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## Cross-Border Credit Agreements: Planning for U.S. Withholding Taxes

By Hannah Terhune (Capital Management Services Group)

This article identifies planning strategies related to U.S. withholding taxes triggered by cross-border credit agreements between U.S. corporate borrowers<sup>1</sup> and foreign corporate lenders.

### Credit Agreements

A credit agreement (e.g., a loan agreement) is the key transactional document in commercial loan financing. A credit agreement sets forth at a minimum: terms of the loan; procedures detailing the “mechanics” of the borrowing and repayment of money; methods of calculating interest payments and other fees due; and liabilities and obligations of the parties to the agreement. While each credit agreement is commercially unique, all have common provisions and core planning issues. One key planning issue relates to U.S. withholding taxes on payments made by a U.S. borrower to a foreign lender.

### Withholding Taxes

Withholding taxes apply to cross-border interest payments, and are commonly used when the lender is not required to file a tax return in the country where the borrower is located. Cross-border interest payments are those made from a borrower resident in one country to a lender resident in another country. In the case of credit agreements, withholding taxes are collected by the borrower and are imposed on interest payments. The borrower is required to deduct the tax due from interest payments and remit the withholding to the tax authority. The amount deducted represents the lender’s tax liability on the interest payment.

### U.S. Withholding Taxes

Foreign persons and non-residents are subject to tax on their U.S. source income. The tax due is collected through U.S. withholding taxes. Special U.S. income tax

rules apply to foreign persons engaged in a U.S. trade or business.

In the case of a cross-border credit agreement, U.S. source interest, including payments of original issue discount (OID), paid to a foreign lender is subject to the U.S. withholding tax rate of 30 percent unless the agreement falls within a statutory or income tax treaty exemption. Interest is treated as U.S. source interest

**One key planning issue relates to U.S. withholding taxes on payments made by a U.S. borrower to a foreign lender.**

if it is paid by a borrower that is a U.S. corporation, U.S. non-corporate resident or U.S. partnership, if the partnership is engaged in a U.S. trade or business. Under a special rule (Section 881(c)(3)(A)), interest paid by a U.S. branch of a non-U.S. bank is also treated as U.S. source interest.

### Asserting U.S. Withholding Tax Exemptions

The most important statutory exemptions from U.S. withholding tax on interest payments are: (1) portfolio interest; and (2) interest that is effectively connected with a U.S. trade or business (or if an income tax treaty applies, interest that is attributable to a U.S. permanent establishment). (See Sections 881(a) and 881(c).)

There are other exemptions from U.S. withholding tax, however, those exemptions are not relevant for cross-border credit agreements. Two examples of those exemptions for interest payments are: (1) bank deposit interest that is not effectively connected with a U.S. trade; or (2) business and interest (or OID) on certain short-term obligations (e.g., obligations payable within 183 days of the original issue date).

### Portfolio Interest Exemption

In many cases, payments of interest made to

*Cross-Border Credit Agreements*, continued on page 16

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# The First Shoe Drops: Notice 2010-92 Provides Guidance on Section 909's Application to Pre-2011 Taxes

By Rebecca I. Rosenberg (Caplin & Drysdale, Chartered)

## Introduction

You have until the end of December to make some decisions about Section 909. To be more precise, you have until the end of the relevant Section 902 corporation's 2010 taxable year, which might provide more time. Section 909, the foreign tax credit anti-splitting rule, applies to foreign taxes paid or accrued in 2010 or earlier, if those taxes are deemed paid under section 902 or 960 in taxable years beginning after 2010. (It also, of course, applies to foreign taxes paid or accrued in taxable years beginning after 2010.) In other words, foreign taxes currently present in the foreign tax pools of a Section 902 corporation (including a CFC)<sup>1</sup> are subject to Section 909 if deemed paid under Section 902 or 960 in taxable years beginning after 2010, even if paid or accrued many years ago. But Section 909 does not apply to foreign taxes deemed paid before 2011 (i.e., before the relevant Section 909 corporation's 2011 tax year). So taxpayers have a decision to make: cause the foreign taxes in a Section 902 corporation's pools to be deemed paid before 2011 (and avoid Section 909's application to those taxes) or leave the foreign taxes in the Section 902 corporation's pools (and risk having Section 909 defer credit for those taxes—when they are otherwise deemed paid—until the related income is taken into account for U.S. tax purposes).

Section 909 essentially provides that if a foreign tax credit-splitting event occurs with respect to foreign income taxes, the foreign taxes will not be taken into account for U.S. tax purposes until the related income is taken into account for U.S. purposes by the U.S. taxpayer or, in the case of a Section 902 or 960 "deemed paid" credit, by either the Section 902 corporation that paid or accrued the foreign tax or by a "Section 902 shareholder" (that is, a U.S. corporation with sufficient ownership to claim a Section 902 credit). A foreign tax credit-splitting event occurs when "related income" is (or will be) taken into account for U.S. purposes by a "covered person," which essentially means a person related to the taxpayer. Taxpayers were hoping for guidance before 2011, to give them time to consider whether to distribute foreign taxes from tax pools before Section 909's effective date.

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On December 6, only two months after the August 10 enactment of Section 909, Treasury and the IRS issued the first installment of that guidance in Notice 2010-92.

## Contents of Notice 2010-92: Uncle Sam Wants YOU *In General*

Notice 2010-92 states that regulations will be issued to provide that pre-2011 foreign taxes<sup>2</sup> paid or accrued by a Section 902 corporation "will not be suspended

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**Claiming a deemed paid credit for such taxes after 2010 is, among other things, potentially a much more complicated process than if the taxes are deemed paid before 2011.**

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under Section 909" unless all four of the following criteria are met:

1. the taxes were paid or accrued in connection with one of four types of transactions or arrangements described in the notice;
2. the taxes were not deemed paid under Section 902(a) or 960 before the Section 902 corporation's 2011 year;
3. the related income has not been taken into account, by either the Section 902 corporation that paid or accrued the foreign taxes or a Section 902 shareholder, before the Section 902 corporation's 2011 year; and
4. the taxes were paid or accrued in taxable years of the Section 902 corporation beginning after 1996.<sup>3</sup>

## *Four Types of Arrangements Set Forth in the Notice*

The four types of arrangements that can cause pre-2011 foreign taxes to be suspended under Section 909 (the only arrangements treated as foreign tax credit-splitting events for such taxes) are the following:

1. a reverse hybrid (an entity treated as a corporation for U.S. tax purposes but as a pass-through entity by the relevant foreign country) owned by a Section 902 corporation;

*Foreign Tax Credit*, continued on page 13

# Canadian Government Not Faring Well in Recent GAAR Challenges

By Elinore Richardson and Stephanie Wong (Borden Ladner Gervais LLP)

The Canadian courts have recently considered appeals in several cases in which the Canadian government has relied on the general anti-avoidance rule (GAAR), either as a primary or secondary basis for challenging tax planning. Generally, the government has been unable in these cases to discharge its evidentiary burden to establish that the taxpayer's planning constituted an abuse of the relevant statutory provisions of the Canadian Income Tax Act (Act) or of the Act as a whole, which is a necessary prerequisite for the application of the GAAR. In some cases, however, the government has fared better in arguing that transactions were incomplete or that a party to a transaction was a Canadian resident.

## *Lehigh Cement Ltd. v. The Queen*

*Lehigh* is important in that it clearly establishes the onus on the Crown to produce evidence of a clear and unambiguous tax policy that a taxpayer's planning has abused if a GAAR challenge is to succeed. It has also arguably raised the benchmark as to what constitutes clear and unambiguous tax policy. The decision supports the view that it is insufficient for the Crown to establish that the abuse may not have been in the mind of the legislator or may have been contemplated but was not specifically caught by the legislation. The case also indicates the importance of the pleadings and of positions taken by the parties before the Courts. In this case, the Crown conceded that arrangements made between the transferee and the transferor that eliminated transferee risk in the transaction should not affect the outcome of the GAAR challenge. The Supreme Court of Canada, on November 4, 2010, refused the Crown's request for leave to appeal the decision of the Federal Court of Appeal.

