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International Bank Tax Newsletter
*Volume 1, May 2013*

# Summary Accounting for Income Taxes Under the Notice of Proposed Rulemaking on the Implementation of Basel III Capital Standards in the United States

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This detailed summary is intended to provide an introduction to the issues on accounting for income taxes under the Notice of Proposed Rulemaking issued jointly by the Federal Reserve, the Comptroller of the Currency, and the FDIC in June 2012[1] regarding the implementation of the Basel III standards on capital in the United States. While home country regulators will set the standards for the implementation of Basel III rules in the different jurisdictions, there should be symmetry among the United States and other country regulators in implementing Basel III standards. The rules are still in development, and there are many unanswered questions raised about how the proposed provisions are intended to apply.

We anticipate that the U.S. banking authorities will clarify uncertainties either when they issue final regulations in this area, in instructions for completing various forms dealing with the computation of regulatory capital, or in administrative practices in the field.

### Acronyms used in this summary

The following acronyms and defined terms are used in this article:

**DTA** – Deferred Tax Asset

**DTL** – Deferred Tax Liability

**MSA** – Mortgage Servicing Asset

**AOCI** – Accumulated Other Comprehensive Income

**CET1** – Common Equity Tier 1 Capital

**T1** – Tier 1 Capital



[1] On June 7, 2012 the Board of Governors of the Federal Reserve System approved for publication three notices of proposed rulemaking with respect to implementing Basel III guidelines regarding the risk-based capital rules for Banks. The notices were intended to be joint rulemakings of the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC and the Office of the Comptroller of the Currency (OCC), and after approval by the OCC and FDIC, were published in the Federal Register on August 30, 2012. See 77 Fed. Reg. 52792 (Aug. 30, 2012).

Significant Investments – Significant Investments in the capital of unconsolidated subsidiaries, i.e., where the bank owns more than 10 percent of the issued and outstanding common shares of the unconsolidated financial institution.

**Specified Items** – DTAs, MSAs, and Significant Investments

**Current Rules** – The rules currently in place for banks regulated by the Federal Reserve, OCC, and FDIC with respect to deferred taxes and risk-adjusted capital.

**Instructions** – Instructions for Preparation of Consolidated Financial Statements for Bank Holding Companies, Reporting Form FR Y-9C, Line Item Instructions for Regulatory Capital, and Schedule HC-R.

**Basel III** – The guidelines issued by the Basel Committee on Banking Supervision, "Basel III: A global regulatory framework for more resilient banks and banking systems," December 2010.

**NPR** – Notice of Proposed Rulemaking. Cites to the preamble cite the pagination of the release by the Federal Reserve on June 7, 2012.

### General Background

In the predecessor Basel accords, Basel I and Basel II, there were no specific rules that dealt with tax assets. Instead, the determination of whether tax assets should be counted as good assets was left largely to local and international financial accounting rules. The first U.S. focus on tax assets as a component of capital came in the mid-1990s, shortly after FAS 109 was adopted.

### Review of Basel III Provisions

The Basel Committee viewed DTAs as being somewhat speculative assets in that when a bank experiences financial difficulties and they most need high-quality assets, the DTAs may need to be written off because there may be substantial doubt about the bank's ability to realize them against future income. For this reason, the Basel III provisions are designed to preserve DTAs only in circumstances where they likely will result in a cash tax recovery. More particularly, DTAs arising from loss and tax credit carryforwards that rely on the future profitability of the bank are to be written off.

**Disallowed DTA calculation steps** – Each participating country needs to adopt rules under national law to implement the Basel III tax provisions. However, the essential rules can be reduced to three steps:

**Step 1** Net DTLs against DTAs to the extent levied by the same taxing authority. DTLs are to be allocated for netting purposes pro rata against DTAs arising from NOL and tax credits carryforwards and DTAs arising from temporary differences. Basel III, paragraph 69.

**Step 2** Subtract the net DTAs relating to NOL and tax credit carryforwards from CET1. Basel III, paragraph 69.

**Step 3** Subject the net DTAs relating to temporary differences to Threshold Deduction calculations. These calculations cover three Specified Items: MSAs, Significant Investments, and DTAs. Each of the items judged separately cannot exceed 10 percent of adjusted CET1. Further, these items cannot exceed 15 percent of adjusted CET1 judged collectively. Basel III, paragraphs 86–89.

**Transition period** – A five-year transition period beginning in 2013 and running through 2017 is provided in the rules. Basel III, paragraph 94, and Annex 4. Although not entirely clear, the adjustments to capital involving DTAs appear to begin in 2014 and are to become effective in 20 percent annual increments over the transition period. There is some confusion on the starting date for the transition since paragraph 88 states that the provisions begin to become effective in 2013, while Annex 4 shows them becoming effective beginning in 2014.

The transition rules need clarification by each national regulator with respect to how they interact, if at all, with the current rules in effect in each country during the transition period. They also need clarification on the year in which the transition begins for the different rules.

**Adjustments to capital for Threshold Deduction calculations.** The 10 percent cap on each Specified Item is calculated after taking into account all of the regulatory adjustments to CET1 except for those pertaining to the Specified Items. The same rule applies for the 15 percent cap during the transition period. However, after the transition period, the 15 percent cap is calculated after taking into account all of the regulatory adjustments to CET1 including the reductions for the Specified Items. Mathematically, this amounts to multiplying the amount of CET1 after all deductions including the deduction for the Specified items by 17.65 percent. Basel III, Annex 2.

### Review of Tax Provisions in NPR

**Overview** – The tax provisions in the NPR are similar to those in Basel III. They start with the basic premise of Basel III that DTAs dependent on a bank's future earnings generally should be written off against the bank's CET1. The NPR provisions add interpretive detail to the Basel III provisions, but they leave a number of open and a number of interpretive questions. We explore some of the open questions in the material that follows.

**Summary of the tax provisions in the NPR** – The basic elements of the tax provisions can be summarized in the following steps.

**Step 1** DTLs and DTAs are to be analyzed to determine the jurisdiction to which they relate and whether when realized the tax law would permit the resulting taxable amounts to be offset (for example, a DTA arising from a capital loss may only be used to offset a DTL arising from a capital gain). NPR, Section 22(d)(1).

**Step 2** Determine the amount of taxes previously paid that can be recovered through a loss carryback. NPR, Section 22(d)(2) & (3).[2]

[2] The interaction between step 2 and step 3 raises some questions as discussed below. The order of the steps in the text appears to follow from the literal language of the NPR in Section 22(e)(3)(ii).

