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Articles

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FATCA: Revised Deadlines

IRS and Treasury Department Issue Notice Postponing Certain FATCA Deadlines and Expanding Scope of FATCA "Grandfather" Rules

By Andrew P. Solomon, Donald L. Korb, S. Eric Wang and Michael Orchowski (Sullivan & Cromwell LLP)

Summary

The IRS and Treasury Department on October 24, 2012 issued Announcement 2012-42 (the "Announcement"), which delays certain FATCA compliance deadlines and identifies three new classes of "grandfathered obligations." Key changes noted in the Announcement include the following:

- "Gross proceeds" withholding will only apply to sales or dispositions occurring after December 31, 2016. Previously, "gross proceeds" withholding was to be effective for sales or dispositions occurring after December 31, 2014.
- FATCA's grandfathering deadline (currently December 31, 2012) will be extended for "obligations" that could be subject to FATCA withholding solely because future guidance treats them as generating either: (i) "foreign passthru payments" or (ii) U.S.-source "dividend equivalent" payments. Such instruments will be grandfathered if they are "outstanding" on the date that is six months after the date when final guidance that would otherwise subject them to FATCA withholding is issued.
- Obligations to make payments with respect to collateral posted to secure an obligation under a grandfathered notional principal contract will also be eligible for grandfathering from FATCA.
- As discussed in additional detail below, the timeframes under which "foreign financial institutions" (FFIs) and other withholding agents will need to review their accounts under FATCA will be modified and generally extended. The new timelines generally harmonize the timelines for FFIs in jurisdictions with and without FATCA intergovernmental agreements (IGAs).
- FFIs in countries that do not sign IGAs will be required to file their first FATCA account reports on March 15, 2015 (the same date when the first such reports from FFIs in IGA countries are due under the model IGAs), rather than the earlier proposal of September 30, 2014.

The Announcement does not modify the January 1, 2014 date on which FATCA withholding will commence on U.S.-source "withholdable payments." In addition, the Announcement observes—in an appendix—that withholding and reporting will need to begin with respect to any documented account, even if the deadline for reviewing that account has not yet expired.

The timeline on page 16 illustrates key FATCA dates under the Announcement and other current guidance:

The Announcement prescribes new deadlines for Participating FFIs and other withholding agents (such as U.S. financial institutions) to conduct their account due diligence and withhold on preexisting accounts.

(*FATCA*, continued on page 16)

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Tax Court Releases PepsiCo Opinion, Upholding Taxpayers' Equity Characterization of Hybrid Instruments

By Chip Harter, Oren Penn, Michael Yaghmour, Nils Cousin, Jared Hermann, Joel Walters, Gary Wilcox, Kevin Brown, Tamara Moravia-Israel and Sean O'Connor (PwC)

In Brief

In recent years, the IRS has increased its scrutiny of cross-border intercompany financing arrangements, challenging the economic realities of such arrangements. These challenges continue to make their way through IRS exam, appeals, and to the judicial level.

Following on a recent taxpayer favorable Tax Court memorandum opinion in the debt/equity area (*NA General Partnership & Subsidiaries v. Commissioner* ("*Scottish Power*"), T.C. Memo. 2012-172, the Tax Court again ruled in this area when, on September 20, 2012, the court issued a memorandum opinion in *PepsiCo Puerto Rico, Inc. v. Commissioner* and *PepsiCo, Inc. & Affiliates v. Commissioner* (*PepsiCo*), T.C. Memo. 2012-269. *PepsiCo* involved a U.S. multinational company that treated certain intercompany advances (advance agreements) from the U.S. to a foreign affiliate as equity investments for U.S. federal income tax purposes, thereby characterizing the payments received by the advancing party as equity distributions. The IRS challenged the treatment of the advance agreements. The Tax Court, ruling in favor of the taxpayers, upheld the taxpayers' treatment of the advance agreements as equity and not as debt for U.S. federal income tax purposes.

Although this decision is a memorandum opinion that does not serve as binding precedent, the decision provides important insight into the Tax Court's current approach to handling ongoing IRS challenges to cross-border intercompany financing arrangements. The court emphasized that it has previously articulated a list of 13 factors important in determining whether a transaction is characterized as debt or equity for U.S. federal income tax purposes and that the factors identified by the IRS in Notice 94-47, 1994-1 C.B. 357, are 'subsumed within the more discerning inquiry espoused' by the Tax Court in previous debt versus equity analyses.

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What Does the Court's Decision Mean for Multinational Companies with Intercompany Financing Arrangements?

There are several important points that multinational companies with intercompany financing arrangements can take away from the court's analysis in the *PepsiCo* decision and its recent decision in *Scottish Power. PepsiCo* confirms, like *Scottish Power,* that a taxpayer's decision as to how to capitalize its affiliates with debt or equity is best left with the taxpayer (so long as the capitalization decision is consistent with the substance) and not the courts, as such inquiries generally are not subject to successful attack on grounds of tax motivation, or lack of business purpose or economic substance. However, the court may determine different outcomes depending on whether the court views the arrangement in connection with legitimate tax planning of an underlying business transaction as compared with the facilitation of what it might view as more structured transactions (*Cf. Hewlett-Packard Co. v. Commissioner*, T.C. Memo. 2012-135 (see May 17, 2012, U.S. Outbound Tax Newsalert: *Tax Court releases Hewlett-Packard opinion, addresses debt vs. equity issues*)).

The decision provides insight into the Tax Court's approach to handling IRS challenges to cross-border intercompany financing arrangements.

In addition, the court's analysis in *PepsiCo* supports the principle that structuring a cross-border intercompany financing arrangement that results in different tax treatment for U.S. and foreign tax purposes is not, by itself, determinative of how the instrument is properly characterized for U.S. federal income tax purposes. Moreover, the *PepsiCo* decision recognizes that although related party arrangements are subject to special

(*Intercompany Financing*, continued on page 11)

Canada's Supreme Court Releases First Transfer Pricing Decision in GlaxoSmithKline

By the National Tax Department of Osler, Hoskin & Harcourt LLP

In a unanimous decision, released on October 18, 2012, the Supreme Court of Canada upheld the judgment of the Federal Court of Appeal in *Canada v. GlaxoSmithKline Inc.* As the first transfer pricing case decided by the Supreme Court, this case provides needed guidance, in particular, with respect to the meaning of, and the proper approach to the determination of, an arm's length price, and the role of the Organization for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines (the Guidelines) in Canada.[1]

Transfer pricing issues arise in the context of non-arm's length transactions involving entities resident in different jurisdictions, where ordinary market forces may not regulate terms and conditions of the transactions. From a policy perspective, the concern is that prices may be set so as to divert profits from higher tax jurisdictions. The objective of transfer pricing legislation is to align, as closely as possible, the prices of non-arm's length contracts with the prices that would have emerged from arm's length negotiations.

In determining appropriate arm's length prices, courts will be required to consider the totality of the economic and business realities out of which non-arm's length transactions arise.

The taxpayer's success in *Canada v. GlaxoSmithKline Inc.* means that, in determining appropriate arm's length prices, courts will be required to consider the totality of the economic and business realities out of which non-arm's length transactions arise, to the extent those realities would have prevailed if the parties to such transactions had been dealing at arm's length.