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Lehigh borrowed money from a consortium of Canadian banks. A related Belgian corporation acquired Lehigh's debt, and Lehigh remitted withholding tax on interest payments. The terms of the debt were then amended to change the interest rate to the then market rate, and to add terms that would make it compliant with the former "5/25" Canadian domestic non-resident

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## Recent cases support a more circumspect application of the Canadian GAAR.

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withholding tax exemption for interest on certain arm's length corporate debt. The Belgian corporation then sold its rights to interest payments on the loan to an arm's length Belgian bank. Following the restructuring, Lehigh paid interest directly to the Belgian bank and did not withhold Canadian non-resident withholding tax in respect of the payments.

The Crown argued that there was a misuse of the 5/25 exemption as it was not intended to benefit a non-resident person who was legally entitled to be paid only the interest on a debt as a result of an interest stripping transaction. Further, the restructured loan did not result in Lehigh accessing funds in the international capital markets. The Tax Court agreed that the 5/25 exemption had been abused because Lehigh had not borrowed the principal of the debt from the Belgian bank or any other non-resident lender and upheld the application of the GAAR.

The Federal Court of Appeal, on May 17, 2010, reversed the Tax Court's decision, concluding that the GAAR did not apply. The Court found that the wording of the exemption was broad enough to include any interest payable by a Canadian resident corporation to an arm's length non resident, "no matter how the non-resident may have become entitled to receive that interest." The exemption required the arm's length test to be met only in respect of the relationship between the person required to pay the interest and the person entitled to receive the interest, and not in respect of the relationship between the person required to pay the principal amount of the debt and the person entitled to receive the principal

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**GAAR** (from page 4)

amount of the debt. Support for the necessary arm's length relationship was found in the fair market value interest rate in the terms of the debt.

The Crown's reliance on a single sentence in the 1975 budget papers was considered by the Court to be a "shaky foundation" and an insufficient basis on which to apply the GAAR to the restructuring of the Lehigh debt. The Crown's argument found no other support in either the Act, the jurisprudence or any other authority. The Court noted that the Crown could not meet its burden of proving a misuse by simply asserting that the transaction was unforeseen or exploited a legislative loophole.

*The Queen v. Collins & Aikman Products Co.*

The Crown had no better result in *Collins & Aikman* before the Federal Court of Appeal. Collins & Aikman, in 1993 and 1994, reorganized its Canadian business operations so that it directly held a Canadian affiliate, Holdings, which in turn wholly-owned the Canadian business. The reorganization resulted in an increase of both paid-up capital (PUC) and adjusted cost base in the shares of Holdings held by its U.S. parent corporation in the amount of \$167 million (a significant increase over the \$425,000 of PUC in the entities that held the Canadian business before the reorganization). It was admitted by the taxpayer that the reorganization was carried out to increase Holdings' capacity to return capital to its U.S. parent corporation in future.

*Dividend Stripping Abusive Tax Avoidance*

The Tax Court of Canada held that the GAAR did not apply, since there was no abusive tax avoidance. The Court concluded that the Crown was unable to establish, through the use of extrinsic aids or relevant statutory provisions, that there was a general scheme of the Act requiring that corporate distributions must be included in income except where specific provisions provide otherwise, or that there was a clear scheme against dividend stripping. The impugned transactions had, in the Court's view, real Canadian tax consequences. Each of the steps in the reorganization was appropriate, and none were abusive, vacuous or artificial.

While not pleaded by the Crown, the Tax Court also considered whether section 212.1 of the Act was avoided and whether the avoidance was abusive. Although the reorganization's success depended upon section 212.1 not applying, the Court was unable to conclude that the application of section 212.1 was avoided as part of the series of reorganization transactions because the entity that was at the core of the PUC planning had become a non-resident of Canada many years prior to the series

of transactions that occurred.

The Tax Court concluded that consistency, fairness and predictability would be significantly eroded if the GAAR were to be lightly applied and upheld, and cautioned that the GAAR should not be used to fill in what the government perceives to be a possible gap left by the legislation.<sup>1</sup>

The Crown's appeal of the Tax Court's decision was dismissed by the Federal Court of Appeal from the bench in a brief decision delivered by Sharlow, J. In addition to finding that the Tax Court had made no error that warranted its intervention, the Court addressed the Crown's argument, raised for the first time on appeal, that the reorganization transactions were abusive having regard to the existence of section 212.1 as part of the relevant statutory scheme against dividend stripping in the Act. The Court agreed with the Tax Court's conclusion that there was no abusive avoidance of section 212.1 since the entity, the sale of shares of which resulted in the PUC increase, was not a resident of Canada at the time it was sold. It had become non-resident in 1961, long before the occurrence of the reorganization transactions and the introduction of section 212.1 into the Act and was outside the reach of the legislation.

Consistent with *Lehigh*, the Federal Court of Appeal's decision in *Collins & Aikman* emphasizes that the Crown must meet its evidentiary burden not only in alleging a taxpayer's misuse or abuse based on the purpose of the relevant statutory provision(s) or of the Act as a whole, but also in establishing the existence of the purpose in the first instance. In this case, the Crown was unable to convince the Court that there was a general scheme of the Act against dividend stripping that supported the application of the GAAR on the facts.

*Copthorne Holdings v. The Queen*

The Supreme Court of Canada is scheduled to hear the taxpayer's appeal from the Federal Court of Appeal decision in *Copthorne* on January 21, 2011. In *Copthorne*, a multinational group's Canadian operations were again reorganized, resulting in a \$67 million increase in the PUC of shares in a Canadian corporation held by a non-resident corporation. The increase resulted from an amalgamation of a Canadian parent corporation with its Canadian subsidiary, which was structured as a horizontal rather than a vertical amalgamation to avoid the elimination of the subsidiary's PUC on amalgamation. The shares of the amalgamated corporation were subsequently redeemed for an amount equal to the aggregate PUC of the two predecessor corporations, resulting in no Canadian non-resident withholding tax on the distribution. The Federal Court of Appeal upheld

GAAR, continued on page 6

**GAAR** (from page 5)

the Tax Court of Canada's decision that the GAAR applied on the basis that the non-resident shareholder had double counted a portion of its actual invested capital in the PUC of the amalgamated corporation. In the Court's view, the double counting was abusive of the statutory provisions in the Act pertaining to share redemptions, the computation of PUC and the effect of an amalgamation on that computation.

The *Cophorne* decision will be of particular interest in that it is expected that the Supreme Court of Canada will be asked to clarify the scope of the term "series" as it may apply for purposes of both the GAAR and other provisions of the Act to which it has relevance. The Court will also hear arguments as to the proper application of the abusive tax avoidance test under the GAAR in a situation where a term used in a provision of the Act is found in another Canadian federal or provincial statute, i.e., the calculation of PUC of a class of

shares of a corporation in the Act that uses as its starting point the determination of stated capital under relevant provincial corporate law statutes.

*Antle v. The Queen*

The Crown has fared somewhat better in its challenges to trust planning but not under the GAAR banner. In *Antle*, the Canadian resident taxpayer implemented a series of transactions described as a "capital step-up strategy." The strategy involved transferring corporate shares owned by the Canadian taxpayer (and having an accrued gain) on a tax-deferred basis to a Barbados trust settled by the taxpayer for the benefit of his wife. The trust then sold the shares to the wife triggering the capital gain. The wife, in turn, sold the shares to a third party purchaser and used the proceeds to pay the trust for the shares. The trust then distributed the proceeds as trust capital to the wife, and then dissolved. If successful, the result would have been to shift a taxable capital gain of the Canadian taxpayer to a Barbados trust that would

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arguably have been exempted from Canadian tax on its gain under the Canada-Barbados Income Tax Convention<sup>2</sup> (Barbados Treaty).

