How Do the Latest US Tax Proposals Affect Your U.S. Corporate Clients With Operations Abroad

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What to Watch For

- Hybrid entities
  - Using foreign hybrid entities for investment abroad
  - U.S. LLC’s as outbound investors
- Impact of foreign tax credit proposals on outbound planning
- Proposed deferral of the U.S. interest expense deductions
- Migrating U.S. intellectual property
- Disclosure by large corporations of uncertain tax positions
- Using hybrid instruments to finance foreign acquisitions or business expansion
- U.S. Withholding tax developments
  - Cross-border equity-linked derivative payments
  - FATCA – new reporting rules for U.S. withholding tax relief
- Challenges to existing foreign tax credit planning
- Codification of economic substance doctrine
- Cross-border guarantee fees
Hybrid Entities
Characterization of U.S. LLC’s by Canada - Paragraph IV(6) Canada–U.S. Treaty

- Treaty entered into force December 15, 2008
- Income, profit or gain will be considered to be derived by a resident of a Contracting State (i.e., the recipient state) where
  - The person is considered under the laws of that State (i.e., the recipient state) to derive income through an entity (other than an entity resident in the other Contracting State (i.e., the source state)), and
  - By reason of the entity being fiscally transparent in the first State (i.e., the recipient state), the treatment of the amount under the laws of that State (i.e., recipient state) is the same as its treatment if the amount had been derived directly by that person
- Paragraph IV(6) applies to amounts derived after February 1, 2009
Characterization of U.S. LLC’s by Canada - Paragraph IV(6) Canada–U.S. Treaty

- Fiscally transparent entities include
  - U.S. partnerships, certain investment and grantor trusts, LLC’s
  - Canadian partnerships and “bare” trusts

- S corps are viewed by the U.S. as fiscally transparent but Canada treats them as corporations entitled to treaty benefits

- Canada currently reviewing status of qualifying S corp subsidiaries
Characterization of U.S. LLC’s by Canada - Paragraph IV(6) Canada–U.S. Treaty

- Regarded as corporations
- Not liable to tax for treaty purposes and therefore not entitled to the benefits of the Canada-U.S. treaty
- TD Securities case (Tax Court decision pending)
Characterization of U.S. LLC’s by Canada - Paragraph IV(6) Canada–U.S. Treaty

U.S. Co

40%

U.S. Individual

30%

U.S. Tax Exempt

30%

U.S. LLC

Can Co

dividend

U.S

Canada

Characterization of U.S. LLC’s by Canada - Paragraph IV(6) Canada–U.S. Treaty

- LLC is a partnership for U.S. tax purposes
- U.S. shareholders, under U.S. tax law, derive dividends through LLC a FTE
- Paragraph IV (6) applies
- Treatment to shareholders same as if dividends had been derived directly for U.S. tax purposes
- Tax exempt entity a company described in subparagraph XXIXA (2)(h) or (i) and exempt on dividends under paragraph XXI (2) or (3)
- Canada will regard the LLC as the taxpayer; it will claim the benefit of the reductions in tax for its members (doc. no. 2007 – 0259011 C6 – January 1, 2008); members are not required to file tax returns with Canada
Characterization of U.S. LLC’s by Canada - Paragraph IV(6) Canada–U.S. Treaty

- CRA Technical Memorandum – February 17, 2010
- Meaning of “derive”
- Canada will not regard an item of income as derived by a member of a U.S. LLC if
  - The amount is disregarded under U.S. taxation laws
  - Concession for 2009 but future claims for treaty benefits will not be accepted
- Canada may accept amounts which are paid by Canadian non-disregarded corporations or trusts that are not disregarded but are treated differently for Canadian and U.S. tax purposes
Use of Foreign Hybrid Entities for Investment Abroad - Denial of Benefits - Paragraph IV(7)(b) Canada–U.S. Treaty

- Applies to amounts paid after January 1, 2010
- Income, profit or gain will NOT be considered to be derived by a resident of a Contracting State (i.e., the recipient state) where
  - The person is considered under the law of the other State (i.e., the source state) to have received income from an entity resident in that other State (i.e., the source state), but
  - By reason of the entity being fiscally transparent in the first State (i.e., the recipient state), the treatment of the amount under the laws of the first State (i.e., the recipient state) is not the same as its treatment would be if the entity were not treated as fiscally transparent in such State
Use of Foreign Hybrid Entities for Investment Abroad - Denial of Benefits - Paragraph V(7)(b) Canada–U.S. Treaty

- Technical Explanation Example 1 - ULC is disregarded entity for U.S. tax purposes

Diagram:
- U.S. Qualifying Persons
- U.S. Co
- Canadian ULC
  - interest
  - royalties
  - management fees
  - 25% withholding
- U.S.
- Canada
- dividends
- 25% withholding
Use of Foreign Hybrid Entities for Investment Abroad - Denial of Benefits - Paragraph V(7)(b) Canada–U.S. Treaty

- Technical Explanation Example 2 – ULC is a partnership for U.S. tax purposes

- Doc. No 2009-0318491I7, November 13, 2009, Example 7
- CRA Ruling issued on December 22, 2009 (not yet posted)
Example 9
Use of Foreign Hybrid Entities for Investment Abroad - CRA Ruling Issued November 20, 2009

**Steps**
1. ULC increases PUC by $x
2. ULC reduces PUC by $x
3. ULC distributes cash to For L.P. as return of capital of $x
Use of Foreign Hybrid Entities for Investment Abroad - CRA Ruling Issued November 20, 2009

- ULC is deemed to pay a dividend to For L.P. equal to the amount of the increase in capital (subsection 84(1), paragraph 212(2)(a))

- The dividend is considered for purposes of applying Article X of the Treaty to be
  - Income
  - Derived by S Corp and the U.S. Investors proportionate to their respective shares of the income of For L.P.