Background Facts

In the relevant years, the taxpayer (Glaxo Canada), was a member of a multinational group of companies that discovered, developed, manufactured and marketed branded pharmaceutical products, one of which was the anti-ulcer drug named Zantac. Glaxo Canada acted as a secondary manufacturer and marketer of Zantac and other drugs. Pursuant to a License Agreement existing at the relevant time between Glaxo Canada and its parent (Glaxo Group), Glaxo Canada was granted rights to sell pharmaceuticals under the Zantac trademark and the patent for its active ingredient, ranitidine, both of which were owned by Glaxo Group. One of the conditions of the License Agreement was that Glaxo Canada purchase ranitidine for sale as Zantac from a source approved by Glaxo Group. Accordingly, Glaxo Canada entered into a Supply Agreement with another Glaxo Group affiliate (Adechsa), an approved source, for the supply of ranitidine. The combined effect of the License and Supply Agreements enabled Glaxo Canada to purchase the ranitidine, put it in a delivery mechanism such as a tablet, liquid or gel, and market it under the trademark Zantac.

The Minister reassessed Glaxo Canada on the basis that the price paid by Glaxo Canada for the ranitidine was not an arm's length price because it was significantly higher than the price paid by two Canadian generic pharmaceutical companies for a chemically identical product acquired by them during the same period of time from arm's length parties. The Minister took the position that paying more than the generic companies had paid would not have been "reasonable in the circumstances" if Glaxo Canada had been dealing at arm's length with Adechsa, within the meaning of Subsection 69(2) of the Income Tax Act, Canada's transfer pricing provision during the years at issue.[2] Those generic companies sold ranitidine products under their own trademarks at a discount to Zantac.

The taxpayer objected to the reassessment, arguing that the transactions entered into by the two generic pharmaceutical companies could not serve as arm's length proxies for its transactions because their relevant circumstances were entirely different from those of Glaxo Canada. In particular, Glaxo Canada argued that the rights and benefits conferred on it by the License Agreement, and the requirement in the License Agreement that it purchase ranitidine from an approved source, were circumstances that an arm's length purchaser would have considered relevant when deciding what price to pay Adechsa for the ranitidine.

Judicial History

On appeal to the Tax Court of Canada, the reassessment was upheld with a minor revision. The Tax Court concluded that the License and Supply Agreements had to be considered independently and that the former could not impact the determination of the appropriate arm's

(*Arm's Length Pricing*, continued on page 5)

Arm's Length Pricing *(from page 4)*

length price under the latter. The Tax Court relied on the OECD Guidelines to apply the comparable uncontrolled price method, based on which it determined that the reasonable price to pay for the ranitidine was the highest price paid by the two generic companies.

On Glaxo Canada's further appeal, the Federal Court of Appeal found that the Tax Court had erred in not considering the License Agreement when determining whether the price paid by Glaxo Canada for the ranitidine was reasonable, and remitted the matter back to the Tax Court for redetermination. The Court of Appeal concluded that the License Agreement was central to Glaxo Canada's business reality and was a "circumstance" that had to be taken into account when evaluating the reasonableness of the price.

Supreme Court Decision

The Crown appealed the Court of Appeal decision to the Supreme Court of Canada, arguing that the License Agreement must not be considered in determining an arm's length price for Glaxo Canada's purchases of ranitidine. Glaxo Canada cross-appealed, arguing that the appellate court should not have remitted the matter to the Tax Court for redetermination.

The Supreme Court dismissed both the appeal and the cross-appeal. Justice Rothstein, writing for a unanimous seven-member panel, held that the License and Supply Agreements must be considered together in order to obtain "a realistic picture of the profits of Glaxo Canada." The Court remitted the case back to the Tax Court to redetermine the arm's length price, "having regard to the effect of the License Agreement on the prices paid by Glaxo Canada for the supply of ranitidine from Adechsa."

Court Rejects the "Transaction-by-Transaction" Approach

In dismissing the appeal, Justice Rothstein rejected the Crown's arguments that Subsection 69(2) and the OECD Guidelines mandate a "transaction-by-transaction" approach, in which the supply of ranitidine by Adechsa must be considered separately from the rights and benefits conferred on Glaxo Canada by the License Agreement with Glaxo Group. Rather, Justice Rothstein held that a transfer pricing analysis necessitates a comparison of the "economically relevant characteristics" of the non-arm's length transaction to those of arm's length transactions to which it is compared. Those characteristics, said Justice Rothstein, may include "other transactions that impact the transfer price under consideration."

Justice Rothstein stated that Subsection 69(2), which requires the determination of the amount that would have been reasonable in the circumstances, necessarily involves "consideration of all circumstances of the Canadian taxpayer relevant to the price paid to the non-resident supplier," including "agreements that may confer rights and benefits in addition to the purchase of property where those agreements are linked to the purchasing agreement." A reasonable arm's length price is then to be determined based on "what an arm's length purchaser would pay for the property and the rights and benefits together."

In the instant case, Justice Rothstein agreed with Glaxo Canada that the License Agreement was linked to the Supply Agreement because the rights and benefits of the former were contingent on Glaxo Canada entering into the latter, and, further, that the requirement that ranitidine be purchased from Adechsa under the Supply Agreement "was not the product of the non-arm's length relationship between Glaxo Canada and Glaxo Group or Adechsa." Rather, it arose because Glaxo Group controlled the trademark and patent of the brand-name pharmaceutical product Glaxo Canada wished to market.

The Court held that a transfer pricing analysis necessitates a comparison of the "economically relevant characteristics" of the non-arm's length transaction to those of arm's length transactions to which it is compared.

Those rights and benefits, according to Justice Rothstein, were not limited to the use of the Zantac trademark and the ranitidine patent, but also included such things as "guaranteed access to new products, the right to the supply of raw materials and materials in bulk, marketing support, and technical assistance." Justice Rothstein found that those rights and benefits, along with the fact that ranitidine purchased from a Glaxo Group-approved source would be manufactured under Glaxo Group's "good manufacturing practices," added value to the ranitidine purchased by Glaxo Canada from Adechsa.

Back to the Tax Court

Justice Rothstein declined, however, to accept Glaxo Canada's argument that the Court of Appeal, having rejected the Crown's theory that it was not reasonable for Glaxo Canada to have paid more for ranitidine than its generic competitors, should simply have allowed the

(*Arm's Length Pricing*, continued on page 6)

Arm's Length Pricing *(from page 5)*

taxpayer's appeal rather than sending the matter back to the Tax Court. Instead, the Supreme Court, like the Court of Appeal, remitted the case to the Tax Court to be redetermined, having regard to the effect of the License Agreement on the prices paid by Glaxo Canada for the supply of ranitidine.

Implications of the Decision for Multinational Corporate Groups

Although Justice Rothstein's reasons for judgment are terse by Supreme Court standards, they nonetheless offer some important guidance for the Tax Court in making its determination—as well as for courts deciding future transfer pricing cases and for multinational corporate groups in developing their transfer pricing. First, with regard to the role of the OECD Guidelines, which have been relied on extensively by litigants and lower courts in transfer pricing cases, Justice Rothstein offered the comment that the Guidelines, while they "contain commentary and methodology pertaining to the issue of transfer pricing," "are not controlling as if they were a Canadian statute." Any set of transactions or prices must be assessed, said Justice Rothstein, and based on Subsection 69(2) of the Income Tax Act rather than any particular methodology or commentary set out in the Guidelines.

Second, Justice Rothstein commented on the "reasonableness" standard enunciated by Subsection 69(2). That provision, he held, allows "some leeway," and requires only that a transfer price fall within what the court determines is a "reasonable range." He also specifically countenanced the use of statistical measures, finding that courts may rely on averages, medians or modes to determine a reasonable arm's length price. Both of these concepts have been strenuously rejected by the Canada Revenue Agency. Further, since it is "highly unlikely that any comparisons will yield identical circumstances," Justice Rothstein said that courts must

(*Arm's Length Pricing*, continued on page 7)

Arm's Length Pricing *(from page 6)*

exercise their "best informed judgment" in determining a satisfactory arm's length price.