The Tax Court denied the taxpayer’s appeal from the Minister’s assessment. From the evidence, it was unclear when the Barbados trust deed was actually signed by the taxpayer and the trustee. It was similarly unclear when

**The Tax Court said the GAAR should not be used to fill in what the government perceives to be a possible gap left by the legislation.**

the Barbados trust was actually formed and when the share transfers occurred. The Tax Court found that the trust was not properly constituted and that the shares were never legally transferred to the Barbados trust. As a result, either the taxpayer had sold the shares to his wife and realized a capital gain on that sale, or he had transferred the shares to his wife on a rollover basis and was attributed the capital gain realized when his wife later sold the shares. In either event, the capital gain was taxable to the Canadian taxpayer.

The Tax Court also held that the GAAR applied to the transactions. In the Court’s view, the underlying rationale of the capital gains exemption in the Barbados Treaty was frustrated, not with respect to the Barbados trust, but with respect to the taxpayer who used the

Barbados Treaty to avoid taxation, thus circumventing a general objective of the Barbados Treaty to prevent tax avoidance. The Court held that the transactions abused both the Act and the Barbados Treaty; the GAAR was applied to deny the taxpayer the benefit of the spousal rollover on the transfer of the shares to the Barbados trust.

The Federal Court of Appeal, on October 20, 2010, dismissed the taxpayer’s appeal in a brief judgment. Reviewing the case law, the Court concluded that the Tax Court had not erred in looking beyond the terms of the trust deed at the taxpayer’s actions and all of the surrounding circumstances to determine whether the requisite intention to settle the Barbados trust existed. The Court upheld the Tax Court’s decision that the trust had not been validly constituted and that therefore the transfer to the trust was ineffective.

*Sham Doctrine*

However, the Court’s decision is important for its comments on the application of the sham doctrine in Canadian avoidance law. The Tax Court had concluded that the series of transactions entered into would not have amounted to a sham. The Federal Court of Appeal found that the Tax Court had misconstrued the intentional deception test required to establish that the Barbados trust was a sham. It was not necessary to conclude that there was a criminal intent to deceive: the test required only that the parties to a transaction present it differently from what they know it to be. Since the Tax Court had found as a fact that both the taxpayer and the trustee knew with the absolute certainty that the trustee had no discretion or control over the shares, yet both had signed the trust deed that stated the opposite, that finding was sufficient to hold that the Barbados trust

GAAR, continued on page 8



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**GAAR** (from page 7)

was a sham. Thus, not only was the proper execution and timing of the transactions a problem in this case, but also the intent of the parties to create a valid trust relationship, which was the linchpin of the capital step-up strategy. This decision may suggest that the Courts will be more receptive to sham arguments in the context of aggressive tax planning in future.

The Court, however, chose not to express its views on the Tax Court's alternative ground for dismissing the taxpayer's appeal based on the GAAR, leaving open the

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**The decision may suggest that the  
Courts will be more receptive to sham  
arguments in the context of aggressive  
tax planning in future.**

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question of whether the government can successfully apply the GAAR where provisions of the Act interact with a treaty capital gains exemption to indirectly result in a tax benefit for a Canadian resident taxpayer.

*St. Michael Trust Corp. v. The Queen*  
(*Garron v. The Queen*)

On November 17, 2010, the Federal Court of Appeal delivered its judgment on the appeal by the taxpayer from the Tax Court decision in *Garron v. The Queen*. In *Garron*, the Tax Court had held that two Barbados trusts were not entitled to claim the benefit of the capital gains exemption in the Barbados Treaty on capital gains of over \$450 million realized on the sale of the shares of two Canadian holding corporations that indirectly owned a Canadian auto parts manufacturing and assembly business. The Tax Court had found that the test for determining trust residence should be consistent with the central management and control test in the corporate context. Based on that test, the Tax Court had determined that the trusts were resident in Canada when the shares were sold and, therefore, the capital gains were subject to Canadian tax.

The Federal Court of Appeal affirmed the Tax Court decision that the Barbados trusts were in fact resident in Canada. In doing so the Federal Court carefully considered the taxpayer's argument that it is the residence of the trustee that must be relied on to determine the residence of a trust and rejected it.

However a rigid test that necessarily ties the residence of a trust to the residence of a trustee regardless of the facts is, in my view, not sound

in principle because it denies the central theme of the jurisprudence on the determination of residence for tax purposes, which is that residence is fundamentally a question of fact. I conclude therefore that where a question arises as to the residence of a trust for tax purposes, it is appropriate to undertake a fact driven analysis with a view to determining the place where the central management and control of the trust is actually exercised.

Though that finding was sufficient to dispose of the matter, the Court also went on to address the Tax Court's findings in relation to the interface of the GAAR in the context of Canada's treaty arrangements. The Court found that had the trusts not been found to be resident in Canada under a facts and circumstances analysis, the deeming rule in subsection 94(1) of the Act would nonetheless have applied to allow the Court to arrive at the same result. The Court then addressed the question of whether, if subsection 94(1) had applied, the Crown's argument that the planning was an abuse of subsection 94(1) and of the Barbados Treaty should succeed. The Court again agreed with the Tax Court in finding that the Barbados Treaty and the exemption it provided would trump subsection 94(1) of the Act.

If the residence of the Trusts is to be determined on the basis of the residence of the [Trustee] ... then the Trusts have not avoided section 94. On the contrary, they have fallen squarely into it. The fact that the Trusts would also be entitled to a treaty exemption flows from the fact that in the [Barbados Treaty], Canada has agreed not to tax certain capital gains realized by a person who is a resident of Barbados. If the residence of the Trusts is Barbados for treaty purposes, the Trusts cannot misuse or abuse the [Barbados Treaty] by claiming the exemption.

The decision leaves little encouragement for the Canadian tax administration's position that GAAR will apply to counter Canada's bilateral agreements with its treaty partners, absent a specific provision in the treaty to support the application of domestic anti-avoidance rules.

When all is said, these recent cases cannot be considered good news for the Canadian tax administration. If anything, they support a more circumspect application of the Canadian GAAR. At the same time however, old concepts—ineffective transactions and the doctrine of sham—are again being argued before the Canadian Courts in the avoidance context and with seemingly more encouraging results. As the saga continues, can it be said over twenty

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**GAAR** *(from page 8)*

years on, that statutory codification of a general anti-avoidance rule has permitted taxpayers in planning that involves Canada to structure their complex transactions with the expectation of more certainty, predictability and fairness of result than before the GAAR was introduced in 1988?

<sup>1</sup>The gap was essentially closed for corporations becoming resident in Canada after February 23, 1998, as a result of the introduction of paragraph 128.1(1)(c) to the Act. Under paragraph 128.1(1)(c), where an immigrating corporation holds shares of a Canadian resident corporation (Canco), Cancos is deemed to have paid to the immigrating corporation (and the immigrating corporation is deemed to have received) a dividend immediately before its immigration generally equal to the amount by which

the Cancos shares' fair market value exceeds PUC capital (except where the Cancos shares are taxable Canadian property and Canada's right to tax any gain realized by the immigrating corporation on the deemed disposition of the Cancos shares is not precluded by a tax treaty capital gains exemption). If the exception applies, the deemed dividend otherwise calculated is reduced by the amount of the capital gain taxed by Canada. The deemed dividend is subject to Part XIII Canadian non-resident withholding tax.

<sup>2</sup>The Canadian Department of Finance released a package of draft legislation on August 27, 2010 that includes a proposed addition to the Income Tax Conventions Interpretation Act that would deem a trust, considered to be resident in Canada for a taxation year under section 94 of the Act, to be a resident of Canada and not a resident of the other Contracting State, for the purposes of applying an income tax treaty between Canada and the other Contracting State. The proposed amendment is directed at eliminating the tax benefits associated with the offshore trust tax planning strategies employed in cases such as *Antle and Garron*. □

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**NETHERLANDS-JAPAN**

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## New Tax Treaty Between Netherlands and Japan Reduces Withholding Tax on Dividends, Interest and Royalties

By Richard Smeding, Thomas van der Vliet and Gerwin de Wilde (Greenberg Traurig, LLP)

Historically, the Netherlands and Japan are important trading partners. On August 25, 2010, a new tax treaty between the Netherlands and Japan was signed. Once in force, this treaty will replace the current tax treaty between these two countries.