- S Corp will be considered for purposes of paragraph X(2) to own shares in Can Co in proportion to its ownership interest in For L.P.
Use of Foreign Hybrid Entities for Investment Abroad - CRA Ruling Issued November 20, 2009

- Paragraph IV (7)(b) will not apply (assumes that no amount of income, profit or gain would arise or be recognized for U.S. tax purposes on the increase of capital, regardless of whether the ULC was or was not fiscally transparent)
- Subsection 245(2) (“GAAR”) will not apply to redetermine the tax consequences
- 2009 CRA Roundtable confirmed this treatment where U.S. Co holds 100% of ULC that carries on business in Canada (consider position of holding companies)

- HMRC’s published view (since June 1997) that underlying tax paid by a U.S. LLC was not available for credit by a U.K. individual
- *Memec v. IRC*, [1998] STC 754 (German silent partnership)
- *Swift v. HMRC* 2010 UK FTT 88 (TC)
  - Delaware LLC treated as a partnership for purposes of entitling U.K. individual to double taxation relief (members entitled to profits as they arose)
Characterization of U.S. LLC’s by Spain - Competent Authority Mutual Agreement Spain–U.S. Treaty

- It clarifies treatment of LLC’s, S corporations, and other entities, organized within or without the US, treated as partnerships or disregarded entities for U.S. tax purposes.
- Income will be treated as derived by a resident of the US to the extent that income received by the LLC or other entity is subject to U.S. tax as the income of a U.S. resident.
Characterization of U.S. LLC’s by Spain - Domestic Characterization

- Inconsistent opinion of the Spanish tax authorities
- Entities incorporated abroad the legal nature of which is identical or analogous to a Spanish transparent entity will be treated as look-through entities
- Ruling V0997-05 (June 2, 2009) does not analyze the legal/tax nature of the LLC but qualifies it as a transparent entity
- Ruling V2097-09 (September 21, 2009) treats the LLC as not tax transparent
- US LP is clearly fiscally transparent (need to analyze the tax residency of partners)
Characterization of U.S. LLC’s by Brazil

- No concept of transparent entities
- For Brazilian purposes, a U.S. LLC is viewed as a regular corporation
- Due to regulations on tax haven jurisdictions there is a risk that U.S. LLCs would be viewed as: (i) located in a tax haven, which would attract more burdensome withholding tax rates on remittances from Brazil and/or (ii) enjoying a Privileged Tax Regime, which could attract deductibility constraints in cross-border payments
- Risk can be mitigated by disclosure of shareholding composition of the LLC and demonstration of economic capability (in relation to the Privileged Tax Regime issue)
- Black list vs. White List – diplomatic problems
Use of Foreign Hybrid Entities for Investment Abroad - Brazil – Hybrid Entities, Treaty Provisions and CFCs

- No concept of transparent entities under Brazilian law (the direct beneficiary of income and earnings derived from Brazil is deemed to be the effective beneficiary for Brazilian tax purposes)

- Brazil has a strong tendency towards source taxation (payments made from Brazil abroad are, in general, taxable in Brazil - Article 7 of the OECD model convention is broadly disrespected)

- For inbound investments to Brazil, in general, the interposition of an intermediary in a treaty jurisdiction has no material effects
  - Dividends paid by Brazilian companies to any recipient are tax exempt
  - Interest and royalties, in most cases, are taxed at the domestic rates (the limited treaty rates are the same with few exceptions such as Japan for interest and Spain royalties)
  - Tax treaties may contain special spare credit provisions related to interest and royalties payments

- No treaty with the U.S.
Use of Foreign Hybrid Entities for Investment Abroad - Brazil – Hybrid Entities, Treaty Provisions and CFCs

- Treaty jurisdiction may make a difference as compared to non-treaty jurisdiction if CFC rules are considered;
- Under Brazilian CFC rules profits of foreign subsidiaries are taxable in Brazil in December of every tax year, regardless of effective distribution;
- If the CFC is in a tax treaty regime the taxation of profits of the CFC may be neutralized or postponed to effective distribution;
- Under Article 7 of the OECD model convention (adopted by Brazil in its treaties) Brazilian taxing rights would be limited in connection with profits of the foreign subsidiary;
- A very controversial decision was recently issued by the Brazilian administrative court stating that the treaty provisions would not prevent the taxation of the profits of indirect subsidiaries.
Characterization of U.S. LLC’s by Germany - Paragraph 1(7) Germany–U.S. Treaty

- An item of income, profit or gain derived by or through a person that is fiscally transparent under the laws of either Contracting State, will be considered to be derived by a resident of a State to the extent that the item is treated for the purposes of the taxation laws of that State as the income, profit or gain of a resident.
Characterization of U.S. LLC’s by Germany  
- Federal Finance Ministry Circular  
Issued March 19, 2004

- Affirmed by German Supreme Tax Court, decision dated August 20, 2008 docket # I R 34/08)