Third, Justice Rothstein contrasted the relatively minor functions performed and risks borne by Glaxo Canada with those performed and borne by Glaxo Group and stated: "Transfer pricing should not result in a misallocation of earnings that fails to take account of these different functions and the resources and risks inherent in each." This, clearly, is a direction for Canadian courts to keep an eye on the bigger picture in making their transfer pricing determinations.

Lastly, Justice Rothstein held that an arm's length price determined under Subsection 69(2) must reflect the court's consideration of the independent interests of each party to a transaction. This two sided approach is fundamental to the determination of an arm's length price, and distinguishes it from the narrower concept of "fair market value."

Although the transfer pricing provision at issue in the Glaxo case, Subsection 69(2), has since been repealed and replaced by the transfer pricing regime in Section 247 of the Income Tax Act, much of the Court's guidance on the interpretation and application of the historical provision and the role of the OECD Guidelines should be equally relevant under the current regime.

[1] The taxpayer was represented on appeal by Osler's Al Meghji, Joseph Steiner, Amanda Heale and Pooja Samtani.
[2] Subsection 69(2) was replaced by Section 247 of the Income Tax Act in 1998.

RUSSIA

Update on Double Tax Treaties

By Natalia Nalyutina (Ernst & Young)

Russia has recently ratified new treaties on the avoidance of double taxation with respect to taxes on income and capital with Argentina[1] and Latvia.[2]

The Treaties will come into force on January 1 after the completion of all necessary internal procedures by both contracting states. It is likely that they will be effective from January 1, 2013.

In essence both Treaties follow the principles of the OECD model convention with some variations, including but not limited to the determination of whether a person is a "resident of a Contracting State." According to the Russia-Argentina treaty, if a person is resident in both Contracting States under the general provisions then its status will be determined as resident in the State of which he or she is a national. If an individual is a national of neither State, and in all other cases, the competent authorities of the Contracting States are to endeavor to settle the question and determine the mode of application of the Convention to such a person by mutual agreement. Under the Russia-Latvia treaty, it is always the Contracting States' competent authorities' duty to determine status of persons resident in both Contracting States under the general provisions, otherwise treaty benefits cannot be applied.

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Under the Russia-Argentina treaty the withholding tax rate on dividends is 10 percent if the recipient is the beneficial owner of at least 25 percent of the capital of the company paying the dividends, and 15 percent in all other cases. The tax rates for interest payments and royalties applicable at source are both capped at 15 percent.

Similarly, under the Russia-Latvia treaty, the tax rate on dividends is 5 percent if the recipient is the beneficial owner of at least a 25 percent interest and the value of its investment in the equity capital of the company paying the dividends is $75,000 (US) or more. The rate is 10 percent in all other cases. The tax rate for interest is 5 percent regarding loans between financial institutions, and 10 percent for all other cases. The maximum tax rate applicable at source to royalties under the treaty is 5 percent.

Finally, the State Duma is considering a draft law on amendments to the Russia-Luxembourg Double Tax Treaty. The law will decrease the minimum rate of tax on dividends at source from 10 percent to 5 percent and introduce a new article on the exchange of information.[3] ❑

[1] Federal law No. 155-FZ of October 2, 2012.
[2] Federal law No. 156-FZ of October 2, 2012.
[3] Draft law No. 143267-6.

Spain Approves New Tax Measures

By Inigo Alonso Salcedo, Laura Ezquerra and José L. Gonzalo (Ernst & Young)

A draft bill in Parliament, expected to come into force January 1, 2013, contains the following amendments to Spanish corporate income tax, nonresidents' tax, personal income tax and VAT.

Corporate Income Tax (CIT)

Optional Step-Up in Value

The option to step up the tax value of tangible fixed assets, real estate investments and assets leased under financial lease agreements by applying percentages (which will be approved by a future regulation) to the assets' book value and accumulated depreciation is proposed for Spanish resident companies and Spanish permanent establishments. The proposed step-up rules have the following features:

- The step up will give rise to a 5 percent tax charge.
- Once the election is made by the taxpayer, all tangible fixed assets and assets acquired under financial lease agreements must be stepped up. The real estate investments to be stepped up may be "cherry-picked."

The step up will give rise to a 5 percent tax charge.

- The stepped-up value of the assets may be limited in the event that the entity has debt-financed its transactions.
- The stepped up amount must be recorded in a specific asset value appreciation reserve. The use of this reserve will be restricted during a three-year term, to be counted from the filing of the tax return reporting the 5 percent tax charge.
- After a review by the Spanish tax authorities or after the three-year period has elapsed, the reserve may be used to offset accounting losses or to increase the company's share capital.
- After 10 years have elapsed from the date of closing of the balance sheet of the step-up, the amount may be allocated to distributable reserves.
- Failing to observe the aforementioned maintenance periods will result in the taxation of the amount utilized at the standard CIT rate, without the possibility of offsetting NOLs.

It is also proposed to apply this measure to assets used in an economic activity carried out by individuals.

Limitation on Depreciation Expenses for "Large Sized Companies"

For FY 2013 and 2014 it is proposed that the depreciation expenses on tangible assets of large sized companies (i.e., companies whose net turnover exceeded €10 million in the previous tax period) is restricted. The deductible depreciation expense is limited to 70 percent of the maximum depreciation applicable under the rate established in the CIT Regulations.

The depreciation expense not taken in FY 2013 and 2014 can be rolled over and become tax deductible after the conclusion of the useful life of each of the respective assets.

Reduced CIT Rate in Case of Maintenance and Creation of Employment

The bill includes an extension to FY 2013 of the application of a reduced CIT rate (20 percent for taxable income up to €300,000 and 25 percent for the excess) in case of maintenance and creation of employment by micro small-sized companies (i.e., entities with a net turnover of less than €5 million and an average work force of not more than 25 workers).

Tax Deduction for Expenses Incurred for the T raining of Employees in the Use of New Technologies

The bill also includes an extension to FY 2013 of the tax deduction for expenses incurred for the training of employees in the use of new technologies.

Value Added Tax Amendments

Joint-Ownerships (Comunidades de Bienes) that Promote Real Estate

It is proposed that the attribution of real estate by joint-ownerships to their members will be subject to VAT. Moreover, the input VAT charged to the joint-ownerships in the promotion of real estate will be deductible by the latter under the proposed rules.

(*Tax Measures*, continued on page 9)

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Tax Measures *(from page 8)*

Modification of the Taxable Base in Case of Defaulted Payments

Under the current VAT Law, in case of defaulted payments, it is mandatory to claim payment of the unpaid invoice in the courts or through a public notary to be able to reduce the VAT taxable base. The proposed amendments provide that where the consideration is due in several installments, payment in one single installment will allow modifying the VAT taxable amount corresponding to the total unpaid installments (instead of having to claim the payment of each of the installments individually).

Personal Income Tax (PIT)

If the amendments are enacted, short term capital gains (i.e., those generated over a period of less than one year) derived by Spanish resident individuals will no longer be taxable at reduced rates but rather at the progressive rates (which, depending on the region, can be charged at rates up to 50 percent for income exceeding certain thresholds).

The draft bill also proposes to abolish the tax credit for investments in primary dwellings for acquisitions made after January 1, 2013.

