exposure in their local jurisdiction.

Phase-In Implementation Time Line

Background

Under FATCA, effective for payments after December 31, 2012 (subject to a limited transitional rule), withholdable payments (defined below) are subject to a new 30 percent U.S. withholding tax (FATCA Withholding Tax) unless a FFI enters into an agreement with the U.S. Internal Revenue Service (FFI Agreement) under which the FFI must, among other undertakings, determine whether it has U.S. account holders, comply with IRS verification and due diligence procedures with respect to the identification of U.S. accounts, annually report U.S. account information to the IRS, and withhold FATCA Withholding Tax on so-called “pass-thru” payments. An FFI that enters into an FFI Agreement is referred to as a “Participating FFI” and an FFI that is not compliant with FATCA is referred to as a “Non-Participating FFI.” A Non-Participating FFI and a “Recalcitrant Account Holder” (i.e., an account holder that fails (i) to comply with reasonable requests for information pursuant to IRS mandated verification and due diligence procedures to identify whether an account is a U.S. account; (ii) to provide a name, address and taxpayer identification number in the case of a direct or indirect U.S. account holder; or (iii) to provide a bank secrecy waiver upon request) are subject to the pass-thru payment rule. A similar but less burdensome rule applies to payments to foreign entities other than FFIs (NFFEs). NFFEes are subject to the FATCA Withholding Tax unless the NFFE (or beneficial owner) provides the Withholding Agent with either (i) a certification that the NFFE does not have substantial (more than 10 percent) U.S. owners that are subject to reporting under FATCA, or (ii) certain information with respect to its substantial U.S. owners.

Withholding

A Withholdable Payment is comprised of two categories:

U.S. FDAP Income Payment. Interest (including original

FATCA & Foreign Banks, continued on page 16
Planning for Cross-Border Financing Arrangements

By Hannah Terhune (Capital Management Services Group)

This article identifies the key tax issues related to financing U.S., UK and Canadian operations through debt. The intent of U.S. tax policy is to encourage investment in the United States, and the current tax rules strongly encourage the use of debt by foreign companies financing U.S. subsidiaries and affiliates. The core tax issues— withholding, income tax, and interest deductions—are considered in the context of both the lender’s and borrower’s home country, with consideration for the tax relief offered by applicable income tax treaties.

**Withholding Tax**

**United States**

The United States imposes a 30 percent withholding tax on U.S. source interest payments to a foreign lender. This tax is collected by requiring the U.S. borrower to withhold the tax from the interest payment. The foreign lender is not allowed any reduction for expenses related to the loan to the U.S. borrower. To avoid the U.S. withholding tax, many non-U.S. lenders will lend through a U.S. branch office. While the interest income is exempt from U.S. withholding tax, it is nevertheless subject to U.S. income tax at the same graduated rate imposed on all other U.S. business operations.

Another way to avoid the U.S. withholding tax is to structure the debt instrument so that the interest payments qualify under the “portfolio interest” exemption. Under this exemption, interest is exempt from U.S. withholding tax when it is paid at an arm’s length interest rate to an unrelated lender, and where such interest payment is not tied to cash flow, dividends, or profits of the borrower or a related party.

U.S. source interest payments are also exempt from U.S. withholding tax if the lender resides in a country where the United States has an income tax treaty providing for such an exemption.

In the United States, there are also exemptions for the withholding tax that flow from tax policies designed to encourage foreign investments. For example, interest paid with respect to bank deposits is not subject to withholding tax; also, original issue discount (OID) is not subject to withholding tax where debt instruments have a maturity date that does not exceed 183 days.

**UK**

The UK imposes a 20 percent withholding tax on

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Interest paid to an arm’s length lender is not subject to Canadian withholding tax unless the interest is “participating debt” interest.

UK source annual interest payments. Interest that is not UK source, or interest on debt instruments with a maturity date of less than a year, is not subject to the 20 percent withholding tax. U.S. source payments of interest and principal to the UK may also be exempt from U.S. withholding tax if the income tax treaty between the U.S. and the UK applies.

In the UK, withholding tax is not imposed on interest paid by a bank in the ordinary course of its business, and no withholding tax is imposed on quoted Eurobond (i.e., a security listed on a stock exchange that HMRC recognizes) interest payments. Furthermore, no withholding tax is imposed when the lender is related to the borrower (i.e., a direct 25 percent capital ownership relationship between the borrower and lender); provided, the lender pays tax in another Europe Union Member State on the interest income, and HMRC has issued an exemption notice.

**Canada**

Interest paid to an arm’s length lender is not subject to Canadian withholding tax unless the interest is “participating debt” interest. Participating debt interest is interest that is either contingent or dependent on the use or production from property in Canada as determined by reference to revenue, profit, cash flow, commodity price or any other similar criterion; or as determined by reference to dividends paid or payable by the individual borrower or any corporation. This exemption also extends to standby and commitment fees, guarantee fees and other amounts that are deemed to be interest under a loan; provided, that the recipient deals at arm’s length and the amounts are not otherwise deemed to be participating debt interest.

Where the issue involves “Canadian Convertible Debt,” the CRA will not consider the premium on the conversion of a convertible debenture as participating debt interest unless the debt instrument meets all of the following conditions:
1. the debentures are unsecured, subordinated debts;
2. the issuer is a public company;
3. the debentures are issued for a fixed amount of money in Canadian dollars that represents the face value of

Cross-Border Financing, continued on page 8
The Australian Taxation Office (ATO) has recently developed a new Reportable Tax Position (RTP) schedule that is designed to accompany companies’ 2012 tax returns as part of an information disclosure package. The ATO has stated that this schedule, if implemented, is intended to help the tax authorities understand tax risks for large businesses with greater precision as well as provide more assurance to corporations about their most contestable and material tax risks.

When Will this Schedule Apply and to Whom Does it Apply?

The schedule would accompany the company tax return and would initially apply only to the largest business tax payers, which the ATO has categorized as “high risk” or “key taxpayers” under the Large Business Risk Differentiation Framework. The RTP schedule would be filed for income years starting on or after July 1, 2011. Potentially affected taxpayers who enter into Annual Compliance Agreements for the current income year will not be required to complete the schedule for that period. The schedule would also apply to those taxpayers who have tax positions that are considered “reportable.”

Defining “Reportable”

The ATO defines a “reportable tax position” as one that has not been otherwise adequately disclosed by the taxpayer and is:
- a material position that is not more likely to be correct than incorrect;
- a position for which “uncertainty about taxes payable or recoverable” is disclosed in the taxpayer’s or related party’s financial statements; or
- a position regarding a “reportable transaction.”
  - A “reportable transaction” occurs when:
    - the taxpayer recognizes more than A$200 million of income in their financial statements for the current income year and treats less than 50 percent of such income as assessable income; and
    - the transaction involved a change to the effective ownership or control of an entity (or entities), business (or businesses) or asset (or assets).

The same, similar or related transactions are to be treated as one transaction. Effective ownership is the extent to which “the taxpayer has rights and participates in the risks and opportunities from holding interests in the entity or asset.” Control exists when a taxpayer holds, directly or indirectly, 50 percent or more of the voting rights in another entity, or when a taxpayer has the power to govern the financial and operating policies of the entity so as to obtain benefits from its activities.

