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Global Netting: Potential Opportunities for Corporate Taxpayers

By James E. Salles, Charles M. Ruchelman and Michael Lloyd (Caplin & Drysdale, Chartered)

Two recent judicial decisions addressing the so-called "global netting" of interest in tax cases potentially offer corporate taxpayers new opportunities. Taxpayers may be able to obtain at least partial netting relief on underpayments and overpayments of federal tax in some circumstances where it had been commonly assumed to be unavailable, and are well-advised to take a second look at their IRS account transcripts in search of previously overlooked claims that may be filed before the statute of limitations expire.

Background

Under Section 6621 of the Internal Revenue Code (the Code), interest is calculated at a higher rate for underpayments of corporate tax than it is for corresponding overpayments. Congress and others have recognized that this can produce unfair results when a corporation simultaneously owes money to the government and is owed money from the government in different tax accounts for overlapping time periods, but the underpayment and the overpayment are not actually offset against one another. (The Code generally eliminates interest on balances that are offset against one another, but not when the amounts are collected and refunded separately.)

When Congress first provided for the interest rate differential in 1986, it assumed the Internal Revenue Service (the Service) would provide for "comprehensive netting" (that is, netting of offsetting balances that are not simultaneously resolved) within three years.[1] This policy was never implemented, so corporate taxpayers were left having to pay an interest differential of up to 4.5 percent on offsetting balances despite not owing any net tax.

In 1998, as part of the IRS Restructuring and Reform Act of 1998 (RRA), Congress amended Section 6621 to provide for a "net interest rate of zero" on reciprocal tax debts that are outstanding at the same time for the same taxpayer. This provision generally applies to interest that accrued after enactment, but an uncodified transition rule allows netting to apply to interest accrued earlier, under certain conditions and "subject to any applicable statute of limitation not having expired with regard to either a tax underpayment or a tax overpayment." RRA § 3301(c)(2).

Taxpayers are advised to take a second look at their IRS account transcripts in search of previously overlooked claims that may be filed before the statute of limitations expire.

The Service implements the "net interest rate of zero" by equalizing interest rates on "equivalent" over- and underpayment balances that are outstanding over the same period. The IRS can reduce the interest rate that it charges on tax underpayments to the lower overpayment rate, or it can increase the interest rate it pays on tax overpayments to equal the higher underpayment rate. The Service normally uses the first method (reducing the interest rate on the underpayment and refunding any "excess" interest charged) when the statute of limitations situation permits.

The Decisions

In *Exxon-Mobil Corp. v. Commissioner*, the Second Circuit ruled against the long-standing Service interpretation of the transition rule language quoted above which required that the statute of limitations on both the underpayment and the overpayment used in a netting computation be open on the date the RRA was enacted (July 22, 1998) in order for the transition rule to apply.[2] The decision created a decisional split with the Federal Circuit, which had previously upheld the Service's interpretation in *Federal*

(*Global Netting,* continued on page 12)

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Integrating Foreign Currency Hedges with Respect to Stock Purchase and Sale Agreements

By Steven D. Bortnick (Pepper Hamilton LLP)

Investment funds that invest globally must deal with volatility in the currency in which they agree to invest. Investment funds entering into obligations to purchase stock in a currency other than the primary currency of the investment fund have become increasingly interested in hedging these obligations to minimize the volatility risk.[1] Similarly, an investment fund entering an agreement to sell stock in a currency other than that of the investment fund may be interested in hedging its right to receive cash. Without planning, these hedges may give rise to ordinary income or loss. In the case of a new investment, this income may not be reflected by the receipt of cash (i.e., "dry" or "phantom" income would result). In the case of a sale of stock, this income would be taxed as ordinary income, rather than long-term capital gain. (Ordinary income derived by individuals is taxed at significantly higher rates than long-term capital gains.) These adverse U.S. tax issues may be avoided, however, if the hedge and the purchase/sale agreement are "integrated" under the applicable rules, discussed herein. This article discusses some of the U.S. tax consequences of hedging stock purchase/sale agreements, and identifies certain practical issues and fixes.

An Example to Illustrate the Issues

On July 25, 2012, XYZ fund entered into a stock purchase agreement to purchase all of the stock of ABC, Inc. for €50 million. XYZ is a Delaware partnership and keeps its books in U.S. dollars. Most of XYZ's transactions are denominated in U.S. dollars. On July 25, 2012, €50 million would cost $60,310,000, based on the exchange rate on that date. The sale closed on February 4, 2013, when €50 million cost $68,245,000. Had XYZ not entered into a hedge, the purchase would have cost XYZ $7,935,000 more than anticipated entirely due to the increase in the value of the euro compared to the U.S. dollar.

Thankfully, on July 25, 2012, XYZ entered into a forward contract, pursuant to which it agreed to acquire €50 million for $60,310,000 on March 29, 2013. Thus, XYZ avoided a large additional cash outlay for the same investment. It also realized a $7,935,000 foreign currency exchange gain (FX gain) on the settlement of the forward contract. Absent further planning at the time of the hedge, this FX gain would be taxable as ordinary income to U.S. taxable investors in XYZ, even though all of this gain was invested into the stock of ABC, Inc. The additional planning of which we speak, and which is the subject of this article, is the integration of hedge (here, the foreign currency futures contract) with an executory contract (here the stock purchase agreement).[2]

Integration Can Avoid the Recognition of FX Gain or Loss

Regulations[3] provide that "if a taxpayer enters into a *hedged executory contract*, amounts paid or received under the hedge by the taxpayer are treated as paid or received by the taxpayer under the *executory contract* or any subsequent account payable or receivable." Moreover, "the taxpayer recognizes no exchange gain or loss on the hedge" for U.S. income tax purposes. The meaning of italicized words, as well as other detailed requirements, are discussed, below. However, the key consequence of this type of planning is that the hedge and the transactions effected pursuant to the executory contract are treated as a single transaction.

Without planning, these hedges may give rise to ordinary income or loss.

Turning back to our example, if the foreign currency forward contract and the stock purchase agreement had been properly identified as part of a hedged executory contract, XYZ would not have recognized foreign currency gain or loss upon receipt of the euros; and XYZ would have been treated as having paid $60,310,000 for the stock of ABC, Inc. acquired pursuant to the stock purchase agreement.

Hedged Executory Contract Definitions and Requirements

The term "hedged executory contract" is defined in the Treasury Regulations. The term itself includes several additional definitions and requirements.

