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International Tax Planning

U.S. and UK Release Joint FATCA Intergovernmental Agreement

By Andrew P. Solomon, S. Eric Wang, Judith R. Fiorini, Andrew Thomson and Michael Orchowski (Sullivan & Cromwell LLP)

Summary

On September 14, the U.S. and UK governments announced that they had—on September 12—signed an agreement (UK Agreement) to implement the Foreign Account Tax Compliance Act (FATCA) in the UK. The UK Agreement closely follows the "reciprocal" version of the model agreements (Model Agreements) released on July 26, which were developed by the U.S. Treasury Department in consultation with France, Germany, Italy, Spain and the United Kingdom. The UK government intends to include legislation implementing the UK Agreement in its 2013 finance bill.

Under the UK Agreement, in addition to collecting and reporting information about "U.S. accounts" to the U.S. authorities, HM Revenue and Customs (HMRC) will be entitled to receive information regarding U.S.-based accounts held by UK residents from the United States. As anticipated, the UK Agreement populates "Annex II," the section of the Model Agreements that had been left empty so that appropriate local entities and products not subject to FATCA reporting could be identified. In addition, the UK Agreement includes a "most favored nation" clause under which the UK will be entitled to the benefit of any terms included in any other FATCA intergovernmental agreement that are more favorable than those included in the UK Agreement. Apart from these provisions, however, the differences between the UK Agreement and the "reciprocal" Model Agreement are minor.

In a related development, HMRC launched a consultation (Consultation) on the UK Agreement on September 17, which will last ten weeks and close on November 23. The Consultation both announces details regarding HMRC's plans for implementing the UK Agreement and asks interested parties for comments.

The UK Agreement includes a "most favored nation" that allows the UK to benefit from any terms in any other FATCA intergovernmental agreement that are more favorable.

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, FATCA encourages: *(i)* so-called "foreign financial institutions" (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. FATCA requires withholding agents to collect a 30 percent withholding tax on U.S.-source "withholdable payments" made to non-compliant entities. FATCA also 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 (such FFIs, "Nonparticipating FFIs").

In conjunction with the issuance of proposed FATCA regulations (Proposed Regulations) in February 2012,

(*FATCA*, continued on page 11)

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Dutch Tax Proposals Would Affect U.S. Multinationals

By Maarten Maaskant, Arjan Fundter, Sven Kuipers and Egon Snijders (PricewaterhouseCoopers LLP)

In Brief

The Dutch government on September 18—budget day—published the 2013 Tax Package, which includes several proposals that could affect U.S. multinationals.

Since both the House of Representatives and the Senate must approve the Tax Package, it could change significantly before enactment. Because elections for the House were held on September 12, the Tax Package will be discussed by a newly composed House of Representatives and may be defended by a new government, depending on how the new government formation proceeds. Most proposals in the Tax Package are set to take effect January 1, 2013.

This article summarizes the most important proposals in the Tax Package for U.S. multinationals and funds. It also addresses the extension of Real Estate Transfer Tax (RETT) relief upon resale, which took effect on September 1 through a ministerial decree.

Thin Capitalization Rules Abolished

Under the current Dutch thin capitalization rules, a company is deemed to be excessively financed by debt if its average annual debt exceeds a 3:1 debt:equity ratio for tax purposes and the excess is greater than €500,000. Interest paid on loans exceeding the 3:1 ratio and the €500,000 threshold is disallowed only to the extent the interest paid on intragroup loans exceeds intragroup interest received. The deduction of interest paid on genuine third-party loans is not limited by the thin cap rules. A ratio higher than 3:1 may apply at the taxpayer's request if the group to which the Dutch company belongs has, according to the consolidated group financial statements, a higher, worldwide debt:equity ratio (group ratio).

The Tax Package would abolish the thin capitalization rules as of January 1, 2013. In light of the other specific interest deduction limitations and the recently approved limitation regarding interest expense deductions for debt used to finance qualifying participations, the government believes the thin capitalization rules no longer make sense as part of the Dutch corporate income tax act.

Fiscal Unity and New Dutch Flexible Company Law

A Dutch parent company must be the legal and economic owner of 95 percent of the shares of a Dutch subsidiary to form a fiscal unity with that subsidiary. The Tax Package would require the ownership to represent at least 95 percent of statutory voting rights. This measure would prevent shares without voting rights, which can be issued under the new private company law rules that will come into force on October 1, 2012, from having access to the fiscal unity regime.

Tax Liability for Director's Fees Extended

The non-resident tax liability of entities established abroad that perform management activities for Dutch entities will be amended. The current legislation regarding the taxation of remuneration for statutory activities of members of a board of directors or commissioners would be extended to include remuneration for actual management activities or management services. The ability to exercise the Dutch taxing right would be determined by the applicable tax treaty. For example, under the U.S.-Netherlands tax treaty, it should not be possible to exercise the Dutch taxing right.

This article summarizes the most important proposals in the Tax Package for U.S. multinationals and funds.

Extension of RETT Relief upon Resale

The Dutch Real Estate Transfer Tax Act (RETT Act) contains an amendment to the existing relief for real estate that is resold within six months. If the acquisition of property takes place within six months of a previous acquisition of the same property by another person, the taxable basis is reduced by the amount on which RETT (or VAT that was not recoverable) was paid upon the previous transfer. In short, RETT is due on only the excess value. In order to stimulate the real estate market, this six-month period has been extended to 36 months, through a ministerial decree. In addition, the measure takes effect for both directly held real estate and indirectly held real estate (that is, held through so-called real estate companies). *Note:* This extension took effect on September 1, 2012. The measure is granted only if the previous acquisition takes place on September 1, 2012 or later. The measure is of a temporary nature and will expire on January 1, 2015. ❑

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Brazil Amends Transfer Pricing Rules

Provisional Measure 563 is Converted into Law

By Werner Stuffer, Demétrio Barbosa, Janaína Costa, Caio Albino de Souza, Marcio Oliveira, Leandro Cassiano and Felipe Mauer (Ernst & Young)

Summary

Provisional Measure (MP) 563 was converted into the Federal Law 12,715 published on September 18, 2012. The law significantly changes the Brazilian transfer pricing rules. The text approved by the Brazilian Congress varies slightly from that of the Provisional Measure. Most of the changes were made to clarify the provisions and reduce uncertainty.

