



# International Securitization & Finance Report

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## The Dante Ruling: Implications for Derivatives In Structured Finance Transactions

BY M. DAVID KROHN, WILLIAM M. GOLDMAN AND  
MARC A. HORWITZ (DLA PIPER LLP US)

The United States Bankruptcy Court for the Southern District of New York recently ruled in the Lehman Brothers Chapter 11 case that provisions that alter payment priorities upon an insolvency of a U.S. swap counterparty may be unenforceable as prohibited ipso facto clauses under the U.S. Bankruptcy Code. These provisions, which are common in CDO and other structured finance transactions, subordinate the right of swap counterparties to waterfall payments and collateral in the event of a counterparty default, including a counterparty insolvency. Sometimes known as "flip clauses," their purpose is to limit counterparty credit risk. If the Bankruptcy Court's ruling stands, it could adversely affect ratings

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## Revised Proposals for Reform of UK CFC Regime

BY SIMON GOUGH, PAUL RUTHERFORD  
AND DAVID THOMPSON (DLA PIPER UK LLP)

### Background

Following extensive consultation with industry, on January 26, 2010, HM Treasury published revised proposals for a new controlled foreign company (CFC) regime for discussion with business and other interested parties. HM Treasury's discussion paper focuses on the overall "shape" of the proposed new regime and looks specifically at how treasury operations and intellectual property management might be addressed.

Comments are requested by April 20, 2010 and the Government intends to publish more detailed proposals and draft legislation later in the year, with a view to the legislation being included in Finance Bill 2011.

The proposals are designed to meet the policy objectives set out in the Policy Principles Document published by HM treasury in July 2009, and in particular to target the artificial diversion of profits from the UK rather than profits genuinely earned overseas.

On February 23, 2010, a stakeholder meeting was held with HMRC and HM Treasury to discuss the proposals.

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Provisions that subordinate the right of swap counterparties to payments and collateral in the event of a counterparty default are supposed to limit counterparty credit risk. Here's why the US Bankruptcy Court's ruling that such provisions are unenforceable may impact the future of structured finance transactions. *Page 1*

#### Revised Proposals for Reform of UK CFC Regime Make New Distinctions

HM Treasury's revised proposals for the CFC regime focus on how treasury operations and intellectual property management might be addressed. Some important distinctions, in both areas, are explored. *Page 1*

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When thin capitalization rules refer to net equity, does this mean only stock and paid-in capital, or are retained earnings also to be included? *ISFR* interviews PWC's Jorge Gross concerning this and other issues arising from Brazil's new thin cap rules. *Page 15*

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# Structured Finance

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**on existing transactions and is likely to have important implications for how future structured finance transactions involving derivatives are documented.**

## The Transaction

The case involves a multi-issuer credit-linked synthetic portfolio note program arranged by Lehman Brothers International (Europe) in 2002 and known as the Dante Program. The Program is governed by an English law Principal Trust Deed between Dante Finance Public Limited Company and a predecessor to Bank of New York. BNY Corporate Trustee Services Limited (BNY) is the Trustee under the Principal Trust Deed.

The specific transactions that were considered by the Bankruptcy Court involved two series of Synthetic Portfolio Notes issued by Saphir Finance Public Limited Company, a special purpose entity created by Lehman Brothers International (Europe), which had acceded to the Principal Trust Deed. Each series of Notes has the benefit of a swap with Lehman Brothers Special Financing Inc. (LBSF), which was guaranteed by Lehman Brothers Holdings Inc. (LBHI). Both the Notes and the Swaps are secured by collateral, held by BNY, as Trustee, for the benefit of the Noteholder and LBSF, as swap counterparty. The Notes were owned by Perpetual Trustee Company Limited.

The governing documents provide that LBSF, as swap counterparty, has priority with respect to any collateral unless an event of default has occurred with respect to LBSF. Should such an event of default occur, the "flip clause" contained in "Condition 44" in the Terms and Conditions gov-

erning the Notes provided that the Noteholder would have the senior claim to the collateral and the swap counterparty's claim would be subordinated. Events of default for LBSF included bankruptcy filings by LBSF or LBHI. The intent of Condition 44 was presumably to reduce counterparty credit risk and allow the Noteholder, upon an LBSF default, to redeem its Notes and have a priority claim on the collateral to pay any early redemption payments before LBSF would be entitled to any recoveries under the swap documentation.