Nonresident Income Tax (NRIT)

Special Levy on Certain Lottery Prizes

To date, certain lottery prizes are exempt from Nonresidents' Income Tax. Taxation on lottery prizes won by nonresidents without a permanent establishment in Spain at a 20 percent tax rate, to be imposed via withholding, is now proposed.

The withholding will become due even where an exemption is applicable under a Double Tax Treaty entered into by Spain and the country of residence of the taxpayer. In such event, the nonresident may apply for the refund of the withholding tax.

This new taxation is also proposed for Spanish resident individuals.

California's Gillette Decision Raises Taxpayer Opportunities for Corporate Taxpayers

By Scott D. Smith (Baker Donelson)

On July 24, 2012, a California Court of Appeals in *The Gillette Company v. Franchise Tax Board* held that Article III of the Multistate Tax Compact (Compact), enacted by California in 1974, provides corporate taxpayers with an income apportionment election, despite changes to California's tax statutes arguably preventing such elections that have occurred since 1993 and 2011.

After the *Gillette* decision was issued, the California Franchise Tax Board moved for rehearing. On October 2, 2012, the Court of Appeal reaffirmed its July 24 decision.

What Should Corporate Taxpayers Be Doing?

Notwithstanding some California procedural uncertainties[1] and the likelihood that the Franchise Tax Board will try to appeal the Court of Appeals' decision to the California Supreme Court, corporate taxpayers with California income and franchise tax filing obligations should review whether the *Gillette* decision and the "Compact election" presents refund opportunities for them. For example, some taxpayers may benefit from an equally-weighted three factor income apportionment formula, as opposed to California's statutory formula with a double-weighted sales factor. In addition, there may be advantages for service providers and other taxpayers earning income from intangibles under the Compact election compared to California's recent move toward market-based sourcing of gross receipts to the sales factor.

Protective refund claims could be in order for some corporate taxpayers.

(*Multistate Tax Compact*, continued on page 10)

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Multistate Tax Compact *(from page 9)*

Protective refund claims should certainly be considered. However, taxpayers should proceed cautiously if contemplating making a Compact election on an original tax return. On October 5, 2012, the Franchise Tax Board issued FTB Notice 2012-01, providing guidance on the protective refund claim procedure. The Franchise Tax Board announced that it will impose the 20 percent Large Corporate Underpayment Penalty to 2011 returns making the Compact election (if *Gillette* is subsequently reversed or vacated) unless the FTB does not appeal the decision and the Court of Appeals' decision becomes final on November 1, 2012.

There are 19 member states of the Multistate Tax Commission who have enacted the Compact. Although *Gillette* is not precedent in any of these states, it is persuasive authority. As a result, some of the other Multistate Tax Commission states may present similar Compact elections and protective refund claims could be in order for corporate taxpayers depending on their facts and circumstances. For example, similar litigation is pending in Michigan and Oregon, and the Oregon Department of Revenue recently issued guidance on how protective refund claims should be prepared and filed in light of the pending controversy. ❑

1 For a discussion of the procedural uncertainties, see: http://www.bakerdonelson.com/spotlight-on-salt-californias-gillette-decision-raises-a-host-of-potentially-significant-taxpayer-opportunities-nationally-08-07-2012

US

Supreme Court to Decide Question of Tax Credits for Foreign Windfall Tax

By Jonathan Stempel and Patrick Temple-West (Reuters)

The Supreme Court said on October 29 it will take the rare step of considering a tax case, one with hundreds of millions of dollars at stake and broad implications for companies with businesses abroad and for the Internal Revenue Service. The court agreed to hear an appeal by PPL Corp, a Pennsylvania-based utility and energy holding company, in a case addressing when a company can claim U.S. tax credits to offset taxes it has already paid to a foreign government.[1]

The case is being watched by a range of U.S. utility companies, including American Electric Power Co Inc and Entergy Corp, but the foreign tax credit question extends well beyond the power business. A Supreme Court win for the IRS would give the agency more authority to challenge foreign tax credit claims where the law may be vague, said Jerold Cohen, a partner at law firm Sutherland Asbill & Brennan LLP and a former IRS chief counsel. "The issue is relevant to any international company," Cohen said. "The (Supreme) Court takes very few tax cases."

PPL is appealing a December 2011 decision by the 3rd U.S. Circuit Court of Appeals in Philadelphia. In a related dispute, the 5th U.S. Circuit Court of Appeals in New Orleans ruled in June 2012 in favor of Entergy. Both cases involve tax credits claimed by utility companies after they paid a "windfall tax" imposed by the United Kingdom.

U.S. utility companies acquired stakes in 32 UK power companies when they were privatized in the 1980s and 1990s. In response to widespread concern in the UK that the government had sold off the companies too cheaply, the British government imposed one-time windfall taxes on those companies. U.S. companies that had to pay the windfall tax claimed foreign income tax credits from the IRS. But the IRS rejected their claims, saying the windfall taxes were based not on the British companies' profits, which could be credited, but on their unrealized value, which could not.

PPL had recorded a $39 million expense in the fourth quarter of 2011 because of the 3rd Circuit ruling and Entergy could owe $239 million in taxes and interest, the companies said in regulatory filings. Several groups filed briefs supporting the companies. A Supreme Court decision is expected by the end of June. ❑

[1] PPL Corp et al v. Commissioner of Internal Revenue, U.S. Supreme Court, No. 12-43.

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scrutiny, related parties are generally presumed to act at arm's length when assessing debt-equity factors in the intercompany debt context, and their intent to create equity or debt will not necessarily be determined based on precise matching of unrelated party terms or actions.

Further, *PepsiCo* provides helpful insight with respect to a taxpayer's ability to assert the relevance of substance and form for U.S. tax purposes. In *PepsiCo*, the Tax Court rejected the IRS's attempt to disregard the form in the related-party context, as well as the broader substance of the transaction, on the basis of the intended treatment for Dutch tax purposes and the facts underlying that treatment. Such a determination by the court stands for the notion that the purpose of an arrangement for foreign tax purposes will not, itself alone, dictate the appropriate treatment for U.S. tax purposes, although the facts that are essential for foreign tax treatment will likely be accepted as facts for U.S. tax purposes, but not to the exclusion of other facts.

Finally, it is important to note that while *PepsiCo* provides helpful guidance for any U.S. multinational that desires to structure an intercompany arrangement as debt for foreign tax purposes but as equity for U.S. tax purposes, it does not necessarily follow that the analysis of debt-equity factors in *PepsiCo* would be adopted by a court in the context of a foreign multinational that desires to structure an intercompany arrangement with its U.S. subsidiary as debt for U.S. tax purposes. Foreign multinationals desiring debt treatment are well advised to seek guidance primarily from cases in which intercompany debt owed by a subsidiary to its parent and another subsidiary was upheld as debt for U.S. tax purposes, such as *Scottish Power*.

In More Detail

What Did the Opinion Address?

The principal issue in these consolidated cases was whether advance agreements issued by PepsiCo, Inc.'s (PepsiCo's) Netherlands subsidiaries to certain PepsiCo domestic subsidiaries and PepsiCo Puerto Rico, Inc. (PPR) constituted debt or equity. Below is a summary of the court's findings of fact.

In the mid-1990s, PepsiCo began to consider large-scale investments in emerging, unestablished markets. In addition, PepsiCo sought to organize its international holdings to allow for a more effective use of overseas earnings and to avoid using cash from the United States to fund its overseas operations. As a result, PepsiCo undertook a global restructuring of its international operations. Pursuant to its global restructuring, and influenced by changes to the U.S.-Dutch treaty, PepsiCo transferred ownership of some of its foreign partnerships from various Netherlands Antilles holding companies to Netherlands holding companies.