Potential Consequences of the RTP Schedule and Transfer Pricing

It is anticipated that the ATO will use the information received from the RTP schedule to make assessments of the relative risk associated with the taxpayer’s operations and whether an audit or further information reviews are required.

For companies operating in Australia that could be subject to the RTP, there are potential strategies to take into consideration. The greater the complexity of a taxpayer’s intercompany transactions with its related entities, the greater the probability that the taxpayer’s and the ATO’s views on particular transactions could differ. Adequate and thorough documentation which categorically shows that the taxpayer’s intercompany transactions are arm’s length will provide greater certainty. To that end, taxpayers who are requested to complete the RTP schedule should pay close attention to their transfer pricing arrangements and their documentation strategies in order to decrease the likelihood that their intercompany pricing policies could give rise to reportable positions.

As with many transfer pricing arrangements, it is recommended that taxpayers at least consider entering into an APA for high-exposure transactions.

It is recommended that taxpayers at least consider entering into an APA for high-exposure transactions.

Start of a Trend?

The RTP schedule follows the example of the IRS' Schedule UTP (Uncertain Tax Positions), or Form 1120. Schedule UTP requires large and mid-sized businesses to report their uncertain tax positions under a five-year phase-in plan. After the IRS and ATO, other revenue authorities could follow suit.

Taxpayers are welcome to submit their views on the schedule to the ATO at the following address: Reportable TaxPosition@ato.gov.au. The major themes and concerns from this feedback will be discussed at consultative meetings which are regularly held between the ATO, the Large Business Advisory Group (LBAG), and the National Tax Liaison Group (NTLG).
Mexico does not have a specific section on corporate restructuring in its tax law as does, for example, the Internal Revenue Code in the United States. However, Mexico’s Income Tax Law (ITL) contains provisions that deal with transfers of stock under certain reorganizations. In addition, some of Mexico’s tax treaties also deal with certain reorganizations.

**Mexican Corporate Shareholders**

Article 26 of the ITL deals with reorganizations (called “restructurings” by the ITL) when the shareholders involved are Mexican corporate taxpayers. Article 26 authorizes transfers of shares or other interest in Mexican entities (Shares) at cost, i.e., at tax basis. By transferring the Shares at tax basis, no profit or gain results from the transaction and, consequently, no tax as well.

The transfers must take place as a result of a restructuring of companies of the same group. A “group” is defined as those companies 50 percent of whose voting Shares are owned, directly or indirectly, by the same persons. Publicly-traded Shares are not taken into account for this computation, provided they have, in fact, been publicly offered and traded. Shares repurchased by the issuer are not considered publicly traded.

In order for the tax-free treatment to apply, the taxpayer must secure a written authorization from the tax administration.

The conditions for these reorganizations to be tax free are the following:

- the price for the Shares being transferred must correspond to the tax basis;
- the tax basis of the Shares being transferred must be determined as of the date of the transfer in accordance with the provisions in the ITL, distinguishing them by transferor, issuer and transferee. This tax basis must be certified by a public accountant registered with the tax authorities;
- the tax basis in the Shares transferred carries to the Shares received in exchange, ratably;
- the increase in the stated capital, recorded by the company acquiring the Shares being transferred, must correspond to tax basis of the transferred Shares;
- the consideration received for the transfer must be Shares of the transferee. That is, the tax exemption applies only to Share-for-Share exchanges;
- the transferor must keep the Shares received in exchange for the Shares being transferred under his direct ownership within the same group, for a period of not less than two years from the date the authorization is secured;
- similarly, the capital stock participation in the entity or entities issuing the Shares transferred must continue in the same percentage by the company controlling the group or by the company created to acquire such Shares, as the case may be;
- the Board of Directors of the entity issuing the Shares received in exchange must approve a resolution regarding the subscription and payment in exchange for Shares of the Shares received, passed before a public notary or public broker, expressing the transaction.

In the event any of the above requirements is not met, the transferor will be required to pay the tax corresponding to the transfer of the Shares. In such an event the transfer price must be determined considering the prices at which the Shares would have been transferred between independent parties in comparable transactions or considering the appraised value determined by an appraiser authorized by the tax authorities. This tax is to be paid, adjusted for inflation from the date of the transfer to the date of payment.

**Foreign Shareholders**

Under Mexican domestic law, foreign residents are subject to tax in Mexico on their Mexican-source income. Mexican-source income includes income from the sale of Shares issued by Mexican companies or from the sale of Shares of foreign companies where more than 50 percent of their value is represented, directly or indirectly, by real property in Mexico. A foreign resident is one who has its...
Corporate Reorganizations (from page 5)

main administration or effective place of business outside of Mexico.

Article 190 of the ITL contemplates reorganizations of entities whose Shares are owned by foreign shareholders.

The ITL provides that in the case of reorganizations of companies belonging to the same group, the tax authorities may authorize deferral of the tax on the gain in the disposition of Shares within the group. A group, here, is defined as the aggregate of companies whose voting shares representing capital stock are owned directly or indirectly by a same entity by at least 51 percent.

This is a mere deferral, not an outright exemption as in the case of the corporate shareholder reorganizations mentioned above. In these events, payment of the deferred tax is to be made within 15 days following the date on which the Shares leave the group. Here again, the tax is to be paid together with inflationary adjustment from the date the tax on the original disposition was due through the date of payment. For the purposes of the preceding paragraphs, a group is considered to be the aggregate of companies whose voting Shares representing capital stock are owned directly or indirectly by a same entity, by at least 51 percent.

Unlike the reorganization rules for Mexican corporate taxpayers, the shares are not transferred at tax basis. Instead, the value of the Shares to be considered in determining the gain is the price or consideration that would have been used by independent parties in comparable transactions, or taking account of the value of the appraisal performed by the tax authorities.

These authorizations must be secured before the fact, prior to the reorganization being implemented.

Other requirements for these authorizations are:
- The consideration for the Shares transferred must be Shares issued by the transferee. So, here again, only Share-for-Share reorganizations qualify.
- Neither the transferor nor the transferee of the Shares in question should be subject to a preferential tax regime or reside in a country with which Mexico

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does not have in effect a broad information exchange agreement. If the transferee or transferor reside in a country with which Mexico does not have in effect a broad information exchange agreement, the authorization may still be secured, provided that the taxpayer files with the tax administration a statement expressing that he has authorized the corresponding foreign tax authorities to provide to the Mexican tax authorities information on the transaction for tax purposes. The issued authorization will be null and void if the information is not actually exchanged upon request. This puts the taxpayer in a very dangerous and unfair position. The taxpayer will have relied on the prior authorization from the tax administration to carry on the contemplated reorganization and later, as a result of an action (or inaction rather) over which the taxpayer has no control, he will be deprived of the benefits on which he relied.

- The transferor taxpayer must appoint a legal representative for tax purposes and must file with the tax authorities an audit report prepared by a public accountant registered with the authorities, to the effect that the tax computation was done in accordance with the tax provisions.
- The authorized transferor must file with the Mexican tax administration, within the first 15 days of March of each year, documentation evidencing that the Shares under the authorization have not left the group of companies. This information is to be filed during every year that the Shares remain within the group. The Shares are presumed to have left the group, and thus the deferred tax triggered, if the taxpayer does not timely file this notice. Of course, there may be a number of reasons why the notice might not be filed in a given year, including mere oversight. In the author’s opinion, the taxpayers should be entitled to file the notice after the abovementioned term, perhaps with a fine, but not suffer the loss of the benefits where the Shares still remain within the group.