The changes are designed to tighten the rules, reduce areas of controversy and attract more investment. The rules determine the calculation of the so-called parameter price, which stipulates the maximum amount of expenses Brazilian residents may deduct with respect to import transactions as well as a minimum amount of gross income Brazilian residents must recognize with respect to export transactions.

With the new wording, the Brazilian tax authorities intend to reduce the level of uncertainty.

Some changes in wording and the inclusion of additional details to the proposed amendments are:

- The new Law excluded the words "manufacturing" and "trading" from the original text in the new minimum statutory gross profit margin when applying the Resale Price Method, for the import of goods, services or rights;
- The possibility of using price publications of authorized institutions in the case of commodities not traded on a stock exchange market; and
- The inclusion of a maximum spread of 3 percent to calculate the limit on interest deductibility.

The following list describes changes to the Brazilian transfer pricing rules introduced by MP 563 that remain in the new Law:

- Introduction of minimum requirement for the application of the Brazilian uncontrolled price method (PIC) using internal comparables;
- New minimum statutory gross profit margins from 20 percent to 40 percent, depending on the industry, required for the Resale Price Method (PRL) in order to analyze import of goods, services or rights;
- FOB price as basis for the PRL calculation;
- New transfer pricing method for import/export transactions of publicly traded commodities;
- Changes to previously selected transfer price methods; and
- Changes to the deductibility of interest for financing transactions.

The proposed changes will go into effect on January 1, 2013. However, taxpayers may opt to adopt the new rules for the full calendar year 2012. The option is binding and will apply to the new rules in their entirety. The application from calendar year 2013 onwards is mandatory.

Introduction of Minimum Requirement for the Application of the Brazilian Uncontrolled Price Method (PIC) for Internal Comparables

The Brazilian uncontrolled price method (PIC) is the weighted arithmetic mean of the prices of identical or similar goods, services, or rights in the Brazilian market or other countries, in purchase or sales transactions made by the foreign related party or the Brazilian taxpayer with unrelated parties or established between unrelated third parties, under similar payment terms.

The required dollar/real amount of comparable transactions has often been controversial due to the lack of legal guidance. With the new wording, the Brazilian tax authorities intend to reduce the level of controversy. Under the new law, a transaction must be at least 5 percent of the value of the controlled import transaction before it can be used to establish a PIC comparable price. If there are no uncontrolled transactions or the amount is lower than 5 percent of the controlled transaction during the same year, the previous year third-party transactions might be used, after making the foreign exchange adjustments.

(*Transfer Pricing,* continued on page 5)

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Transfer Pricing *(from page 4)*

These limitations should be individually considered for each good, service or right imported from related parties, and they only apply when the taxpayer compares intercompany prices with its own prices charged from unrelated parties.

The new 5 percent threshold rule does not apply to other parameter prices based on external information regarding purchase and sales transactions provided by other parties.

New Minimum Statutory Gross Profit Margin Required When Applying the Resale Price Method, for the Import of Goods, Services or Rights, Range from 20 percent to 40 percent Depending on the Industry

The Resale Price Method (PRL) was significantly affected by the changes. Before the new Law, this method had two versions: one for simple resale of imported goods, services or rights (PRL20 percent), and another for goods imported and applied in production (PRL60 percent). Each of the two versions had its own calculation methodology and minimum profit margin (20 percent on the gross resale price for finished goods, and 60 percent on the net resale price for raw materials/components/parts).

The Resale Price Method has been a concern of taxpayers because its pre-determined profit margins applied to all industry segments. Therefore, either the 20 percent margin for pure resale, or the 60 percent margin for imports undergoing further processing, had to be adopted. However, these margins do not reflect the gross profit of most industries; furthermore, the biggest transfer pricing discussion and exposure in Brazil was due to two interpretations of the calculation of the resale price minus the 60 percent parameter price (PRL60 percent) since the issuance of Normative Instruction 243/02 in 2002.

Additionally, taxpayers were uncertain about which gross margin, production or resale value should be applied when imported products undergo a "light" manufacturing process in Brazil (e.g., repackaging, small assembly, etc.). Taxpayers generally applied the resale price version (20 percent gross margin) while the authorities generally applied the production version (60 percent margin).

The new rules avoid this uncertainty by unifying both versions of the PRL. Now the minimum statutory profit margins are established by economic sector. The calculation criterion is now described more precisely and applied the same way for imports intended for resale and for imports intended for further manufacturing. The new statutory profit margins are:

- 40 percent: pharmaceutical/pharma-chemical products; tobacco products; optical, photographic and cinematographic equipment and instruments; dental, medical and hospital equipment and instruments; extraction of petroleum and natural gas; and petroleum-related products;
- 30 percent: chemical products; glass and glass products; pulp, paper and paper products; and metallurgy; and
- 20 percent: for all the other businesses.

The list above is exclusive/exhaustive with respect to the economic sectors considered in the 40 percent and 30 percent gross margin categories. Therefore, all other sectors, whenever applying the resale minus method, fall into the 20 percent margin. In cases where the same legal entity performs activities in different sectors where different margins would apply, the calculations should be separated according to the respective industry sector and the final comparable price should be the weighted average of the respective industry sector prices.

To the extent that taxpayers start to apply the new rule, it is uncertain how to determine the correct economic sector. As an example, the "metallurgical" sector does not distinguish between activities by heavy industry or more broadly to a range of companies. The law states that the margin to be selected must correspond to the activity to which the purchased good was addressed in a production process or final destination. Additional guidance is expected from the government by Normative Instruction before the end of the year.