In 1996, the interests in the foreign partnerships were ultimately contributed to newly formed subsidiaries, PepsiCo Worldwide Investments (PWI) and PepsiCo Global Investments (PGI). Both PWI and PGI were *besloten vennotschaps* (private limited liability companies) organized under Dutch law. By having PWI and PGI each hold an interest in each foreign partnership, the foreign partnerships continued their status as partnerships for U.S. federal income tax purposes. PepsiCo would eventually cause PWI to merge into PGI and thereafter file check-the-box elections to treat the foreign partnerships as disregarded entities for U.S. federal income tax purposes.

The terms of the advance agreements indicated that there was no intent to create traditional debt.

In September 1996, a U.S. related party contributed certain pre-existing notes to PGI and PWI in exchange for advance agreements having similar face amounts. Subsequently, in May 1997, PGI issued an advance agreement to PPR, a Delaware corporation that elected the benefits of sections 936 and 30A, in exchange for pre-existing notes held by PPR. Similarly, these pre-existing notes had an aggregate principal face amount equal to the face amount of the advance agreement.

The advance agreements issued by PGI and PWI to the U.S. related parties were carefully drafted by PepsiCo and thoroughly reviewed by the Dutch Revenue Service. It was PepsiCo's intent for the advance agreements to be classified as debt in the Netherlands and as equity in the United States. PepsiCo contemplated that the tax treatment of these instruments would reduce PGI's Dutch corporate taxable income from accrued interest from the pre-existing U.S. related party notes by the amounts accrued under the advance agreements. From a U.S. tax perspective, the taxpayers anticipated that payments to the U.S. entities pursuant to the advance agreements would be treated as distributions on equity and that the taxpayers were unlikely to be subject to subpart F income or dividend treatment on the distributions, as PGI's earnings and profits were predicted to be reduced or eliminated by the foreign partnerships' losses in the foreseeable future.

In order to obtain the intended treatment of the advance agreements for Dutch tax purposes, the

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taxpayers, their Dutch tax counsel, and the Dutch Revenue Service participated in a lengthy and detailed negotiation process to create instruments capable of securing a Dutch tax ruling. The negotiations included significant discourse between the parties; in particular, intercompany communications as well as representations and other dialogue with the Dutch Revenue Service. One issue of particular importance throughout the negotiations was the Dutch Revenue Service's position that amounts paid on the advance agreements should at least be equal to the interest received by PGI on the U.S. related party notes. The taxpayers stressed their reluctance to include such language in the advance agreements, as such a specific obligatory link between PGI's receipt of interest payments relating to the U.S. related party notes and PGI's payments pursuant to the advance agreements would undoubtedly be susceptible to the IRS recharacterizing the arrangement as debt for U.S. federal income tax purposes. The taxpayers eventually assured the Dutch Revenue Service that each payment of interest on the U.S. related party notes to PGI would be used to fund payments relating to the advance agreements, and as a result, the Dutch Revenue Service approved the tax ruling.

The court found that the taxpayers' actions during the years at issue were in accordance with legitimate tax planning.

The final advance agreements incorporated many of the initial provisions, but also included several provisions that were tailored to address the concerns of the Dutch Revenue Service. The advance agreements provided for payments of principal amounts after initial terms of 40 years, with PGI (and PWI) having unrestricted options to renew the advance agreements for a period of 10 years and, if these options were exercised, the ability to exercise a separate option delaying payment of principal for an additional 5 years. If, however, a related party defaulted on loan receivables held by PGI (or PWI), the advance agreements would become perpetual.

The advance agreements provided that a preferred return would accrue on any unpaid principal amounts. The preferred return accrued semiannually and consisted of two components, a base preferred return and a premium preferred return. The preferred return unconditionally accrued pursuant to the advance agreements, but the instruments required that PGI (and PWI) make payments of accrued preferred return only under certain specified circumstances, which included making such payments only to the extent that 'net cash flow' exceeded 'accrued but unpaid operating expenses incurred' and 'capital expenditures made or approved' by PGI during the applicable year. The provision further provided that in no event would the amount of net cash flow be less than the aggregate amount of all interest payments and payments of capitalized interest received from related parties during such year. In the event any accrued preferred return was not paid when due, such amounts were to be capitalized. The payment of capitalized base preferred return was required annually and the payment of capitalized premium preferred return was required only when the principal amount of its corresponding advance agreement was paid in full. Both were subject to "net cash flow" restrictions similar to the payment of accrued preferred return.

Furthermore, the advance agreements provided that PGI (and PWI) could pay in full or in part at any time unpaid principal, accrued but unpaid preferred return, any unpaid capitalized base preferred return amount, and any unpaid capitalized premium preferred return amount. The obligation to pay any of these amounts was subordinated to all the indebtedness of PGI (and PWI). In addition, the rights of all PGI (and PWI) creditors to receive payments from PGI (and PWI) were 'superior and prior to' the rights of the holders of the advance agreements. The advance agreements did provide the holders the right to declare unpaid principal and preferred return immediately due and payable upon dissolution, insolvency, or receivership of PGI, but such rights were subject to the 'net cash flow' restrictions and remained subordinated to all indebtedness of PGI and the rights of all creditors.

During the years at issue (1998 through 2002), PGI, preferring to borrow cash from PepsiCo affiliates rather than from third-party lending institutions because of the higher costs of external borrowing, had outstanding indebtedness to related parties that ranged from approximately $437 million to more than $937 million. During that same period, PGI made loans and equity investments in affiliates of approximately $1.415 billion.

From 1997 through 2009, nearly all of the amounts received by PGI under the U.S. related party notes were paid out to the holders of the advance agreements, with each preferred return payment being made on the same day that interest due on the U.S. related party notes was paid to PGI. On their U.S. federal income tax returns, the taxpayers treated the payments of preferred return as distributions on equity and claimed as a deduction the interest due to PGI on the U.S. related party notes. The payments of interest to PGI on the U.S. related party

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notes were, pursuant to the Dutch tax treaty, exempt from U.S. withholding tax. PepsiCo included the interest on the U.S. related party notes as subpart F income on its consolidated U.S. federal income tax returns, but only to the extent of PGI's earnings and profits. PPR did not report any subpart F income during the years at issue.

The IRS's Position

The IRS asserted that the substance of the transactions, as revealed primarily through the taxpayers' dialogue with the Dutch Revenue Service during negotiations to secure a Dutch tax ruling, evidenced the taxpayers' clear intentions in structuring the advance agreements and underscored that the instruments manifest a creditor-debtor arrangement for U.S. federal income tax purposes.

The Taxpayers' Position

The taxpayers disputed the assertion that the advance agreements should be characterized as debt, contending that the form of the advance agreements, together with the risks assumed by the holders of the advance agreements, justified their characterization as equity instruments for U.S. federal income tax purposes.