The documentation to be filed to evidence that the shares subject to the deferral authorization have not left the group is as follows:

- Shareholding certificates of the companies issuing the shares subject to the authorization and of the companies forming part of the group to which it belongs, signed under oath by the companies’ legal representatives, updated through December of the year preceding the year the information is to be filed;
- Organizational chart of the group to which the companies subject to the authorization belong, showing the direct and indirect shareholding of the group companies, in particular the issuers subject to the authorization, updated through December of the year preceding the year the information is to be filed.

The Regulations call for the following documentation to be provided to the tax administration when filing for the deferral authorization:

- Organizational chart of the group before and after the restructuring, showing the direct and indirect shareholdings of the companies in the group;
- Certificates of shareholdings signed under oath by the legal representatives of the companies in the restructuring group, duly apostilled or legalized, as the case may be;
- Certificates of residence of the transferee and transferor companies in the restructuring, issued by the competent authority of the country in which each company resides for tax purposes;
- Statement by the legal representative of the companies that issued the shares subject matter of the authorization, undertaking to inform the tax administration of any change in its shareholders registration book taking place within a period of 12 months following the date of the tax deferral authorization. This notice must be filed within 30 days following the date any such change is recorded in the shareholders registry book. If no change takes place, this must also be stated under oath within the aforesaid period.

**Foreign residents are subject to tax in Mexico on their Mexican-source income.**

Some of the Mexico’s tax treaties also deal with tax-free reorganizations. Importantly, the treaty between Mexico and the U.S. exempts transfers of property between members of a group of companies from taxation. The conditions for the exempt status to apply are:

- The group of companies must file a consolidated tax return. Does this prevent, for example, that the Shares of the Mexican entity are transferred from one member of the group to an LLC of the group, because the LLC itself does not appear in the consolidated tax return as a result of its pass-through nature? In our view, such a transaction should qualify as the assets and results of the LLC are reflected in the consolidated tax return;
- The consideration received by the transferor must consist of participation or other rights to the capital of the transferee or of another company resident in the U.S. that owns, directly or indirectly, 80 percent or more of the voting rights and value of the transferee.

*Corporate Reorganizations, continued on page 8*
Corporate Reorganizations (from page 7)

The consideration need not necessarily be Shares. In the author’s opinion the consideration could be, for example, a mere increase in the value of Shares already subscribed and paid in. Nonetheless, if cash or property other than such participation or other rights is received, the amount of the gain (limited to the amount of cash or other property received), may be taxed by Mexico;

• the transferor and transferee must be companies resident in the U.S.;
• before and immediately after the transfer, the transferor or the transferee must own, directly or indirectly, 80 percent or more of the voting rights and value of the other, or a company resident in the U.S. must own, directly or indirectly (through companies resident in the U.S.), 80 percent or more of the voting rights and value of each of them.

For purposes of determining gain on any subsequent disposition, the initial cost of the asset for the transferee is determined based on the cost it had for the transferor, increased by any cash or other property paid, or, alternatively, the gain can be determined by another method that gives substantially the same result.

A very similar tax-free reorganization is called for under the treaties with The Netherlands and Switzerland. However, under these treaties there is no tax consolidation requirement; rather, the transferee must be a resident of a country with a broad tax information exchange agreement with Mexico.

Other treaties do not deal with reorganizations in such detail. A few treaties simply exempt transfers of Shares under a corporate reorganization. In this respect, neither the treaties nor domestic law should define what constitutes a reorganization. Nonetheless, based on an analysis of the domestic law provisions discussed above, one might conclude that a reorganization is a transfer of Shares between members of the same corporate group where the consideration received is Shares or other interest in the recipient entity.

Yet other treaties do not refer to reorganizations at all, but under their terms certain transfers of stock can take place without triggering Mexican taxes. Such is the case, for example, with the treaty between Mexico and Spain, where an investor could own 100 percent of the stock of a Mexican entity through at least five Spanish companies, each owning not more than 25 percent of the Shares. Under this structure, the Shares of the five Spanish companies could be sold without Mexican tax effects.

Similarly, while also not a reorganization, under certain treaties transfer of the Shares or other interest in foreign entities that own the stock of Mexican entities would not be taxable in Mexico regardless of whether their value is represented 50 percent or more by real property in Mexico, in our view. Such is the case, for example, with the treaty with the U.S.

Conclusion

Tax free reorganizations are available in a limited number of circumstances, especially under Mexico’s treaty network, either as a reorganization or as a mere tax-free transfer of Shares. In other instances, the only available option is a tax deferral authorization from the Mexican Tax Administration.

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REGIONAL

Cross-Border Financing (from page 3)

the debentures;
4. the debentures are issued with no original discount;
5. the debentures bear interest at a commercial fixed rate per year calculated on their face value;
6. the interest on the debentures is paid by the issuer at least annually;
7. the debentures are convertible at any time at the holders’ option into the common shares of the issuer before maturity;
8. the terms of the debentures specifically provide a fixed conversion price or a fixed conversion ratio;
9. the conversion price exceeds the price at which the common shares of the issuer could have been purchased on the market at the time the debentures are issued; and
10. the debentures have a specified maturity date and, at maturity, the debentures are redeemable by the issuer at a redemption price of 100 percent of the face value, plus accrued and unpaid interest.

Where interest is considered a “Related Party Interest Payment,” Canada imposes a 25 percent withholding tax on interest paid or credited to a non-arm’s-length lender, unless the interest paid or credited is on government obligations or other amounts that qualify as fully exempt interest. With
Cross-Border Financing (from page 8)

the exception of the U.S. income tax treaty, all of Canada’s income tax treaties reduce this rate to between 10 percent and 15 percent. The U.S. income tax treaty exempts most interest payments from withholding tax.

The Canada-U.S. Income Tax Treaty normally exempts from withholding tax interest that is paid or credited by a Canadian borrower to a U.S. lender, except for amounts considered contingent interest. “Contingent interest” is subject to a 15 percent withholding tax and is defined in the treaty to include Canada source interest determined by reference to: the receipts, sales, income, profits or cash flow of the debtor or a related person; the value of any property of the debtor or a related person; or any dividend or distribution of the debtor or a related person. While the definition of contingent interest may appear similar to the definition of participating debt interest, a key difference is that contingent interest is determined with reference to the receipts, sales, income, profits, cash flow, dividends or distributions of the debtor or a related person or to the value of the debtor or related person’s property. In the case of participating debt interest, such interest may be determined with reference to a contingency unrelated to the debtor.

The exemption from Canadian withholding tax on related party interest and treaty-covered interest is restricted or denied where the interest is paid to U.S. partnerships with Canadian partners that have “checked the box” to be treated as a U.S. corporation for U.S. tax purposes, but are nevertheless treated as partnerships under Canadian law for Canadian tax purposes; and, where the interest is paid by companies that are treated as corporations under Canadian law for Canadian tax purposes, and are fiscally transparent for U.S. tax purposes.