With regard to calculation mechanics, the new resale-minus method is similar to that established by Normative Instruction 243/02 for importation of raw materials/components applied in production. For better understanding, we refer to the simple example below:

REF	Description	Amount
(A)	Net sales price to third parties	5.000
(B)	Import cost of product (FOB cost)	1.000
(C)	Total cost	3.500
(D) = (B)/(C)	Ratio FOB cost x total cost	29 percent
(E) = (A)x(D)	Net sales proportional to FOB cost	1.429
(F) = (E)X20 percent	20 percent margin*	(286)
(G) = (E)-(F)	PRL Method (comparable price)	1.143

* Statutory profit margin applicable for all other business not previously listed.

(*Transfer Pricing*, continued on page 6)

Transfer Pricing *(from page 5)*

Under the new rules, there is some discussion among tax practitioners about whether, and how, total costs (C) should (or should not) include costs related to international freight, insurance and import duties.

It is important to point out that, from the inclusion of the MP563 amendments and ratified in the new Law, Sales (A) are now narrowly defined as third-party sales in Brazil, excluding exports. This new definition represents an important modification for the application of Resale Price Method.

This new definition represents an important modification for the application of Resale Price Method.

FOB Cost as Basis for the PRL Calculation

In order to determine the purchase price on imports to be tested, the current regulations of the tax authorities state that import cost should include international freight, insurance and non-recoverable import duties. Taxpayers have been discussing whether or not any amount other than FOB should be considered as part of the tested price. The questioning arises because the other expenses, including non-recoverable taxes, are not paid to related parties and, therefore, should not be tested for transfer pricing purposes. In that respect, the recent changes to law established for purposes of determining the ratio of import cost to total cost, taxpayers should consider only the FOB cost (import cost above). Please note that, the FOB was inserted in the context of determining the comparable price; however, nothing has been mentioned in the law about the tested price, which is a relevant topic in the Brazilian transfer pricing arena.

(*Transfer Pricing*, continued on page 7)

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Transfer Pricing *(from page 6)*

Individual Deviation from the 20 Percent to 40 Percent Gross Margin

The new rules confirm that taxpayers may seek application of a different gross margin. Since the introduction of transfer pricing rules, taxpayers could apply for margin changes, according to their type of business. However, the Brazilian government has not provided specific guidance on the procedure for requesting such change (historically, exceptions were not granted). As this is reemphasized in the new rules, changes to the procedures are expected to make this a realistic option. The details remain an open item for the new administrative guidance.

New Transfer Pricing Method for Import/Export of Commodities Traded Publicly

According to the new law, intercompany imports or exports of commodities must be tested using PCI (quotation on imports) and PECEX (quotation on exports) methods, respectively. These methods are defined as the quotation daily average values of assets or rights subject to public prices in internationally known futures or commodity markets, and the prices used will be adjusted to more or less the market average premium, on the date of the transaction or the latest known transaction. Therefore, both methodologies will rely on internationally accepted commodity quotations from international commodity exchanges.

In the case there are no internationally recognized futures quotations, the price of exported goods can be compared:

- With the prices obtained from independent data sources provided by internationally recognized research institutions; or
- With the price defined by agencies or regulation organizations and published in the Federal Official Gazette of Brazil.

For imports, in the case of lack of internationally recognized market quotations, the price of exported goods can be compared with prices obtained from independent data sources provided by internationally recognized research institutions.

The Brazilian government will determine through Normative Instruction which international quotations will be accepted for purposes of applying PCI or PECEX. The new Law includes cases where there is no quotation, as mentioned above; (this situation was not part of the MP 563). As stated in the law, related party import or export transactions of commodities must follow PCI or PECEX, therefore, the other transfer pricing methodologies (CUP, RPM, CPM) will not be applicable to analyze the commodity intercompany price. However, there are several additional issues to be addressed, including whether these new methods are mandatory for commodities without quotation. The literal interpretation of the Law seems to indicate that taxpayers can select the most favorable method and not be bound to PCI or PECEX.

The Brazilian tax authorities will provide a list of accepted commodity exchanges and the independent market research institutions for further guidance on how to apply the new rules. Currently, many points are unclear, including what is to be considered a commodity, how to adjust for functional and economical differences, etc.

Generally speaking, and in the international context, when applying the CUP method for commodities, it is necessary to identify the closest market index to where the product is delivered or from where it is being sold. Furthermore, adjustments such as transportation cost, payments terms, credit risk and others must be made.

Now the minimum statutory profit margins are established by economic sector.

Safe harbors (e.g., the 90 percent of the domestic price) will not apply to the exports of commodities traded in the Stock Exchange market. However, the margin of difference rule (5 percent) established in previous Normative Instruction continues to be accepted by tax authorities for imports and exports. (This should be confirmed once a new Normative Instruction is issued.) There is a discussion among tax practitioners about whether it is justifiable under the constitution to exclude taxpayers dealing with commodities from all other transfer pricing methods.

The expected new Normative Instruction should also address if the two secondary safe harbor rules (known as *Dispensa de Comprovação* or relief of proof rules) apply to commodities traded in the Stock Exchange market. These safe harbor rules exempt taxpayers with small relative export amounts (less than 5 percent of net revenue) or adequate overall intercompany export profitability levels (average of at least 5 percent net profitability for 3 years) from the burden of preparing detailed transfer pricing documentation.

It is important to mention that transfer pricing requirements apply to all intercompany transactions as well as transactions with unrelated parties located in tax favored jurisdictions (so called "blacklist" of the Brazilian tax authorities) or benefiting from privileged tax regimes (so called "grey list" published by the Brazilian authorities).

(*Transfer Pricing*, continued on page 8)

Transfer Pricing *(from page 7)*

Change to the Previously Selected Methodology

Under the new law, starting from fiscal year 2012, the transfer pricing method elected by the taxpayer cannot be changed by the taxpayer once the tax inspection has been initiated. However, the taxpayer may opt for another method in the event that the tax auditor disqualifies the first option during a tax inspection. However, if the tax auditor applies the method(s) selected by the taxpayer and only corrects the calculation (e.g., in the event of unprocessed information or missing documentation) the taxpayer can no longer change the method to defend his position.