Executory Contract—An executory contract is an agreement entered into before the "accrual date" (defined below) to pay nonfunctional currency (or an amount determined with reference thereto) in the future with respect to the purchase of property used in the ordinary course of the taxpayer's trade or business, or the acquisition

(*Foreign Currency Hedges*, continued on page 15)

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Australian Court Rules that Limited Partners are the Relevant Taxpayers for Gains Realized by a Limited Partnership

By Nick Malley and Wendy Hartanti (PricewaterhouseCoopers)

The Australian Federal Court recently held *in Resource Capital Fund III LP v Commissioner of Taxation* [2013] FCA 363 (April 26, 2013) (RCF) that the limited partners of a Cayman Islands limited partnership (LP), not the LP itself, are the relevant taxpayers with respect to the gain the LP made on its disposal of an Australian investment.

Essentially, the RCF case confirms that it is possible to look through an LP to identify the relevant taxpayer for purposes of applying a tax treaty. Therefore, when U.S. investors invest into Australia through an LP, they might be able to apply the Australia-U.S. double tax treaty when determining whether the gain on disposal of the Australian investment by the LP should be subject to Australian tax.

Essentially, the case confirms that it is possible to look through an LP to identify the relevant taxpayer for purposes of applying a tax treaty.

In Detail

The Australian Federal Court on April 26 upheld RCF's appeal against the Commissioner who had disallowed RCF's objection to the assessment of income tax and penalties. The appeal to the Federal Court primarily concerned the Australian tax treatment of a capital gain made by a private equity fund (RCF) on the sale of shares in an Australian mining company.

The Facts

RCF was a Cayman Islands LP formed in the Cayman Islands with more than 97 percent of the LP's contributed capital held by U.S. residents, principally funds and institutions. For U.S. tax purposes, RCF was treated as a 'fiscally transparent' or 'flow through' entity not subject to U.S. tax.

During the 2008 tax year, RCF sold shares in St Barbara Mines Ltd (SBM).

The Commissioner assessed RCF (as a company) for the gain on the sale. The Commissioner reasoned that RCF was not an Australian resident, and that the capital gain was not exempt from the capital gains tax (CGT) under the non-resident CGT exemption because the market value of SBM's assets that relate to Australian land or interest in land exceed the market value of the company's other assets and RCF owned more than a 10 percent interest in SBM.

The Issues

The principle issues considered by the Federal Court were:

- Whether the Commissioner was prevented from issuing an assessment to RCF because of the Australia-U.S. tax treaty; and
- Whether the capital gain should be disregarded under the Australian domestic CGT exemption discussed above; this issue turned on various valuation methodologies regarding the Australian land assets.

The Decision

The Court allowed RCF's objection against the assessment on the basis that issuance of the assessment to RCF was precluded by the tax treaty. The Court reached this view based on general principles of interpretation of double tax treaties established in case law.

The Court noted that the purpose of the tax treaty is to avoid double taxation of income of U.S. and Australian residents and that this policy objective would not be achieved if Australia was authorized under Article 13 of the tax treaty (taxation of income or gains from the alienation of 'real property'), to tax the gain to RCF.

This was because the U.S. resident limited partners in RCF would be liable to U.S. tax without credit for the Australian tax assessed to RCF on the gain.

The Court said that by authorizing Australia to tax a gain in the hands of the US-resident limited partners in RCF, the tax treaty recognized Australia's taxing right while providing, in Article 22(1), a credit for any Australian tax suffered as a result if the exercise of that right. This therefore prevents double taxation of the gain.

The Australian Taxation Office (ATO) had previously released Taxation Determination TD 2011/25, which is consistent with the Court decision. The ATO believes the tax treaty applies to Australian-source business profits of a foreign LP when the limited partners are resident in a country with which Australia has a tax treaty (treaty country) and the LP is treated as fiscally transparent under the treaty country's tax laws.

In light of its conclusion that the tax treaty prevented the Commissioner from assessing RCF on the gain, the

(*Treatment of Limited Partnership* continued on page 5)

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Treatment of Limited Partnership *(from page 4)*

Court did not have to consider whether the Australian CGT exemption is available with respect to disposal of the SBM shares.

Although the judgment did confirm that it is possible to look through an LP, it did not provide any commentary on:

- Whether RCF held the investment in SBM on 'revenue' or 'capital' account; the judgment refers to all gains arising to RCF as capital gains. This may imply that the foreign private equity fund held its investment on capital account. This is inconsistent with the ATO's statement in Tax Determination TD 2010/21 that gain realized by a foreign private equity fund is generally on revenue account, but this issue does not appear to have been raised in the RCF case
- Whether the gain arising on the share disposal had an Australian source
- Whether RCF was required to file an Australian income tax return with respect to the gains attributable to the limited partners in countries that do not have a tax treaty with Australia.

Conclusion

The RCF case confirms that when U.S. investors invest into Australia through an LP, they might be able to apply the Australia-U.S. tax treaty when determining whether the gain on disposal of the Australian investments should be subject to tax in Australia. This requires the LP to be treated as a 'fiscally transparent' entity for U.S. tax purposes.

It is not known whether the Commissioner will appeal the Federal Court decision. We will continue to monitor developments in this case. ❑

CYPRUS

The Cypriot Crisis: What Does It Mean for Cypriot Corporate Structures?

Assessing the Next Steps

By Alexander Anichkin, Timur Aitkulov, Vladimir Barbolin, Nicholas Rees, Evgeny Soloviev, Julian Traill and Logan Wright (Clifford Chance)

The Immediate Impact?

The Cypriot crisis clearly threw a curve ball at businesses due to settle transactions in or through Cyprus in late March (including M&A deals settling through Cypriot escrow accounts and loans due for repayment by Cypriot borrowers or to Cypriot banks), leading to some hasty reviews of "business day" and "disruption event" definitions, and driving businesses to shift settlements to accounts outside Cyprus where possible.

The immediate impact of the crisis resolution plans seems to be limited to the continuing freeze of funds on Cypriot bank accounts and the significant "haircuts" imposed on Bank of Cyprus and Laiki Bank depositors with large account balances as at close of business on March 15, 2013. At this stage, no additional taxation or levies have been formally introduced (although the memorandum announced by the Cypriot government and the Troika on April 2 as a pre-condition to the €10 billion financing package calls for an increase in the corporate tax rate from 10 percent to 12.5 percent and in the tax rate on interest income from 15 percent to 30 percent), and the double tax treaties that Cyprus has with the Russian Federation, Ukraine and other countries remain intact.