**Step 3** Once the analysis in Step 2 is complete, DTLs are to be setoff on a prorata basis against DTAs arising from NOL and tax credit carryforwards, and DTAs arising from temporary differences on a pro rata basis taking into account the analysis in Step 1 and 2.

**Step 4** The net balance of DTAs arising from NOL and tax credit carryfowards, if any, still existing after Steps 2 and 3 must be written off. NPR, Section 22(a)(3).

**Step 5** The net balance of DTAs arising from temporary differences, if any, are subject to the Threshold Deduction Calculations. Any balance that exceeds the limits determined in these calculations must be written off. NPR, Section 22(d).

**Application of U.S. GAAP (or IFRS, where applicable) and the Current Rules –** Historically, the starting point for all of the provisions dealing with regulatory capital has been the audited financial statements of a bank under GAAP. Form FR Y-9C, General Instructions, Section A, Applicability of GAAP, Consolidation Rules and SEC Consistency. For U.S. banks, the starting point is U.S. GAAP. In a similar vein, foreign banks complying with the Basel III rules applicable in their respective countries will be expected to follow IFRS or whatever their local country's financial reporting rules are as the starting point in their analysis.

**Netting of DTLs against DTAs and Associated Assets –** The basic provisions in the NPR replicate almost verbatim the provisions in Basel III. They provide:

- To be netted against a DTA, DTLs must "relate to taxes levied by the same taxation authority and …[be] eligible for offsetting by that authority …"
- Where a bank has DTAs arising both from NOL and tax credit carryforwards and from temporary differences, any DTLs apart from those already netted against related assets are to be allocated between the two different sets of DTAs "in proportion to the amount of DTAs."
- With respect to the potential alternative of netting DTLs against assets to which they relate, DTLs are permitted to be netted against such assets provided they "are associated with the asset [and] would be extinguished if the associated asset becomes impaired or is derecognized under U.S. GAAP." Moreover, a DTL can only be netted against a single asset (i.e., not netted against assets to which they relate and against DTAs). This is discussed below.
- See NPR, Section 22(e); Preamble pp. 77 for each of the above propositions.

**Election to net DTLs against DTAs or to associate them with assets subject to deduction or adjustment –** There is some ambiguity as to whether banks can *elect* to net DTLs against their DTAs (both those arising from temporary differences and those relating to operating loss and tax credit carryforwards) or, *alternatively*, to net them against associated assets subject to deduction or adjustment under the NPR.

Under Section 22(a) many assets, such as goodwill, are to be deducted from regulatory capital net of an associated DTL in accordance with the terms in Section 22(e). However, this cross-reference to Section 22(e) is ambiguous because Section 22(e) states that netting is "permitted" rather than "required" or "mandated." A strong argument can be made that banks should be able to elect to net DTLs against the assets to which they relate or, alternatively, as part of a separate analysis of their DTAs. The Preamble states that the netting of DTLs against assets subject to deduction under the NPR is "generally consistent with the approach that the agencies currently take with respect to the netting of DTLs against goodwill." Preamble p. 77. Under the Current Rules, a bank can choose to net DTLs associated with goodwill against the goodwill or to treat them as part of its analysis of its overall DTA position. If an election is permitted to treat DTLs associated with an asset subject to deduction under Section 22(a) separate from the asset, most banks will choose a course that results in the greatest netting of their DTLs against the assets subject to deduction from capital or against DTAs arising from NOL and tax credit carryforwards since both are fully deducted from capital, and this alternative will maximize their regulatory capital. By comparison, netting DTLs against DTAs arising from temporary differences may provide a bank little capital relief because these DTAs may not have to be written off even when considered on a gross basis.

**Netting of *DTAs* against associated assets and liabilities subject to adjustment or deduction from capital –** The NPR is focused on limiting the benefit to be given to certain assets in a bank's regulatory capital. In calculating the various limits, it provides for the netting of DTLs against associated assets and for netting them against DTAs arising from operating loss and tax credit carryforwards and temporary differences in accordance with Section 22(e). Section 22(e) is silent on whether *DTAs* arising from temporary differences can be treated in a fashion similar to the treatment of DTLs. A reasonable argument can be made that a bank should be permitted to net DTAs against a mark-to-market or similar adjustment on an asset or liability if it is associated with the adjusted value of an asset or liability that itself is subject to adjustment or deduction under the NPR and the DTA would be derecognized if the adjustment in value were reversed. For example, in the case of cash flow hedges, the NPR specifically provides that banks must deduct any unrealized gains and add any unrealized losses to capital included in AOCI on cash flow hedges not recognized at fair value on the bank's balance sheet "net of applicable tax effects" (with no reference to Section 22(e)). Presumably, this reference is to both DTAs and DTLs. NPR Section 22(b)(1).

**Threshold deduction calculations for Specified Items –** As under Basel III, limits are imposed on the amount of the Specified Items that can be included in a bank's CET1. The limits, the 10 percent and 15 percent caps, are identical to the ones discussed above for Basel III.

**Treatment of DTAs arising from NOL and tax credit carryforwards –** NOL and tax credit carryforward DTAs are to be deducted fully from regulatory capital. NPR, Section 22(a)(3). Banks are permitted, however, to net DTLs against these DTAs in accordance with the provisions of Section 22(e). As noted previously, most banks will attempt to maximize the DTLs that can be netted against these DTAs because they are not eligible to be preserved by running the gamut of the Threshold Deduction limits and must be deducted 100 percent from a bank's regulatory capital.

**Application of the loss carryback rule –** The NPR provides that a bank is not required to deduct from its CET1 "DTAs arising from timing differences that the bank could realize through net operating loss carrybacks." Section 22(d)(1)(i). The DTA NPR goes on to provide that a bank filing tax returns as a member of a consolidated group should not credit an amount of these DTAs in excess of the amount that the bank "could reasonably expect to have refunded by its parent" corporation. NPR, Section 22(d), note 14.

**Interpretations of how the loss carryback rule should be applied –** The DTA NPR does not prescribe how the amount of carryback recovery is to be measured. It is generally thought there are two possibilities (1) a recovery measure based on the Current Rules that measures the carryback DTAs on a gross basis (i.e., without regard to DTLs that might offset the DTAs) and (2) a recovery measure based on the Current Rules that measures the carryback DTAs on a net basis with all DTL's solely allocated against DTAs from temporary differences. Generally, the first alternative will be more favorable and would appear to follow the face of the text at Section 22(e)(3). Irrespective of which measure is used, once the carryback recovery is determined, the balance of the DTAs that cannot be realized on a carryback analysis will enter into the overall evaluation of a bank's DTAs.