Since the restriction on changing the selected transfer pricing method applies from fiscal year 2012, for previous years taxpayers might be able to elect any other method even after starting a transfer pricing inspection.

However, taxpayers are still allowed to apply all possible methods—with the exception for commodities, established by the legislation and to choose the most beneficial one. (Such provision reinforces the need for taxpayers to prepare adequate documentation by exploring all possible alternatives.) Before filling the income tax return the transfer pricing study should be finalized with no further amendments or updates.

Changes to the Deductibility of Interest

In addition to the modifications on the methodologies, Federal Law 12,715 changed the interest deductibility on foreign intercompany loans. All loan agreements with related parties overseas will be subject to the new transfer pricing rules, regardless of registration with Brazilian Central Bank (BACEN). The Law changed MP 563 and reestablished the original limit for loans not registered with the BACEN. Thus, the limit on the deductibility of interest is LIBOR for deposits in U.S. dollars with a six-month term plus a spread using a fixed spread margin of 3 percent. However, the Brazilian government retains the right to reduce the spread.

As a result of these changes, taxpayers may look for alternatives by amending their current loan terms (which often carry a higher interest rate), when possible, or setting up a new loan agreement based on the new transfer pricing rules. Importantly, however, terminating or amending an existing loan will often trigger other consequences that should be carefully considered. ❑

FRANCE

France Raises Tax Rates on Wealthy and Businesses to Slash Deficit

By Daniel Flynn and Leigh Thomas (Reuters)

Socialist President Francois Hollande unveiled higher levies on business and a 75 percent tax for the wealthy on September 28 in a 2013 budget aimed at showing France has the fiscal rigor to remain at the core of the euro zone.

The package aims to recoup €30 billion (£24 billion) for the public purse with a goal of narrowing the deficit to 3.0 percent of national output next year from 4.5 percent this year—France's toughest belt-tightening in 30 years.

But the budget dismayed business and pro-reform lobbyists by hiking taxes and holding France's high public spending at the same level rather than cutting it as Spain, Greece and Italy have done to chip away at their debt mountains.

Near-Zero Growth

With record unemployment and a barrage of data pointing to economic stagnation, there were also fears the deficit target will slip as France falls short of the modest 0.8 percent economic growth rate on which it is banking for next year.

"We do not want France to be delivered shackled to the markets as has happened to other neighboring countries that have succumbed to the temptation of letting their budgets get out control," Finance Minister Pierre Moscovici said of France's determination to stick to its deficit goal. Prime Minister Jean-Marc Ayrault dismissed fears about possible slippage, insisting the 0.8 percent growth target for next year was "realistic and ambitious."

Hollande's aim is to achieve the savings without hitting the purchasing power of low-income families. But France's main employers group said the measures would backfire by weakening the competitiveness of French industry. "Its stated aim is to prepare the future. But the way it is put together holds it to ransom by putting investment and employment at a serious risk," Medef President Laurence Parisot said in a statement.

(*Tax Hike*, continued on page 8)

Tax Hike (from page 7)

With public debt at a post-war record of 91 percent of the economy, the budget is vital to France's credibility not only among euro zone partners but also in markets that for now are allowing it to borrow at record-low yields around two percent. The government said the budget was the first in a series of steps to bring its deficit down to 0.3 percent of GDP by 2017—slightly missing an earlier target of a zero deficit by then.

France's benchmark 3.0 percent 10-year bond was steady, yielding 2.18 percent after the announcement but some analysts remained skeptical.

"The ambitions that were flagged are very audacious," said Philippe Waechter at Natixis Asset Management. "I struggle to see how we'll find the growth needed in 2013 and afterwards."

Of the total €30 billion of savings, around €20 billion will come from increased levies on households and companies, with tax rises already approved this year to contribute some €4 billion to revenues in 2013. The freeze on spending will contribute around €10 billion.

Exodus Fear

To the dismay of business leaders who fear an exodus of top talent, the government confirmed a temporary 75 percent super-tax rate for earnings over €1 million and a new 45 percent band for revenues over €150,000. Together, those two measures are predicted to bring in around half a billion euros. Higher tax rates on dividends and other investments, plus cuts to existing tax breaks are seen bringing in several billion more.

Jean-Paul Agon, chief executive of cosmetics giant L'Oreal, warned in the run-up to the budget that the new super-tax, which compares to a euro zone average top rate of 43 percent, will make it harder to attract top executives. Bernard Arnault, France's richest man and chief executive of luxury group LVMH, created a storm in September by declaring he had applied for Belgian nationality—but stressed he would continue to pay taxes in France.

Business will face measures including a cut in the amount of loan interest that is tax deductible and the cutting of an existing tax break on capital gains from certain share sales—moves worth around €4 billion and €2 billion each.

Four months after he defeated Nicolas Sarkozy, Hollande's approval ratings are in free-fall as many French feel he has been slow to get to grips with the economic slow-down and unemployment at a 10-year high and rising.

Finance Minister Pierre Moscovici defended next year's growth target on French radio. But, highlighting the bet on growth underpinning the entire budget, he added that it was achievable "if Europe steadies."

Data on September 28 confirmed France posted zero growth in the second quarter, marking nine months of stagnation, as a pickup in business investment and government spending was offset by a worsening trade balance and sluggish consumer expenditure.

Despite a rise in wages, consumers—traditionally the motor of France's growth—increased their savings to 16.4 percent of income from 16.0 percent a year earlier. In another setback, other data showed consumer spending dropped 0.8 percent in August. ❑

GERMANY

Earnings Stripping Rules: No EBITDA Carryforward in Case of Net Interest Income

By Dr. Gerrit Adrian (KPMG)

In an administrative guideline dated July 17, 2012, the regional tax office Frankfurt/Main opines that an EBITDA carry-forward cannot arise in fiscal years in which the interest income generated by a business equals or exceeds interest expense (so-called net interest income).