Therefore, entities with Cypriot companies whose transactions are settled through accounts held with banks outside Cyprus (and do not hold significant deposits with a Cypriot bank) do not seem to be directly impacted by the measures introduced in Cyprus to date, but will need to consider the impact of proposed tax changes (and any further changes) on their business.

Entities with funds frozen in a Cypriot bank account (especially if they are affected by the "haircut") should consider the following:

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Next Steps *(from page 5)*

- The impact on contracts with third parties (e.g., do the recent developments constitute an event of default under their financings, or trigger *force majeure* or other "outs" under corporate and commercial contracts?).

Are further increases in tax rates and/or the imposition of additional restrictions inevitable?

- If monies are held in an escrow account with Bank of Cyprus or Laiki Bank, which party will bear the cost of the "haircut"?
- Are any remedies available against the Cypriot government or central bank to reclaim/release monies affected by the resolution plan or obtain compensation for consequential losses flowing from the measures that have been imposed?

Should a Company Stay or Should a Company Go . . .

The obvious questions to ask are:

- Will Cyprus be able to maintain its favorable tax regime for resident holding, financing, shipping and IP vehicles, or are further increases in tax rates and/or the imposition of additional restrictions inevitable?
- Is confidence in the future stability of the jurisdiction so compromised that entities should look to migrate their corporate structures away from Cyprus anyway?

Different entities will have their own points of view, but the following observations may help to inform the decision:

- There are various options for creating structures through jurisdictions offering comparable tax efficiency to Cyprus (for instance, the Netherlands and Luxembourg may be attractive alternatives within the European Union). However, there is no "one-size-fits-all" solution, and depending on the nature of a company's business, the location of its assets and its

(*Next Steps* continued on page 7)

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financing structures, other jurisdictions may well also be worth considering.

- Just as the decision to stay or leave Cyprus will be influenced by the macro-economic and political situation there, similar considerations, along with specific legal and tax analysis, should be taken into account with respect to any jurisdictions that an entity is considering migrating to. As events in Cyprus have shown, a company can no longer assume that today's business-friendly legal and tax regime will still be available tomorrow, and dramatic shifts can occur overnight if a country's economy collapses or the balance of political power changes.
- The process of migrating from Cyprus may not be straightforward, as explained below.

Corporate Migration

In principle, a corporate migration from Cyprus could be done in a number of ways:

- If a company is concerned only about changes in Cypriot tax laws, then it may be sufficient to relocate the place of effective management and control of its Cypriot vehicle to another jurisdiction, thereby making it a tax resident of that other jurisdiction (this has the advantage of ensuring legal continuity of the Cypriot vehicle).
- A company can look at re-domiciling the Cypriot vehicle to another jurisdiction (which also ensures legal continuity, while potentially giving a "clean break" from Cyprus). Legal advice will be needed in Cyprus and the proposed "recipient" jurisdiction to implement a re-domiciliation, but it is worth highlighting that:
  - the process itself can be quite lengthy (e.g., interim financial statements will need to be prepared, and notice of an intended re-domiciliation must be published in newspapers at least three months before the Cyprus Registrar of Companies will consent to a re-domiciliation);
  - co-operation is required from the Cypriot company's directors, who in many cases will be professional nominees (e.g., directors' solvency statements are required, which if improperly made could result in criminal liability). Will directors be willing to provide these statements in the current climate, particularly where the Cypriot company has actual or contingent liabilities (e.g., as a loan guarantor)?
  - re-domiciliation will not be possible while the Cypriot company has outstanding filing/other obligations under the Cyprus companies legislation (therefore, corporate housekeeping checks will be needed);
  - creditors may challenge a re-domiciliation proposal (and the Cypriot courts have powers to block or impose conditions on a re-domiciliation proposal).
- In certain cases, a company may be able to convert its Cypriot vehicle into a European Company (*Societas Europaea)*(which also ensures legal continuity).
- Alternatively, a company could look at various means of transferring the underlying business to an entity in another jurisdiction, including by:
  - a dividend *in specie* of the assets owned by its Cypriot vehicle;
  - liquidating its Cypriot vehicle and distributing its assets to its shareholder(s) in other jurisdictions;
  - for a Cypriot holding company, implementing a share-for-share exchange with a company in another jurisdiction that becomes the new ultimate holding company;
  - selling the assets of a Cypriot company to a new holding entity in another jurisdiction;
  - potentially, a court-approved scheme of arrangement or statutory merger.

There are various options for creating structures through jurisdictions offering comparable tax efficiency to Cyprus.

Other Considerations

Other issues a company should consider (and that may also impact on the method of corporate migration) include:

- Ensuring that the corporate migration is implemented in a way that does not jeopardize the Cypriot vehicle's prior treatment as a Cypriot tax resident.
- What needs to be done to qualify for tax residency rules in the proposed "incoming" or "recipient" jurisdiction? Is the company in a position to satisfy these requirements? Does that jurisdiction have more restrictive rules on dividends/recognition of profits that could impact on agreed distribution arrangements (e.g., in relation to preference shares or IRR calculations)?
- Restrictions under shareholders agreements may impact on the company's ability to implement its preferred migration structure (e.g., minority shareholders may have blocking rights).
- Future corporate governance of a JVCo—the laws of the "incoming" or "recipient" jurisdiction may not allow the same flexibility as Cyprus (which is a common law-based jurisdiction) in structuring JVs. This may require existing governance arrangements to be revisited.

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Next Steps *(from page 7)*

- Will existing shareholders agreements survive a corporate migration, or will replacement agreements be needed? If the latter, does this present negotiating leverage opportunities for any counterparties?
- Depending on the nature of the assets held by the Cypriot vehicle, a transfer of assets to another entity may trigger regulatory approval requirements (e.g., anti-trust clearances, central bank approvals, or approvals under the Russian Strategic Investments Law).
- Re-domiciliation or the transfer of shares/assets by a Cypriot holding company may require creditor consent, e.g., under loan or bond documentation. In deciding whether or not to give consent, creditors may look at the robustness and reliability of creditor protections (such as security mechanisms and enforcement regimes) under the laws of the new jurisdiction. Also relevant would be the statutory requirement to release any encumbrance of Cypriot shares prior to transferring them, and the potential creation of new hardening periods where security needs to be retaken.
- Ensuring that the corporate migration does not lead to negative regulatory or tax consequences as a result of the new jurisdiction being treated as an "offshore territory" by the Russian Central Bank and the Ministry of Finance.
- Ensuring an orderly handover of corporate registers/books and records from the Cypriot company's corporate administrators (where applicable), and retention/availability of books and records for future tax audit purposes.