The new treaty provides for—among other things—a further reduction or exemption of the withholding taxes on dividends, interests and royalties. The new tax treaty will be of great importance due to significant inbound and outbound investments to and from Japan through Dutch companies. This new treaty will further strengthen the economic relationship between the

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Netherlands and Japan.

The new treaty needs to be ratified by both countries. It will apply on or after January 1 in the calendar

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### The treaty introduces an independent arbitration committee for unresolved disputes over double taxation.

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year following that in which the treaty is effectively ratified.

The main changes of the new tax treaty can be summarized as follows:

#### Dividends

The most important change is the introduction of a full dividend withholding tax exemption (in the current tax treaty the rate is (at least) five percent) if the beneficial owner of the dividends is a resident of the other Contracting State and is either:

- a company that has owned, directly or indirectly, shares representing at least 50 percent of the voting power of the distributing company for the period of

*Tax Treaty*, continued on page 10

## Tax Treaty *(from page 9)*

six months ending on the date on which entitlement to the dividends is determined; or

- a pension fund, provided that such dividends are not derived from the carrying on of a business, directly or indirectly, by such pension fund.

The maximum dividend withholding tax rate under the new treaty is reduced to five percent if the beneficial owner of the dividends is a company that directly or indirectly holds at least 10 percent of the voting power of the distributing company for a period of six months ending on the date on which entitlement to the dividends is determined.

The maximum dividend withholding tax rate is reduced to 10 percent in all other situations.

In addition, article 22 (“Elimination of double taxation”) now explicitly states that dividends distributed by a Dutch resident entity to its Japanese resident corporate shareholder, are excluded from the basis upon which the Japanese tax is imposed, provided this Japanese shareholder holds at least 10 percent of either the voting power or shares of the distributing Dutch company during the period of six months immediately before the day the obligation to pay the dividends is confirmed (Japanese participation exemption).

### Interest

The maximum interest withholding tax rates will be:

- zero percent if the interest is paid to: the government (or certain governmental institutions) of the other Contracting State; a bank; an insurance company; a securities company; or any other company that in the three preceding years derived more than 50 percent of its liabilities from the issuance of bonds in financial markets or from taking deposits at interest, and more than 50 percent of the assets of the enterprises consist of debt-claims against persons that are not a related company and pension funds; and
- 10 percent in all other situations.

The Netherlands does not levy a withholding tax on outgoing interest payments.

### Royalties

The withholding tax on royalties is reduced to zero percent (from 10 percent). The Netherlands does not levy a withholding tax on outgoing royalty payments.

### Limitation on Benefits

The above mentioned zero percent withholding tax rates will only apply if the so-called “limitation on benefits” requirements are met (article 21 of the Netherlands-Japan tax treaty). Based on these

requirements, a taxpayer can only benefit from the reduced treaty rates if such taxpayer qualifies under one of the limitation on benefits tests (e.g., the stock-exchange test, the headquarter test or the equivalent beneficiary test). Although many existing Netherlands-Japan investment structures may still meet the limitation on benefits test, these structures should be reviewed.

### Tokumei Kumiai Investments

Many multinationals have structured their inbound Japanese investments through a Japanese silent partnership (a so-called Tokumei Kumiai, or TK) with a Dutch silent partner, because under the current tax treaty a TK can distribute its profits free of Japanese corporate income tax or withholding tax.

Based on article 9 of the Protocol to the new tax treaty, Japan may tax the income and capital gains from silent partners in a TK. This may effectively result in a 20 percent Japanese withholding tax on distributions by a TK to its Dutch resident silent partner.

### Transfer Pricing Adjustments

Under article 9, paragraph 2 and 3 of the new treaty, a transfer pricing adjustment made by one country will be followed by a corresponding adjustment of the other country, provided the competent authorities of both countries agree that part of the profits of a company that are charged to tax in one country would have been accrued to a company of the other country if the conditions between these two companies would have been those that would have been made between independent companies.

### Mutual Agreement Procedure

The mutual agreement procedure (MAP) to avoid double taxation is now included in the new treaty in more detail (article 24). In addition, the MAP introduces an independent arbitration committee in case of a dispute concerning double taxation that has not been solved by the authorities of both countries within two years of the presentation of the dispute to the authorities. This is the first treaty that Japan closed in which this procedure is arranged.

### Real Estate

Based on article 13 of the new treaty (capital gains), gains derived by a resident of a Contracting State from the alienation of shares in a company or of interests in a partnership or trust may in principle be taxed in the other Contracting State to the extent the shares or the interests derive at least 50 percent of their value directly or indirectly from immovable property situated in that other Contracting State.

# Presidium of the Supreme Arbitration Court Overrules the Tax Provisions of a PSA in Relation to Contractors

By Maureen O'Donoghue (Ernst & Young (CIS))

A ruling published in November<sup>1</sup> rejects recent court practice and the tax authorities' firmly held views in relation to the tax rate payable by contractors and subcontractors carrying out activities related to the Sakhalin-2 Production Sharing Agreement (PSA). The PSA was concluded in 1994, but it is only in the last few years that the tax authorities have sought to enforce a provision intended to fix the rate of profits tax payable by contractors and subcontractors at 32 percent. Given that the statutory rate of profits tax is 20 percent (previously from 2002 to 2008 it was 24 percent), many of the additional tax claims presented to taxpayers have been substantial.

The Tax Code includes a grandfathering provision (clause 15 of Article 346.35) that allows certain types of tax provisions of the PSAs concluded before the entry into force of Federal Law No. 225-FZ "Concerning Production Sharing Agreements" of December 30, 1995 (PSA Law) to prevail over the provisions of the Tax Code and other acts of Russian tax legislation. The Tax Code does not, however, provide any indication as to what those provisions might be.

## Profits Tax Unenforced

As parties to the PSAs, investors and the Russian government had this information. Contractors and subcontractors did not unless their customers chose to share this information with them. The texts of the PSAs are not in the public domain.

Even the Sakhalin tax authorities seem to have been unaware for several years of the tax provisions of the Sakhalin-2 PSA concerning profits tax payable by contractors and subcontractors (either that or they were strangely disinclined to enforce them). Contractors and subcontractors started paying tax at rates lower than 32 percent with effect from April 1, 1999, when the statutory profits tax rate was reduced from 35 percent to 30 percent (under Federal Law No. 62-FZ of March 31, 1999).

It was not until 2007, in the course of tax audits of certain contractors and subcontractors for 2003 and subsequent years, that the local tax authorities started to ask why profits tax was not being paid at a rate of 32 percent on PSA-related activities. Until this point few

taxpayers were even aware of the existence of language in the PSA open to this interpretation. Indeed it was only when disputes on this point were the subject of court rulings that the relevant language entered the public domain. As the Presidium's ruling explains:

"According to paragraphs 1 and 2a of [Addendum 1 "Taxes and Compulsory Payments" to Appendix E to the "Sakhalin-2" Agreement], the Company [Sakhalin Energy] and its contractors and subcontractors are liable to pay profits tax on income from the Sakhalin project in accordance with the provisions of the Profits Tax Law as effective as at January 1, 2004. In this respect, the conditions, rates and procedure for the levying of profits tax must remain unchanged for the entire term of the Agreement, including extension periods. The rate of profits tax for the Company and its contractors and subcontractors as calculated in accordance with Addendum 1 must not exceed 32 per cent."

Soon taxpayers that were not being audited were

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## The ruling has significant implications for other taxpayers.

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receiving letters from the tax authorities on the issue urging them to apply the 32 percent rate going forward and settle any arrears arising from the application of other rates in the past. Some taxpayers paid the additional tax, but litigation followed since a number of others challenged audit decisions received.

## Court Challenges

Various arguments were put to the courts for limiting the application of the 32 percent rate to Sakhalin Energy Investment Company (SEIC), the investor and operator under the Sakhalin-2 PSA, for example:

- since the Sakhalin-2 PSA is a confidential agreement between Russia and SEIC, and it is not an act of tax or levy legislation or an international agreement, the PSA's provisions should not apply to third parties;
- as contractors and subcontractors were not parties to

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*PSA Tax*, continued on page 12

## PSA Tax *(from page 11)*

the PSA they are not subject to provisions established by the PSA. Article 2.1 of the PSA Law states: "The agreement shall specify all necessary terms and conditions associated with the use of subsurface resources, including the conditions and procedure for the division of the extracted production *between the parties to the agreement* in accordance with the provisions of this Federal Law;"

- the Sakhalin-2 PSA is a confidential agreement that is not publicly available.