- Criteria that qualify an LLC as a corporation
  - Centralised management (as opposed to management and representation by partners)
  - Limitation of liability
  - Transfer of LLC interest without consent requirements
  - Profit distribution requires a resolution before owners have a claim
  - Contribution of capital required
  - Unlimited lifetime of the company (irrespective of whether a partner dies/retires)
  - Profit distribution is proportional to the nominal share capital
  - Registration of LLC as a formal requirement for formation

- There is no “beat all” criterion (all facts and circumstances have to be considered)

- An LLC is deemed to be a corporation if a majority of the first five criteria are met
Characterization of U.S. LLC’s by Germany - Paragraph 1(7) Germany–U.S. Treaty

Federal Supreme Tax Court, decision dated August 20, 2008 (docket # I R 34/08)

No partnership for German tax purposes

Paragraph 10(1) (dividends) not applicable as the LLC is not resident in the US for treaty purposes

Germany has taxing right on profits according to Article 21 (other income)

LLC is transparent for US tax and a corporation for German tax

Foreign tax credit would only be possible as equitable relief since the US income tax has not been incurred by the German individual from a German tax perspective
Use of Foreign Hybrid Entities for Investment Abroad - Paragraph 1(7) Germany–U.S. Treaty

S Corporation is a corporation for German tax purposes (Federal Supreme Tax Court, decision dated August 20, 2008, docket # I R 39/07)

German withholding tax rate - 0% or 15%?

German tax officials view the dividend as attributed to the shareholders of an S Corporation due to its transparency, hence 15% rate.

S-corporation is transparent for US tax and a corporation for German tax.

Same treatment if a U.S. LLC holds a GmbH if the LLC is classified as a corporation for German tax purposes.
Use of Foreign Hybrid Entities for Investment Abroad - Interest from a German Partnership to its US Partner

Section 50d(10) Income Tax Act reverses the result of guaranteed payments in case of German partnerships.

Article 11 is rendered not applicable.

Interest qualifies as trade income and constitutes profit of the partnership (Germany has the taxing right according to Article 7).

New Section 50d(10) Income Tax Act does not constitute a treaty override because the domestic rules merely define taxable profits (Tax Court Munich, decision dated July 30, 2009 – Docket # 1 K 1816/09)
Use of Foreign Hybrid Entities for Investment Abroad - India–Germany Treaty

Under the tax treaties between India and the U.S./Brazil/Canada the withholding tax on dividends is 15%.

In Germany a KG is transparent for general income/corporate tax purposes but it is an entity for trade income tax purposes (tax rate 14%).

Dividend income is 95% exempt (tax leakage 1.5% of dividend).

Is trade income tax considered an income tax for foreign tax credit purposes?

India considers a German KG to be a resident person for treaty purposes (Income Tax Appellate Tribunal, Mumbai decision dated July 4, 2008, Chiron Behring GmbH and Co.)

10% withholding tax rate under the India-Germany Treaty requires beneficial ownership by the recipient (see Prevost Car Inc. v. The Queen, 2009 DTC 5053 (FCA) on - beneficial ownership for treaty purposes).
Characterisation of U.S. LLCs by India

- Treatment of hybrids – no specific rules / regulation
- No established case law precedents in India
- Would depend on examination of qualification as a body corporate for Indian law purposes – Canaro case
- Usually will qualify as a corporation
Characterisation of U.S. LLCs by India - U.S. – India Treaty

- Dual criteria to be satisfied
  - Liable to tax
  - Subject to tax

- Eligibility of LLC / ‘S’ Corp to Treaty benefits
  - The GE Pension Trust Case
  - No established precedents
  - Possibility of denial of Treaty benefits for LLC/‘S’ Corp as well as the US interest holders

- Use of LLC as a tax deferral tool for outbound investment from India
Use of Hybrid Entities for Investment Abroad - India

- Fiscally transparent entities
  - U.S. Partnerships, Trusts (under India US Tax Treaty)

- Fiscally non transparent entities
  - ‘C’ Corporation
  - ‘S’ Corporation

- Partnership under Indian law are treated as a taxable unit – no additional taxes at the partner level
Use of Hybrid Entities for Investment Abroad – India

Pooling vehicle (Trust) set up for Indian investments

U.S. LLC acts as the fund manager

The Fund makes downstream Indian portfolio investments

Management fee charged by US LLC for managing the investments

U.S. Investors

Trust

US LLC

Fund Manager

U.S.

India

Portfolio Investments
Use of Hybrid Entities for Investment Abroad - India - U.S. - India Treaty

- If the fund is set up as a Trust vehicle, to the extent that the beneficiary is a US investor subject to tax, treaty benefits would be available.
- US LLC may not be eligible to treaty benefits.
- Under the Indian domestic law, a non resident earning fees in respect of services utilized for purpose of making or earning income from any source in India is treated as Indian source income.
- Management fee charged by US LLC may be treated as Indian source income.
Use of Hybrid Entities for Investment Abroad - India - U.S. - India Treaty

- US Cos set up a general partnership / LLP in the US
- Partnership / LLP carries on the activities in India through a Indian branch / permanent establishment in India
Use of Hybrid Entities for Investment Abroad - India - U.S. - India Treaty

- Treatment of partnership entity / LLP for Indian tax purposes
  - LLP may not be regarded as a Partnership for Indian tax purposes
- Application of US-India Treaty for tax treatment of partnership
- Tax arbitrage opportunity: 42.23% v. 30% tax on Indian branch operations
- Issues to consider – whether to set up the partnership in a different jurisdiction
Impact of Foreign Tax Credit Proposals on Outbound Planning
Foreign Tax Credit Proposals - New Pooling Approach

- A distribution from a CFC may entitle a US taxpayer to a “deemed paid” foreign tax credit
- Calculation of Section 902 deemed paid foreign tax credit under existing law:

\[
\text{Taxes in CFC’s Pool} \times \text{Distribution} = \text{Creditable FTCs} \\
\text{E & P Pool}
\]
Foreign Tax Credit Proposals - New Pooling Approach

**Current Law Example**

US Co.