## The Lehman Bankruptcy and Perpetual's Priority under English Law

LBHI filed its voluntary petition for relief under Chapter 11 of the Bankruptcy Code in the Southern District of New York on September 15, 2008. LBSF did the same on October 3, 2008. On December 1, 2008, Saphir sent notices to LBSF terminating the swaps on the basis of the LBSF bankruptcy and designating December 1 as the early termination date. The termination of the swaps invoked the priority reversal of Condition 44 and obligated Saphir to redeem the Notes.

On May 13, 2009, Perpetual, as Noteholder, commenced litigation against BNY in England in the High Court of Justice, to establish the Noteholder's priority claim to the collateral and to require BNY to liquidate the collateral and redeem the Notes. Because the swaps at the time of termination had significant value to LBSF and its bankruptcy estate, and because the collateral would not be sufficient to pay both the Notes and

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WorldTrade Executive  
P.O. Box 761  
Concord, MA 01742-0761/USA  
(978) 287-0301 Phone  
(978) 287-0302 Fax  
[www.wtexecutive.com](http://www.wtexecutive.com)

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Gary A. Brown, Esq.

**CONTRIBUTING EDITOR**  
Scott P. Studebaker, Esq.

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## Private Equity Funds Well Prepared for Currency Fluctuations

BY DAN WEIL

**Latin American currencies have gone through a wild ride since the financial crisis began in September 2008. At first, the currencies fell against the dollar, which benefited from a flight to quality, despite the fact that the crisis had its origins in the U.S. mortgage market.**

But that currency trend didn't last long. The real, for example, surged 33 percent last year, as investors focused on the economy's buoyant growth and lack of debt. But then the Brazilian currency dropped 8 percent in January, as investors started pulling back their exposure to "risk" assets.

So what's the upshot for private equity activity in the region? "I believe that given the long-term nature of investment in private equity – three to five years – any fluctuations by the Brazilian currency aren't a major risk, or if they are, it's part of investing in any foreign currency," said Alberto Camoes, managing partner at Stratus Group in São Paulo.

There are several levels at which private equity funds are exposed to currency. First is the fund itself. Fund managers generally have to convert the dollars they receive from investors into local currencies to invest in companies. And then they have to convert the local currencies to dollars when returning money to investors.

"The issue is: at the fund level should you be hedging long-term currency fluctuations to protect the ultimate return for your fund's investors?" said Chris Meyn, a senior partner at Gavea Investments.

"In some markets you can easily hedge, making it cost effective. In our market (Brazil), it's not cost effective." Thanks to the premium of Brazil interest rates over U.S. rates, hedging a decline in the real can cost up to a high single digit percent of your principal.

"So you're essentially paying that much for insurance. That's not worth it," Meyn said. Gavea aims for a long-term return that takes into account possible currency fluctuation.

You may actually be costing yourself money, notes Russell Deakin, a partner at Brazilian private equity firm CRP. "If you put on a hedge in 1998, when the real traded at about 4 per dollar, it would have cost you 5-7 percent of your principal," he explained.

"The real has appreciated tremendously since then. It's now worth about 1.85 per dollar. So if you have put on a hedge, you lost about 60 percent. The

last thing you wanted to do is hedge."

Erik Peterson, a managing partner at Aureos Capital, points out that there are less expensive ways to control currency exposure.

"When possible, we seek investment structures that will reduce currency risk," he said. "These structures include convertible debt instruments as well as equity structures that realize a significant part of the investment return through preferential cash flows in the early stages of an investment."

**Latin American currencies have gone through a wild ride since the financial crisis began in September 2008. At first, the currencies fell against the dollar, which benefited from a flight to quality, despite the fact that the crisis had its origins in the U.S. mortgage market.**

At Aureos, the focus is "investing in high growth companies where the underlying business growth will overcome any reasonable decline in investment value related to currency devaluation," he said.

"Obviously in countries like Colombia, this has worked in our favor, as strong portfolio company performance has been enhanced by a stronger Colombian peso."

Joaquin Avila, a co-founder of EMX Capital, which manages the Carlyle Mexico fund, points out there's no guarantee that the dollar's long-term trend will be upward. With ratings agency Moody's warning that the U.S.' triple-A credit rating may be at risk if the government doesn't get its debt under control, the dollar's outlook is cloudy, he explained.