Some litigants also pointed out that the tax authorities' calculations were clearly incorrect, being based on a very selective application of the provisions of the PSA. If the provisions of Addendum 1 "Taxes and Compulsory Payments" to Appendix E to the "Sakhalin-2" Agreement apply to a taxpayer, the tax authorities

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### **The lower courts are expected to follow the precedent established in the Presidium's ruling.**

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should not have applied only the profits tax rate for the calculation of profits tax attributable to the PSA-related activity but also the conditions and procedure for the levying of profits tax in force as at January 1, 2004. Several cases were fought through three levels of courts unsuccessfully. A case concerning Schlumberger was reviewed by the Supreme Arbitration Court but also resulted in a ruling supporting application of the 32 percent rate.

The Presidium's ruling concerns the Joint Venture Limited Liability Company Sakhalin-Shelf-Service, which the tax authorities held liable for additional profits tax of some 7 million rubles (about US\$2.4 million) with respect to 2004 to 2006 based on a tax rate of 32 percent. Having failed to convince the lower courts that its earnings are subject to the statutory profits tax rate, the taxpayer petitioned the Supreme Arbitration Court to invalidate the decisions of those courts and the contested elements of the tax inspectorate's decision.

#### **24 Percent Rate Applies**

The Presidium identified a key omission from the matters considered by the lower courts. When the Sakhalin-2 PSA was concluded, issues relating to the conclusion of PSAs were regulated by Presidential Edict No. 2285 of December 24, 1993. Article 1 of this edict defines a PSA as a form of contractual arrangement

between the state and an investor/subsurface user that provides for extracted mineral raw materials to be divided between the contracting parties and replaces the levying of taxes, levies, duties, including customs duties, and excise duties (with the exception of profits tax and payments for the right to use subsurface resources). As the ruling notes:

"It follows from the provision cited above that it was only in relation to an investor that a special taxation regime could be established when concluding production sharing agreements."

From this reasoning it follows that the taxation conditions laid down in Addendum 1 "Taxes and Compulsory Payments" to Appendix E to the Sakhalin-2 PSA cannot be applied other than in relation to investors. The Presidium concludes that the taxpayer acted properly in calculating profits tax in accordance with the normal rules provided in the profits tax chapter of the Tax Code and in applying the 24 percent tax rate in the years 2006 to 2008.

The ruling is clearly intended by the Presidium to conclusively settle the issue of the applicable tax regime. It states that:

"The interpretation of legal provisions that is contained in this Ruling of the Presidium of the Supreme Arbitration Court of the Russian Federation is universally binding and must be applied in relation to similar cases examined by arbitration courts."

Other taxpayers that have been awaiting a decision as to whether the Supreme Arbitration Court would agree to their petitions to transfer similar cases for reconsideration to the Presidium are being instructed to apply for reconsideration of the case by the lower courts under the newly discovered circumstances. The lower courts are expected to follow the precedent established in the Presidium's ruling. The ruling may have significant implications for any taxpayer other than an investor that has applied a special tax regime or concession established by a PSA.

<sup>1</sup>Ruling No. 1674/10 of the Presidium of the Supreme Arbitration Court of September 29, 2010. □

#### **Submission of Articles**

The editors of *Tax Strategies* invite in-house tax counsel, tax practitioners and other tax specialists to submit original articles for publication. *Tax Strategies* reserves the right to make revisions to articles. Please send inquiries and articles to [scott.studebaker@thomsonreuters.com](mailto:scott.studebaker@thomsonreuters.com)

**Foreign Tax Credit** *(from page 3)*

2. foreign consolidated group structures, but only to the extent that the taxpayer has not allocated legal liability among the foreign consolidated group's members in accordance with each member's pro rata portion of the foreign tax base, under the principles of the joint and several liability rule of the current legal liability regulations;<sup>4</sup>
3. group relief or other loss sharing, but only if the shared loss is associated with a hybrid debt instrument that is disregarded for U.S. tax purposes; and
4. hybrid instruments that are treated as debt for U.S. tax purposes but as equity for foreign tax purposes, or vice versa, but only with respect to pre-2011 foreign taxes associated with the amount that is deductible for U.S. but not for foreign purposes, or which is deductible for foreign purposes but does not give rise to income for U.S. purposes.

(Notice 2010-92, Sec. 4.) The IRS and Treasury were, arguably, quite restrained in crafting such a narrow list of transactions.

**How to Apply Section 909 to Foreign Taxes Not Exempted by the Notice**

Pre-2011 foreign taxes not exempted by the notice (pre-2011 split taxes) will become subject to Section 909, for purposes of determining taxes deemed paid under Section 902 or 960, starting with the Section 902 corporation's 2011 tax year. Such pre-2011 foreign taxes from foreign tax credit splitting events will be removed from the Section 902 corporation's foreign tax pools, starting with the corporation's first post-2010 year. These taxes will not be taken into account for U.S. tax purposes until the related income is taken into account by the Section 902 corporation that paid or accrued the taxes (payor Section 902 corporation) or by its Section 902 shareholder (with a special affiliated group rule, described below). However, "there is no increase to a Section 902 corporation's earnings and profits for the amount of any pre-2011 taxes to which Section 909 applies that were previously deducted in computing earnings and profits in a pre-2011 taxable year." (Notice 2011-92, Sec. 2.02.)

Suppose the taxpayer decides to avoid this result by causing pre-2011 split taxes to be deemed paid under Section 902 or 960 before the Section 902 corporation's 2011 year. The notice provides some general rules on how to pull up (cause to be deemed paid) pre-2011 split taxes. Foreign taxes deemed paid under Section 902 or 960 (or otherwise removed from foreign tax pools) in pre-2011 years are treated as coming pro rata from

pre-2011 split taxes and other taxes (including pre-1997 taxes). (Notice 2010-92, Sec. 4.06(c)(1).) That means that causing X amount of pre-2011 split taxes to be deemed paid could require pulling up considerably more than X amount of aggregate foreign taxes. For example, assume that Section 902 corporation A has 100 of foreign taxes in its post-1986 tax pool for the general basket (which is its only basket), including 50 of pre-2011 split taxes. A dividend of 60 percent of A's post-1986 undistributed earnings pool pulls up 60 of foreign taxes, but only 30 of the pre-2011 split taxes. This pro rata rule is specific to taxes deemed paid before 2011, so it is possible that Treasury and the IRS could provide a different rule for foreign taxes deemed paid after 2010.

**Additional Rules for Applying Section 909 to Pre-2011 Split Taxes**

Notice 2010-92 also sets forth additional rules for the application of section 909 to pre-2011 split taxes and

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**Causing X amount of pre-2011 split taxes to be deemed paid could require pulling up considerably more than X amount of aggregate foreign taxes.**

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related income. (Notice 2010-92, Sec. 4.06.) Among other things, these rules apply to determine whether related income has been taken into account by the payor Section 902 corporation or its section 902 shareholder (or an affiliate) before the payor Section 902 corporation's 2011 tax year, which would be grounds for non-application of section 909 to the relevant taxes. (See Notice 2010-92, Sec. 3(c).)

The notice provides that distributions and inclusions out of earnings and profits of covered persons are treated as made pro rata from related income and other income (including pre-1997 income). (Notice 2010-92, Sec. 4.06(b)(3).) However, a Section 902 shareholder may elect to instead treat such distributions and inclusions as made first out of related income. This election can be made on a timely filed original tax return for the first post-2010 year in which the shareholder computes foreign taxes deemed paid with respect to a Section 902 corporation's pre-2011 split taxes. The method, if chosen, must be applied consistently for all pre-2011 splitter arrangements (the four types of transactions that can be treated as foreign tax credit-splitting events with respect to pre-2011 taxes under the notice).