The earnings stripping rules applicable in Germany stipulate—albeit with three exceptions—that interest expense incurred by a business is deductible as business expense only up to the amount of interest income. The amount of interest expense exceeding interest income is deductible only up to the amount of the so-called clearable EBITDA. The clearable EBITDA is 30 percent of the applicable earnings, increased by interest expenses, depreciations and amortizations (with the exception of writedowns to going-concern value) and decreased by interest income.

When Interest Expense is Fully Deductible

Where one of the three exceptions applies, the interest expense incurred by the business is fully deductible, i.e., the restrictions under the earnings stripping rules will, in principle, cease to apply. This is the case if:

(*Earnings Stripping*, continued on page 10)

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Earnings Stripping (from page 9)

- the amount by which interest expense exceeds interest income (so-called net interest expense) is less than €3 million (so-called tax exemption threshold);
- the business does not or only partially belong to a consolidated group; or
- the business belongs to a consolidated group but its equity ratio at the close of the preceding financial statement date is equal to or greater than that of the consolidated group. An equity ratio up to two percentage points below that of the group is not detrimental.

An EBITDA carryforward arises whenever the clearable EBITDA of a fiscal year exceeds the net interest expense incurred in such fiscal year and none of the three exceptions applies. The EBITDA carryforward is determined separately and may be carried forward into the subsequent five fiscal years. Any interest expense incurred in a fiscal year which is not deductible due to the earnings stripping rules may be deducted in the amount of EBITDA carryfowards from preceding fiscal years (the oldest EBITDA carryforwards must be used first).

So far it is not clear whether an EBITDA carryforward also arises in fiscal years in which the interest income generated by a business is higher than its interest expense (net interest income). To date, no decisions appear to have been passed pertaining to this problem. It is the view of the regional tax office (OFD) Frankfurt/Main that in these cases no EBITDA carryforward arises. According to the OFD, this is clear from the wording as well as from the purpose and intent of the German earnings stripping rules regulations in question.

Since administrative guidelines do not have the status of a law, the guideline issued by the OFD Frankfurt/Main generally only has to be observed by the authorities. This means that the taxpayer may hold a different opinion than said guideline. ❑

SWEDEN

Sweden's 2013 Budget: Lower Corporate Tax Rate, Sharper Interest-Stripping Rules

By Erik Björkeson (DLA Nordic)

On September 20, the Swedish government submitted its budget proposal for 2013.

The proposal includes a suggestion to lower the corporate income tax rate from the current rate of 26.3 percent down to 22 percent. The new tax rate will apply from January 1, 2013.

Further, the proposal includes a sharpening of the interest-stripping rules for interest accruing in 2013.

Under the current rules, interest on intra-group debt that is put into place in order to acquire shares of an entity from a related party will be disallowed completely, unless it satisfies either one of two conditions:

- the interest income will be taxed, in the hands of the beneficial owner of such income, at a rate of at least 10 percent in the jurisdiction in which the beneficial owner is resident; or
- both the shares acquisition and the related debt are "mainly" motivated by a commercial reason.

While the current rules only apply to interest arising in connection with shares purchased from a related party, the proposal is that all intragroup debt would be covered.

Interest payments are deductible if the interest income will be taxed in the hands of the beneficial owner at a rate of at least 10 percent in the jurisdiction in which the beneficial owner is resident. Interest payments will not be deductible, however, if the main reason for the debt structuring was to achieve considerable tax benefits (75 percent or more) for the company group.

Commercial reasons for the loan are still an alternative test for deduction. According to the budget proposal, the commercial purpose test only applies if the creditor is resident within the European Economic Area or in a tax treaty jurisdiction with which Sweden has a full tax treaty.

Companies with a Swedish presence whose interests may be affected by this proposed budget should consider carrying out a careful review of their current finance structures before January 1, 2013. ❑

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Medical Device Excise Tax—IRS Issues Revised Form 637 for Registration Regarding Exempt Sales for Export or Use in Further Manufacturing

By John S. Stanton and Beth L. Roberts (Hogan Lovells)

The IRS has just issued the revised Form 637, which provides for registration of a manufacturer that claims exemption from the medical device excise tax for purchases or sales for export or for use in further manufacturing.

In the case of exports of components or finished devices from the U.S., no excise tax is due by reason of the export exemption in Section 4221(a)(2) of the Internal Revenue Code. Sales (or imports) of components that are also considered listed devices for other uses for incorporation by the purchaser into an overall finished medical device are exempt under the "further manufacture" exemption of Section 4221(a)(1).

The general manufacturers' excise tax rules provide for a detailed registration system under which, in order for the exemption from tax to apply, the manufacturer and the purchaser must register with the IRS, and certain information must be exchanged upon each exempt transaction, including the parties' registration numbers and the exempt purpose for which the taxable item is being used. (Treas. Regs. §§ 48.4222(a)(1)-1, 48.4221-1(c)). However, a foreign purchaser need not be registered in order for the U.S. manufacturer to qualify for the export exemption. (Treas. Reg. § 48.4221-3).

IRS Form 637 serves as the application form for this registration and requires the taxpayer to list all taxable articles it manufactures, the taxable articles it intends to export and to whom the export will be made, the taxable articles to be purchased for further manufacturing, and the taxable articles to be sold for further manufacturing and who will be doing the further manufacturing. This registration must be accepted by the IRS and a registration number issued before the manufacturer can engage in tax-free sales. ❑

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the U.S. Treasury Department released a joint statement with the governments of France, Germany, Italy, Spain and the United Kingdom (Joint Statement) outlining these countries' intention to "intensify their co-operation in combating international tax evasion" and to explore common approaches to implementing FATCA. The Joint Statement also outlined a possible framework for FATCA implementation based on reciprocal reporting between the United States and a country with which the United States signs an agreement.[1]

In July 2012, the U.S. Department of the Treasury published the Model Agreements. The Model Agreements: *(i)* specify the time and manner of exchanging information and provide for collaboration between the countries on compliance and enforcement; *(ii)* describe the treatment the United States will give to FFIs in the counterparty country (FATCA Partner); and *(iii)* include a mutual commitment to continue to enhance the effectiveness of information exchange and transparency. There are also two annexes to the Model Agreements. Annex I describes the due diligence procedures that will be required to identify and report on U.S. accounts, and for making payments to Nonparticipating FFIs. Annex II is intended to provide a list of FATCA Partner FFIs and products that are exempt from FATCA reporting obligations, and is to be completed jointly by the United States and the FATCA Partner.