**Risk weighting of DTAs –** The DTA NPR contains a variety of rules to risk weight the DTAs that are to be given capital credit. The main rules relating to the tax provisions are:

- DTAs arising from temporary differences that can be carried back - These DTAs are risk weighted at 100 percent both during and after the transition period that begins in 2013 and ends in 2018. NPR, Section 22(d) ftn. 14.
- DTAs arising from temporary differences that satisfy the Threshold Deduction limits – These are the DTAs that exceed the amount of DTAs that can be realized by being carried back. During the transition period, these DTAs are to be risk weighted at 100 percent and thereafter beginning in 2018, they are to be risk weighted at 250 percent. NPR, Sections 22(d)(4) and 300(c)(4)(ii) & Table 8.
- DTAs relating to AOCI items - The rules for these DTAs are discussed in Section 5.12.
- All other DTAs – These DTAs are to be written off against regulatory capital; hence, no risk weighting is relevant for them.

**Transition rules –** In general, the transition rules parallel the transition rules in the Basel III provisions; however, the NPR provides much more specificity. The transition period begins in 2013 and runs through 2017.

**Transition rule for NOL and tax credit carryforward DTAs –** In 2013, these DTAs net of any relevant DTLs are subtracted 100 percent from T1. Thereafter, they are subtracted in growing 20 percent increments from CET1 with the remaining balance being subtracted from T1. In 2018, all of these DTAs will be subtracted from CET1. DTA NPR, Section 300 (c)(1)(i) and Table 3. This rule departs from the more lenient Basel III provision in dealing with these DTAs (discussed in Section 4.4) because the U.S. banking regulators have historically treated some deductions, such as goodwill, more strictly than regulators in other countries. Preamble, pp. 84-86.

**Transition rule for temporary difference DTAs –** These DTAs (net of any that can be recovered on a carryback basis and net of DTLs) that remain after the Threshold Deduction calculations are deducted from regulatory capital in growing 20 percent increments beginning in 2014. NPR, Section 300(c)(4)(i) and Table 8. While in 2013 there is an explicit transition rule impacting DTAs arising from operating loss and tax credit carryforwards as noted above, the transition rule provided in the NPR that applies to DTAs arising from temporary differences results in no impact in 2013 as the phase-in percentage is zero.

**Treatment of AOCI items –** The NPR contains a set of provisions dealing with AOCI items, such as the mark to market of AFS debt securities. These provisions have their own set of transition rules, which are effectively a "phaseout" of the current treatment in the United States.

As discussed above, these rules are only proposed, and certain noted ambiguities will need to be addressed before they are made final. While the NPR represents the US regulator's interpretation of the impact of a bank's tax assets and liabilities on its regulatory capital, we would expect your home country bank regulator to adopt similar rules. We will continue to provide updates as these rules develop.

# Overview of Current U.S. Position on Taxation of Business Profits

*By Anthony Marsicovetere, Tax managing director, and Rowan Liu, Tax associate, KPMG LLP*

In December 2012, the Board of Governors of the Federal Reserve proposed a new intermediate holding company (*IHC*) regime in an effort to implement certain provisions of the Dodd-Frank Act for foreign banking organizations. The proposal has forced many foreign banks to reexamine the structure of their U.S. operations; specifically, whether their U.S. assets should be in a U.S. branch or a U.S. subsidiary. The attribution of business profits to U.S. branches of a foreign bank is an important consideration in the exercise, one that has become significantly more complicated since the adoption of the approved OECD approach (AOA) in certain U.S. tax treaties. The AOA uses a two step process to attribute profit to permanent establishments (PE):

- First, a functional and factual analysis is applied to delineate the permanent establishment (i.e., the U.S. branch of a foreign bank) from the rest of the bank. This step focuses on identifying "the economically significant activities and responsibilities undertaken by the [branch]."[1]
- Second, a comparability analysis applying the OECD Transfer Pricing Guidelines[2] is used to determine the arm's-length price of dealings attributed to the branch. This second step ensures that transactions recognized and attributed to the branch are priced according to the arm's-length principle.[3]

The AOA principals are discussed in further detail later in this article.

Historically, the U.S. has generally attributed business profits to a PE based on the Effectively Connected Income (ECI) rules of §864(c), with some modification.[4] Under these rules, income is attributed to a U.S. branch in its entirety if the people or assets of the branch were a material factor in its generation.[5] The Code's all-or-nothing approach is less nuanced than the AOA. Therefore, in any given case, the Code-based approach may attribute more or less income to a branch than the AOA would.[6]

In the Technical Explanation to the 2006 U.S. Model Treaty,[7] the U.S. Treasury Department (the Treasury) states that the language under paragraph 2 of Article 7 permits an enterprise to apply either the ECI rules or the AOA in attributing profits to a PE,[8] but that the approach selected must be applied on a consistent basis.[9] However, the Treasury also has stated that it will follow the AOA only when the attribution of profits to a PE is addressed and agreed to in treaty negotiations.[10] Treasury was concerned that the allocation of expenses authorized by Article 7 paragraph 3 was not consistent with the AOA's arm's-length approach.[11] Currently, the AOA has been adopted in only seven U.S. treaties—Belgium, Bulgaria, Canada, Germany, Iceland, Japan, and the United Kingdom.

In most cases, the residence country is unlikely to respect any allocation based on United States tax laws. Therefore, foreign banks resident in one of the listed countries will likely apply the AOA in order to determine the PE's profits eligible for double tax relief in the residence country, and only elect to be taxed in the U.S. under the Code if the U.S. tax would be smaller than the tax determined based on the AOA. This could result in some double nontaxation, particularly where the residence country provides an exemption.[12] Conversely, to the extent the residence country (other than the seven countries listed above) takes a position inconsistent with that of the United States, and retroactively adopts the AOA into an existing treaty, the bank may be ''over taxed'' in the United States. In such a case it is not clear whether and how the residence country would apply a treaty's re-sourcing rule. Double taxation in such cases would appear to be eligible for relief under a treaty's Mutual Agreement Procedure. A foreign bank should determine its residence country's position with respect to the AOA, and

[1] 2010 OECD Report Part I ¶ 10.

[2] OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration (1995).

[3] *See* OECD Model Tax Convention Art. 9(1).

[4] *See* Rev. Rul. 81-78, 1981-1 C.B. 604.

[5] Treas. Reg. § 1.864-6(a).

[6] See the Technical Explanation to the U.S. Model Income Tax Convention of November 15, 2006 for examples.

[7] U.S. Model Income Tax Convention of November 15, 2006.

[8] *See* The Technical Explanation to the 2006 U.S. Model with respect to paragraph 2 of Article 7. A taxpayer may generally elect to be taxed under the Code and not under the Treaty. See 2006 U.S. Model, Article 1(2).