Court Decision

In ruling in favor of the taxpayers with respect to the appropriate characterization of the advance agreements, the Tax Court applied a traditional debt versus equity analysis, examining 13 factors developed by the court to aid in resolving debt versus equity issues. The Tax Court focused on factors developed by its own case law because the Court of Appeals for the Second Circuit, the court to which appeal in these cases would lie, has not explicitly adopted a specific factor test; rather, the Second Circuit has implied that a thorough inquiry would include factors designated by Notice 94-47, supplemented with additional, pertinent factors generally considered by other courts. The Tax Court, citing *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476, 493 (1980) and stating that the factors identified by Notice 94-47 'are subsumed within the more discerning inquiry espoused in *Dixie Dairies Corp.*', explained that it considers the following factors as germane to debt versus equity inquiries:

- names or labels given to the instruments
- presence or absence of a fixed maturity date
- source of payments
- right to enforce payments
- participation in management as a result of the advances
- status of the advances in relation to regular corporate creditors
- intent of the parties
- identity of interest between creditor and stockholder
- "thinness" of capital structure in relation to debt
- ability of the corporation to obtain credit from outside sources
- use to which advances were put
- failure of debtor to repay
- risk involved in making advances.

The court further stated that the various factors are merely aids in determining "whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship."

The advance agreements contained certain equity-like terms, including the subordination of payments to all other debt; restrictions on use of net cash flows received from related party to make payments; lack of sufficient default remedies; and long, possibly perpetual, terms. The court's analysis of the factors relating to these terms is highlighted below.

Status of the Advances in Relation to Regular Corporate Creditors

One factor courts frequently consider in making debt versus equity determinations is whether an advance is subordinated to obligations of other creditors. The advance agreements, by their own terms, unequivocally subordinated any obligation of PGI under the agreements to all indebtedness of PGI and the rights of all its creditors.

The IRS argued that this feature was not dispositive of equity characterization and that irrespective of the subordination provision the practical likelihood of it affecting payments was nonexistent. The court acknowledged that the IRS was correct in asserting that this feature is not dispositive, but explained that the same is true for all other factors. In finding that this factor weighed in favor of equity treatment, the court focused on terms described above as well as the impact of PGI's outstanding indebtedness to affiliates (i.e., $980 million) and its exposure to liabilities of its foreign investments, all of which ranked superior to any rights engendered in the advance agreements.

Source of Payments

Courts often consider the source of payments in analyzing whether an instrument is debt or equity. In particular, if a taxpayer is willing to condition the repayment of an advance on the financial well-being of the receiving company, then the taxpayer is acting more as a classic capital investor, and not as a creditor. The Tax

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Court noted that in considering this factor, it must discern whether certain discrete terms of the advance agreements reflect the transaction's substance.

Despite the restrictions on the use of net cash flows with respect to payments under the advance agreements, which alone may be indicative of equity treatment, the court found that this factor favored debt characterization. In reaching this conclusion, the court weighed heavily on the taxpayers' intercompany memos and representations to the Dutch Revenue Service that uniformly expressed an intent that PGI's receipt of interest on the U.S. related party notes would in turn be used to fund payments of base preferred return on the advance agreements. Furthermore, the court found that PGI's payment of nearly all amounts received under the U.S. related party notes to the holders of the advance agreements during the years at issue exemplified PGI's commitment to make payments on the advance agreements from a reasonably certain stream of revenue.

The court was not persuaded that the express language in the advance agreements made such payments too speculative and subject to PGI's unfettered discretion at least during the five-year period of the Dutch tax ruling. Furthermore, the court noted that payments on the advance agreements generally were made on the same date that interest due on the U.S. related party notes was paid to PGI, and in substantially similar amounts. The court also found that PGI could, and did, deviate from the intended payment schedule and that, under Dutch law, it could treat the advance agreements as debt for Dutch law purposes, even if it could no longer rely on the Dutch tax ruling. Overall, the court concluded there was a connection between the payments of interest on the U.S. related party notes to PGI and the payments by PGI on the advance agreements. This, however, was only one factor in the overall facts and circumstances analysis considered by the court.

Right to Enforce Payments

Courts have held that the ability of a party to enforce repayment is indicative of debt. While there was no mechanism that provided the holders of the advance agreements with the right to demand immediate repayment of outstanding principal and interest in the event PGI defaulted, the IRS contended that there was no real possibility that PGI would default because PepsiCo controlled all the entities involved and would be economically disadvantaged if PGI were to default. The court rejected this contention, reiterating that there was no basis in fact or in law for the argument that the taxpayers could ensure the timely payment of intercompany obligations based solely on the subsidiaries' inter-relatedness.

The IRS further argued that PGI intended to, and was, internally committed to make payments on the advance agreements. The court rejected this assertion and found that full repayment of principal and interest on the advance agreements was not unconditional, as the long and perhaps perpetual terms of the advance agreements rendered payment of principal speculative and the payments of base preferred return were subject to the business realities and uncertainties of the taxpayers' global expansion throughout the long term of the investment.

The IRS alternatively argued that the advance agreements provided other legitimate creditor safeguards, such as the provision which allowed holders to declare unpaid principal and preferred return 'immediately due and payable' upon dissolution, insolvency, or receivership of PGI. The court, rejecting this assertion, stated that pursuant to the provisions of the advance agreements the subordination of any such payments to all indebtedness of PGI and the rights of all creditors would be meaningful and significant in light of PGI's $980 million in outstanding indebtedness to affiliates in addition to other exposures during the years at issue. The court concluded that the absence of any legitimate creditor safeguards afforded to the holders of the advance agreements was a significant factor weighing in favor of an equity characterization.

Presence or Absence of a Fixed Maturity Date

Another factor courts consider important in determining whether an instrument constitutes debt or equity is the presence of a fixed maturity date. The absence of a fixed maturity date is strongly indicative of equity, as this would indicate that repayment was in some way tied to the fortunes of the business. The Tax Court highlighted that the advance agreements had terms of 40 years which could be unilaterally extended by the holders an additional 15 years, but that to the extent a related party were to default on any loan receivables held by PGI, such terms were to be voided, rendering the instruments perpetual.

The IRS argued that the maturity dates of the advance agreements were fixed and that the perpetual clause was meaningless, as there was an unrealistic possibility that the terms of the advance agreements would become perpetual presuming that the taxpayers, through their own control of all involved entities, would never cause a related party to default on any loan receivables held by PGI. The court rejected these arguments as well as the IRS's assertion that the court should consider PepsiCo's entire business operations in determining the reasonableness and likelihood of repayment.

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Instead, the court determined that under the circumstances the uncertainty of repayment of the principal amounts of the advance agreements at maturity was too great to conclude that PGI had an unqualified obligation to pay a sum certain at a reasonable fixed maturity date. The court based its conclusion on the taxpayers' uncontested reluctance to use domestic moneys to further its global expansion and their desire to create a more self-sustaining international business component. The court found that this accentuated the uncertainty of repayment because there was no assurance that the international investments would succeed and that the extended maturity date of the advance agreements effectively subjected the principal amounts of the instruments to an uncertain international economic climate for an inordinate period. The court further emphasized that, given that PGI made a significant amount of loans to its affiliates during the years in issue and that repayment of those loans was subject to the success of the taxpayers' speculative new investments in unestablished foreign markets, PGI could not be certain that its foreign affiliates would be able to fulfill all their payment obligations.

Other Factors

The Tax Court also analyzed the parties' intent, the thinness of PGI's capital structure in relation to debt, and PGI's ability to obtain credit from outside sources.

With respect to the parties' intent, the court found that the negotiations with the Dutch Revenue Service underscored the taxpayers' expectation that the advance agreements would be characterized as equity for U.S. federal income tax purposes and as debt under Dutch tax law. The terms of the advance agreements also indicated that there was no intent to create traditional debt. The advance agreements had long, and possibly perpetual, terms; the repayment of principal was effectively subject to PGI's speculative investments in undeveloped foreign markets; and the realistic possibility that a U.S. related party might default on a receivable held by PGI, which would cause the advance agreements to become perpetual instruments, further dissipated any reasonable expectation of repayment of principal. In addition, the court found that the taxpayers' actions during the years at issue were in accordance with legitimate tax planning and further supported the taxpayers' intent to create a hybrid instrument. Accordingly, the court concluded that the taxpayers' intentions comport with the substance of the transaction, as they did not intend to create a definite obligation, repayable in any event.