The above list is non-exhaustive, but underscores that any decision to migrate from Cyprus raises a number of issues that will need to be carefully considered. ❑

INDIA

May 31 Deadline for Tax Opportunity Affecting Multinationals with India Operations

By Dharmesh Pandya (DLA Piper), Akil Hirani and Ravishankar Raghavan (Majmudar & Partners)

Multinationals with operations in India have only until May 31, 2013 to act before a newly proposed provision in India's new Finance Bill will affect their tax planning.

Private companies operating in India typically resort to a buyback of shares instead of payment of dividends to avoid dividend distribution tax, particularly where the capital gains arising to the shareholders are either not chargeable to tax or are taxable at a lower rate.

Under the proposal, which is likely to take effect from June 1, a private unlisted company would be taxed at the rate of 20 percent on the consideration paid by it as reduced by the amount it received at the time of issue of such shares.

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However, it is likely that the new Indian tax on the buyback of shares would not qualify for a direct foreign tax credit in the U.S., since it is a tax to be paid by the Indian company and not the recipient shareholder.

Implications for Foreign Investors

The proposed provision will also have a significant impact on foreign investors who have made investments from Mauritius, Singapore and Cyprus, where a buyback of shares would not have been taxable in India due to the availability of tax treaty benefits. Further, foreign investors may not be entitled to a foreign tax credit for such tax payments.

Conditions for Buyback

Under Indian company law provisions, a private company is permitted to buy back up to 25 percent of its total paid-up capital and free reserves, if it fulfills certain conditions. For instance, (a) the buyback does not exceed 25 percent of its total paid-up equity capital in that financial year; (b) the private company's articles of association authorize a buyback of its shares; (c) the buyback is approved by passing a special resolution (i.e., by a 75 percent majority of the shareholders present and voting) at a general meeting of the private company; and (d) the ratio of the debt owed by the private company does

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Tax on Buyback of Shares *(from page 8)*

not exceed twice its paid-up capital and free reserves after the buyback.

The consideration received by a shareholder on buyback of shares by a private company in India is taxable as capital gains in the hands of the shareholder. A private company having distributable reserves, generally speaking, has two options: (a) to distribute the surplus funds to its shareholders by way of dividends; or (b) to purchase its own shares at fair market value. In the first case, the dividend payout will incur dividend distribution tax at the rate of 16.22 percent and, generally, no tax credit is available for dividend distribution tax in the home country. In the second case, the income is taxed in the hands of the shareholder as capital gains, either at (a) 15 percent if the shares are held for short term (less than 12 months); or (b) 20 percent, if the shares are held for long term (more than 12 months), depending on the period of holding; or (c) 0 percent, if the shareholder is located in a tax-friendly intermediary jurisdiction fulfilling commercial substance requirements.

Private companies typically resort to buyback of shares instead of payment of dividends to avoid dividend distribution tax particularly where the capital gains arising to the shareholders are either not chargeable to tax or are taxable at a lower rate.

Multinationals with Indian operations should prepare for this change, which is very likely to become effective on June 1. If it makes business sense, multinationals should consider a buyback before May 31, 2013.

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South African Revenue Service Continues Increased Scrutiny of Permanent Establishment Exposure Risk

By Jacqui Peart (Ernst & Young, Johannesburg)

Due to the ever increasing infrastructure/power energy activity in South Africa in the past couple of years, the South African Revenue Service (SARS) has increased its scrutiny with respect to permanent establishment exposure risk for foreign companies doing business in South Africa. Accordingly, the SARS has been specifically focusing on foreign companies contracting with local entities (both private and government entities). This trend has also become increasingly evident in the South African mining sector in recent times. The trend of SARS queries to request information from South African tax resident entities as to their contractual arrangements with offshore entities for the provision of services/goods in South Africa, both in the infrastructure and the mining arena, has continued unabated. This is generally the first step in assisting SARS to assess the foreign entities' activities in South Africa from a permanent establishment perspective, among other things. This is clearly a "hot topic" within the SARS and companies are facing increasing queries.

In addition, the SARS is making further queries addressed to the respective foreign entities based on the information obtained from the initial queries.

Information Requests

The SARS has continued to request fairly specific information which includes, but is not limited to the following:

- A description of the primary business activities of the South African entity, as well as the foreign entity;
- Details of the contractual arrangement between the South African tax resident entity and the non resident entity/non resident individual to assist, advise, plan, supervise or consult on any of the South African entity's activities in South Africa;
- Details of any contractual arrangements between the South African tax resident entity and the offshore entity for the supply of goods and machinery;
- Specific details as to employees of the foreign entity spending time in South Africa relating to consulting services, technical services, installation or general assistance training;
- Details as to the contract fee;
- Details of the duration of the contract plus confirmation of any extension of scope or duration of the project; and
- Details as to whether the foreign entity has been registered for tax.

The SARS queries specifically state that the information is required for the purposes of determining whether a South African permanent establishment has been created by the foreign contractor utilized by the South African company during the period under review. It is important for companies to be aware of this trend and consider action to assess past exposures and identify where action may need to be taken to comply with existing South African tax requirements. ❑

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South Africa Issues Draft Rules on Excessive Debt; Comments Requested by May 24, 2013

By Justin Liebenberg and Ide Louw (Ernst & Young, South Africa)

South Africa's National Treasury released draft legislation for public comment on April 29, 2013 in which it proposes certain limitations to counter excessive debt deductions. Citing sources such as the OECD's paper on Base Erosion and Profit Shifting, the National Treasury identified four concerns including hybrid debt, connected party debt, transfer pricing, and acquisition debt.

Hybrid Debt

New legislation is proposed that will be designed to combat the use of hybrid debt instruments, effective January 1, 2014. The broader set of hybrid rules applies two-fold. First, the debt instrument will be reclassified as equity in its entirety. Instruments falling under this regime are the typical open-ended shareholder loans that do not have a maturity date or maturity date of more than 30 years, the issuer may discharge its obligation by issuing shares (capitalizing the loan claim), or the obligation to settle the loan claim is dependent on the solvency of the company. Second, the yield is reclassified as a dividend. Instruments falling under this regime include profit participation loans (i.e., the yield is not determined with reference to the time value of money or a specified rate of interest) or the obligation to settle the interest claim is dependent on the solvency of the company. Any amount of tainted interest is deemed a dividend in relation to the issuer and the holder.

Hybrid debt instrument will be reclassified as equity.