- **CFC1**
  - $400 earnings & profits
  - $100 foreign tax paid
  - $200 remitted to US Co.
  - Deemed paid credit under current law
  - $200/$400 X $100 = $50

- **CFC2**
  - $600 earnings & profits
  - $100 foreign tax paid
  - $200 remitted to US Co.
  - Deemed paid credit under current law
  - $200/$600 X $100 = $33
Foreign Tax Credit Proposals - New Pooling Approach

US Co. would determine its deemed paid foreign tax credit on a consolidated basis based on the aggregate foreign taxes and earnings & profits of its foreign subsidiaries.

**Deemed paid credit under proposed law**

**CFC1**

- $400 earnings & profits
- $100 foreign tax paid
- $200 remitted to US Co.
- Deemed paid credit under proposed law
- $200/$1000 X $200 = $40

**CFC2**

- $600 earnings & profits
- $100 foreign tax paid
- $200 remitted to US Co.
- Deemed paid credit under proposed law
- $200/$1000 X $200 = $40
Foreign Tax Credit Proposals - New Pooling Approach

Potential work around by conversion of CFC to disregarded entity creates Section 901 instead of Section 902 credit

$400 earnings & profits
$100 foreign tax paid
$200 remitted to US Co.
Deemed paid credit under proposed law
$200/$1000 X $200 = $40

All earnings & profits currently taxed in US
$100 foreign tax paid
$200 remitted to US Co.
Direct credit is $100
Foreign Tax Credit Proposals - New Pooling Approach - Spain

- Conversion of CFCs to disregarded entities
  - SA to SL considered a simple transformation which does not give rise to a deemed liquidation
Proposed Deferral of U.S. Interest Expense Deductions
Proposed Deferral of Interest Expense Deductions

- Under current law, interest expense properly allocable to unrepatriated foreign source income that is deferred and not subject to current US tax is deductible
  - Assume US Co buys CFC for US $1 million and the acquisition is 100% financed through a loan from a third party ("Financial Institution")
  - US Co has tax basis of US$ 1 million in “US source” assets
  - US Co paid Financial Institution US$ 50,000 interest expense on the acquisition loan during the tax year
  - CFC has no earnings and profits during the tax year
  - US Co would generally be permitted to deduct the $50,000 interest expense paid on the acquisition indebtedness
Proposed Deferral of Interest Expense Deductions

- US$ 50,000 interest expense on acquisition indebtedness

**US Co**

- Deduction permitted

**Financial Institution**

**CFC**

**US source assets**
Proposed Deferral of Interest Deductions

- Under the proposal, US Co would have to defer its deduction of interest expense that is allocable to foreign source income that is not currently subject to U.S. tax.

- The deferred deductions would be carried forward indefinitely and permitted as a deduction in any subsequent tax year in proportion to the amount of the previously deferred taxable income that becomes subject to U.S. tax (i.e. 50% of the US$50,000 interest expense on the acquisition indebtedness would be currently deductible).
Proposed Deferral of Interest Deductions

US Co

CFC

US source assets

Financial Institution

US$ 50,000 interest expense on acquisition indebtedness

$25,000 current interest deduction with $25,000 deferred
Proposed Deferral of Interest Deductions - Push Down to CFC - Spain

- No rules like the proposed US rules
- Recent case law (TEAC, May 2007) denying push downs if no sufficient business grounds (non tax deductibility of interest)
- The Spanish tax authorities issued an internal report in 2006 against debt push downs with no sufficient business grounds (*frau legis*)
Proposed Deferral of Interest Deductions - Push Down to CFC - Spain

US
Interest non tax deductible

100%

Spain

US Bank

US

100%

US Bank

Tax consolidation group

Spanish New Co
Interest tax deductible

100%

Spain

Spanish Bank

Loan repayment

Loan

Purchase price

100%
Proposed Deferral of Interest Deductions - Push Down to CFC - Brazil

- Brazilian administrative court last year analyzed a debt push down
- The court decided that the interest expense related to a push down loan was not deductible for corporate income tax purposes, as the expense was not “necessary” (deductibility requirement under Brazilian income tax regulations)
- Court decided that although a debt was allocated to the Brazilian sub, the intention of the group was to inject capital into the Brazilian company to allow the acquisition of another business (a capital contribution and not a debt push down should have been put in place)
- In December 2009, the Brazilian government enacted rules limiting the deductibility of payments to related parties (among other payments), similar to thin capitalization rules
- Current deductibility rules for debt transactions with related parties require proof that the debt is necessary for the company’s activities and as well that (a) the amount of the Brazilian entity’s indebtedness to the related party does not exceed twice the value of the interest held by the related party in the net equity of the Brazilian borrower and (b) the Brazilian entity’s total indebtedness is not higher than twice the value of the interest held by all related parties in the net equity of the Brazilian borrower
Proposed Deferral of Interest Deductions - India