The two Model Agreements are generally identical, except that one agreement (reciprocal agreement) provides for the United States to send certain information on U.S. accounts held by residents of the FATCA Partner to the FATCA Partner, while the other (nonreciprocal agreement) does not.[2]

Discussion

Overview

In general, the UK Agreement provides that FFIs operating in the United Kingdom will be entitled to comply

(*FATCA*, continued on page 12)

FATCA *(from page 11)*

with FATCA by reporting information regarding their U.S. accounts to HMRC, rather than to the IRS. HMRC will then relay this information to the IRS. As with the Model Agreements, the UK Agreement determines an FFI's eligibility for benefits by looking at the location of the relevant branch, rather than where the financial institution is incorporated or otherwise tax resident. The UK Agreement also does not require FFIs to sign an agreement with the IRS to avoid the imposition of FATCA withholding tax on withholdable payments to UK-based branches.

The UK Agreement contains very few changes from the Model Agreements, apart from the completion of the Annex II list of exempted products and FFIs. As under the Model Agreements, an FFI is entitled to comply with FATCA under the UK Agreement if it is a "United Kingdom Financial Institution"—that is: *(i)* a financial institution resident in the United Kingdom (but excluding any branches that are located outside the United Kingdom); and *(ii)* any branch of a financial institution not resident in the United Kingdom, if that branch is located in the United Kingdom. Under the UK Agreement, unless identified as a "nonreporting United Kingdom Financial Institution" listed in Annex II (or otherwise exempted by U.S. Treasury Regulations), a UK Financial Institution will be required to:

The UK Agreement also specifies due diligence standards that UK-based FFIs will be required to apply to determine which accounts are reportable.

- identify "U.S. Reportable Accounts"[3] and report information regarding them annually to HMRC;
- report annually the recipient of, and aggregate amount of, payments made in 2015 and 2016, to "Nonparticipating FFIs;"
- to the extent that it has elected to be a qualified intermediary for other reporting purposes under the Internal Revenue Code, or has elected to be a withholding trust or withholding partnership, withhold 30 percent of any "U.S. Source Withholdable Payment"[4] (that does not include gross proceeds from the sale or disposition of U.S. stocks and bonds) to any Nonparticipating FFI; and
- if it has not elected to be a qualified intermediary or withholding trust or partnership, to the extent it makes a payment of, or acts as an intermediary with respect to, a "U.S. Source Withholdable Payment" to any Nonparticipating FFI, provide to the person from whom it directly receives the U.S. Source Withholdable Payment the information required so that the person making the payment can satisfy its own FATCA withholding and reporting obligations.

The "phase-in" timeline under the UK Agreement is identical to the timeline specified in the Model Agreements. Like the Model Agreements, the UK Agreement also does not directly deal with "foreign passthru payments" or gross proceeds withholding other than to indicate a joint intent to develop a "practical and effective alternative approach to achieve the policy objectives of foreign passthru payment and gross proceeds withholding that minimizes burden."[5] In addition, as in the Model Agreements, the UK Agreement provides that UK Financial Institutions will not be required to withhold tax on payments to "recalcitrant account holders" or to close such accounts, if the U.S. Treasury Department receives the relevant information for each account.[6] Under the terms of the UK Agreement, it is unclear what the FFI is supposed to do if relevant information (e.g., the account holder's U.S. taxpayer identification number) is not received by the U.S. Treasury Department because the FFI does not have the information.

The UK Agreement also provides that a UK Financial Institution will not be prevented from becoming a Participating FFI because it is related to entities or branches that are Nonparticipating FFIs, if such related parties and branches are operating in jurisdictions that prevent them from becoming a Participating or deemed-compliant FFI. While the Proposed Regulations include a similar provision,[7] the equivalent rule in the Proposed Regulations is more stringent and expires at the end of 2015, while the relief granted under the UK Agreement (and the Model Agreement) will extend indefinitely.

Perhaps in recognition of the small number of changes between the UK Agreement and the Model Agreements, the UK Agreement includes a "most favored nation" clause under which the UK will be entitled to the benefit of any terms that are included in any other FATCA intergovernmental agreement that the U.S. subsequently negotiates that are more favorable than those included in the UK Agreement.

The UK Agreement also—like the Model Agreement—specifies due diligence standards that UK-based FFIs will be required to apply to determine which accounts are reportable. The due diligence provisions are—save for two minor changes—substantively unchanged from the Model Agreements. The first of these changes is that the UK Agreement clarifies that new individual accounts do not need to be reviewed or reported unless the account balance exceeds $50,000 "at the end of any calendar year or other appropriate reporting period." The Model Agreements leave this language out of the "new accounts," discussion, with the potential implication that new accounts might have needed to be reported if

(*FATCA*, continued on page 13)

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the account balance exceeded $50,000 at any time.[8] The second change includes start-up companies that have been organized for less than 24 months (and are investing capital into a non-financial business) within the definition of "Active NFFEs."[9] The Proposed Regulations contain a similar provision stating that such entities are not FFIs and treat them as "excepted" NFFEs.[10] Because other types of "excepted" NFFEs (such as holding companies) were on the "Active NFFE" list in the Model Agreements, it is possible that the omission of start-up companies from this provision in the Model Agreements was an oversight.