[9] This broadened consistency rule has been discussed elsewhere. See, e.g., Letter from the Institute of International Bankers to Eric Solomon, Assistant Secretary (Tax Policy), dated Oct. 1, 2007, 191 *BNA Daily Tax Rpt.* I-2 (10/3/07).

[10] See *16 Tax Mgmt. Transfer Pricing Rpt.* 107 (6/13/07).

[11] *Id.* However, the Technical Explanation to the 2006 U.S. Model appears to endorse use of the OECD Transfer Pricing Guidelines to determine the expenses of a PE.

[12] The consistency rule mentioned above may foreclose this opportunity. However, that rule may simply be limited to consistent application of Article 7. *See id.* Also, the U.S. consistency rule would appear to be unable to override domestic law of another jurisdiction, which may import the AOA by treaty.

evaluate the likelihood of double taxation (or nontaxation) of its U.S. branch income before deciding on whether to conduct its U.S. operations in branch form.

## The AOA for Banks

The Report on the Attribution of Profits to Permanent Establishments (the Report) discusses in detail the basic principles of the AOA's two-step approach to banks operating through branches:

### 1. Step One: Functional and Factual Analysis

This step requires a foreign bank to delineate each of its branches as a separate and independent enterprise. The analysis takes into account the assets used and risks assumed with respect to each function the branch performs.

The AOA identifies "Key entrepreneurial risk-taking functions" (KERT functions) as a subset of significant people functions specific to banks and other financial institutions.[13] Generally, KERT functions require "active decision-making with regard to the acceptance and/or management of individual risks and portfolio of risks."[14] The creation and management of assets are the central activities of a bank; accordingly, the OECD identifies sales/trading and risk management as KERT functions most relevant to the attribution of economic ownership of financial assets to bank branches.[15]

*Assets and Risks*

Under the AOA, economic ownership of an income-generating asset is attributed to the part of the bank that performs the KERT functions related to that asset.[16] If the KERT functions are performed by more than one part of the bank, the analysis must determine whether one part is the sole economic owner of the asset or whether multiple parts share economic ownership.[17] If one part is attributed sole ownership, the other parts are then entitled to receive arm's-length compensation for services performed under step two of the AOA.[18]

In addition to KERT functions, banks also require significant people functions creating nonfinancial assets. The analysis relevant to non-financial assets follow the general application of the AOA, and are attributed to the permanent establishment if performed by its people. Similarly, economic ownership of other tangible assets is generally attributed to their place of use.

*Capital*

Banks require capital to support the risks they assume in making and maintaining loans, and to absorb the losses when such risks are realized. The AOA treats the branch as having "an appropriate amount of capital in order to support the functions it performs, the assets it uses and the risks it assumes."[19] Regulatory capital requirements generally represent minimum standards and do not accurately reflect the assumption of risk by the branch as a separate entity.[20] Therefore, banks must first determine the aggregate risk attributable to the branch.[21]

The AOA accepts a variety of approaches in measuring risks. Regulatory-based approaches, such as risk-weighting assets against benchmarks set by the BASEL committee, provide uniform application with international acceptance. Alternatively, nonregulatory-based approaches, such as using the bank's own risk assessment models, may provide more accurate measurement of risks. Notwithstanding the different measurement methods available, the attribution of capital must be made with respect to all risks taken, including off-balance sheet items without immediate funding requirements.[22]

Once the aggregate risks attributed to a permanent establishment are determined, the AOA provides two methods of capital allocation, with a third safe harbor alternative:[23]

- Capital allocation approach—the equity capital held by a bank is attributed according to the proportion the aggregate risks of the branch bears to the aggregate risks of the bank.
- Thin capitalization approach—a permanent establishment is attributed the same amount of equity capital as an independent bank would carry in the host country.
- Quasi thin capitalization/regulatory minimum capital approach—a permanent establishment is allocated the same amount of equity capital as required by regulation of an independent bank in the host country.

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[13] OECD, 2010 Report on the Attribution of Profits to Permanent Establishments, Part II ¶ 16.

[14] *Id.* Part II ¶ 8.

[15] *Id.*

[16] This analysis may be performed at the portfolios level by grouping together similar assets and risks following the aggregation principle set forth in paragraph 3.9 of the Transfer Pricing Guidelines.

[17] 2010 OECD Report, *supra* note 13, Part II ¶ 67.

[18] *Id.*

[19] 2010 OECD Report, *supra* note 13, Part II ¶ 84.

[20] See 2010 OECD Report, *supra* note 13, Part II D-1(iii)(a).

[21] *Id.*

[22] *Id.*

[23] *Id.*

**2. Step Two: Comparability Analysis**

The comparability of intracompany dealings to third-party transactions in the analysis is evaluated according to the five factors set out in the OECD Transfer Pricing Guidelines: (1) characteristics of service and property, (2) functional analysis, (3) contractual terms, (4) economic circumstances, and (5) business strategies. As with other business sectors, dealings within the bank are compared with comparable transactions between independent parties to ensure profit attributed to the permanent establishment from intra-bank dealings reflect the arm's-length principle.

It is important to note that intracompany interest charges are generally not recognized under the AOA to the extent the principal is considered "free" capital;[24] however, the report provides an exception for banks as the internal movement of funds is essential to the business.[25] The Treasury has accepted interest allocation based on risk-weighted assets as an alternative to the formulaic approach under Treas. Reg. § 1.882-5 for treaties that have adopted the AOA.

## Implementing the AOA

The AOA leaves the determination of the deductibility of expenses to the domestic tax law of the residence and source countries to the extent such laws are consistent with the principles of the AOA. In most situations, the residence country and the United States will vary with respect to their treatment of expense items. Therefore, even when both the United States and the residence country follow the AOA, the amount of income taxable by the United States and the amount of relief available to the taxpayer may be different. A foreign bank should carefully examine how income and expense items are booked at its U.S. branch in order to minimize any adverse inconsistencies between residence and source country tax laws. Additionally, foreign banks resident in the seven countries that have adopted the AOA should decide whether to follow the AOA or the modified ECI rules in determining their U.S. tax liabilities.

Additionally, it is unclear whether and how U.S. transfer pricing rules apply to intra-enterprise transactions priced under the OECD Transfer Pricing Guidelines. The §482 regulations contain more detailed rules than the OECD Guidelines, and include various safe harbors that may be useful to taxpayers. The Treasury views the §482 regulations as ''wholly consistent'' with the OECD Guidelines.[26] Given the uncertainty, a foreign bank should carefully consider how to substantiate the attribution of risk and capital to the branch, and document intracompany dealings between the branch and other parts of the bank. In certain instances, it may be prudent to minimize any risk of IRS challenge by participating in the Advanced Pricing Agreement Program.