- Proposed Indian Direct Taxes Code
- Financing raised abroad for the purpose of earning income from any source in India considered as Indian source income
- Offshore leverage allocated for Indian business – potential Indian withholding taxes
- Eligibility of foreign tax credit in the US?
Migrating U.S. Intellectual Property
Restrictions on Use of Foreign IP Holding Companies

- **Taxpayer’s Premise**
  - As part of a restructuring or in connection with an asset acquisition, U.S. multinational transfers intangible property to a commonly controlled non-U.S. company

- **Benefit Sought**
  - Earnings stripping through license fees, shifts income attributable to the intangible property to the non-U.S. company and out of U.S. tax base
Restrictions on Use of Foreign IP Holding Companies

- Current Law
  - Transfer Pricing Rules

- Current Law
  - Special Rules for Intangibles

- Proposed change (the “Stick”)
  - Clarifies definition of “intangible property” to include workforce in place, goodwill and going concern value
  - Provides standard for valuing transferred intangible property
Restrictions on Use of Foreign IP Holding Companies
Restrictions on Use of Foreign IP Holding Companies

- Proposed change (the “Hammer”)
- Tax on
  - “Excessive returns” for intangible property transferred to a related controlled foreign corporation subject to a low tax rate
  - “In circumstances that evidence excessive income shifting”
- Proposed effective for taxable years beginning after December 31, 2010
Proposed IRS Tax Return Disclosure Requirements by Large Corporations for uncertain Tax Positions
Proposed IRS Tax Return Disclosure Requirements by Large Corporations for uncertain Tax Positions

- Under the current process, a typical series of steps for the tax and accounting treatment of a major transaction would be as follows

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<tr>
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<th>Accounting Treatment</th>
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Proposed IRS Tax Return Disclosure Requirements by Large Corporations for uncertain Tax Positions

- In IRS Announcement 2010-9, the IRS announced it was developing a new schedule for disclosure of uncertain tax positions to attach to the tax return.
- The proposed effective date would be for returns filed after the release of the new schedule.
- Under the proposal, companies would be required to provide a concise description of each uncertain tax position for which the taxpayer or related entity has recorded a reserve in its financial statements and the maximum potential federal tax liability attributable to each uncertain tax position.
- By “concise” IRS Commissioner Shulman clarified this to mean “a few sentences that inform us of the nature of the issue, and not pages of factual description or legal analysis.”
Proposed IRS Tax Return Disclosure Requirements by Large Corporations for uncertain Tax Positions

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Disclosure Requirements for Uncertain Tax Positions under proposed IFRS (Exposure Draft ED/2009/2 at #49)

- An entity shall disclose information about the major sources of estimation uncertainties relating to tax to enable users of the financial statements to assess the possible financial effects of the estimation uncertainties and their timing (for example, the effects of unresolved disputes with the tax authorities) including:
  - A description of the uncertainty and
  - An indication of its possible financial effects on amounts recognised for tax and the timing of those effects

- No finalization of the proposed IFRS standard in the near future
  - Very complex rules
  - FASB suspended the convergence project
  - Resources for a fundamental review are not available at this moment
Using Hybrid Instruments to Finance Foreign Acquisitions or Business Expansion
U.S. Parent Funding Strategies for Foreign Subsidiary
U.S. Parent Funding Strategies for Foreign Subsidiary

U.S. Parent

loan

U.S. Bank

For Sub
Hybrid Instruments

- A hybrid instrument is a series of transactions and instruments which is viewed by one country as having a particular tax character and by the other country as having a different tax character.
- For example, a hybrid instrument can be a financing arrangement (securities plus related agreements) having both equity and debt features that one country views as equity and the other country as debt.
- Hybrid instruments are used to reduce after-tax financing costs.
- Paragraph IV(7) Canada-U.S. Treaty denies treaty benefits to hybrid entities, but does not apply to hybrid instruments.
Hybrid Instruments – Outbound Financing

US Co 2 lends funds to Canco (not FTE)

Canco can elect to pay interest by issuing preferred shares; alternative is reinvestment agreement

US Co 2 agrees to subscribe for US LLC shares in an amount equal to principal amount of Canco loan; secured by assignment of loan to US LLC

US LLC agrees to subscribe for Canco shares equal to principal amount of Canco loan; secured by assignment of rights of US LLC under subscription agreement with US Co 2 to Canco
Hybrid Instruments - Outbound Financing

- **US tax result**
  - US Co 1 has deduction on third party debt
  - Loan to Canco plus forward subscription agreement regarded as equity investment by US Co 2 in Canco
  - Interest paid by Canco regarded as tax-free stock dividend (IRC 305)
  - Dual consolidated loss rules do not apply

- **Canadian tax result**
  - Transactions regarded as debt to Canco owed to US Co 2
  - Interest expense is deductible to Canco subject to thin cap rules (2:1 debt to equity must be respected) and eligible use/reasonableness
  - Proposed paragraph 143.3(3)(a) will not apply (Ruling 2008 – 0300101R3)
  - No Canadian non-resident withholding tax as treaty exemption applies to interest paid by Canco to US Co 2
  - US LLC not regarded as recipient of tax-free stock dividend (Doc. no. 2009 – 0345351(6))
Hybrid Instruments – Outbound Financing