Because the UK has opted for a "reciprocal" agreement, the IRS will also report information about UK residents to HMRC. At the moment, this "reciprocal" reporting includes details on "depository accounts"[11] held at U.S. financial institutions by individual residents of the United Kingdom, and other "financial accounts" held by individual and entity residents of the United Kingdom. This provides a level of coverage that is less comprehensive than the reporting required of UK-based FFIs because certain accounts (e.g., depository accounts held by entities) are not reportable. Presumably this difference is due to the fact that under current U.S. rules (including the U.S. rules scheduled to go into effect on January 1, 2013), the only federal income tax reporting generally required with respect to a financial account of a non-U.S. person is the annual reporting of the amount of interest paid on depository accounts of certain non-U.S. individuals. (Reporting is also required on amounts paid to non-U.S. recipients that are subject to withholding. If, however, the amounts are paid through a "qualified intermediary," the rules allow the reporting requirement to be met without identifying the non-U.S. beneficial owner of the payment.) Nevertheless, the UK Agreement commits the United States to pursue the adoption of domestic regulations and supporting relevant legislation to achieve a level of reciprocal automatic exchange in which the information the United States is able to provide is equivalent to the level of information being provided by the UK.

Annex II

The majority of the new information in the UK Agreement is in Annex II, which outlines certain categories of institutions that will be "non-reporting United Kingdom Financial Institutions" (either because they are "exempt beneficial owners" or "deemed compliant" with FATCA) and products that will be exempted from FATCA reporting.

1. Exempt beneficial owners—Annex II identifies the following as "exempt beneficial owners" that will be non-reporting UK Financial Institutions:

- devolved administrations and local authorities;
- Bank of England; and
- any UK office of certain international organizations.[12] This list includes organizations that are not "international organizations" as defined under FATCA's statute and the current proposed regulations under FATCA (which requires an "international organization" to be entitled to the benefits of the International Organizations Immunities Act). It is not known whether this is a UK-specific accommodation, or whether, instead, this reflects a broader view of the term "international organization" at the U.S. level.

2. Deemed Compliant FFIs—In addition, Annex II specifies two classes of "deemed compliant" FFIs that will not be required to undertake FATCA reporting. The first category of such FFIs consists of non-profit organizations, and includes *(i)* any entity registered as a charity with the Charity Commission of England and Wales; *(ii)* any entity registered with HMRC for charitable tax purposes; *(iii)* any entity registered as a charity with the Office of the Scottish Charity Regulator; and *(iv)* any Community Amateur Sports Club if registered as such with HMRC.

The second category of "deemed compliant" non-reporting UK financial institutions consists of any "financial institution" that meets a series of tests designed to ensure its business is substantially confined to the UK. These tests provide that an FFI will be entitled to "deemed compliant" status if it:

- is licensed and regulated under the laws of the UK;
- has no fixed place of business outside the UK;
- does not solicit account holders outside the UK (provided, however, that the operation of a website that does not specifically indicate that the Financial Institution provides accounts or services to nonresidents or otherwise target or solicit U.S. customers does not preclude this requirement from being satisfied);
- is required under UK tax law to perform either information reporting or withholding of tax with respect to accounts held by UK residents;
- has at least 98 percent of its accounts (by value) held by residents (including residents that are entities) of the UK or another Member State of the European Union;
- does not (beginning on January 1, 2014) provide accounts to *(i)* any "Specified U.S. Person" who is not a UK resident (including a U.S. Person that was a UK resident when the account was opened but subsequently ceases to be a UK resident); *(ii)* a Non-participating FFI; or *(iii)* any "passive non-financial foreign entity" with "controlling persons" that are U.S. citizens or residents;
- on or before January 1, 2014, implements policies and procedures to monitor whether it provides any account held by a person described above and if such an account is discovered, the Financial Institution must report such account as though the Financial Institution were a Reporting UK Financial Institution or close such account;
- with respect to each account that is held by an individual that is not a UK resident or by an entity (and

(*FATCA*, continued on page 14)

FATCA (from page 13)

that was opened before the date on which the policies and procedures described above were implemented), reviews those accounts to identify any "U.S. Reportable Account" or account held by a Nonparticipating FFI, and either *(i)* closes any such accounts that were identified; or *(ii)* reports on such accounts as though the Financial Institution were a normal, "reporting" UK Financial Institution; and

- has no "Related Entities" (i.e., speaking generally, entities under common control) that are not incorporated or organized in the UK or that do not meet the above requirements.

These requirements are very similar (but not identical) to the requirements for registered "Local FFIs" under the Proposed Regulations, but several features are worthy of independent discussion. First, these requirements are preceded by a list of potentially qualifying institutions, such as credit unions, friendly societies and building societies. Nevertheless, the provision allowing for deemed compliance applies to any "Financial Institution," meaning that this list is non-exclusive (and that an entity that is on this list is not eligible for non-reporting status if it does not meet the specified requirements). Second, there are several differences between provisions in the Proposed Regulations and their counterparts in the UK Agreement that could foreshadow changes that will be made to the final FATCA regulations. These include *(i)* that unlike the Proposed Regulations, the UK Agreement allows "deemed compliant" FFIs to offer U.S. dollar-denominated products; and *(ii)* that the UK Agreement specifies that the 98 percent threshold FATCA International Agreements September 20, 2012 mentioned above is determined by value (while this was unspecified in the Proposed Regulations). Third, the UK Agreement's provisions dealing with accounts held by "passive non-financial foreign entities" are slightly different, and prohibit the maintenance of accounts for such entities with "controlling persons" that are U.S. citizens or residents, rather than entities that are controlled or beneficially owned by a "specified U.S. person."

Because the UK has opted for a "reciprocal" agreement, the IRS will also report information about UK residents to HMRC.

Exempted Products—The UK Agreement also includes a list of exempted products which, to the extent established in the UK and maintained by a UK Financial Institution, will not be considered "U.S. Reportable Accounts." These include certain pension schemes (including, among others, "Self-Invested Personal Pensions"), Individual Savings Accounts and Premium Bonds. Because individuals can hold substantial assets in some of these products, it is not clear if these products are exempted because the United States views them as presenting a low risk of tax evasion or whether— instead— the IRS believes that it can obtain sufficient information about these products from what is currently reported to HMRC.