*Foreign Tax Credit*, continued on page 14

## Foreign Tax Credit *(from page 13)*

Related income, other income, pre-2011 split taxes and other taxes, and the amounts distributed or deemed paid, must be determined for each taxable year of a Section 902 corporation, starting with the first post-1996 tax year for which it paid or accrued pre-2011 split tax and ending with its last pre-2011 tax year. (Notice 2010-92, Sec. 4.06(a).) Such annual amounts of related income and pre-2011 taxes with respect to the

### Four types of arrangements can cause pre-2011 foreign taxes to be suspended under Section 909.

same pre-2011 splitter arrangement are aggregated. Annual and aggregate amounts of related income and pre-2011 split taxes are determined for each separate category (as defined in Treas. Reg. § 1.901-4(m), which basically describes Section 904(d) categories and other classifications that are treated as Section 904(d) categories), each covered person, and each other person that succeeds to such income or taxes. (*Id.*)

For each pre-2011 splitter arrangement, when related income is taken into account (by the payor Section 902 corporation or a Section 902 shareholder), a ratable portion of the foreign taxes associated with that arrangement loses its character as a pre-2011 split tax. (Notice 2010-92, Sec. 4.06(c)(4).) Thus, distribution or inclusion of related income affects section 909 deferral only for pre-2011 split taxes associated with that income, not for the pre-2011 split taxes associated with other transactions. The notice further provides that, for reverse hybrid and foreign consolidated group arrangements, if related income is reduced to zero or less, the associated pre-2011 split taxes retain their character as pre-2011 split taxes, and remain suspended under Section 909 until aggregate related income for the relevant arrangement becomes positive and is taken into account as Section 909 requires. (*Id.*) This limited rule raises a question, and a possible negative inference, about the treatment of pre-2011 split taxes associated with a loss sharing or hybrid instrument arrangement for which aggregate related income is reduced to zero or less.

Related income is considered taken into account by a Section 902 shareholder to the extent recognized as gross income (upon a distribution or inclusion out of earnings and profits of a covered person attributable to the related income) by *either* the shareholder or any member of an affiliated group (as defined in Section 1504) that


files a consolidated return including the Section 902 shareholder. (Notice 2010-92, Sec. 4.06(b)(7), (b)(9).) This rule regarding income recognition by an affiliated group member is a relaxation of the statutory rule, which requires that the income be taken into account for U.S. tax purposes by the payor 902 corporation or a Section 902 shareholder of such corporation.


Related income is treated as taken into account by a Section 902 corporation if either the income is included in the Section 902 corporation's earnings and profits by reason of a distribution or inclusion from the covered person's earnings and profits attributable to the related income, or the corporation and the covered person are combined under Section 381(a)(1) or (2). (Notice 2010-92, Sec. 4.06(b)(8).)

### Content of Future Guidance

The rules for applying Section 909 to post-2010 taxes are still not certain. Notice 2010-92 clearly states that

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## Foreign Tax Credit *(from page 14)*

further guidance is expected, and that future rules for post-2010 taxes may not mirror the rules for pre-2011 taxes. (See Notice 2010-92, Sec. 1.)

But the notice does appear to be the IRS's definitive word on which transactions are treated as foreign tax credit splitting events for pre-2011 foreign taxes. (See Notice 2010-92, Sec. 1.) For example, if pre-2011 foreign taxes paid or accrued by Section 902 corporation X relate to a plain vanilla loss-sharing election that is not described in Notice 2010-92, then Section 909 does not apply to those taxes. Future guidance may apply Section 909's anti-deferral rule to additional loss-sharing fact patterns that are not described in the notice, including corporation X's loss sharing fact pattern. The notice appears to provide that Section 909 will still not apply to X's pre-2011 foreign taxes, even after such hypothetical future guidance is issued. (See Notice 2010-92, Sec. 1.) However, X's post-2010 foreign taxes that relate to such later-described loss-sharing would be subject to Section 909, if so provided in a future guidance.

Notice 2010-92's rules on pulling up related income regarding pre-2011 splitter arrangements (including moving such income to the payor Section 902 corporation) and pre-2011 split taxes might not apply indefinitely to pre-2011 taxes, and might instead be changed in future guidance.<sup>5</sup> It is also possible that such rules will differ for post-2010 foreign taxes. For example, rules for distributions from earnings and profits containing both related income and other income may be different from the notice's rules: the notice requests comments on "ordering rules for dividends" in such situations. (Notice 2010-92, Sec. 8.)

### Considerations for Whether to Pull Up Pre-2011 Taxes Before the End of 2010

For pre-2011 foreign taxes that are not "pre-2011 split taxes," i.e., that Notice 2011-92 treats as not connected with a splitter transaction (see Notice 2010-92, Sec. 4), Section 909 does not apply regardless of whether the foreign taxes are pulled up before or after the end of the 2010 tax year. (Notice 2010-92, Sec. 4.) If Notice 2010-92 exempts such pre-2011 taxes from Section 909, it does not appear that future guidance will change that result. (See Notice 2010-92, Sec. 1, *cf.* Notice 2010-92, Sec. 7 (effective date).) Therefore, causing such pre-2011 taxes to be deemed paid before 2011 provides no particular benefit with respect to Section 909's application, except that such taxes may need to be pulled up as part of an effort to bring up pre-2011 split taxes from the same tax pools.

For pre-2011 split taxes, the calculus is different.

If those taxes are deemed paid before the Section 902 corporation's 2011 year, they are not subject to suspension under Section 909. But pulling the foreign taxes up essentially requires a dividend or Subpart F inclusion. Some fact patterns might require a sizable dividend or Subpart F inclusion (depending on the relative sizes of the earnings and profits and tax pools) to pull up a significant amount of pre-2011 split taxes,

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**Taxpayers must decide whether to pull up foreign taxes from Section 902 corporations before the end of such corporations' 2010 tax years, because taxes deemed paid or accrued under Section 902 or 960 before 2011 are not subject to Section 909.**

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while for other taxpayers a relatively small income inclusion might result. Pre-2011 split taxes and other taxes are treated as pulled up pro rata, which potentially increases the amount of earnings and profits required to pull up the pre-2011 split taxes, and may require pulling up other taxes earlier than planned. Causing taxes to be deemed paid in 2010 also starts the 10-year carryforward period under Section 904(c).

In contrast, if pre-2011 split taxes are not deemed paid before 2011, then Section 909 does apply. As a result, pre-2011 split taxes are removed from the Section 902 corporation's tax pools in 2011. After 2010, to claim a credit for pre-2011 split taxes, related income must be taken into account by the payor Section 902 corporation or a Section 902 shareholder (or a member of its affiliated group that uses the same consolidated return). This may be sizable, depending on the taxpayer's facts. In addition, not only must the taxpayer identify the related income, but it often needs to move the related income from the covered person to the Section 902 corporation, section 902 shareholder, or affiliated corporation. In some cases this could be accomplished by a dividend, but in other cases it might be difficult, for example, if the covered person has no earnings and profits in a later year.

If Section 909 applies to such pre-2011 split taxes (because they are not deemed paid before 2011), then, at least as long as Notice 2010-92's rules continue to apply, the taxpayer needs to identify the related income for each splitter transaction and calculate related income,

*Foreign Tax Credit, continued on page 16*

## Foreign Tax Credit *(from page 15)*

other income, pre-2011 split taxes, and other taxes for each year, starting with the Section 902 corporation's first post-1996 year in which it has a pre-2011 split tax and ending with its last pre-2011 year. (Notice 2010-92, Sec. 4.06(a)(1).) These calculations are made separately for each Section 904(d) "basket" and each covered person. (*Id.* Sec. 4.04(a)(2).) Thus, claiming a deemed paid credit for such taxes after 2010 is, among other things, potentially a much more complicated process than if the taxes are deemed paid before 2011.