US Co 1 loans money to US LP
Can LP loans same amount to Canco
Dividends are paid by ULCs to Lux Co
Hybrid Instruments - Outbound Financing

- **US tax result**
  - Zero rated E & P accumulates in Can LP (same country exception for subpart F)
  - Watch new US international tax proposals

- **Canadian tax result**
  - Canco interest is deductible subject to eligible use/reasonableness
  - Thin capitalization rules should not apply to US LP interest paid to US Co 1
  - ULCs offset interest income from Canco with interest expense of US LP (spread taxable to ULCs)
  - US LP is deemed resident of Canada (212(13.1)(a)) and is not fiscally transparent under US tax rules therefore IV(7)(b) does not apply
  - No Canadian non-resident withholding tax on Canco interest to Can LP
  - Canadian non-resident withholding tax on dividends at 5% rate
  - Application of GAAR (has Article IV(7)(b) of the Canada-US Income Tax Convention been frustrated/avoided?)
Withholding Tax Developments

Equity-Linked Derivative Payments

FATCA (Hire Act)– New Reporting Rules for U.S. Withholding Tax Relief
Equity-Linked Derivative Payments

- Withholding tax at a rate of 30% generally applies to U.S.-source fixed or determinable annual or periodic ("FDAP") income paid to a non-U.S. person
- FDAP income includes dividends of a U.S. corporation
Equity-Linked Derivative Payments

- Former (pre Hire Act) source rules for notional principal contracts
  - Residence of the recipient of notional principal contract payments
  - Non-U.S. investors able to invest in equity swaps and similar equity-linked derivatives to get economic benefit of dividends without being subject to 30% U.S. withholding tax
  - Same result for substitute dividend payments in securities loans
Equity-Linked Derivative Payments

Foreign non-treaty shareholder

U.S. Corp

30% U.S. withholding dividend

Foreign non-treaty shareholder

NPC payment

Equity swap agreement

foreign source NPC (economically similar to dividend)

0% U.S. withholding

U.S. Hedge Fund or Financial institution

U.S. Corp

dividend
Tax Equity-Linked Derivative Payments

Foreign Account Tax Compliance Act of 2009 ("FATCA") offset provisions of the HIRE Act (the "Act") introduce new source rules for equity swaps that reference U.S. equities

- If an instrument is covered under the Act, non-U.S. persons would treat dividend derived payments under such instrument as U.S. source income subject to 30% U.S. withholding tax (on a gross basis)
- Covered payments: (i) substitute dividend payments made pursuant to a securities lending or sale-repurchase transaction that reference U.S. equities, (ii) payments made under “specified notional principal contracts” that reference U.S. equities or (iii) any other payment determined by the Treasury Secretary to be substantially similar to payments made under clauses (i) or (ii)
Tax Equity-Linked Derivative Payments

- Beginning September 14, 2010, through March 18, 2012, “Specified Notional Principal Contracts” include any notional principal contract where:
  - party “crosses in” or “crosses out”,
  - underlying security is not readily tradable on an established securities market,
  - short party posts the underlying security as collateral with long party or
  - such contract identified by Treasury as a “Specified Notional Principal Contract.”

- After March 18, 2012, “Specified Notional Principal Contracts” will include any notional principal contract unless Treasury determines that the contract does not have the potential for tax avoidance.
Withholding Tax on Foreign Accounts That Do Not Report U.S. Owners

- FATCA offset provisions under the Act require withholding of tax at a rate of 30% on certain payments from U.S. sources made to a foreign financial institution ("FFI") and to foreign entities that are not FFIs unless new U.S. reporting requirements are met

- Effective for payments made after December 31, 2012 (with some exceptions for grandfathered agreements)
Withholding Tax on Foreign Accounts That Do Not Report U.S. Owners

- FFIs are non-U.S. entities that
  - accept deposits in banking business
  - hold financial assets for the account of others
  - engage primarily in the business of investing or trading securities
Withholding Tax on Foreign Accounts That Do Not Report U.S. Owners

- Withholding required on
  - U.S. source FDAP income
  - Stock/bond sales – gross proceeds from sale of property that produces U.S. source interest or dividends
  - Specific exclusions
Withholding Tax on Foreign Accounts That Do Not Report U.S. Owners

- U.S. reporting requirements to avoid new withholding rules
  - Information sharing agreement
  - Annual reporting of investor and account information
  - Exceptions
  - Certain U.S.-owned foreign entities are treated as U.S. persons
  - Special rules for “recalcitrant account holders”
Withholding Tax on Foreign Accounts That Do Not Report U.S. Owners

- **Rules applicable to payments made to “non-financial institutions”**
- **30% withholding required with respect to any “withholdable payment” made to a foreign entity that is not an FFI, unless**
  - Beneficial owner provides withholding agent with either (i) a certification that no specified U.S. person owns, directly or indirectly, more than 10% of its stock, by vote or value (in the case of a corporation) or of its profits or capital interests (in the case of a partnership) or (ii) certain identifying information with respect to each specified U.S. person (10% threshold)
  - Withholding agent does not know or have reason to know that any of this information is incorrect
  - Withholding agent reports the foregoing identifying information with respect to specified U.S. persons to the Treasury
  - Exceptions for certain beneficial owners of payment (includes a corporation with regularly traded stock, foreign government, international organization, foreign central bank and low tax evasion risk persons)
Withholding Tax on Foreign Accounts That Do Not Report U.S. Owners