In analyzing PGI's capital structure, the court examined PGI's debt-to-equity ratio and relied on the taxpayers' uncontested expert report and expert testimony, which provided that PGI's debt-to-equity ratio was untenable according to industry standards if the advance agreements were treated as debt. In analyzing PGI's ability to obtain credit from outside sources, the court again relied on the taxpayers' uncontested expert, who asserted that no reasonable commercial lender would have issued a loan to PGI in similar amounts and under any reasonably similar terms to those of the advance agreements.

Actions to Consider

Given the inherently factual nature of this inquiry, taxpayers with cross-border financing arrangements should consider preparing contemporaneous analysis and documentation to clearly establish the parties' intent and the substance with respect to the desired characterization of the arrangement for U.S. federal income tax purposes. ❑

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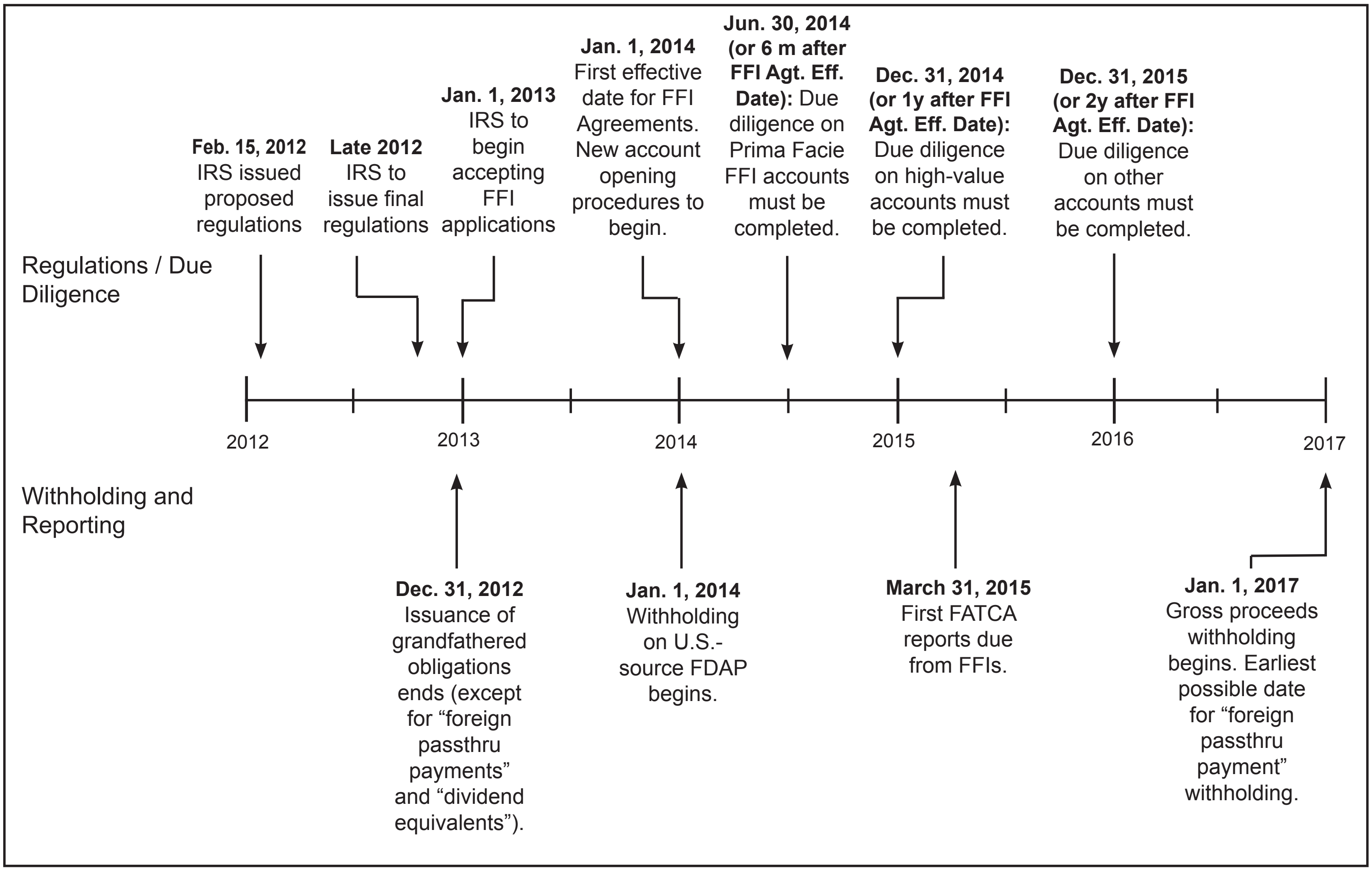

Background

FATCA, which was enacted by the U.S. Congress in March 2010, is intended to prevent U.S. citizens and residents from evading their U.S. tax obligations by holding assets offshore. To accomplish this objective,

In many cases, these new dates extend the deadlines in the Proposed Regulations by six months, and are consistent with the requirements under the model IGAs.

FATCA encourages: (i) FFIs to sign agreements to report information regarding their U.S. account holders to the IRS (such FFIs, “Participating FFIs”) and (ii) other foreign entities to provide information regarding their beneficial owners to U.S. withholding agents, including Participating FFIs. The U.S. Treasury Department and the IRS are negotiating IGAs that will allow FFIs to report U.S. account holders to their local governments (which will share the information with the IRS) in lieu of reporting directly to the IRS.[1] FATCA requires withholding agents to collect a 30 percent withholding tax on U.S.-source “withholdable payments” made to non-compliant entities. FATCA also generally requires Participating FFIs to withhold on certain “passthru payments” made to “recalcitrant account holders” and to FFIs that have not signed a reporting agreement with the IRS.

Prior to the Announcement, the timetables for implementing FATCA were included in proposed regulations (Proposed Regulations) issued in February 2012, and an IRS Notice (Notice 2011-53) issued in July 2011.[2] Slightly modified timetables (for FFIs in IGA jurisdictions) were announced in the model IGAs, which were released in July 2012.

Discussion

The Announcement includes new guidance on four principal topics: (i) account due diligence and U.S.-

(*FATCA*, continued on page 17)

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source income withholding, (ii) account reporting, (iii) gross proceeds withholding, and (iv) grandfathered obligations.

A. Account Due Diligence and U.S.-Source Income Withholding

The Announcement prescribes new deadlines for Participating FFIs and other withholding agents (such as U.S. financial institutions) to conduct their account due diligence and withhold on preexisting accounts. In many cases, these new dates extend the deadlines in the Proposed Regulations by six months, and are consistent with the requirements under the model IGAs. Equally significant, the Announcement harmonizes the FATCA deadlines for withholding agents that make U.S.-source payments with those established under the general rules applicable to Participating FFIs.

The table below illustrates the new deadlines and compares them with the timeframes that had been announced in prior guidance.