Multiple factors can affect a taxpayer's decision of whether to pull up pre-2011 taxes of a Section 902 corporation before Section 909's effective date. For example, a taxpayer may consider the effective rate of the foreign taxes in a Section 902 corporation's tax pools, the size of the dividend or Subpart F inclusion that would be required to pull up the taxes, the relative size of the related income, whether the taxpayer can use a foreign tax credit, and whether the taxpayer wants to delay starting the 10-year carryforward period for foreign taxes (which begins when the taxes are deemed paid).<sup>6</sup>

### Summary/Conclusion

Taxpayers must decide whether to pull up foreign taxes from Section 902 corporations before the end of such corporations' 2010 tax years, because taxes deemed paid or accrued under Section 902(a) or 960 before such Section 902 corporations' 2011 tax years are not subject to Section 909. Notice 2010-92 provides important guidance to assist taxpayers in making this determination. In particular, it narrows the types of

arrangements that are treated as foreign tax credit splitting events for pre-2010 taxes, and also exempts pre-1997 foreign taxes of Section 902 corporations from Section 909. Notice 2010-92 is very clear that rules for post-2010 taxes, in future guidance, may differ from the rules the notice provides for pre-2011 taxes. Stay tuned for the dropping of the next shoe.

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<sup>1</sup>For purposes of Section 909, a Section 902 corporation means "any foreign corporation in which one or more domestic corporations meets the ownership requirements of subsection (a) or (b) of Section 902." Section 909(d)(5). The term therefore includes a controlled foreign corporation (CFC).

<sup>2</sup>For purposes of Notice 2010-92, "pre-2011 taxes" means foreign income taxes paid or accrued by a Section 902 corporation in its pre-2011 tax years. That term and "pre-2011 foreign taxes" are used interchangeably in this article.

<sup>3</sup>The notice explains that this exception for pre-1997 taxes is provided "because it is unlikely that material amounts of foreign income taxes described in that paragraph were accumulated and not previously deemed paid." Notice 201-92, Sec. 3.

<sup>4</sup>"... to the extent that the taxpayer did not allocate the foreign consolidated tax liability among the members of the foreign consolidated group based on each member's share of the consolidated taxable income included in the foreign tax base under the principles of § 1.901-2(f)(3)." Notice 2010-92, Sec. 4.03.

<sup>5</sup>See Notice 2010-92, Sec. 1 (creating a possible negative inference by stating that "future guidance . . . relating to the definition of a foreign tax credit splitting event will apply only with respect to foreign income taxes paid or accrued in post-2010 taxable years," *emphasis added*), Lee Sheppard, News Analysis: IRS Discusses Foreign Tax Credit Splitter Notice, 2010 Tax Notes Today 238-9 (December 13, 2010) (quoting Ronald Dabrowski, IRS Deputy Associate Chief Counsel (International), as stating that the election to pull up related income first might not be available in future years, and that the notice was intended to encourage taxpayers to move related income to the payor Section 902 corporation or its Section 902 shareholder, presumably because the rules relating to pre-2011 taxes might change in the future).

<sup>6</sup>See Section 904(c). □

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## Cross-Border Credit Agreements *(from page 2)*

a non-U.S. lender qualify for the portfolio interest exemption. The portfolio interest exemption applies to non-contingent interest paid to a non-U.S. person that is (1) unrelated to the borrower; and (2) not a bank receiving interest on a loan made in the ordinary course of its business (Section 881(c)(3)(A)). A non-U.S. lender should be required by the terms of the credit agreement to provide the U.S. borrower with an IRS Form W-8BEN and proof of its right (e.g., a tax opinion letter) to claim the benefits of the portfolio interest exemption.

*Caveat: It is always the lender's responsibility to ensure that it can receive interest payments free of withholding tax.*

*Foreign Bank Loans.* Because of the restrictions in Section 881(c)(3)(A), a foreign bank that makes a loan to a U.S. borrower under a standard credit agreement generally will not qualify for the portfolio interest exemption. For this reason, a foreign bank will lend through a U.S. branch (unless the bank qualifies for a complete exemption from U.S. withholding tax under an income tax treaty).

If a foreign lender cannot claim the portfolio interest exemption, the 30 percent U.S. withholding tax applies to interest payments unless the interest is effectively connected with the foreign lender's U.S. trade or business (see below). Alternatively, if an

*Cross-Border Credit Agreements, continued on page 17*



## Cross-Border Credit Agreements *(from page 16)*

income tax treaty applies, the withholding tax rate may be reduced or eliminated if the interest income is attributable to a U.S. permanent establishment of the foreign lender (see below).

### *Effectively Connected Income Exemption*

A foreign lender engaged in a U.S. trade or business

**In many cases, payments of interest made to a non-U.S. lender qualify for the portfolio interest exemption.**

is not subject to the 30 percent U.S. withholding tax on effectively connected income (ECI), or if an income tax treaty applies interest income that is attributable to a U.S. permanent establishment.

The Internal Revenue Code (Code) defines neither (1) ECI nor (2) what it means to be engaged in a U.S. trade or business. A foreign lender has ECI if it derives U.S. source income with respect to lending business

activities it conducts in the United States (see Advice Memorandum 2009-010). Foreign lenders carrying on a U.S. trade or business (or that have a U.S. permanent establishment) are taxed on a net income basis (similar to U.S. taxable persons) on income that is effectively connected with the U.S. trade or business.

While a U.S. branch of a foreign bank generally is treated as engaged in a U.S. trade or business, special rules apply to determine whether the interest income received by the branch is ECI. Portfolio interest that is effectively connected with a U.S. trade or business does not escape U.S. income tax. A foreign lender is subject to U.S. income taxation on a net income basis (similar to U.S. taxable persons) on income, including interest and capital gains that are "effectively connected" with that U.S. trade or business (Section 882(a)(1)).

Whether a foreign lender is engaged in a U.S. trade or business is based on its facts and circumstances. Generally, the threshold for finding a U.S. trade or business is low. In Advice Memorandum 2009-010 dated September 22, 2009, the Office of the Chief Counsel of the IRS examined a foreign corporation's U.S. lending activities and concluded that the interest income received by the foreign corporation was effectively

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## **Cross-Border Credit Agreements** *(from page 17)*

connected U.S. source interest income. In the Advice Memorandum, the foreign corporation outsourced all loan origination activities, other than final approval and signing of the loan documents, to a U.S. corporation. The final approval and physical signing of the loan documents took place outside the United States. The IRS concluded that the foreign corporation was engaged in a lending trade or business in the United States and the interest payments were ECI and therefore subject to U.S. tax on a net income basis.

A non-U.S. lender should be required by the terms of the credit agreement to provide the U.S. borrower with an IRS Form W-8ECI and proof (e.g., a tax opinion letter) that the interest payments are not subject to U.S. withholding tax because they are effectively connected with the lender's U.S. trade or business.

### **Income Tax Treaty Exemption**

If a foreign lender is not eligible for a U.S. statutory exemption (e.g., the portfolio interest exemption or the ECI exemption), the 30 percent U.S. withholding tax applies to interest payments unless the tax rate is reduced or eliminated under an applicable income tax treaty. If an income tax treaty applies, foreign lenders carrying on U.S. trade or business through a U.S. permanent establishment generally are taxed on a net income basis (similar to U.S. taxable persons) on income attributable to that U.S. permanent establishment, rather than on ECI.

The tax treaty concept of a U.S. permanent establishment is less broad than the U.S. statutory concept of a U.S. trade or business. As a result, a foreign lender that is engaged in a U.S. trade or business under the U.S. statutory concept may not have a U.S. permanent establishment under the applicable income tax treaty.

The tax treaty concept of a permanent establishment generally includes a fixed place of business through which the business of the foreign lender is wholly or partly carried out. When applicable, many tax treaties reduce or eliminate U.S. withholding tax applicable to interest payments (although there are exceptions).

A non-U.S. lender should be required by the terms of the credit agreement to provide the U.S. borrower with an IRS Form W-8BEN and proof (e.g., a tax opinion letter) of its right assert the income tax treaty exemption.