[24] 2010 OECD Report, *supra* note 13, Part I ¶ 164.

[25] 2010 OECD Report, *supra* note 13, Part II ¶ 161-69.

[26] Generic Legal Advice AM 2007-007 (March 15, 2007).

# An Overview of Private letter Ruling 201305006 on Use of a Contractual Arrangement to Create a Corporation for US Federal Tax Purposes

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The Internal Revenue Service (the IRS) recently released Private Letter Ruling 201305006 (the PLR), holding that a contractual agreement to enter into a joint venture gave rise to a separate foreign business entity for U.S. federal income tax purposes.

The PLR examines a proposed Profit Participation Agreement (the Agreement) between a U.S. corporation (Taxpayer) and its foreign affiliate (Affiliate), whereby Affiliate will acquire a certain percentage interest in the capital of Taxpayer's branches in a certain region located outside the United States (the Branches) in exchange for a cash investment. In addition, Affiliate will acquire a certain percentage interest in the profits and losses from all business operations of the Branches. No separate juridical legal entity will be created as a result of the Agreement. Taxpayer will retain legal ownership of all assets, liabilities, and contractual obligations of the Branches.

Taxpayer represents that the Agreement: (i) will be signed outside the United States, (ii) will be governed by the laws of a foreign country, and (iii) will provide that Taxpayer and Affiliate consent to the exclusive jurisdiction of courts located outside the United States with respect to any mater or action arising out of or in connection with the Agreement. Taxpayer also represents the rights and obligations of it and Affiliate under the Agreement will be legally binding under the laws of a foreign country and will be enforceable by courts located outside the United States. The Taxpayer makes additional representations regarding a non-U.S. court having jurisdiction to resolve issues that may arise under the Agreement.

Under the terms of the Agreement, Affiliate will be entitled to nominate one of 10 members on a management committee who will oversee the operations and management of the Branches. All management meetings will take place outside the United States. This provision presumably is intended to allow Affiliate's proportionate share of any foreign income tax credits incurred by the joint venture to potentially be creditable when the joint venture's profits are ultimately repatriated to its indirect U.S. shareholder.

Taxpayer intends to treat the resulting separate business entity arising from the Agreement as a foreign corporation for U.S. federal tax purposes.

The IRS determined that: (1) the Agreement will create a separate business entity; (2) all items of income and expense properly allocable to the business carried on by the separate business entity will be treated as the income and expense of that entity for U.S. federal income tax purposes; and (3) the separate entity created by the Agreement will be a foreign business entity.

In its reasoning, the IRS cites to regulatory provisions providing, in part, that for U.S. federal income tax purposes, (1) the recognition of a separate entity does not depend on legal status under local law,[1] and (2) a joint venture or contractual arrangement may create a separate entity if participants carry on a trade, business financial operation, or venture for profit.[2] Noting the intent of Taxpayer and Affiliate to engage in an active business, and share in the profits, losses, and management of all activities of the Branches, the IRS recognizes the undertaking as a separate business entity notwithstanding the lack of a separate juridical entity.

The PLR may offer significant flexibility for foreign financial institutions operating in the United States through both branch and subsidiary form in how they choose to structure their U.S. operations for U.S. federal income tax purposes.

For example, a foreign bank can enter into a profit participation arrangement with an affiliate with respect to the operations of its U.S. branches, and thereby effectively form a separate business entity for U.S. federal income tax purposes. An election can be made to treat this separate business entity as a corporation for U.S. federal income tax purposes. Provided the arrangement is structured so that the entity formed is properly capitalized and considered a U.S. corporation, some of the U.S. federal income tax provisions governing the taxation of U.S. branches of foreign banks may not be applicable. Specifically, the interest allocation requirements under Treas. Reg. § 1.882-5 may not apply, potentially allowing the U.S. branches to currently deduct all interest actually paid to head office. Additionally, transactions between the U.S. branches

[1] *See* Treas. Reg. § 301-7701-1(a)(1).

[2] *See* Treas. Reg. § 301-7701-1(a)(2).

and foreign branches of the same foreign bank would no longer be ignored as interbranch transactions. It is important to note, however, that in such a case, the parties must take into account transfer pricing considerations, and maintain contemporaneous documentation evidencing the arm's-length nature of such transactions.

Other tax provisions not specific to foreign bank operations must also be considered. For example, tax attributes generated prior to the arrangement would remain with the foreign bank since they would not carry over in the deemed contribution to the newly formed corporation. Therefore, these tax attributes may never be utilized if the foreign bank no longer has a U.S. banking business (or other U.S. trade or business). Another issue to consider is whether creating a U.S. corporation that will serve as the new parent of an affiliated group filing on a consolidated basis triggers any negative tax consequences to an existing U.S. consolidated group when the foreign bank is deemed to contribute the stock of the existing consolidated parent to the newly formed corporation. If, for example, the existing U.S. consolidated group terminates as a result of this planning, the separate return limitation year rules may limit the ability of the new U.S. consolidated group to fully utilize those net operating loss carryovers in a given tax year.

In addition to U.S. federal tax considerations, the transaction may also have state and local as well as home country tax implications. Questions to consider include whether the arrangement will be respected under home country tax rules, and what effect, if any, changes in U.S. federal tax treatment will have in other tax jurisdictions.

# Non-U.S. (international) banks and the latest FATCA implications

*By Laurie Hatten-Boyd, principal, Tax; Danielle Nishida, senior manager, Tax; and Erin Kragh, senior associate, Tax, KPMG LLP*

The U.S. Treasury Department (Treasury) and the Internal Revenue Service (IRS) released final regulations implementing FATCA on January 17, 2013.[1] Congress enacted FATCA to combat tax evasion by U.S. persons with offshore bank accounts or investments through the imposition of a penal withholding tax on certain foreign entities that refuse to disclose the identities of their U.S. account holders.

FATCA impacts any international bank that receives payments of U.S. source FDAP income or gross proceeds from the sale or other disposition of property that can produce U.S. source interest or dividends (U.S. withholdable amounts), along with any international bank that is in the same expanded affiliated group[2] as an international bank that receives such payments.[3] Moreover, even international banks that do not receive U.S. withholdable amounts will, in many cases, be required to determine and provide their FATCA classification to other FATCA-compliant financial institutions and counterparties. International banks that do not know, or do not provide, upstream withholding agents with their FATCA status may potentially suffer the imposition of a 30 percent FATCA withholding tax.

For an overview of the practical implications facing international banks under FATCA, please see *KPMG Newsletter – Final FATCA Regulations & the Practical Implications for International Banks*.