Taxation of Interest Income

United States

In the United States, the tax classification of a payment from a U.S. corporation is determined by the corporation’s tax attributes. A corporate distribution with respect to its shares of stock is taxed as follows: a dividend to the extent of the corporation’s current and accumulated earnings and profits that can support such a dividend; as a return of capital to the extent that there are no current or accumulated earnings and profits and there is basis in the stock of the distributing corporation; as capital gain from the deemed sale of stock in the distributing corporation after basis in the stock of that company has been reduced to zero. A return of capital is not subject to U.S. tax.

Generally, capital gains of non-U.S. residents are exempt from U.S. tax unless the U.S. corporation is an entity whose value is substantially attributable to U.S. real property interests, or the gain is attributable to a U.S. permanent establishment.

UK

Interest income from debt is subject to the UK corporate tax rate of 26 percent (reduced from 28 percent April 1, 2011; the rate is reduced by 1 percent until it reaches 23 percent on April 1, 2014). Lower rates may apply to small companies. Interest income is subject to UK tax where the lender is either a UK tax resident, or is.
Cross-Border Financing (from page 9)

carrying on a banking business through a UK permanent establishment.

Canada

Each person resident in Canada is subject to income tax on their worldwide income. To determine Canadian taxable income with respect to interest payments, it is necessary to determine if the taxpayer is a financial institution because different rules govern other types of lenders. Financial institutions include: banks, trust companies, insurance companies, credit unions, corporations whose principal business is the lending of money, securities dealers, and any corporation that is controlled by another financial institution. Financial institutions other than securities dealers generally are required to mark-to-market loan or other debt securities for tax purposes that are marked-to-market for accounting purposes. Taxable gains (or losses) are realized and recognized by a financial institution on a disposition of a loan or debt security subject to the mark-to-market rules. Securities dealers are generally required to mark-to-market loan or debt securities regardless of the accounting treatment.

Lenders other than financial institutions typically include accrued interest to the end of their tax year, or that is received or receivable during the tax year if such income was not included in the lender’s income in a previous tax year. If a lender disposes of a loan during a particular tax year, it must include the accrued interest up to the time of the disposition in income. Special rules apply to deem interest to accrue on prescribed debt obligations, including zero coupon bonds, stripped interest coupons and certain obligations with contingent interest payments. A lender is typically required to include in income any fees received or receivable in relation to a loan.

The corporate tax rate on amounts paid under a loan depends on whether the lender is a Canadian-controlled private corporation (CCPC). A CCPC is subject to combined federal and provincial corporate tax rates of between 28 percent and 34 percent for active business income, and 44.7 percent and 50.7 percent for investment income, the latter of which includes a 6-2/3 percent refundable tax. A corporation that is not a CCPC is subject to a combined federal and provincial tax rate of between 28 percent and 34 percent.

Interest Expense Deductions

United States

The benefit of debt arises from the deduction for interest expenses. In the United States, debt service reduces the tax base for federal, state and local tax purposes. Given that the top U.S. corporate income tax rate is 35 percent (not taking into account combined federal, state and local income tax rates), the benefit of debt service is substantial.

Earnings-stripping provisions limit the ability of U.S. companies to deduct interest expenses. Specifically, the rules limit deductions for interest expenses that are paid or accrue to a non-U.S. related party, or guaranteed by certain non-U.S. related parties where the debtor company’s debt-to-equity ratio exceeds the statutory safe harbor (i.e., 1.5:1), and the company’s net interest expenses exceed 50 percent of its adjusted taxable income.

UK

The United States does not follow strict legal form to the same extent as the UK, but applies its tax law on a “substance over form” approach. Debt instruments must be viewed under U.S. common law principles as either bona fide debt, or an instrument that represents an equity interest. This determination is based on a variety of facts and circumstances. U.S. law requires that related party debt bear an arm’s length interest rate. As in the UK, no deduction is allowed for related party interest payments until the interest is actually paid. In addition, the U.S. dual consolidated loss rules operate to prevent a double deduction of a single economic loss incurred by dual-resident companies (e.g., a UK resident company electing to be a disregarded subsidiary of a U.S. company for U.S. tax purposes). The tax regulations allow the use of such a loss to shelter U.S. taxable income where taxpayers certify that no portion of the dual consolidated loss has been, or will be, used to offset income of any other person under the income tax laws of another country.

Canada

Interest is generally deductible in computing a corporation’s income when it is paid in, or payable to, with respect to a given tax year, provided: there is a legal obligation to pay interest; the borrowed funds are used for the purpose of earning income from the business or property, or the interest relates to the unpaid purchase price for property used in the corporation’s business or is otherwise used to earn income.

Special rules apply to limit the deductibility of interest where a non-resident lender (or persons with whom it does not deal at arm’s length) holds more than 25 percent of the equity of a Canadian corporate debtor, the deductibility

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Cross-Border Financing (from page 10)

of interest paid to that lender is restricted under Canada’s thin-capitalization rules to the extent the debts owed to such persons exceed twice the debtor’s equity. Special rules apply for determining the relevant debt and equity for these purposes.

Special rules also apply to limit the deductibility of interest where a non-resident lender interest that is paid or payable in a year relating to money used to acquire vacant land or for construction period financing is capitalized to the cost of the property. Other financing expenses (apart from certain contingent amounts that are not deductible) are generally deductible over a five-year period, although standby fees, guarantee fees and other fees that relate solely to a particular year can generally be deducted in that year. A pre-payment penalty, or bonus, or rate reduction payment is typically deductible as interest but will be amortized over the remaining term of the loan.

Conclusion

The core tax issues related to financing U.S., UK and Canadian operations through debt— withholding, income tax and interest deductions—must be considered in the context of both the lender’s and borrower’s country and analyzed for the potential tax relief offered by applicable income tax treaties.

RUSSIA

Russia Adopts New Transfer Pricing Rules Effective 2012

By Arseny Seidov and Roman Bilyk (Baker & McKenzie CIS)

On July 18, 2011, President Medvedev signed into law new transfer pricing rules that substantially change the manner in which transfer pricing applies in Russia. The new rules will come into force on January 1, 2012. Most Russia based taxpayers should start working on meeting the expected documentation requirements and adjusting their transfer pricing policies in light of the upcoming changes. The key provisions of the new rules are as follows.

Controlled Transactions

The new rules require taxpayers to notify the tax authorities on controlled transactions that are performed in a given calendar year. Controlled transactions include any transactions between related parties (domestic or cross-border). Among other criteria, parties are considered related if one directly or indirectly owns more than 25 percent of another or can control the formation of at least 50 percent of the board of directors or the executive body of such other party. The courts may also determine that parties are related if the relationship between the parties could affect the results of transactions between them or their economic activities even in the absence of the statutory criteria.

In addition, the following transactions are subject to transfer pricing control:

- cross-border transactions with oil and oil products, ferrous and non-ferrous metals, mineral fertilizers, precious metals and stones;
- cross-border transactions with foreign entities registered in certain low-tax jurisdictions according to a list established by the Russian Finance Ministry, provided that the total revenues under these transactions exceed RUR 60 million (approximately US$2.1 million) in total in a given calendar year.

The new rules provide detailed guidance on selecting and adjusting comparables.