Indeed, many investors view their commitments to Latin American private equity partly as a hedge against the dollar. "I've heard a lot of investors in fact saying they want to be exposed to the real, given their fear of a weakening dollar or even euro," said Camoes of Stratus.

"They tell us not to hedge our fund or to use only natural hedges, like investing in exporters, as they take care of currency exposure themselves."

In any case, fund managers' focus should be investing in solid businesses, Avila said. "They

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# Private Equity

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*Private Equity Funds, from page 3*

should be concerned a little bit about currency, but they should be fundamentally concerned about creating value through sound business practices. If they do that, they will make money regardless of currency."

**The explosive growth in the number of Latin American companies that export has eased some currency concern, because those exports serve as a natural currency hedge, assuming the exporter is being paid in dollars or some other foreign currency.**

The second level at which fund managers have to worry about currency risk is in their individual portfolio holdings. Most managers say they seek to match the currency denomination of their com-

panies' cash flows with the denomination of the company's debt.

"We have several investments in the financial services sector, both in Mexico and Colombia, which always have matched assets with liabilities in local currency," Peterson said. "Recent swings in foreign exchange rates have led us to be even more focused on this matched balance sheet, hedging portfolio borrowing that is not borrowed in the local currency."

The explosive growth in the number of Latin American companies that export has eased some currency concern, because those exports serve as a natural currency hedge, assuming the exporter is being paid in dollars or some other foreign currency.

Gavea's portfolio companies do some currency hedging but only on a long-term basis. "We don't want our companies speculating on currency," Meyn said. □

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*Dan Weil is a correspondent for Venture Equity Latin America, also published by Thomson Reuters/WorldTrade Executive.*

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## Tax

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### China Steps Up Tax Enforcement

BY DAN HARRIS (HARRIS & MOURE, PLLC, SEATTLE, WASHINGTON)

**It has long been believed that China is stepping up its enforcement of laws against foreigners, but I am getting a strong vibe that things just ratcheted up another notch or two. Two times in the last few weeks, two clients in two different industries and two different cities, both of whom we are in the process of registering Wholly Foreign Owned Entities (WFOE) reported how Chinese tax authorities had come by to complain about their not paying their taxes. In both cases, our clients informed the tax authorities that they were just in the process of starting out and explained how they were waiting to hear back on their WFOE applications. In both cases, the tax authorities told them to hurry it up, which is great except the company registration people seem to be taking longer than ever these days.**

Never before had a client of ours been approached by the Chinese tax authorities during the pre-WFOE stage. I see this as part of the tax crackdown against foreigners. At the end of last year I predicted the following on tax enforcement in China:

China will increase its tax collection efforts. This has been going on at a rapidly accelerating pace over the last six months or so. If your China operations

are not making a healthy profit, do not be surprised if the government imputes healthy profits to it. In particular, the government will look very closely at your transfer pricing and in many cases it will not like what it sees.

We also just got two denied China visa calls and we usually only get two or three of these a year. Both came from people insisting they had been getting China visas for years without any problem, and that nothing should have changed for them.

What is going on here? Is this just a payback for America's recent foreign policy? If so, is this being coordinated from Beijing, or is this just some locals expressing their own unhappiness regarding a few F-16s? Were the visa denials just a Shanghai Expo house cleaning? Or is all of this a sign of China's intention to increase the pressure on foreign businesses even further? □

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*Dan Harris is a partner in the Seattle, WA law firm of Harris & Moure, PLLC. Harris & Moure is an international law Boutique firm with lawyers in Seattle and in China. Harris & Moure also maintains a China law blog at [www.chinalawblog.com](http://www.chinalawblog.com). Mr. Harris can be reached by phone at (206) 224-5657 or via e-mail at [dan@harrismoure.com](mailto:dan@harrismoure.com).*

**China will increase its tax collection efforts. This has been going on at a rapidly accelerating pace over the last six months or so.**

## **The Dante Ruling, from page 2**

any Swap termination payments, LBSF joined the litigation to challenge the Noteholder's claim to priority under English law.

The stakes are significant. According to Lehman's filings with the Bankruptcy Court, if the flip clause in Condition 44 were to be enforced, the LBSF bankruptcy estate would suffer a loss of \$70 million. In addition, some have estimated that Lehman may stand to lose as much as \$8 billion if similar clauses in other transactions were to be enforced. Similarly, if these clauses are not enforced, noteholders are likely to suffer similar losses.