Since the publication of the final FATCA regulations, the IRS has issued draft versions of:

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|---|---|
| Form 1042-S (2014) | Annual Information Return for Non-U.S. Persons |
| Form 1042 (2014) | Annual Withholding Return for Non-U.S. Persons |
| Form 8957 | FATCA Registration-Process Form |

In addition, the IRS released a Foreign Financial institution (FFI) list schema with test files to illustrate the data and format of its FFI List. The FFI List is a list maintained by the IRS of FATCA compliant FFIs. These FFIs are considered to be compliant with FATCA either by executing an agreement with the IRS (a Participating FFI) or by qualifying for a deemed-compliant status (a Registered deemed-compliant FFI).

Finally, since January 17, 2013, Treasury has executed Intergovernmental Agreements (IGAs) with Ireland, Switzerland, and Norway, and is discussing IGAs with numerous other jurisdictions, including the Cayman Islands and Taiwan.

**(1) Annual Information Return for Non-U.S. Persons (Form 1042-S (2014)) & Annual Withholding Return for Non-U.S. Persons (Form 1042 (2014))**

On April 2, 2013, the IRS released a draft version of the updated Form 1042-S for 2014. Certain international banks will use this updated form to report payments of U.S. source FDAP income made to non-U.S. persons in 2014. The deadline for completing and filing Form 1042-S (2014) with the IRS is March 15, 2015.

The revised version of the Form 1042-S contains new boxes, including boxes for a recipient's Global Intermediary Identification Number (GIIN), date of birth, and chapter 4 exemption codes (for example, codes designating a payment's status as a grandfathered payment or designating the payee as not subject to withholding under chapter 4). For international banks, the updated Form 1042-S means that those currently undertaking information reporting in connection with chapter 3 of the Internal Revenue Code, and those that intend to be compliant with FATCA, may face the need to revise or amend their current systems, vendor solutions, and processes.

In addition, on April 9, 2013, the IRS released an updated Form 1042. Form 1042 is the annual return used to report tax withheld on payments of U.S. source FDAP income to non-U.S. persons. Similar to the updated version of the Form 1042-S, international banks will be required, under FATCA, to amend their current processes due to the expansion of the form and the inclusion of additional fields. For example, the current Form 1042 requests only total tax liabilities whereas the revised Form 1042 also requests total payments of U.S. source FDAP income and U.S. source substitute payments.

The addition of these new fields to the annual returns means that international banks will need to be able to collect and efficiently retrieve and report this information. Current systems, including vendor options, are unlikely to capture all of the information

[1] Treasury and IRS released proposed FATCA regulations on February 8, 2012.

[2] For purposes of FATCA, an entity is within the same expanded affiliated group if it is more than 50% owned, by vote and value, by the same parent.

[3] Payments considered "in scope" for purposes of the final FATCA regulations generally includes U.S. source payments of Fixed Determinable Annual or Periodic ("FDAP") income made on or after January 1, 2014, and payments of gross proceeds from the sale of property that could produce U.S. source interest or dividends if the payment if made on or after January 1, 2017. However, certain withholding exceptions exist regarding obligations or accounts in existence prior to the effective date of an FFI agreement and certain payments that are exempted from the definition of a withholdable payment such as income that is effectively connected with the conduct of a trade or business in the United States or designated nonfinancial payments.

required on the new form. Moreover, international banks will need to implement training on FATCA to ensure that their staff understands the new reporting requirements.

**(2) FATCA Registration (Form 8957) & FFI List Schema**

As indicated above, the IRS has released a draft of the Form 8957, which is the form that FFIs will use to register with the IRS as participating FFIs or registered deemed-compliant FFIs, and the FFI List Schema. These forms detail how GIINs will be assigned to FFIs registering in an Expanded Affiliated Group.[4] Registration with the IRS for FFIs seeking to be compliant with FATCA will begin in July 2013 (and must be completed by October 2013 for FFIs that want to secure placement on the IRS's initial list of compliant FFIs). Although the IRS released the draft for purposes of review and comment, the questions listed on the form are expected to be similar to those presented at registration.

Given the aggressive timeline, international banks should now be developing a plan for obtaining necessary information regarding their legal entities, including the identification of their Responsible Officer and points of contact, and preparing such information in order to register with the IRS.

**(3) Intergovernmental Agreements (IGAs)**

Treasury is also actively pursuing IGAs as an alternative to the regulatory FATCA regime. IGAs are designed to address local law impediments to compliance in addition to tailoring the implementation process to accommodate local due diligence procedures. On November 8, 2012, Treasury announced that it was negotiating IGAs with over fifty (50) jurisdictions, includings:

| | | |
|---|---|---|
| Argentina | Germany | Malaysia |
| Australia | Gibraltar | Malta |
| Belgium | Guernsey | Netherlands |
| Bermuda | Hungary | New Zealand |
| Brazil | India | Romania |
| British Virgin Islands | Isle of Man | Russia |
| Canada | Israel | Seychelles |
| Cayman Islands | Italy | Singapore |
| Chile | Japan | Sint Maarten |
| Cyprus | Jersey | Slovak Republic |
| Czech Republic | Korea | Slovenia |
| Estonia | Lebanon | South Africa |
| Finland | Liechtenstein | Spain |
| France | Luxembourg | Sweden |

At present, Treasury has executed IGAs with the following countries: United Kingdom, Denmark, Mexico, Ireland, Switzerland, and Norway, with the latter three IGAs being the most recent.[6] International banks should monitor the proliferation of the IGAs since the execution of IGAs will result in additional compliance challenges for those banking organizations operating both within and without IGA countries.

Despite attempts of Treasury and the IRS to harmonize the IGA requirements to the final FATCA regulations, certain fundamental differences remain that may create unintended complexities for international banks. In particular, certain international banks may have to develop various account due diligence, withholding, and reporting responsibilities between their branches and/or group members dependent on the branch or entity's jurisdiction of residence.

**(4) Preparing for Implementation**

To address the numerous and complex requirements that FATCA imposes, international banks may benefit from the assistance of third-party advisers and service providers. International banks may leverage the expertise of third parties that provide specialized knowledge of local laws in each jurisdiction executing an IGA, which will assist in the development of operating models that address these jurisdictional differences.

To gain insights into business decisions made by other financial institutions, including market or industry approaches to the FFI registration process, and to train staff for FATCA compliance, international banks may also look to the experience of third-parties. Third party advisers and service providers may also assist international banks in the development of processes and the testing of systems to ensure the capture and accurate reporting of necessary data.