- Practical issues for investment funds
  - Information shared with the Treasury will not be confidential
  - Treaty benefits allowed, but will not be useful for Cayman Islands/BVI funds and any other “tax haven” jurisdiction fund
  - No 10% shareholder rule applies (funds will have a very difficult time obtaining the requested information unless fund-of-funds will comply - must go up the chain of ownership to beneficial investors - use of recalcitrant rules to withhold on non-reporting investors)
  - Applicable to non-US based managers
Withholding Tax on Foreign Accounts That Do Not Report U.S. Owners

Prior Law Reporting Requirements

- U.S. Investors
- U.S. Feeder Fund
- Cayman Feeder Fund
- Cayman Master Fund
- Prime Broker
- US Public Corporation

FATCA/Hire Act Reporting Requirements

- U.S. Investors
- U.S. Feeder Fund
- Cayman Feeder Fund
- Cayman Master Fund
- Prime Broker
- US Public Corporation

All FATCA certifications require W/H agreements with IRS
Failure to have IRS agreement requires W/H tax on payments

Sales of stock will be subject to W/H
Sales of stock will be subject to W/H

Gross proceeds
Gross proceeds

Prior Law Reporting Requirements
- W8
- W8BEN

FATCA/Hire Act Reporting Requirements
- FATCA Certification
- FATCA Certification

Sales of stock of publicly held US corporations are not subject to W/H
Sales of stock of publicly held US corporations are not subject to W/H
Challenges to Existing Foreign Tax
Credit Planning
Foreign Tax Credit Generators
Proposed Foreign Tax Credit Reform – No Splitting of Foreign Income and Foreign Taxes

- Under current law, for purposes of claiming foreign tax credits, an entity is deemed to have paid a foreign tax if, under foreign law, that entity is legally liable for the foreign tax
  - *Guardian Industries v. United States, 477 F.2d 1368 (Fed. Cir. 2007)*
  - Under Luxembourg law, the tax liability for the entire Luxembourg tax group was imposed on GIE Sarl
  - GIE Sarl was legally and exclusively liable for the tax paid for the entire Luxembourg tax group
  - The taxpayer was permitted a foreign tax credit on the tax paid by GIE Sarl but could continue to defer tax on the income earned by the Luxembourg Opcos
Proposed Foreign Tax Credit Reform – No Splitting of Foreign Income and Foreign Taxes

Guardian Industries

US Holding Co.

GIE Sarl (Luxembourg)

Luxembourg Opco 1

Luxembourg Opco 2

150 FTC

Disregarded entity for US tax purposes
Regarded entity for Lux. tax purposes

200 Income 30% tax rate

300 income 30% tax rate
Proposed Foreign Tax Credit Reform – No Splitting of Foreign Income and Foreign Taxes

Under Proposed Regulation

US Holding Co.

GIE Sarl (Luxembourg)

Zero FTC

Disregarded entity for US tax purposes
Regarded entity for Lux. tax purposes

Luxembourg Opco 1

200 Income
30% tax rate
60 add to tax pool

Luxembourg Opco 2

300 Income
30% tax rate
90 add to tax pool
Proposed Foreign Tax Credit Reform – No Splitting of Foreign Income and Foreign Taxes

Reverse Hybrid
(Prop. Reg. § 1.901-2(f) (6) Example 7)

Income of 500
Taxed to partners at 30%

Share of income is 250 subject to US taxation
Country Z tax is 7.5

US Co B

Share of income is 4750 subject to US taxation
Country Z tax is 142.5 (treated as paid by US Co)

US Co A

Foreign Company (Country Z)

Corporation for US tax purposes
Partnership for Country Z purposes

5%

95%
Proposed Foreign Tax Credit Reform – No Splitting of Foreign Income and Foreign Taxes

Under Proposed Treas. Reg. § 1.901-2(f), the IRS issued proposed regulations to prevent the mismatching of tax credits and income inclusions. Under the proposed regulations, the tax paid by US Co A to Country Z would be allocated on a pro rata basis and the 142.5 Country Z tax paid would be allocated to Foreign Company and US Co A would not be permitted to claim foreign tax credits for that tax.

Share of income is 25 Country Z tax is 7.5 treated as paid by Foreign Company

Income of 500 Taxed to partners at 30%

Deemed capital contribution

US Co B

5%

US Co A

95%

Deemed capital contribution

Foreign Company (Country Z)

Share of income is 475 Country Z tax is 142.5 (treated as paid by Foreign Company)

Corporation for US tax purposes
Partnership for Country Z purposes
Proposed Foreign Tax Credit Reform – No Splitting of Foreign Income and Foreign Taxes

- Under the proposed change, in the case of foreign taxes with respect to which a taxpayer claims a credit under IRC § 901, the proposal would adopt a matching rule to prevent the separation of creditable foreign taxes from the associated foreign income.

- This provides clear authority for the IRS to promulgate a regulation like Treas. Reg. § 1.901-2(f).