Certain exemptions are also proposed for short and long-term insurers, and regulated bank capital.

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Connected Party Debt

Excessive debt remains a concern where the creditor falls outside the South African tax net. It is proposed that where a company pays interest to another entity within the same IFRS (International Financial Reporting Standards) group and the interest is untaxed or taxed at a lower rate when received or accrued by the other entity, the interest will be subject to the following interest limitation: 40 percent of the debtor's taxable income (ignoring interest incurred or accrued) plus interest accrued less interest incurred in respect of debt falling outside the limitation. Interest deductions on excess debt will be denied and rolled forward for five years.

Transfer Pricing

It is interesting to note in the proposals that the connected party debt and transfer pricing rules are split, and more guidance is sought in this regard. A potential safe harbor is proposed in terms of which interest on the connected person debt may not exceed 30 percent of taxable income with no adjustment for other interest received, accrued, interest paid or incurred, and interest on the debt may not exceed the foreign equivalent of the South African prime rate if denominated in foreign currency, or the South African prime rate if denominated in Rand.

Acquisition debt

The acquisition debt rules will follow similar principles as the connected party debt rules. If, for instance, a debt pushdown transaction is used, the following interest limitation applies: 40 percent of the debtor's taxable income (ignoring interest incurred or accrued) plus interest accrued less interest incurred. The five-year roll forward continues to apply. The interest limitation taking into account a share acquisition will also follow the 40 percent rule, and will be further adjusted in accordance with the percentage stake being acquired if the purchaser is not acquiring all the shares of Target Company. If the acquisition debt was funded or secured by another entity within the same IFRS group and the interest thereon is untaxed when received or accrued by that other entity, the limitation will be the lesser of (i) 40 percent of the target company's taxable income or, (ii) 40 percent of the acquirer's taxable income. ❑

The UK Patent Box—Tax Benefits for Both UK and Non-UK Companies

By David Wraige and Anne Campbell (Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C.)

As of April 1, companies paying UK corporation tax can take advantage of a new tax regime, dubbed the "Patent Box," to reduce their tax burden. This article explains why the regime has been adopted and how companies (both UK and non-UK) can benefit.

Purpose of Regime

Although the UK is expected to narrowly avoid a triple-dip recession, its economic woes are still ongoing, which is widely recognized to be due in part to an over-reliance on service industries. The UK government recognizes the need for a healthier split between manufacturing and services industries, and the Patent Box is the latest initiative to help in this regard by fostering UK-based innovation and development.

Effect of Regime

The scheme will give companies corporation tax relief on profits generated from UK-based innovation. Specifically, profits earned from patented products developed in the UK will be subject to taxation in FY13/14 at an effective rate of 15.2 percent rather than the usual 23 percent. The full benefit will be phased in on a sliding scale such that from FY17/18 onwards the rate will be 10 percent.

This all sounds simple, but the implications are far-reaching. A patent covers an invention, which will typically only be an aspect of a product, *but the tax relief is applicable to the profits on the whole product.* For example, relief might be given for profits on a car even if only the gearbox is patented. *Furthermore, the tax relief is extended to profits earned worldwide despite the fact that the product might be patented only in the UK.*

The patent can have been granted either directly via filing at the UK Intellectual Property Office, or via the European Patent Office or PCT routes. Non-UK businesses should note that the patent does not have to be first-filed in the UK. Supplementary Protection Certificates and plant variety rights can also be used to claim the tax relief.

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Importantly, the Patent Box tax relief will apply to profits gained up to six years prior to grant. This means that you will be able to obtain tax relief for pre-grant sales, which will be particularly useful for companies operating in fast-moving markets where a technology could be obsolete shortly after or even before a patent is granted. The tax relief could still cover the cost of obtaining a UK patent despite the short lifespan. There are possibilities for accelerating the grant of a UK patent, which will enable tax relief to be obtained more quickly.

As mentioned above, "IP Income" on which the Patent Box tax relief is available includes proceeds of sales of a patented product. However, it also includes license fees received on a patented product or process.

While the patent coverage may be narrowly defined, the tax relief applies to the profits of the entire product.

It further includes damages for infringement of the patent awarded by a UK court. Other income such as insurance, compensation or damages in respect of non-UK infringement can also count. It is also possible to obtain relief for products that are not covered by a patent if they are made using a patented process, for which a notional royalty will be used to calculate the level of relief.

Strategic Considerations

We see the Patent Box as very significant because it introduces new ways in which value can be gained through patents. Traditionally, patents are crafted to make it impossible for competitors to design around, thereby excluding them from an entire marketplace. This monopoly generates revenue for the patent owner directly.

However, using the Patent Box a patent can have value even if it doesn't entirely eliminate the competition or you don't wish to use it for this purpose. Provided it covers a product developed in the UK, Patent Box tax relief will apply. As long as the reduced exposure to corporation tax covers the cost of obtaining the patent (typically £750 to £1000 a year amortized over its 20 year life), then it will have paid for itself. This is compounded by the fact that it may well cost less to obtain a narrower patent for this purpose because it will be quicker for your patent attorney to draft. This could mean that in the case of technology for which it might only be possible to obtain a narrow patent, and particularly if the cost of filing and prosecuting an

(*Patent Box Benefits*, continued on page 12)

Patent Box Benefits *(from page 11)*

application via the EPO seems not to be justified, it may nonetheless be worth filing in the UK.

The Patent Box may well bring about a change in the way companies think about patents: businesses will need to have compelling reasons not to obtain a patent.

Since tax relief is available for profits earned on sales of a whole product incorporating a patented invention, another consideration is how to direct the claims of your patent application. For example, if you have invented a new and improved fuel injector, it may be worth ensuring that as well as having a claim directed to the fuel injector, you also have a claim directed to an engine and a vehicle containing the fuel injector. That way, you could benefit if you are also selling engines or vehicles but equally, if you want to license your patent to engine or vehicle manufacturers an incentive on their part to take a license would be the possibility of obtaining Patent Box relief on the engines or vehicles they manufacture that use your fuel injector.

The tax relief is extended to profits earned worldwide despite the fact that the product might be patented only in the UK.

Who Can Claim the Benefit?

The Patent Box can be used by either the owner of the patent or the holder of an exclusive license under the patent, provided, of course, that it pays UK corporation tax. The patent owner or the licensee must satisfy the "Development Condition" which means that the claimant will need to have made a significant contribution to the creation of the patented invention or have performed a significant amount of activity to develop it. It's too early to know how this will operate in practice, but in theory, a non-UK-based owner of a UK subsidiary that pays corporation tax could be an ultimate beneficiary. For example, if the UK subsidiary has designed or developed a patented product, or even just carried out work to adapt a product for the European market, the UK subsidiary should be able to claim the relief.