**For your reference**

The draft Form 1042-S can be accessed by clicking here: http://www.irs.gov/pub/irs-dft/f1042s--dft.pdf

The draft Form 8957 can be accessed by clicking here: http://www.irs.gov/pub/irs-utl/13f8957_040113.pdf

The FFI List Schema and Test Files can be accessed by clicking here:
http://www.irs.gov/Businesses/International-Businesses/IRS-FFI-List-Schema-and-Test-Files

[4] See Treas. Reg. 1.1471-5(i)(1).

[5] Treasury issued a press release on November 8, 2012.

[6] Treasury executed the U.K.-U.S. IGA on September 12, 2012; the Denmark-U.S. IGA on November 19, 2012; the Mexico-U.S. IGA on November 19, 2012; the Ireland-U.S. IGA on January 23, 2013; the Switzerland-U.S. IGA on February 14, 2013; and the Norway-U.S. IGA on April 15, 2013.

# New guidance may exempt bank foreclosure property from UNICAP rules

*By Denise Schwieger, Washington National Tax, Financial Institutions and Products Group; and Carol Conjura, Washington National Tax, Income Tax & Accounting Group*

The Internal Revenue Service (IRS) recently changed its long-standing position on applying the uniform capitalization (UNICAP) rules under section 263A[1] to a bank's other real estate owned (OREO) portfolio. For many years, banks under audit have had to address the IRS Large Business & International (LB&I) exam division's position that banks must capitalize carrying and disposition costs associated with OREO property, such as taxes, insurance, maintenance, and other similar carrying and disposition costs. Recently issued guidance concludes costs of carrying OREO property acquired by a bank on the default of its loan are exempt from UNICAP, whether the OREO property was held for sale or not.

Within a month of each other, two IRS legal memos were released to the public. The first memo was a "field attorney advice" (FAA) expressing the view of the LB&I exam teams. The other, a "generic legal advice" memo (GLAM), takes a taxpayer-favorable approach that signals a change in IRS position on the treatment of OREO property costs by banks.

### Background

Both pieces of guidance address the application of section 263A to property acquired by a bank through a foreclosure proceeding or by a deed in lieu of foreclosure. Banks generally refer to property acquired through foreclosure proceedings or by deed-in-lieu of foreclosure as OREO or real estate owned (REO) property. Section 263A generally requires resellers to capitalize acquisition costs and certain indirect costs allocable to property held for resale. Some banks have taken the position that the bank did not acquire the OREO for resale and thus section 263A should not apply to require capitalization of the expenses incurred to carry OREO; other banks applied section 263A to capitalize the expenses. In recent years, the IRS has proposed adjustments on audit requiring banks to capitalize OREO expenses into the basis of OREO properties under section 263A. In response, many banks have conceded the issue on audit or proactively implemented a voluntary change in accounting method to capitalize the direct costs of carrying the OREO to avoid an audit of the issue.

Section 263A generally requires direct and indirect costs allocable to real or personal property described in section 1221(a)(1) that is acquired by the taxpayer for resale to be capitalized into the basis of the property.[2] Section 1221(a)(1) includes property that is held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. The regulations provide an exception to capitalization treatment for loans originated by the taxpayer.[3] Specifically, the regulations provide that the origination of loans is not considered the acquisition of intangible property for resale; however, loans that are acquired by the taxpayer for resale are treated as "acquired by the taxpayer for resale" for purposes of section 263A.

If section 263A applies in the OREO property context, the type of costs that would be required to be capitalized include the costs incurred to foreclose on the property, including legal and valuation fees, as well as the direct expenses incurred to carry the property, such as real estate taxes, utility expenses, insurance and general maintenance costs.

Under Federal Reserve policies, banks should make a "good faith" effort to dispose of OREO property as soon as practicable.[4] Generally, the Federal Reserve allows bank holding companies to hold OREO property for a five-year period.[5] A bank may request a five-year extension under certain circumstances. As a bank is not permitted to hold OREO property indefinitely, it has been argued that a bank is a "reseller" of OREO because it is generally required to dispose of the property within a certain time period. On the other hand, one can argue that even though OREO property must be sold, it is not "acquired" for resale. Rather, it is acquired to recover the lender's investment, and a sale is a necessary step in recouping the funds lent to the borrower.

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1 Unless otherwise indicated, all references to "section" or "sections" contained in the text of this document are references to the Internal Revenue Code of 1986, as most recently amended, or to the U.S. Treasury Department Regulations (Treasury Regulations), as most recently adopted or amended.

2 Treas. Reg. section 1.263A-1(a)(3)(iii).

3 Treas. Reg. section 1.263A-1(b)(13).

4 See Federal Reserve Policy Statement on Rental of Residential Other Real Estate Owned Properties, April 5, 2012.

5 12 CFR section 225.140.

## General Legal Advice Memo

On March 1, 2013, the IRS Office of Chief Counsel released the GLAM addressing the situation in which a bank originated a loan made in the ordinary course of its lending business.[6] The loan was secured by the real property purchased by the borrower. The bank, either through foreclosure proceedings or a deed-in-lieu of foreclosure, acquired the real property after the borrower defaulted on the loan. The bank acquired title to the real property to mitigate any loss on the defaulted loan. The bank sought to sell the OREO immediately after acquisition. The GLAM assumed that the bank held the OREO for sale to customers in the ordinary course of its business under section 1221(a)(1).

The GLAM addresses the issue as to whether the OREO was acquired for resale as required by section 263A. The GLAM recites the rule in section 1.263A-1(b)(13) of the Treasury Regulations, and states that loan origination is not considered the acquisition of property for resale, regardless of the frequency with which the taxpayer sells the originated loans or the percentage of originated loans that it sells.

The bank acquired the OREO property "in its capacity as a lender and not as a traditional reseller of property," as the bank is "economically compelled to acquire the property" to recover the funds that it originally loaned to the borrower, the GLAM explains. The GLAM reasons that when a bank originates loans, those loans are not treated as the "acquisition of property for resale" for purposes of section 263A; and therefore, the acquisition of the property securing the loan should not convert the bank into a reseller. The acquisition of the OREO is an "extension" of the bank's loan origination activity.

The GLAM does not address the treatment of foreclosure property associated with a loan acquired from an unrelated bank. However, the logic of the GLAM might reasonably be extended in certain situations to certain acquired loans as follows. The GLAM concludes that section 263A does not apply to originated loans because originated loans are not subject to section 263A, and the foreclosure property is merely an extension of that loan origination activity. Similarly, although not addressed by the GLAM, loans that are acquired by a bank would not be subject to section 263A if they are not held for sale. Therefore, foreclosure property associated with such loans may not be subject to section 263A because the foreclosure is similarly an extension of that activity. However, while under the GLAM, originated loans are exempt from section 263A whether held for sale or not, this is not the case for acquired loans, which could be exempt from section 263A only if not acquired for resale.