These dates do not change the January 1, 2014 effective date for FATCA withholding on U.S.-source "withholdable payments." Furthermore, an appendix

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Milestone	New Date	Prior Date (Proposed Regulations)	Model IGA Date
Effective Date of FFI Agreements.	January 1, 2014 (immediate if registration occurs on or after January 1, 2014).	July 1, 2013 (immediate if registration occurs on or after July 1, 2013).	N/A.
Deadline for Implementation of New Individual and Entity Account-Opening Procedures.	January 1, 2014 (or, if later, effective date of FFI Agreement or date on which FFI registers as a deemed-compliant FFI)	July 1, 2013 for Participating FFIs (or, if later, effective date of FFI Agreement). For deemed-compliant FFIs, the date on which the FFI registers as a deemed-compliant FFI.	January 1, 2014.
Deadline for Due Diligence by all withholding agents on Pre-Existing Accounts of Prima Facie FFIs.	June 30, 2014 (or if later, six months after effective date of FFI Agreement).	Withholding on U.S.-Source Amounts: December 31, 2014. FFI Due Diligence Rules: June 30, 2014 (or if later, one year after effective date of FFI Agreement).	N/A.
Deadline for Due Diligence by All Withholding Agents on Pre-Existing Entity Accounts (Other than Accounts of Prima Facie FFIs).	December 31, 2015 (or if later, two years after effective date of FFI Agreement).	Withholding on U.S.-Source Amounts: December 31, 2014. FFI Due Diligence Rules: June 30, 2015 (or if later, two years after effective date of FFI Agreement).	December 31, 2015.
Deadline for Due Diligence by FFIs on Pre-Existing High-Value Individual Accounts.	December 31, 2014 (or if later, one year after effective date of FFI Agreement).	June 30, 2014 (or if later, one year after effective date of FFI Agreement).	December 31, 2014
Deadline for Due Diligence by FFIs on Other Pre-Existing Individual Accounts.	December 31, 2015 (or if later, two years after effective date of FFI Agreement).	June 30, 2015 (or if later, two years after effective date of FFI Agreement).	December 31, 2015

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to the Announcement observes that withholding and reporting will need to begin with respect to an account immediately after it has been documented, even if the deadline for reviewing that account has not yet expired.

B. Account Reporting

The Announcement also postpones the deadline for Participating FFIs in non-IGA jurisdictions to file their first FATCA reports to March 15, 2015 (from September 30, 2014), a date that is harmonized with the first reporting date in the model IGAs. The Announcement specifies that these reports must be filed for both the 2013 and 2014 calendar years, notwithstanding the fact that it also postpones the effective date of FFI Agreements to January 1, 2014.

The Announcement harmonizes the FATCA deadlines for withholding agents that make U.S.-source payments with those established under the general rules applicable to Participating FFIs.

C. Gross Proceeds Withholding

In addition, the Announcement delays the effective date of "gross proceeds" withholding, which was previously scheduled to take effect on January 1, 2015, to January 1, 2017.

D. Grandfathered Obligations

The Announcement also states that the final FATCA regulations will specify three new classes of "grandfathered obligations." Under the Proposed Regulations, a "grandfathered obligation" is any "obligation" (a term that includes indebtedness and most other legal agreements, including many derivative contracts and credit facilities, but excludes, among other things, any instrument that is treated as equity for U.S. federal income tax purposes, any agreement that lacks a stated expiration date or term, and any custodial arrangements) that could produce a "passthru payment" and is "outstanding" on January 1, 2013.[3]

1. Obligations Generating Foreign Passthru Payments

The Announcement provides that "grandfathered obligations" will include any obligation that: (i) produces (or could produce) a "foreign passthru payment," (ii) cannot produce a U.S.-source "withholdable payment" and (iii) is outstanding as of the date that is six months after the date when final regulations defining "foreign passthru payments" are filed with the Federal Register.[4]

(*FATCA*, continued on page 20)

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This change will permit FFIs that issue, for example, indebtedness and other fixed-term instruments that pay foreign-source income, to continue issuing grandfathered obligations after the end of 2012. The Announcement does not express an intent to modify the definition of an "obligation." Accordingly, equity instruments and other agreements that do not have a definitive term will remain ineligible for grandfathering.

2. Obligations Paying U.S.-Source Amounts Under Section 871(m)

In addition, the Announcement states that "grandfathered obligations" will include any instrument that gives rise to U.S.-source "withholdable payments" solely because it is treated as making a "dividend equivalent" payment under Section 871(m),[5] so long as it is outstanding on the date that is six months after the date on which instruments of its type first become subject to "dividend equivalent" treatment.

3. Collateral Arrangements

Finally, the Announcement provides that "grandfathered obligations" will also include any obligation to make a payment with respect to, or to repay, collateral posted to secure obligations under a notional principal contract that is a grandfathered obligation.[6] ❑

For a discussion of the model IGAs, please see the Sullivan & Cromwell LLP publication entitled "FATCA Model Joint Agreements Released—U.S. Treasury Department Publishes Model Intergovernmental Agreements Permitting Foreign Financial Institutions to Report Information About U.S. Account Holders to Their Home Jurisdictions Instead of the Internal Revenue Service" (August 1, 2012). At present, there is one IGA—with the United Kingdom—although it is generally understood that other jurisdictions are negotiating IGAs. The United Kingdom IGA is discussed in the Sullivan & Cromwell LLP publication entitled "FATCA International Agreements—U.S. and UK Release Joint FATCA Intergovernmental Agreement" (September 20, 2012).

[2] Additional background on the Proposed Regulations can be found in the Sullivan & Cromwell LLP publication entitled "FATCA: Proposed Regulations—IRS and Treasury Department Release Proposed FATCA Regulations" (February 28, 2012). Further background on Notice 2011-53 is available in the Sullivan & Cromwell LLP publications entitled "FATCA: Postponed Deadlines—IRS and Treasury Department Propose 'Phase-In' of FATCA Requirements" (July 15, 2011) and "FATCA: IRS Clarifies New Deadlines—IRS Clarifies That Withholding on Payments Made to NFFEs Will Commence at the Same Time as Withholding on Payments Made to Nonparticipating FFIs" (July 26, 2011).

[3] To be "outstanding" on January 1, 2013, however, an obligation generally must be issued before that date (i.e., on or before December 31, 2012). See Prop. Treas. Reg. §1.1471-2(b).

[4] The Proposed Regulations require withholding, starting on a date that will be no earlier than January 1, 2017, on "foreign passthru payments," but reserve on the definition of "foreign passthru payments."

[5] Section 871(m) requires taxpayers to treat "dividend equivalent" payments on "specified notional principal contracts" and certain other types of transactions as U.S.-source dividends. At present, temporary regulations limit the application of Section 871(m); however, proposed regulations that could broaden the scope of Section 871(m) were issued in January 2012, and final guidance in this area remains under development. Section 871(m) has no grandfathering provision. While Section 871(m) also imposes regular U.S. dividend-withholding tax on "dividend equivalent payments," absent the grandfathering rule in the Announcement, new classes of "dividend equivalent" payments could cause an instrument previously believed to be exempt from FATCA withholding to become (i) an obligation subject to "gross proceeds" withholding and (ii) subject to an increased rate of withholding if dividends would otherwise be subject to withholding at a rate of less than 30 percent under a treaty (although the owner of the payment may be entitled to reclaim the FATCA withholding by filing a treaty claim with the IRS). For additional background on Section 871(m), please see the Sullivan & Cromwell LLP publication entitled "Withholding Tax on Dividend Equivalent Payments—IRS and Treasury Issue Temporary and Proposed Regulations on 'Dividend Equivalents' on 'Specified Notional Principal Contracts,'" (January 24, 2012.

[6] Presumably, this is necessary because under the Proposed Regulations, any "custodial arrangement" is not an "obligation" eligible for grandfathering.