- The proposed change with the matching rule appears to be a broader approach than the approach taken in the proposed regulations which relied in part of the requirement that foreign taxes be allocated based on income reporting under foreign law.
Proposed Foreign Tax Credit Reform – Foreign Tax Credit Generators

- Memorandum dated February 19, 2009 issued by the Internal Revenue Service (LMBS-04-0109-002)

- FTC generators are highly structured transactions that exploit the FTC regime. Some of these transactions are designed to recover the foreign tax claimed as a FTC, so that, in substance, the transaction incurs no foreign tax cost. Other types of transactions are structured to eliminate the income that results in the FTC. Some transactions do both, and in either case, the FTC is inappropriate because the taxpayer claims an FTC where no double taxation occurs. In these situations, the FTC becomes an unintended monetary benefit generated by the transaction, which the parties to the transaction share. The parties adjust interest rates on loans or pay fees to share the US FTC benefit. These transactions are particularly offensive because they are designed strictly to generate credits in any amounts desired by the parties.
Some Canadian corporations have recently been engaging in schemes, often referred to as ‘foreign tax credit generators’, that are designed to shelter tax otherwise payable in respect of interest income on loans made, indirectly to foreign corporations. These schemes artificially create foreign taxes that are claimed by the Canadian corporation as a FTC, or a FAT or a UFT deduction, in order to offset Canadian tax otherwise payable.

There are two main categories of these schemes, and many variations within these categories. The first category involves the use of a foreign partnership, the second involves the use of a foreign corporation that is intended to qualify as a foreign affiliate. The main thrust of all of these schemes is to exploit asymmetry, as between the tax laws of Canada and those of a foreign country, in the characterisation of the Canadian corporation’s direct or indirect investment in a foreign entity earning the income that is subject to the foreign tax.
Proposed Foreign Tax Credit Reform – Foreign Tax Credit Generators

- **U.S. Parent**
  - Common shares (10% of For Sub earnings)
  - Preferred shares (100% of residual)

- **U.S. Sub**
  - 100% of total equity

- **Canopco**
  - 100% of total equity
  - Common shares are 30% of total equity
  - Preferred shares are 70% of total equity

- **Can Sub**
  - 100% of total equity
  - 1% of total equity

- **For LP**
  - Preferred shares (90% of For Sub earnings)

- **For Sub**
  - 100% common shares (10% of For Sub earnings, 100% of residual)
Codification of the Economic Substance Doctrine
Codification of the Economic Substance Doctrine

- What is the “Economic Substance” Doctrine?
  - Developed by courts over many years
  - Courts may ignore aspects of transactions
  - Several factors used by courts including
    - whether a taxpayer’s economic position meaningfully changed
    - whether there is a non-tax business purpose for the transaction
Codification of the Economic Substance Doctrine

- Enacted as part of Health Care and Education Affordability Reconciliation Act of 2010 on March 30, 2010
- New Section 771 (o) of the International Revenue Code requires that for a transaction to have economic substance:
  - It must change the taxpayer’s economic position in a meaningful way and
  - Taxpayer must have a substantial non Federal-income tax purpose for entering into the transaction
Codification of the Economic Substance Doctrine

- If taxpayer is relying on profit potential, economic substance exists only if pre-tax profit is “substantial” in relation to NPV of federal tax benefits arising from transaction.
- State and local tax benefits are not a non-tax purpose if “related to the federal tax benefit”
- Financial accounting benefits are a business purpose only if the origin of the financial accounting benefits is not a federal income tax
Codification of the Economic Substance Doctrine

- Technical Explanation indicates that the new doctrine does not affect certain transactions where decisions are entirely or primarily based on tax advantages:
  - Capitalization of a business with debt or equity
  - Use of US or foreign corporation to make a foreign investment
  - Decision to enter one or more steps of a corporate reorganization transaction
  - Decision to use related party entity in a transaction
Codification of the Economic Substance Doctrine

- **Strict liability penalty for an understatement of tax**
  - 40% of amount of the underpayment of tax attributable to the transaction lacking economic substance
  - 20% if adequate disclosure of relevant facts by taxpayer

- **Effective for transactions entered into on or after March 30, 2010**
Codification of the Economic Substance Doctrine - Spain

- Measures contained in the Spanish General Tax Law based on “substance over form principle”

- Frau legis (conflict in the application of the tax rules)
  - The taxpayer avoids totally or partially a taxable item or reduces its tax debt using acts or business that
    - considering them individually or partially are improper to obtain the planned result
    - their major aim is to obtain tax savings

- Simulation
  - Simulated business or acts will be taxable according to their real nature
Codification of the Economic Substance Doctrine - Brazil

- Based on the legality principle
- If a transaction was legal, it would be valid and produce the desired tax effects
- Lately, Brazilian administrative courts have been looking at the business purpose and economic substance of a transaction (where not absolutely clear the transactions could be disregarded for tax purposes or even treated as a sham)
- No clear parameters for defining business purpose and economic substance
- No guidance in tax or civil law
- Misinterpretation of the civil law concepts of sham and fraud
Cross-border Guarantee Fees
Guarantee Fees

- Guarantee payment is for “service” not for use of money
- Sourcing rule for services applies making the fee non-U.S. source
- No U.S. withholding tax
Guarantee Fees – Spain

- No Spanish rule on the issue but, if the guarantee transaction is compensable, then among related parties, the agreed compensation should be at arm’s length.
Guarantee Fees

- General Electric Capital Canada Inc. v. The Queen, 2009 TCC 563
- IRS review:
  - is guarantee transaction compensable under the arm’s length principle
  - appropriate compensation
  - methodology for valuing a financial guarantee
Thank You!

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