Licenses

In view of the fact that the Patent Box regime does not apply to non-exclusive licenses, licensees should generally negotiate for an exclusive license. Under the Patent Box, an exclusive license will be far more valuable to potential licensees, and this should be reflected in the royalty. Patent Box tax relief can also be claimed for non-patent IP relating to an item covered by the licensed patent, and this non-patent IP (such as trademarks and registered designs) need not be exclusively licensed. Businesses should therefore consider applying for a broad spectrum of IP rights to maximize the benefits available under the Patent Box.

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Global Netting *(from page 2)*

National Mortgage Ass'n v. United States, 379 F.3d 1303 (Fed. Cir. 2004).

The question of when consolidated groups of corporations are the "same taxpayer" also presents thorny issues, particularly where one group joins another pre-existing group or the common parent of the group changes. There has never been clear guidance on this issue and the Service's administrative practice has changed over time. The Court of Federal Claims, in *Magma Power v. United States*, allowed the taxpayer to claim the benefit from netting its underpayment against its "share" of a consolidated group's overpayment for a later taxable year.[3]

The reported decision on the legal issue came out at the end of 2011, but the parties continued to wrangle over allocation issues, so a final order in the case did not issue until September 2012. In December, the government withdrew its notice of appeal, apparently in the context of a settlement. It is not clear whether and how the IRS will change its administrative practices in light of the case.

The *Magma* court's focus on the individual members of the group in deciding the "same taxpayer" issue could pose significant practical hurdles in applying netting to consolidated groups. On the other hand, the decision potentially allows taxpayers at least some benefit in situations where the Service has not previously allowed netting.

Exxon-Mobil and the Transition Rule

As explained above, Congress provided that the interest netting requirement not only would operate prospectively, but also would apply to prior periods under certain circumstances. The transition rule ("special rule") reads as follows:

Special Rule. Subject to any applicable statute of limitation not having expired with regard to either a tax

(*Global Netting*, continued on page 13)

Global Netting *(from page 12)*

underpayment or a tax overpayment, the amendments made by this section shall apply to interest for periods beginning before the date of the enactment of this Act [July 22, 1998] if the taxpayer:

(A) reasonably identifies and establishes periods of such tax overpayments and underpayments for which the zero rate applies; and

(B) not later than December 31, 1999, requests the Secretary of the Treasury to apply section 6621(d) of the Internal Revenue Code of 1986 . . . to such periods.

Revenue Procedure 99-43

In 1999 the Service issued guidance regarding the application of Section 6621(d) and the Special Rule to interest accruing before October 1, 1998. Revenue Procedure 99-43 interprets the introductory language of the special rule to require that "both periods of limitation applicable to the tax underpayment and to the tax overpayment . . . must have been open on July 22, 1998" in order to obtain retrospective interest netting. On the other hand, the revenue procedure also waives the December 31, 1999 notification requirement if one of the applicable statutes of limitations expires after December 31, 1999. In many cases, there was no way to predict what underpayments and overpayments might later be determined for past years, and the IRS did not want to be submerged in protective filings in cases where final tax liabilities might not be determined for years.

Federal National Mortgage Association v. United States

The U.S. Court of Appeals for the Federal Circuit, in *Federal National Mortgage Association v. United States*, 379 F.3d 1303 (Fed. Cir. 2004), was the first federal circuit court to address the interpretation of the transition rule. Federal National Mortgage Association (FNMA) filed a netting claim with the Service under the transition rule in December 1999, which was rejected to the extent that it implicated underpayments for years for which the statute of limitations had run before July 22, 1998. Reversing the Court of Federal Claims—which had held in FNMA's favor—the Federal Circuit ruled that the transition rule was a waiver of sovereign immunity against suit and had to be strictly construed in favor of the government, and upheld the Service in requiring that both statutes of limitation have been open upon enactment.

Exxon Mobil Corp. v. Commissioner

Exxon Mobil's dispute related to overlapping income tax underpayment and overpayment balances for its 1975 through 1980 tax years. Again, the statute of limitations for some of the underpayments—but not the overpayments—had expired before July 22, 1998. At the conclusion of the Tax Court litigation, Exxon-Mobil applied for netting relief in computations. In February 2011, the Tax Court held for Exxon-Mobil, expressly rejecting the Federal Circuit's reasoning in *Federal National Mortgage Association v. United States*. The Tax Court concluded that the critical language was ambiguous and that "section 6621(d), as modified by the special rule, is a remedial statute that must be interpreted to achieve the remedial purpose Congress intended; i.e., taxpayer relief from disparate interest rates."

The Second Circuit affirmed the Tax Court's decision. Rejecting the Federal Circuit's conclusion that the transition rule operated as a waiver of sovereign immunity, the court considered the Special Rule's structure, history, and purpose, noting that since the zero net rate can be achieved by adjusting the rate on either the overpayment or underpayment "leg" of the transaction it would be anomalous to require that the statute of limitations for both legs be open. In addition, like the Federal Circuit, the Second Circuit held that the interpretation of the transition rule in Rev. Proc. 99-43 was not entitled to administrative deference because it was not promulgated pursuant to an explicit or implicit Congressional delegation of law-making authority and the revenue procedure did not set forth any reasoning in support of its conclusion regarding the language of the Special Rule.

Magma Power may point the way to obtaining substantial netting relief for overlapping consolidated groups.

Comments

The Second Circuit noted that because of the Special Rule's requirement that request for interest netting be made prior to December 31, 1999, the court's opinion was unlikely to affect many taxpayers. The court does not appear to have considered that Revenue Procedure 99-43 generally waived the December 31, 1999 deadline when the statute of limitations remained open after that date, so that it is possible that later claims might be affected. On the other hand, considering the court's strong dismissal of the relevance of Rev. Proc. 99-43 in interpreting the Special Rule, a taxpayer may not be able to rely on the same procedure's waiver of a statutory deadline for filing a netting claim.

Magma Power and Netting Among Consolidated Groups

Administrative Practice

The IRS has generally treated a corporate consolidated group as the "same taxpayer" so long as the same entity remains as common parent. However, thorny questions arise in cases where the netting occurs between the consolidated group and one of its members or between a

(*Global Netting*, continued on page 14)

Global Netting *(from page 13)*

consolidated group and as successor consolidated group with a different common parent. Such situations fall into two general classes, illustrated by the examples below (in each case, Group A is a consolidated group some of the members of which later continue into Group B).