The High Court ruled in favor of the Noteholder, holding that the priority reversal provisions contained in Condition 44 are enforceable under English law. The High Court noted that LBSF's interest in the collateral was "always limited and conditional" and that the reversal provisions therefore did not violate the "anti-deprivation principle" under English law – the analog to the Bankruptcy Code's restriction on ipso facto clauses. The High Court also held that the priority reversal occurred automatically on September 15, 2008, the date of the LBHI bankruptcy filing, and not at the time of the LBSF bankruptcy filing in October or the delivery of the termination notice in December. LBSF appealed the High Court's judgment to the English Court of Appeal, which unanimously affirmed the ruling of the High Court on November 6, 2009 in all relevant respects.

### **The U.S. Bankruptcy Proceeding and BNY's Defense**

Shortly after the commencement of the litigation in England, on May 20, 2009, LBSF commenced an adversary proceeding in the Bankruptcy Court against BNY seeking a declaratory judgment that the flip clause provision in Condition 44 is an unenforceable ipso facto clause under the Bankruptcy Code. In general, Section 365(e)(1) of the Bankruptcy Code provides that an executory contract may not be terminated or modified at any time after the commencement of a bankruptcy case solely because of a provision that is conditioned on the commencement of the case. Such provisions are known as "ipso facto clauses." In addition, Section 541(c)(1)(B) of the Bankruptcy Code provides that a debtor's interest in any property becomes property of the bankruptcy estate notwithstanding any provision in any agreement that is conditioned on the commencement of a bankruptcy case. LBSF therefore took the position that it had senior rights to the collateral at the time of its bankruptcy filing, that provisions in Condition 44 that subordinate LBSF's rights in the collateral in the event of its

bankruptcy were unenforceable ipso facto clauses under Sections 365(e)(1) and 541(c)(1)(B), and that any action by BNY to enforce those clauses would violate the automatic stay protections of the Bankruptcy Code.

**The United States Bankruptcy Court for the Southern District of New York recently ruled in the Lehman Brothers Chapter 11 case that provisions that alter payment priorities upon an insolvency of a U.S. swap counterparty may be unenforceable as prohibited ipso facto clauses under the U.S. Bankruptcy Code.**

BNY made several arguments in defense of the enforceability of Condition 44. First, it asserted that because the documents are governed by English law, the Bankruptcy Court must defer to the Court of Appeal's determination that the subordination provisions were effective on September 15, 2008, with the result that LBSF had no right to any priority in the collateral on October 3, 2008, when it filed for bankruptcy. BNY therefore argued that the property rights had already been lost before LBSF filed for bankruptcy and the prohibitions on ipso facto clauses contained in the Bankruptcy Code are not applicable.

Second, BNY argued that even if the priority reversal provisions of Condition 44 are ipso facto clauses, they are nevertheless enforceable under safe harbor provisions contained in Section 560 of the Bankruptcy Code that protect the right of a non-defaulting party to a "swap agreement" to liquidate, terminate or accelerate one or more swap agreements and the "offset or net out" of the parties' positions as a result of an ipso facto clause. The Bankruptcy Code definition of "swap agreement" is "any agreement, including the terms and conditions incorporated by reference and all documents that the market deems part of the parties' transaction" that governs a range of listed of swap transactions. BNY argued that Condition 44 was incorporated in the swap agreement and that its priority reversal provisions were therefore enforceable under the safe harbor of Section 560.

Third, BNY directed the Bankruptcy Court

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# Structured Finance

## *The Dante Ruling, from page 5*

to Section 510(a) of the Bankruptcy Code, which provides that subordination agreements are enforceable in a bankruptcy proceeding to the same extent that such agreements are enforceable under applicable nonbankruptcy law. BNY argued that Condition 44 is a subordination agreement subject to protection under Section 510(a). Because the Court of Appeal had found explicitly that Condition 44 is enforceable under English law, BNY asserted that the priority of the Noteholder and the subordination of LBSF must be given effect.

**The stakes are significant. According to Lehman's filings with the Bankruptcy Court, if the flip clause in Condition 44 were to be enforced, the LBSF bankruptcy estate would suffer a loss of \$70 million.**

### **The Bankruptcy Court's Ruling**

The Bankruptcy Court rejected each of BNY's arguments and found that Condition 44 was an unenforceable ipso facto clause and that any action taken by BNY to enforce the provision would violate the Bankruptcy Code's automatic stay.