HMRC Consultation

On September 17, 2012, HMRC opened a consultation on the UK Agreement, which details HMRC's current views on a number of FATCA-related issues and seeks comments on twenty-four questions that are raised by the UK Agreement. The responses to the consultation will be considered in formulating draft legislation, which the UK intends to publish by the end of 2012 and include in its 2013 Finance Bill. HMRC's views on the UK Agreement (and the UK legislation that implements the UK Agreement) will be integral to its operation because the UK Agreement—like both of the Model Agreements—provides that terms that are not otherwise defined will (unless the context requires otherwise or a competent authority agreement is reached) be defined by reference to the law applying the agreement.

Many of the questions raised by the UK Agreement are "general" FATCA questions that are not specifically applicable to the UK. For example, the Consultation document observes that the UK Agreement defines a "Depository Institution" as "an entity that accepts deposits in the ordinary course of a banking or similar business," and asks if there are concerns that the reference to a "similar business" could unintentionally (and presumably, inappropriately) classify certain entities as "Depository Institutions." Other questions asked in the Consultation document are operational in nature: as an example, the Consultation document asks when businesses and others would need to know the required data format and transmission method (for FATCA account information) in order to be in a position to timely report information to HMRC. The Consultation document also suggests that HMRC has put considerable thought and effort into the FATCA process, and has developed initial positions on a number of FATCA-related issues. Potentially significant information points in the Consultation include:

- that HMRC may impose an earlier deadline for UK financial institutions to report FATCA information than the date specified in the UK Agreement. In particular, HMRC is considering requiring UK financial institutions to: *(i)* report FATCA information for 2013 by March 31, 2015, *(ii)* report FATCA information for 2014 to HMRC by June 30, 2015; and *(iii)* transmit FATCA information for subsequent years to HMRC by March 31 of the year following the relevant reporting year; and
- that while the Model Agreement does away with the need (contained in the Proposed Regulations)

(*FATCA*, continued on page 16)

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for UK Financial Institutions to have a "responsible officer" who must certify the completion of certain FATCA objectives, HMRC is considering requiring UK-based financial institutions to have a "nominated individual" who acts as a point-of-contact for certain inquiries, confirms that FATCA's due diligence procedures have been completed and confirms that relevant reporting requirements have been satisfied.

[1]The Joint Statement is discussed in the Sullivan & Cromwell LLP publication entitled "FATCA: Proposed Regulations" (February 28, 2012). Separately, on June 21, 2012, the U.S. Treasury Department released joint statements with the governments of Switzerland and Japan, which provide for a different compliance model. Under this alternative framework, FFIs would remain responsible for reporting their U.S. accounts directly to the IRS, and the role of the local tax authorities would be limited to serving as an intermediary for information regarding recalcitrant account holders. For a further discussion of the Japan and Switzerland joint statements, please see the Sullivan & Cromwell LLP publication entitled "FATCA: New Government-to-Government Model: U.S. Treasury Department Issues Joint Statements with Japan and Switzerland Outlining a New Intergovernmental Model" (June 29, 2012).

[2]For a detailed discussion of the Model Agreements, 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).

[3]"U.S. Reportable Accounts" are "financial accounts" maintained by a UK Financial Institution and held by one or more specified U.S. persons or by a non-U.S. entity with one or more "controlling persons" that is a specified U.S. person. A "specified U.S. person" is defined, in the UK Agreement, in substantially the same way as that term is defined in the Proposed Regulations and includes any individual U.S. citizen or resident. *See* Prop. Treas. Reg. § 1.1473-1(c).

[4]A "U.S. Source Withholdable Payment" is defined as "any payment of interest (including any original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income, if such payment is from sources within the United States," except to the extent that such payment is not treated as a withholdable payment in relevant U.S. Treasury Regulations.

[5]The only proposed definition of foreign passthru payments was in an earlier IRS Notice regarding FATCA, which was not in the Proposed Regulations. Notice 2011-34 proposed treating payments made by Participating FFIs that were not U.S.-source income as "passthru payments" subject to 30 percent withholding in proportion to the percentage of the Participating FFI payor's assets that were "U.S. assets."

[6]While the UK Agreement specifies the "U.S. Competent Authority" as the party that must receive this information, the Consultation document suggests that reporting this information to HMRC will be sufficient.

[7]*See* Prop. Treas. Reg. § 1.1471-4(e)(2) and (3).

[8]The Consultation document (from HMRC) notes that the references to an "other appropriate reporting period" (which is also referenced elsewhere in both the Model Agreement and the UK Agreement) is intended to provide for products where year-end valuation is not appropriate (e.g., insurance policies that are valued annually on the policy's anniversary date, rather than at year end), but also solicits comments on other products where it may be appropriate to use a reporting period other than the calendar year.

[9]Speaking generally, "Active NFFEs" are "non-financial foreign entities" that are not subject to FATCA withholding or reporting because they have (or are considered to have) an active, non-financial business.

[10]*See* Prop. Treas. Reg. § 1.1471-5(e)(5).

[11]In general, "depository accounts" include "bank deposit" accounts maintained by banks, such as current accounts, checking accounts, time deposit accounts and the like, and interest-bearing accounts maintained by insurance companies.

[12]In particular, Annex II lists: *(i)* International Monetary Fund; *(ii)* World Bank; *(iii)* International Bank for Reconstruction and Development; *(iv)* International Finance Corporation; *(v)* International Finance Corporation Order, 1955; *(vi)* International Development Association; *(vii)* Asian Development Bank; *(viii)* African Development Bank; *(ix)* European Community; *(x)* European Coal and Steel Community; *(xi)* European Atomic Energy Community; *(xii)* European Investment Bank; *(xiii)* European Bank for Reconstruction and Development; *(xiv)* OECD Support Fund; and *(xv)* Inter-American Development Bank. ❑