In the first pattern, Group A is entitled to an overpayment for a pre-combination year and Group B is liable for an underpayment for a post-combination year. Group A's common parent receives the refund, to which individual group members' rights will generally be proportionate to their contribution to the overpayment. Those members of Group A that later become members of Group B will be jointly and severally liable for the underpayment.

The second fact pattern involves the reverse situation: Group A is liable for an underpayment for a pre-combination year and Group B is entitled to an overpayment for a post-combination year. All members of Group A will be jointly and severally liable for the underpayment; those that survive as members of Group B may be entitled to a portion of the refund depending on their contribution.

Taxpayers are well-advised to take a second look at their IRS account transcripts in search of previously overlooked claims.

For some time, the IRS' administrative practice was to allow "forward cross-netting" in the first fact pattern, but deny "reverse cross-netting" in the second fact pattern. The reasoning appeared to be that in the first situation, the Group A members collectively entitled to the refund were jointly and severally liable for Group B's entire underpayment, while in the second situation, the group A members liable for the underpayment would probably not be entitled to the whole of Group B's overpayment (and might not be entitled to any of it). The IRS seems to have changed its practice around 2009, and it is now not clear whether or when it will allow netting between two consolidated groups with different common parents.

Energy East and *Magma Power*

Energy East Corp. v. United States upheld the Service's consistent position that two consolidated groups whose memberships did not overlap when the over- and underpayments arose were not the "same taxpayer" even though they later combined into a single group.[4] The fact pattern in *Energy East* did not correspond to either example above: the question was whether group A's pre-combination underpayment and group B's pre-combination overpayment could be netted because they later combined into group C.

When the IRS sought to extend *Energy East* to consolidated groups with overlapping membership in Magma Power, however, it ran into a roadblock. Magma Power (Magma), which had joined the CalEnergy consolidated group in 1995, paid a substantial deficiency, with interest, for its taxable year 1993. The CalEnergy group had overpayments for its taxable years 1995 through 1998, "a substantial part" of which were attributable to Magma. Magma filed a refund claim for 1993 claiming a reduced interest rate based on global netting with the consolidated overpayments. The IRS denied the claim on the grounds that Magma and the CalEnergy consolidated group were not the "same taxpayer."

The court decided the "same taxpayer" issue in favor of the taxpayer on cross-motions for summary judgment. The court concluded that the "taxpayers" were the component group members rather than the group as a whole: "Following the government's reasoning to its natural conclusion, the members of a consolidated group have lost their separate identity. . . . However. . . [t]he group itself is not a "taxpayer" under the Code nor does it have a separate EIN for tax purposes. For purposes of our plain meaning analysis, we are concerned only with the individual member of that group as identified by its EIN, which is responsible for equivalent amounts of underpayments and overpayments in separate tax years."

Potential Implications

Magma Power may point the way to obtaining substantial netting relief for overlapping consolidated groups in both the fact patterns described above (including the second fact pattern under which netting was generally not allowable even under the Service's pre-2009 practice). Taxpayers may be able to obtain at least partial netting relief to the extent that they can attribute an overpayment to individual group members liable for the underpayment. Taxpayers in this situation would be well-advised to take a second look at their IRS account transcripts in search of previously overlooked claims that may be filed before the pertinent statute of limitations expire. On the other hand, the decision raises some basic questions about how consolidated groups should be treated in netting computations that remain unresolved, especially where members join and leave an existing group. Depending on future legal developments and whether and how the Service changes its administrative procedures, some consolidated taxpayers may lose some of their expected netting benefit. ❑

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[1] Conf. Rep. No. 841, 99th Cong., 2d Sess. (1986).
[2] *Exxon-Mobil Corp. v. Commissioner*, 689 F.3d 1 (2d Cir. 2012), aff'g 136 T.C. 99 (2011).
[3] *Magma Power v. United States*, 101 Fed. Cl. 562 (2011).
[4] *Energy East Corp. v. United States*, 92 Fed. Cl. 29 (2010), aff'd, 645 F.3d 1358 (Fed Cir. 2011).

Foreign Currency Hedges *(from page 3)*

of services in the future, or to receive nonfunctional currency (or an amount determined with reference thereto) in the future with respect to the sale of property used or held for sale in the ordinary course of the taxpayer's trade or business, or the performance of services in the future. The purchase/sale of stock and securities for investment purposes generally is not considered a trade or business. However, the regulations specifically indicate that a contract to buy or sell stock shall be considered an executory contract.[4] Thus, a private equity fund may well integrate its stock purchase/sale transactions, even though its activities typically would not rise to the level of a trade or business.

For purposes of these rules, the accrual date is the date that the income, expense or capital expenditure would be accrued under the taxpayer's method of accounting. The functional currency of a business unit generally is the currency in which a significant part of such unit's activities are conducted, and which is used by the unit in keeping its books and records. Any other currency would be considered a nonfunctional currency. In our example, XYZ keeps its books in U.S. dollars, and a significant part of its activities are conducted in U.S. dollars. Thus, the U.S. dollar would be XYZ's functional currency, and the euro (i.e., the currency with which stock of ABC, Inc. was acquired) was a nonfunctional currency.

Hedge—The term hedge means a deposit of nonfunctional currency in a hedging account, a forward or futures contract, or a combination thereof, which reduces the risk of exchange rate fluctuations by reference to the taxpayer's functional currency with respect to nonfunctional currency payments made or received under the executory contract. Returning to our example, the forward contract to purchase euros (i.e., the currency of payment under the stock purchase agreement) reduces the risk of exchange fluctuations by reference to XYZ's functional currency (i.e., the U.S. dollar). An option to purchase a nonfunctional currency also may qualify as a hedge if the expiration date is no later than the accrual date. (In this case, the premium paid for the option also would be integrated with the executory contract.) Additionally, a series of hedges may qualify as a hedge.

Additional Requirements—An executory contract that is the subject of a hedge will be considered to be a hedged executory contract only if the following additional requirements are satisfied:

1. *Identification*. The executory contract and the hedge must be identified as a hedged executory contract. Although no special form is required for this, a record must be made before the close of the date the hedge is entered into, must record a clear description of the executory contract and the hedge, and indicate that the transaction is being identified in accordance with Treasury Regulation Section 1.988-5(b)(3).

2. *Timing*. The hedge must be entered into on or after the date the executory contract is entered into and before the accrual date.