Transactions Outside Scope of Transfer Pricing Control

With certain exceptions, the following domestic transactions are not subject to transfer pricing control:

- transactions between related parties not exceeding RUR 1 billion. (approximately US$35 million) in

Transfer Pricing, continued on page 12
Transfer Pricing (from page 11)

total in a given calendar year. For 2012 and 2013, this threshold will be RUR 3 billion (approx. US$107 million) and RUR billion (approximately US$71 million), respectively;

• transactions where both parties are registered and have all operations in the same region and do not have tax losses, including loss carry-forwards.

Russian taxpayers forming a consolidated taxpayer group would not be subject to transfer pricing control for profits tax purposes. The draft law on tax consolidation for profits tax purposes is currently being considered by parliament and is expected to come into force in 2012 together with the new transfer pricing rules.

Functional Analysis and the Use of Comparables

The new rules provide detailed guidance on selecting and adjusting comparables. The rules on performing a functional analysis are generally in line with the OECD Transfer Pricing Guidelines. There is a broad list of permitted data sources on comparables. The rules prohibit the tax authorities from using any outside comparables if the taxpayer has comparable transactions with unrelated parties.

Transfer Pricing Methods

Similarly to the OECD Transfer Pricing Guidelines, the new rules provide for five transfer pricing methods (comparable uncontrolled price, resale, cost plus, comparable profits, and profit split). The comparable uncontrolled price method is the primary method to be applied. In all other cases, the best-method rule applies. The profit-split method remains the last resort method. The use of two or more methods combined is also allowed for transfer pricing purposes. One-off transactions that are outside the scope of ordinary activities of the taxpayer may be valued through an independent appraisal.

Market Price Range and Transfer Pricing Adjustments

The existing 20 percent safe harbor for price deviations is eliminated, and a quasi-interquartile market price range is introduced instead. Adjustments are permitted with respect to the following taxes: profits tax, VAT (if one of the parties does not pay VAT), mineral extraction tax (if paid on an ad valorem basis), and individual income tax. In certain cases taxpayers are permitted to make true-up adjustments for previous tax periods. Corresponding adjustments (i.e., in case a transfer pricing adjustment is made to another party of a controlled transaction) are allowed for Russian corporate taxpayers only. In a cross-border context such adjustments are not allowed.

Documentation Requirements

Taxpayers having controlled transactions (with certain exceptions) are required to maintain transfer pricing documentation and provide it to the tax authorities within 30 days of the relevant request. The transfer pricing documentation may be requested no earlier than June 1 of the year following the calendar year in which the relevant transactions took place.

For 2012 and 2013 the transfer pricing documentation and notification requirements and transfer pricing audit rules will apply only if the total value of controlled transactions with a given party exceeds RUR 100 million (approximately US$3.5 million) and RUR 80 million (approximately US$2.9 million), respectively.

Transfer Pricing Audits

Transfer pricing audits will be performed by a special department in the Federal Tax Service separate from the regular tax audit process. A transfer pricing audit for 2012 may be initiated no later than December 31, 2013, and for 2013—no later than December 31, 2015. For 2014 and thereafter, a transfer pricing audit may be initiated for the three calendar years preceding the year when it is initiated.

Penalties

A 40 percent tax penalty will apply if a transfer pricing adjustment is made and if the taxpayer fails to submit the required transfer pricing documentation to the tax authorities within the established deadlines. There will be no tax penalty in the case of a transfer pricing adjustment for the tax periods 2012-2013. For tax periods 2014-2016 the tax penalty will be 20 percent. Starting from 2017 the 40 percent tax penalty will apply.

Advance Pricing Agreements (APA)

Taxpayers that are regarded as major taxpayers under the Russian Tax Code will be permitted to enter into unilateral or multilateral advance pricing agreements (APAs) with the Russian Federal Tax Service. The new rules also enable taxpayers to conclude APAs covering cross-border transactions with a party resident in a state having a double tax treaty with Russia under the competent authority procedures with the participation of the relevant foreign tax authority. In case of changes in the Russian rules covering APAs, the terms of concluded APAs are grandfathered.

There are also important transition rules that need to be considered.
On June 20, 2011, the Third Circuit held that a three-party swap-and-assign transaction was a disguised loan for tax purposes. As a result, the court treated the transaction as giving rise to income under Subpart F of the Code.

The Facts

Schering-Plough, a New Jersey based corporation, had foreign subsidiaries with large untaxed cash reserves that Schering-Plough wanted to access. If the subsidiaries would have distributed the cash to Schering-Plough directly, either as a dividend or loan, Schering-Plough would have been immediately taxable on the cash reserves under Subpart F of the Code. Instead, Schering-Plough entered into an interest rate swap with ABN-AMRO Bank NV (ABN), after which Schering-Plough assigned its “receive leg” to its foreign subsidiary in exchange for a lump sum. This assignment triggered a provision in the swap agreement that would require full payment of both legs monthly. ABN then entered into a mirror swap offsetting its economic risk on the original swap. The transaction was designed so that Schering-Plough would receive a lump sum that was taxed over the life of the swap rather than all at once as long as the transaction could be characterized as a sale and not a loan.

Schering-Plough reported the transactions to the IRS as a sale. The IRS determined that the transactions were loans rather than sales, and that Schering-Plough owed a deficiency of $472,870,042 for 1989, 1991, and 1992. The district court upheld the IRS’s determination and held that the transactions, in substance, were loans to Schering-Plough. In the alternative, the district court held that the transactions had no economic substance.

The Third Circuit’s Opinion

On appeal, the Third Circuit noted that Schering-Plough’s internal documentation of the assignment transaction appeared to support a desire on behalf of the taxpayer to enter into a borrowing arrangement, using terms such as “payment,” “interest,” and “principal reduction” to describe the transaction’s components. Moreover, ABN, the swap counterparty, had described the transactions as a tax-motivated repatriation strategy undertaken by Schering-Plough. Additionally, the court indicated that this circuitous structure was designed to disguise the source of the funds and would not have been necessary had Schering-Plough believed the transaction with its foreign subsidiary actually was a sale.

Although the transactions had indicia of loans, the court noted that in order for a transaction to be considered a loan, the purported borrower must have an unconditional obligation to repay the borrowed funds. The court stated that, despite the lack of a legal obligation to repay, this requirement will be satisfied if the transaction is designed to ensure repayment.

Schering-Plough argued that ABN’s involvement meant that there could not be a loan between itself and its foreign subsidiary. The court found, however, that there is no reason that a loan cannot involve three parties. In the alternative, the court held that ABN could be considered a mere conduit because it was not exposed to any risk as a result of the mirror swap. Because it determined that the transaction was in substance a loan, the Third Circuit declined to address whether the transaction lacked economic substance.

Schering-Plough also argued that it had suffered disparate treatment by the IRS because another taxpayer had engaged in a similar transaction and had not been assessed a deficiency after it was audited. During its audit of the other taxpayer, the IRS had issued field service advice to its examining agents concluding that the transaction would not be treated as a loan. Citing International Business Machines Corp. v. United States (IBM), Schering-Plough argued that “the IRS cannot treat similarly-situated taxpayers differently.” The Third Circuit, however, noted that courts have applied IBM narrowly and distinguished the instant case on its facts.
Disguised Loan (from page 13)

Unlike the facts of IBM, in which the IRS had issued a binding private letter ruling to IBM’s competitor but had denied IBM’s request for a similar ruling, the IRS in this case merely issued field service advice—a nonbinding document meant to provide guidance to an audit team rather than a guarantee to the taxpayer under audit. In addition, the court noted that the field service advice was not issued until 1997; as a result, Schering-Plough could not have relied upon the advice in the early 1990s. The court therefore rejected Schering-Plough’s disparate treatment argument.