*Caveat: When the income tax treaty only reduces the rate of withholding, the transaction may not be economically attractive to either the lender or the borrower. The borrower may not want the cost*

*of grossing-up the lender under the tax gross-up provision and the lender may not want to incur the withholding tax.*

Many U.S. income tax treaties contain anti-conduit and limitation on benefits rules to reduce treaty shopping. Treaty shopping exists when a company is inserted into a transaction to gain the benefits of an income tax treaty. As a result, most U.S. income tax treaties provide that treaty benefits are only available to

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**The tax treaty concept of a U.S. permanent establishment is less broad than the U.S. statutory concept of a U.S. trade or business.**

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the "beneficial owner" of the interest income (but few income tax treaties define that term). Newer income tax treaties contain provisions that negate the benefits of the interest section of the tax treaty where the U.S. borrower is thinly capitalized. A "thinly capitalized" borrower exists when it has a high debt to equity ratio.

### **Tax Gross-Up Provision**

Withholding taxes represent a cost for either the borrower or the lender. It is a cost for the borrower when the borrower is required to pay a grossed-up amount to the lender and a cost for the lender when the lender is required to accept a net payment from the borrower. A "net payment" results when the borrower has no obligation to gross up the lender for withholding taxes.

A prudent foreign lender generally will insist that the cross-border credit agreement be drafted so that it receives the full amount of any interest payment due, irrespective of the U.S. withholding tax. The tax gross-up provision in a cross-border credit agreement requires that payments be made without withholding, unless the borrower must deduct tax by law, and if the borrower must deduct tax from the payments, those payments will be grossed up so that a lender receives an amount equal to the amount that the lender would have received had no tax been deducted.

The tax gross-up provision is included in the tax matters section of the cross-border credit agreement. The typical wording of a tax gross-up provision provides that:

any and all payments of the borrower shall be made free and clear of and without reduction

*Cross-Border Credit Agreements, continued on page 19*

## **Cross-Border Credit Agreements** *(from page 18)*

or withholding taxes provided that if the borrower is required by applicable law to deduct any withholding taxes from such payments, then the amount payable shall be increased so that after making all required deductions the lender receives an amount equal to the amount it would have received

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### **Many tax treaties reduce or eliminate U.S. withholding tax applicable to interest payments.**

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had no such deductions been made, and the borrower shall make such deductions and timely pay the full amount deducted to the relevant governmental authority in accordance with applicable law.

#### **Tax Gross-Up Exclusions**

There are exceptions to tax gross-up obligations. Foreign lenders should not be grossed up for withholding taxes that: (1) exist at the time of execution and delivery of the cross-border credit agreement; or (2) are attributable to the failure of the foreign lender to provide the tax forms or other documentation required by the U.S. borrower.

The credit agreement should also address the tax gross-up obligations of the U.S. borrower in the event that the loan is assigned or opened up to other lenders (e.g., loan participation). A U.S. borrower should demand consent rights for any assignment or expanded loan participation to ensure that it does not obligate itself to gross-up new foreign lenders if it would not have been required to gross up the original lenders.

The U.S. borrower should make sure that the credit agreement does not require it to gross up the lender for net income taxes, franchise taxes and branch profit taxes of the lender. In addition, a U.S. borrower should not agree to gross up a foreign lender for withholding taxes that exist when the credit agreement is executed or when the lender fails to provide the tax forms or other documentation required by the credit agreement.

The tax gross-up exclusions provision is also commonly included in the tax matters section of the cross-border credit agreement. Typical wording should provide that “excluded taxes” include:

income, net profits, or capital taxes imposed on or measured by net income, and franchise

taxes imposed on it (in lieu of net income taxes), by the United States, any branch profits taxes imposed by the United States or any similar tax, and any withholding tax that is imposed on amounts payable to the foreign lender at the time the foreign lender becomes a party to the credit agreement.

U.S. borrowers making payments to foreign lenders after December 31, 2012 may also want to include the 30 percent FATCA withholding tax (see below) in the list of taxes excluded from the tax gross-up provision. “Taxes” should be defined to include “any and all present or future income, stamp or other taxes, levies, imposts, duties, deductions, charges, fees or withholdings imposed, levied, withheld or assessed by any governmental authority, together with any interest, additions to tax or penalties imposed thereon and with respect thereto.”

The foregoing exclusions result in foreign lenders not being grossed up for withholding taxes that either exist at the time of execution and delivery of the credit agreement or are attributable to the failure of the foreign lender to provide the tax forms or other documentation required by the U.S. borrower.

#### **30 Percent FATCA Withholding**

U.S. borrowers will want to negotiate amendments to their credit agreements to address the new 30 percent FATCA withholding tax. On March 18, 2010, President Obama signed the Hiring Incentives to Restore Employment Act, which includes the Foreign Account Tax Compliance Act (FATCA). FATCA creates a system of information reporting and a new 30 percent FATCA withholding tax on certain payments made by U.S. persons and others to foreign financial institutions and certain other foreign parties (Sections 1471-4744). Payments made after December 31, 2012 by U.S. borrowers, U.S. issuers and other U.S. persons to foreign entities (specifically foreign banks, securities dealers, investment funds, including private equity and hedge funds), private investment vehicles and other non-publicly traded foreign entities may also be subject to the new 30 percent FATCA withholding tax.

To avoid the 30 percent FATCA withholding tax, a foreign payee may need to comply with the new information reporting requirements that differ depending on whether a foreign payee is categorized as a “foreign financial institution” or non-financial foreign entity (Section 1471(d)(5)).

If the foreign payee falls within the FATCA information reporting requirements but does not comply, the 30 percent FATCA withholding tax

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## Cross-Border Credit Agreements *(from page 19)*

applies to payments that are otherwise exempt from, or subject to a reduced rate of, U.S. withholding tax. For a credit agreement between a U.S. borrower and a foreign lender not in compliance with FATCA, the 30 percent FATCA withholding tax applies to: (1) payments of interest that qualify for the portfolio interest exemption; (2) repayments by a U.S. borrower of the principal amount of debt; and (3) gross proceeds from the sale of U.S. issued debt instruments (Section 1473).

U.S. borrowers should carefully study and revisit all credit agreements and negotiate amendments that (1) require specific documentation so it can comply with its FATCA withholding obligations, and (2) carve-out the new 30 percent FATCA withholding tax from the tax provision so that a foreign lender will not be grossed up for the new 30 percent FATCA withholding tax.

Even though debt obligations outstanding on March 18, 2012 are grandfathered, revolving credit agreements that allow draw downs or are "significantly modified" after that date are not grandfathered. For this reason, U.S. borrowers should negotiate FATCA-specific provisions for grandfathered credit agreements. (For more information about the FATCA changes due in 2013, refer to the July 2010 and August 2010 issues of *Practical International Tax Strategies*.)

### Ultimate Burden on U.S. Borrower

The U.S. borrower must withhold at the 30 percent


U.S. withholding tax rate unless the foreign lender demonstrates its entitlement to income tax treaty benefits. A cross-border credit agreement should require the foreign lender to deliver to the borrower (on or before the date that the credit agreement is executed) whichever of the following is applicable: (i) two completed copies of IRS Form W-8BEN claiming eligibility for benefits of an income tax treaty to which the United States is a party; (ii) two completed copies

### U.S. borrowers should negotiate FATCA-specific provisions for grandfathered credit agreements.

of IRS Form W-8ECI; (iii) in the case of a foreign lender claiming the benefits of the exemption for portfolio interest under Section 881(c) of the Internal Revenue Code (Code), (x) two completed copies of IRS Form W-8BEN and (y) two certificates to the effect that the foreign lender is not (a) a "bank" within the meaning of Section 881(c)(3)(A) of the Code, nor (b) a "10 percent shareholder" of the borrower within the meaning of Sections 871(h)(3)(B) and 881(c)(3)(B) of the Code, nor (c) a "controlled foreign corporation" described in Section 881(c)(3)(C) of the Code; or (iv) any other form, duly completed and signed, required by law to claim an exemption from or a reduction in U.S. withholding tax, together with such

additional documentation as may be required by applicable law to permit the borrower to determine the withholding or deduction required to be made.

<sup>1</sup>Reference herein to a U.S. corporate borrower also includes a limited liability company (LLC) that elects corporate tax status and reference to a U.S. partnership includes an LLC that is taxed as a partnership. □



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