## Field Attorney Advice

In February 2013, the IRS released a Field Attorney Advice (FAA) dated June 18, 2012, that, on facts similar to those in the 2013 GLAM, concludes that section 263A requires capitalization of direct costs and an allocable share of indirect costs associated with a bank's OREO property.[7] The FAA reasons that since, due to regulatory restrictions, a bank is generally not permitted to hold OREO for more than five years, upon foreclosure the bank acquires the OREO for resale. As the bank holds the OREO for sale to customers in the ordinary course of its trade or business, by its terms, section 263A requires capitalization of the direct and an allocable share of indirect costs associated with acquiring and owning OREO property. The FAA makes an exception to capitalization treatment for OREO that is rented to third parties. The FAA provides that rental activity is not resale or production activity as defined by section 263A. The FAA further provides that if the OREO is subject to section 1231(b)(1), real property used in a trade or business, as opposed to section 1221(a)(1), held for sale to customers in the ordinary course of the bank's trade or business, then section 263A does not require capitalization of the operating expenses associated with the property.

The conclusion in the FAA, on seemingly similar facts, is in direct opposition to the conclusion in the GLAM. While the FAA is advice from an IRS field attorney to LB&I, the GLAM is a legal memo written on behalf of the IRS Chief Counsel to LB&I and espouses the Chief Counsel's view of the law as applied to the facts. The GLAM is likely afforded more weight than the FAA, and generally reflects the IRS's position on an issue.

## Changing a bank's accounting method

Up until the issuance of the GLAM, the position in the FAA had been asserted on exam by the LB&I division for many years, and a bank may have conceded the issue to one degree or another out of a desire to settle it on either a method change or non-method change basis. In light of the GLAM, banks may no longer be required to concede this issue on exam or in appeals. If a bank has established a method of capitalizing these costs in response to prior exams, or by making a voluntary accounting method change outside the exam context, it may want to consider requesting an accounting method change to begin currently expensing these costs. Banks should consider their options for resolving this issue in light of the IRS change in position.

The manner in which a bank potentially changes its method depends on its specific facts. If a bank currently capitalizes the direct or indirect costs associated with the bank's OREO property, the bank may be able to change its accounting method to currently deduct those costs. This method change is likely a nonautomatic method change for which the bank would be required to file a Form 3115, *Application for Change in Accounting Method*, for a nonautomatic method change. In some cases, if it is determined that the bank had an established method of expensing OREO costs and settled the issue in a prior exam cycle, but did so on a nonaccounting method change basis, the bank may be able to change to a current expensing method on amended returns or by requesting an affirmative adjustment in the exam.

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6 AM2013-001 (Feb. 22, 2013, released Mar. 1, 2013).

7 FAA 20123201F (June 18, 2012, published Feb. 26, 2013). The FAA makes no distinction between originated loans and acquired loans.

# Treaty Update

*By Jason Connery,*
*Jennifer Balsdel-Marinescu, Washington National Tax*

Currently, a number of pending U.S. tax treaties and protocols to existing tax treaties have stalled with the U.S. Senate. As of April 2012, pending treaties and protocols with the following countries are currently with the U.S. Senate: Chile (treaty signed February 4, 2010), Hungary (treaty signed February 4, 2010), Japan (protocol signed January 24, 2013), Luxembourg (protocol signed May 20, 2009), Poland (treaty signed February 13, 2013), Spain (protocol signed January 14, 2013) and Switzerland (protocol signed September 23, 2009).

In late 2011, Senator Rand Paul, R-KY, placed a hold on Senate floor consideration of the pending Swiss and Luxembourg protocols as well as the pending treaty with Hungary. According to tax analysts, various sources stated Senator Paul placed this hold based on his objection to the treaty information sharing provisions contained in these agreements. These agreements contain updated information exchange provisions that implement the OECD standard on information exchange. Prior to Senator Paul's implementation of this hold, the U.S. Senate Foreign Relations Committee (the SFRC) held a hearing on these agreements in June 2011. After this hearing, the SFRC recommended that the full U.S. Senate approve these agreements.

Under U.S. law, the following steps generally must occur before a pending U.S. tax treaty or pending protocol to an existing tax treaty can enter into force:

(i) The SFRC must consider and hold a public hearing addressing the pending tax treaty instrument

(ii) The full U.S. Senate must unanimously approve the pending tax treaty instrument

(iii) The U.S. President must sign a U.S. Instrument of Ratification

(iv) The U.S. government must formally notify the other contracting state through diplomatic channels that the U.S. ratification process has been completed.

The pending protocols to the existing Swiss and Luxembourg tax treaties broaden the scope of the current information exchange provisions contained in the Swiss and Lux tax treaties. For example, the pending protocol to the existing Swiss tax treaty states the United States can request information that "may be relevant . . . to the administration or enforcement of the domestic laws concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention" (emphasis added). The current information exchange provision in the U.S.-Switzerland tax treaty applies much more narrowly in that it limits information disclosure to cases involving tax fraud (as defined by Swiss law). In June 2010 the Swiss government ratified the pending protocol to the U.S.-Switzerland tax treaty. The Hungarian and Luxembourg governments have also ratified their pending agreements with the United States.

On December 31, 2012, the 112th Congressional session closed. Because the full Senate did not approve the pending agreements with Hungary, Luxembourg and Switzerland before the 112th Congressional session closed, the SFRC must again consider these pending agreements. It is anticipated that the SFRC will reapprove these pending agreements and report them back out to the full U.S. Senate. At this time it is not known for sure whether Senator Paul will again impose a hold on full U.S. Senate consideration of the pending agreements with Hungary, Luxembourg and Switzerland. The other treaties and protocols pending with the U.S. Senate (specifically, the agreements with Chile, Japan, Poland and Spain) are also currently waiting for a SFRC hearing and SFRC recommendation. Similar to the pending agreements with Hungary, Luxembourg and Switzerland, these other pending agreements also contain information exchange provisions that adopt the OECD standard on information exchange.

For decades, KPMG's International Bank Tax practice has been recognized for its presence in and commitment to working with foreign banking organizations. We have nine dedicated tax partners and directors who are supported by 30 managers and staff, in addition to specialists in transfer pricing, state and local tax, M&A tax, and other tax disciplines. We serve our clients locally and globally through our international network of member firms. The professionals in our International Bank Tax practice have the knowledge, experience, and skills to help our clients address their most pressing tax challenges, sort through today's complex business problems, and achieve their goals.

Please click here to learn more about KPMG's Tax Services practice.

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