Microsoft Use of Low-Tax Havens Drives Down Tax Bill

By Lynnley Browning (Reuters)

If you want to know why tax from surging corporate profits isn’t making much of a dent in the United States’ crippling budget deficit, a glance at Microsoft Corp’s recent results provides some clues. Things were rosy in the giant software company’s just-ended fiscal fourth quarter, which produced record sales of nearly $17.4 billion, a 30 percent increase in after-tax profit, and a 35 percent gain in earnings per share.

But for the Internal Revenue Service and foreign tax authorities, things weren’t so rosy. Microsoft reported only $445 million in taxes in the U.S. and other foreign countries, just 7 percent of its $6.32 billion in pre-tax profit.

Given the rancor in Congress and in the country about how to tackle the nation’s budget deficit and debt, including how companies stash profits overseas and enjoy lucrative tax breaks, it is instructive to see how Microsoft achieved this eye-popping tax result.

Partly it was because the company had a one-time refund of $461 million from the IRS for previous overpayments and because of its over-estimation of tax rates in previous quarters. There may be increased sales of products to consumers overseas, though it is not clear from company disclosures how much of a factor this might be.

But Microsoft is straightforward about the core reason for its lower tax bill: It is increasingly channeling earnings from sales to customers throughout the world through the low-tax havens of Ireland, Puerto Rico and Singapore.

Microsoft’s pre-tax profits booked overseas nearly tripled over the past six years, to $19.2 billion in the fiscal year that just ended, from $6.8 billion in the year ended in June 2006, according to company filings. By contrast, its U.S. earnings have dropped, to $8.9 billion from $11.4 billion in the same period. Foreign earnings now make up 68 percent of overall income.

According to its 2010 annual report, by keeping a good chunk of foreign earnings away from the U.S., Microsoft has accumulated $29.5 billion overseas—and that is before the impact of its last financial year.

In theory, the company has saved $9.2 billion in U.S. federal taxes on that figure, though if it brought the entire $29.5 billion back home tomorrow its tax bill would be lower because of credits for foreign taxes paid and other U.S. deductions.

Microsoft’s effective worldwide tax rate fell to 17.5 percent in the last fiscal year, down from 25 percent the previous year and 31 percent in the year to June 30, 2006.

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Microsoft’s effective worldwide tax rate fell to 17.5 percent in the last fiscal year, down from 25 percent the previous year and 31 percent in the year to June 30, 2006. The company said it expects to owe tax at an effective rate in the next year of between 19 percent and 22 percent.

Few companies, including Thomson Reuters, pay the standard U.S. corporate rate of 35 percent thanks to loopholes and deductions but the Microsoft tax rate is still at the low end when compared with other large technology companies.

In their last reported fiscal years, Google Inc.’s effective tax rate was 21 percent, Apple Inc.’s 24 percent, Microsoft, continued on page 15
Microsoft (from page 14)

and IBM’s was 25 percent.

A Twin Shift
Concern about the use of tax-reducing measures now used by many major U.S. corporations has been a big issue for President Obama and the Democrats as they race to hammer out a deal with Republicans by August 2 that would allow the United States to avert imminent default on its debt.

Some Congressional leaders are calling for a “repatriation holiday” that would allow corporations to bring back money held offshore at a lower rate of 5.25 percent, similar to a one-off deal in 2005 through which corporations brought back $312 billion.

Nearly $1.2 trillion of accumulated U.S. corporate profits are now held in overseas subsidiaries.

The U.S. government taxes U.S. businesses on income earned worldwide but allows them to defer taxes on the money until brought back to the U.S., so corporations like to keep the money abroad, particularly as they increase investment overseas. Critics argue the U.S. system also encourages businesses to move jobs overseas at a time of high unemployment—now at a 9.2 percent rate—in the U.S.

Obama and the Treasury Department oppose a “repatriation holiday” while Microsoft, along with other multinationals, including Apple, Cisco Systems and Pfizer Inc, backs the repatriation idea, through Win America, a Washington, D.C. lobbying group.

Most industrialized nations tax businesses only on income earned within their borders. U.S. corporations argue the U.S. worldwide system is anti-competitive and forces money overseas. But critics such as Richard Murphy of Tax Research LLP, an anti-poverty and tax research firm based in Britain, argue the U.S. system allows companies to park profits in places where the tax obligation largely disappears. He called Microsoft “a giant tax-planning exercise.”

Lower Rates Abroad
Microsoft said its lower taxes in the recent quarter were “primarily due to a higher mix of earnings taxed at lower rates in foreign jurisdictions resulting from producing and distributing our products and services through our foreign regional operations centers in Ireland, Singapore and Puerto Rico, which are subject to lower income tax rates.” The details of precisely how it does this have not been disclosed.

U.S. companies do not have to break out earnings in foreign subsidiaries, making it hard to determine from financial filings how much tax they are saving through each jurisdiction.

What is clear is Microsoft’s increasingly sophisticated use of the havens. Foreign earnings taxed at lower rates reduced Microsoft’s U.S. rate by 16.3 percentage points to 18.7 percent, for the just-ended year. That compares with a lowering by just 4.6 percentage points to 30.4 percent in 2006, according to SEC filings.

Ireland taxes corporate profits at 12.5 percent. Singapore taxes them at anywhere from 0 percent to 17 percent. Puerto Rico, a U.S. territory but a foreign country in the eyes of the IRS, offers U.S. multinationals an unusual credit for taxes paid there as well as tax credits for production. Microsoft operates a 123,000 square-foot factory in Puerto Rico that makes up to 80 million disks a year for sale in the Americas, according to its Spanish-language website—its only company-owned plant in the world.

A Microsoft spokeswoman declined to answer questions on how it records revenue and earnings in certain jurisdictions, adding, “Microsoft complies with the tax laws of every jurisdiction in which we do business.”

Legislation introduced this month by Senator Carl Levin, a Michigan Democrat, would require large U.S. corporations to report results country-by-country.

The Securities and Exchange Commission earlier this year asked the company to do the same, citing what it called the “disproportionate relationships among domestic and foreign revenues, pre-tax income and tax rates.” Microsoft told the SEC it would supply additional information in future filings. The company says it will provide the requested information in its 2011 annual 10K financial report due to be filed on July 28.

By finding ways to minimize its taxes, Microsoft can argue that it is only behaving in the interests of its shareholders.

Nearly $1.2 trillion of accumulated U.S. corporate profits are now held in overseas subsidiaries.
### FATCA & Foreign Banks (from page 2)

issue discount) dividends, rents, salaries, wages, premium annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits and income, if such payment is from sources within the United States.

**Gross Proceeds Payment.** Any gross proceeds from the sale or other disposition of any property of a type that can produce interest or dividends from U.S. sources (e.g., from the sale of disposition of U.S. stocks or securities).

A Withholding Agent is any person, whether U.S. or foreign, having the control, receipt, custody, disposal, or payment of any Withholdable Payment. A Withholding Agent may include a Participating FFI.