3. *Permanent hedge*. The executory contract must be hedged in whole or part throughout the period beginning with the date the hedge is identified and ending on or after the accrual date.

4. *No related parties*. None of the parties to the hedge may be related. Existing rules in the Code determine the relationships, and include entity relationships.

5. *Proper reflection*. If the business unit resides outside the United States, both the executory contract and the hedge must be properly reflected on the books of the same business unit.

6. *Identity of parties*. Both the executory contract and sale hedge are entered into by the same individual, partnership, trust, estate or corporation. It is not sufficient that the parties to the respective agreements are related—they must be identical.

Certain Practical Issues

The various definitions and special rules raise certain practical issues that must be taken into account in order to ensure that a hedge will be considered part of a hedge executory contract, and, thus, will not generate foreign currency exchange gain or loss. Below are some of the issues, as well as some practical tips as to how to deal with these issues.

One cannot rush into the hedge and assume that the tax department can make things work from a tax standpoint after the fact.

Same-Day Identification—One of the requirements is that the hedge and the executory contract be identified as part of the hedged executory contract on the date of the hedge. In our experience, different personnel are responsible for executing hedges from those responsible for the tax function. As the identification must be made so quickly, it is very easy for this requirement to be missed. In order to avoid this, we attempt to include the identification in a long-form confirmation of the hedge, as well as the executory contract itself. It is important that the confirmation be issued the same day.

The Holding Structure Has To Be Funded in Advance—Many private equity transactions include complex holding company structures. It may not be practical to convert dollars to euros and flow the cash down a chain of holding

(*Foreign Currency Hedges*, continued on page 16)

Foreign Currency Hedges *(from page 15)*

companies on a single day in time for closing. However, once the executory contract is hedged, it must remain hedged continuously until the accrual date. This issue may be dealt with by having the nonfunctional currency deposited into a separate account that itself is identified as part of the hedged executory contract.

The Acquisition Vehicle May Not Be Able to Hedge—As mentioned above, many private equity transactions include holding company structures. It may appear that the best entity to enter into the hedge would be the company acquiring the stock of the target company. However, a hedge at that level may trigger taxable foreign currency gain or loss in that country. Moreover, as the functional currency of the acquisition vehicle may well be the currency in which payments are to be made under the stock purchase agreement, integration may not be available (which could generate earnings and profits that would support a dividend in the case of a subsequent distribution, or trigger gain if the holding company is a pass-through entity for U.S. tax purposes). To deal with these issues, a fund may enter into an agreement to purchase stock of the acquisition vehicle, and hedge this obligation, identifying such agreement and hedge as parts of the hedged executory contract.

Conclusion

Foreign currency hedging may make business sense for investment funds that invest globally. To avoid the recognition of foreign currency gain for U.S. income tax purposes, it often is useful to integrate these hedges with the stock purchase agreement to which the hedge relates. As identification of the hedge as part of a hedged executory contract must be done on the same day the hedge is entered into, and because there are various practical issues present in the typical investment structure, it is important to think about the hedging process well in advance of the time of the hedge. Notably, one cannot rush into the hedge and assume that the tax department can make things work from a tax standpoint after the fact. ❑

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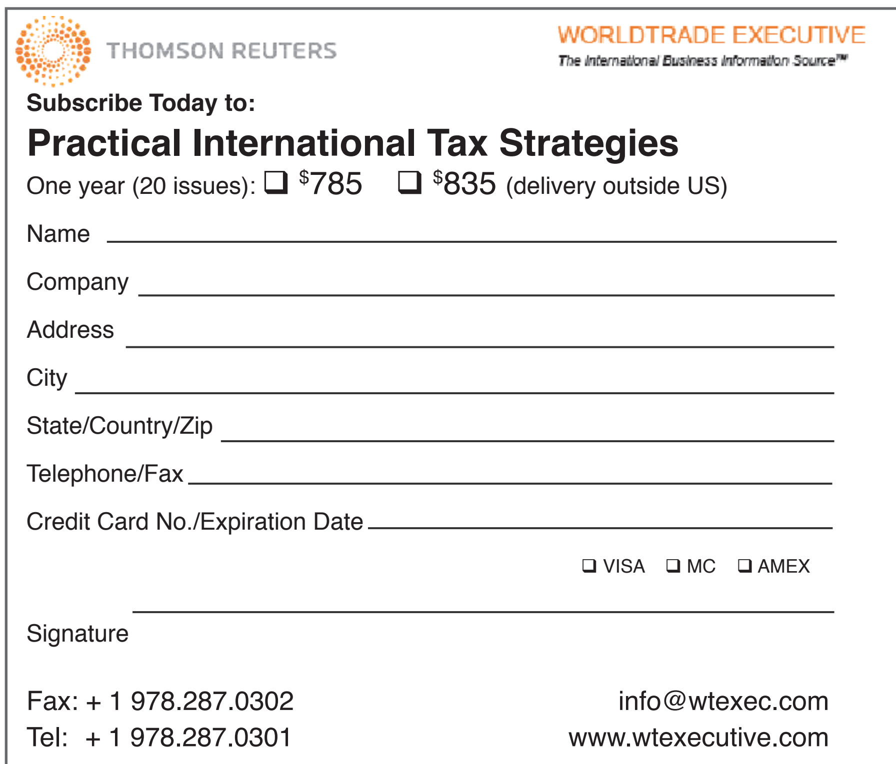
[1] Corporations making strategic stock purchases or sales also may have the same interests in hedging, and integrating their hedges. The focus of this article, however, is on investment funds that invest globally.

[2] The discussion herein is equally relevant to funds based outside the United States. Investment funds typically are formed as partnerships. The income, gain, loss and expenses of partnerships flows through to investors. Accordingly, U.S. investors in foreign funds would be taxed on FX gain, and be entitled to a deduction for FX loss. We regularly advise non-U.S. investment funds regarding the integration of currency hedges to avoid adverse consequences to the U.S. investors.

[3] Unless otherwise stated, all references to a "Section" are to the Internal Revenue Code of 1986, and all references to a "Regulation" are to the Treasury Regulations promulgated thereunder.

[4] Interestingly, the Regulation does not refer to an agreement to purchase an interest in a partnership or limited liability company. Consider whether the general rule that a partnership is treated as the aggregate of its partners would apply in this case such that a contract to purchase/sell an interest in a partnership or limited liability company taxed as a partnership would be treated as a contract to purchase/sell the underlying assets. Unfortunately, there is no direct authority on this question.

[5] That is, the same part of the executory contract that was originally hedged.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