### Withholding Phase-In

**Withholdable Payments.** The Notice provides two phase-in dates:

1. For payments on or after January 1, 2014, Withholding Agents will be obligated to withhold only on U.S. FDAP Income Payments.
2. For payments made on or after January 1, 2015, Withholding Agents will be obligated to withhold on all Withholdable Payments.

**Comments.** The transitional rule for Gross Proceed Payments should be particularly helpful to Withholding Agents because, by delaying withholding for these payments, Withholding Agents can continue to use their existing withholding systems (for U.S. FDAP Income Payments) for an additional year while they implement systems for the more expansive FATCA Withholding Tax.

The interaction between the Withholdable Payment rule and the Pass-thru Payment rule (discussed below), particularly because any person is a Withholding Agent for a Withholdable Payment. Examples illustrating this interaction are provided in the comment section of the transitional Pass-thru payment rule below.

**Pass-thru Payments.** A Pass-thru Payment means any Withholdable Payment or “other” payment to the extent attributable to a Withholdable Payment. The Pass-thru Payment rule does not apply to NFFEs.

The Notice provides that, for payments made on or after January 1, 2015, a Participating FFI must withhold the FATCA withholding tax on Pass-thru Payments, particularly “other” Pass-thru Payments.

The Notice provides that the obligations of a Participating FFI with respect to computing and publishing its pass thru payment percentage (PPP) will not begin before the first calendar quarter of 2014.

The Notice provides that the grandfather rule for obligations in existence on March 18, 2012, will apply to Pass-thru Payments in existence on that date (unless the obligation is treated as equity for U.S. tax purposes, or lacks a definite expiration or term).

**Comments.** Participating FFIs will be obligated to withhold on U.S. FDAP Income Payments made on or after January 1, 2014 but will not be required to withhold with respect to “other” Pass-thru Payments made before January 1, 2015.

In application, the different phase-in dates applicable to Withholdable Payments and Pass-thru Payments create different effective dates for withholding. For example, assume a Participating FFI holds stock of a U.S. corporation in a custodial account for a Recalcitrant Account Holder and receives a dividend in 2014 from a U.S. corporation.

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### Summary of Phase-In Dates

<table>
<thead>
<tr>
<th>Item</th>
<th>Date</th>
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<tbody>
<tr>
<td>Withholding on:</td>
<td></td>
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<tr>
<td>• U.S. FDAP Income Payments</td>
<td>January 1, 2014</td>
</tr>
<tr>
<td>• Gross Proceeds</td>
<td>January 1, 2015</td>
</tr>
<tr>
<td>• Pass-thru Payments</td>
<td>January 1, 2015</td>
</tr>
<tr>
<td>Entering into FFI Agreement:</td>
<td>By June 30, 2013 to avoid FATCA withholding commencing January 1, 2014.</td>
</tr>
<tr>
<td>U.S. Account ID Procedures for pre-existing (including high-risk accounts) and new U.S. accounts:</td>
<td>Will begin in 2013, as summarized below.</td>
</tr>
<tr>
<td>Reporting of U.S. Accounts:</td>
<td>Earliest date, September 30, 2014, as summarized below.</td>
</tr>
<tr>
<td>Time for Future Published Guidance:</td>
<td></td>
</tr>
<tr>
<td>• Proposed Regulations</td>
<td>By December 31, 2011</td>
</tr>
<tr>
<td>• Final Regulations</td>
<td>By summer 2012</td>
</tr>
<tr>
<td>• Draft, followed by final versions of, FFI Agreements and reporting forms</td>
<td>By summer 2012</td>
</tr>
</tbody>
</table>
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The FFI must treat the dividend, U.S. FDAP Income, as a Withholdable Payment when credited to the account of the Recalcitrant Account Holder and withhold the FATCA Withholding Tax, even though the Notice provides that the Pass-thru Payment rule only applies to pass-thru payments in 2015. Effectively, in this case, the transitional Withholdable Payment rule only applies and not the transitional Pass-thru Payment rule.

Contrast the foregoing example with an example in which a Participating FFI holds the stock of a U.S. corporation for its own account and receives a dividend from the U.S. corporation in 2014 and makes a payment to a Recalcitrant Account Holder in 2015. In this case, the payment to the Recalcitrant Account Holder would not be a U.S. FDAP Payment, since the payor is a foreign corporation. The dividend would be foreign source and would constitute an “other” payment for Pass-thru Payment purposes. Thus, under the transitional rule for Pass-thru Payments, there would be no FATCA Withholding Tax imposed in 2014 but there would be a FATCA withholding tax imposed in 2015, based on the PPP of the Participating FFI that is making the payment to the Recalcitrant Account Holder.

In view of the phase-in dates for computation of the PPP, FFIs need to be careful as to how they compute their PPP. FFIs may want to consider using the alternative transition method specified in Notice 2011-34 for computing the PPP for 2014.3

Registration of FFIs Phase-In

The Notice provides that the IRS will begin accepting applications to enter into FFI Agreements no later than January 1, 2013. For FFIs that enter into an FFI Agreement before June 30, 2013, the IRS will treat those FFIs as Participating FFIs, effective on July 1, 2013. Thus, the Withholding Agents will not be required to withhold on these FFIs when the FATCA Withholding Tax takes effect on January 1, 2014.

FFIs that enter into FFI Agreements after June 30, 2013, but before January 1, 2014, will be Participating FFIs for 2014 but might not be identified as such in time to prevent withholding beginning on January 1, 2014 because of the time needed to process FFI applications and for U.S. Withholding Agents to verify whether a payee is a Participating FFI.

Effective Date of FFI Agreement

• The effective date of an FFI Agreement entered into any time before July 1, 2013 will be July 1, 2013.
• The effective date of an FFI Agreement entered into after June 30, 2013, will be the date the FFI enters into the FFI Agreement.

Comment. The effective date of an FFI Agreement is an important date and must be kept in mind for various FATCA implementation purposes, including for the application of the alternative transition method rules relating to FFI due diligence and the determination of the PPP, as discussed above.

Participating FFI Due Diligence

New Accounts

A Participating FFI must put in place account opening procedures to identify U.S. accounts that are opened after the effective date of an FFI Agreement (as described in Notice 2010-60). These procedures must be in place on or after the effective date of the FFI Agreement.

Comment. The Notice requires a Participating FFI to have in place the new account opening procedures, as described above, on or after the effective date of the FFI Agreement. Thus, if an FFI decides to enter into an FFI Agreement effective July 1, 2013, it will be necessary that it commence development and implementation of its IT systems prior to the effective date of the FFI Agreement. The IRS’s proposed timeline for finalizing Treasury Regulations may not give the FFI much time to develop IT systems.

Pre-Existing Private Banking Accounts Equal to or Greater than $500,000

A Participating FFI must put in place account opening procedures (as described in Notice 2011-34) on all Private Banking Accounts opened before the effective date of the FFI Agreement and that have a balance or value of at least $500,000 on the effective date of the FFI Agreement. The Participating FFI must perform a diligent review of paper and electronic files for each such account to determine whether the account reflects indicia of U.S. ownership and follows protocols to make determinations of U.S. status within one year of the effective date of the FFI Agreement.

Comment. The Notice, through use of a parenthetical, states that the private banking identification procedures will also apply to entity accounts, which is an expansion on the scope of the private banking procedures contained in Notice 2011-34.

Pre-Existing Private Banking Accounts Less than $500,000

A Participating FFI must put in place account opening procedures (as described in Notice 2011-34) on all Private Banking Accounts opened before the effective date of the
FATCA & Foreign Banks (from page 17)

FFI Agreement and that have a balance or value less than $500,000 on the effective date of the FFI Agreement. The Participating FFI must perform a diligent review of paper and electronic files for each such account to determine whether the account reflects indicia of U.S. ownership and follow protocols to make determinations of U.S. status by the later of (i) December 31, 2014, or (ii) the date that is one year after the effective date of its FFI Agreement.

Comment. The Notice lengthens the Notice 2011-34 (Step 3) one-year time period for performing the private banking account due diligence protocols for private banking accounts with less than $500,000, compared to those for $500,000 or more, which due diligence inquiry must be performed within a one year time period.

Due Diligence Requirements for Other Pre-Existing Accounts

The Notice provides that, for all accounts other than Private Banking Accounts, the Participating FFI must complete the due diligence procedures specified in Notice 2011-34 (requiring the FFI to determine whether an account reflects indicia of U.S. ownership and procedures for determining U.S. status) within two years of the effective date of the FFI Agreement.

Additional Due Diligence Guidance

The Notice states that forthcoming regulations will provide further guidance on the scope of the private banking procedures and the associated search of account holder files, as follows:

Forthcoming regulations will also provide that, for purposes of the private banking account review procedures set forth in Notice 2011-34, the diligent review of the account files may be completed by any person designated by the Participating FFI.

Comment. The Notice permits any person designated by the Participating FFI (no longer limited to the account relationship manager) to perform the diligent review.

Accounts subject to due diligence procedures and identified as either U.S. accounts or non-U.S. accounts under such procedures will not be subject to additional due diligence procedures in subsequent years unless the account undergoes a change of circumstances.

Reporting Account Information

New Accounts, Documented U.S. Accounts and Private Banking Accounts

The Notice provides that an account for which a participating FFI has received a Form W-9 from the account holder (or, with respect to an account held by a U.S.-owned foreign entity, from a substantial U.S. owner of such entity) by June 30, 2014, must be reported to the IRS as a U.S. account by September 30, 2014.

Where an FFI is not able to report the information above for a U.S. account by June 30, 2014, the FFI will be required to identify such account to the IRS as a Recalcitrant Account Holder by September 30, 2014.

Comment. The Notice provides greater flexibility for FFIs to satisfy the reporting requirements specified in Notice 2011-34 in 2014, but is not intended to change the information that generally must be reported in Notice 2011-34.

The Notice provides that the IRS will assess the accuracy of the information reported by the FFI and communicate with the FFI to resolve discrepancies in the information received. Unresolved discrepancies could result in an account being treated as held by a Recalcitrant Account Holder.

Significantly, the Notice provides that for each account for which the Participating FFI is not able to report information because, for example, the account holder has not waived any applicable local law reporting restrictions, the FFI will report the account among its Recalcitrant Account Holders.

It is not clear how or when conflicts between the local laws of foreign jurisdictions and FATCA will be resolved.

Account Holders with U.S. indicia in accordance with Section IV.F. of Notice 2010-60, which requires a Participating FFI to report the number and aggregate value of financial accounts held by Recalcitrant Account Holders that have U.S. indicia. This means of reporting ostensibly may not violate local law restrictions on data protection or bank secrecy because the report does not disclose individual names or data, but is reported on an aggregate basis.

Reporting for Post-2013 Years

Reporting with respect to 2014 and subsequent years will be required as contemplated in Notice 2010-60 and Notice 2011-34 and as implemented in future regulations.

Timeline for Future Guidance

The Notice announced that the IRS anticipates issuing proposed Treasury Regulations incorporating the contents of the Notice, Notice 2010-60 and Notice 2011-34 by December 31, 2011 and final Treasury Regulations in the summer of 2012. The Notice further announced that the IRS anticipates issuing draft versions (followed by final versions) of the FFI Agreement and reporting forms to be used by Withholding Agents and participating FFIs in the summer of 2012.

General Comments

In announcing the transitional rules, the IRS
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FATCA & Foreign Banks (from page 18)

Commissioner stated that “… the IRS recognizes that implementing FATCA is a major undertaking for financial institutions” and “[Notice 2011-53] is a reflection of our serious commitment to implementation of the statute, but also a serious commitment to listen to the implementation challenges of affected financial institutions and make appropriate adjustments to ensure a smooth and timely roll-out.”

The transitional rules represent a positive step in addressing the financial industry’s concerns about implementing FATCA by January 1, 2013, particularly because of the current lack of guidance on a number of issues and the significant lead time required to implement IT system enhancements or changes. Nonetheless, the timing of the phase-ins and the manner in which the Notice refers to the two earlier notices raise additional questions and concerns.

Timing

The promulgation of guidance implementing FATCA is a massive and complex undertaking. If the contemplated timeframes for finalizing the Treasury Regulations are delayed beyond the summer of 2012, the dates for phasing in FATCA information reporting and withholding will no longer comport with the projected completion of the project, thereby causing new concerns regarding the time period necessary to understand, evaluate and implement IT systems and protocols. As a number of commentators have suggested, it would have been far more preferable for the IRS to establish implementation timeframes by reference to dates after the final Treasury Regulations are published.

Content

The Notice states that the IRS anticipates proposing regulations incorporating the guidance contained in the notices, as modified and supplemented, and provide further guidance on other issues not previously considered. These statements (as well as other references in the Notice) may indicate that the IRS intends to incorporate the guidance contained in the notices in the regulations without significant modification to reflect recent taxpayer comments. Even if this were the case, stakeholders still would have to the opportunity to comment on the positions taken by the IRS in the proposed regulations.

As mentioned in the Notice, the IRS must still issue more guidance on a number of issues. Some of the important issues on which additional guidance should be issued include insurance/reinsurance companies and products, trusts and reclaims and refinement of guidance on such issues as deemed compliant status and retirement plans. Further, the Pass-thru payment provisions are contentious. Notice 2011-34 requested comments on potential exceptions to Pass-thru payments and other portions of the Pass-thru Payment provisions may be the subject of additional consideration. Finally, although beyond the scope of the regulations, it is not clear how or when conflicts between the local laws of foreign jurisdictions and FATCA will be resolved.

Thus, at this juncture, stakeholders should evaluate their particular situations by reference to the current guidance and await further developments.

1 On July 25, 2011, the IRS announced that it has revised the Notice to clarify that the phase-in dates applicable to the FATCA Withholding Tax will apply to Withholdable Payments made to FFIs and NFEs.

2 Notice 2011-34 provides that the PPP is determined by reference to the FFI’s total gross U.S. assets and other assets, unreduced by liabilities, as of its quarterly testing dates, by dividing the sum of its U.S. assets held on each of the last four quarterly dates by the sum of its total assets held on those dates. Notice 2011-34 provided an alternative transition method for computing the PPP.

3 See Notice 2011-34, Section 5 (which provides that each participating FFI will be required within three months after its quarterly testing date to make available its PPP calculated for that testing date; otherwise, the Participating FFI’s PPP will be treated as 100 percent).