With respect to BNY's arguments that the Court of Appeal's determination that the subordination provisions of Condition 44 became effective on September 15, 2008, before the LBSF bankruptcy and that, therefore, LBSF no longer held a senior right in the collateral at the time of its bankruptcy filing in October, the Bankruptcy Court held that while it could recognize the English Courts' judgment as a matter of comity, it was not obligated to do so. In this case, the Bankruptcy Court declined to be bound by the decisions of the English Courts based on the "strong interest" in having U.S. Bankruptcy Courts resolve bankruptcy law issues within their jurisdiction.

Having declined to give preclusive effect to the Court of Appeal's ruling, the Bankruptcy Court found that Condition 44 was not automatically invoked upon the LBHI bankruptcy filing, or even upon the LBSF bankruptcy filing. Instead, it found that the priority flip only becomes effective when the underlying collateral is actually sold. Because the collateral was not sold at the time of the LBSF bankruptcy filing on October 3, 2008 (or after – the Noteholder brought the case in England to compel BNY to enforce its rights in

the collateral), the Bankruptcy Court found that LBSF still has a valuable property right that has the protection of the ipso facto provisions of the Bankruptcy Code.

The Bankruptcy Court went on to say that even if the correct operative date for the priority reversal were determined to be September 15, the date on which LBHI filed for bankruptcy, the commencement of the LBHI bankruptcy case would trigger the ipso facto protections under Sections 365(e) and 541. Put another way, the Bankruptcy Court found that the commencement of a bankruptcy case by an entity that was not a party to the swap agreement (i.e., LBHI) could invoke the ipso facto protections with regard to an entity that was not in bankruptcy (i.e., LBSF). The Bankruptcy Court noted the novelty of its determination, observing that "[n]o case has ever declared that the operative bankruptcy filing is not limited to the commencement of a bankruptcy case by the debtor-counterparty itself but may be a case filed by a related entity...."

The Bankruptcy Court then turned to BNY's arguments that even if Condition 44 were to be determined to be an ipso facto clause, it is nevertheless enforceable under the safe harbors for swap agreements under Section 560 and for subordination agreements under Section 510(a) of the Bankruptcy Code. With respect to Section 560's protections for terms in swap agreements, the Bankruptcy Court noted that Condition 44 was contained in the Trust Deed, not the documents governing the swaps themselves. The Bankruptcy Court's review of each swap agreement, the ISDA Master Agreement, schedules and confirmation indicated that there was no reference at all to Condition 44, the priority provisions or even the relevant Trust Deeds. It therefore concluded that Condition 44 was not part of a "swap agreement" and concluded that it did not have the benefit of the protections of Section 560. This review and the Bankruptcy Court's analysis arguably ignores the language of Section 101(53B)(A)(vi) of the Bankruptcy Code which states that the term "swap agreement" as used in the Bankruptcy Code includes any "credit enhancement related to" the underlying swap agreement.

Finally, the Bankruptcy Court turned to BNY's argument that Condition 44 is a protected subordination agreement under Section 510(a) of the Bankruptcy Code. After noting that the Bankruptcy Code contains no definition of "subordination agreement," the Bankruptcy Court held without citation to any authority and with little analysis that while Section 510(a) protects

subordination agreements that have become “permanently fixed,” Section 510(a) provides no protection against the ipso facto provisions of Sections 365 and 541. Accordingly, the protections of Section 510(a) provided no protection to Condition 44 and the Bankruptcy Court ruled in favor of Lehman in all respects.

### Implications of the Bankruptcy Court Ruling

The most immediate practical consequence of the Bankruptcy Court’s ruling is that it puts BNY in a very difficult position as it is now subject to the conflicting rulings of the Court of Appeal and the Bankruptcy Court. It is no surprise that BNY announced on February 2, 2010 that it would appeal the Bankruptcy Court’s ruling.

Second, the ruling could have important economic implications for the Lehman bankruptcy and holders of notes in similar transactions if, as has been reported, Lehman entities are parties to transactions containing similar clauses with a value of as much as \$8 billion to Lehman’s bankruptcy estate.

More broadly, if not reversed on appeal, the Bankruptcy Court’s ruling could have important consequences for outstanding and future structured finance transactions that involve shifting priorities in waterfalls as a consequence of the insolvency of a swap counterparty, or any other party for that matter. It is clear that the intent of the parties at the time the Dante Program was structured was to protect the Noteholder from the risk of an early termination of the swap and redemption of the Notes solely as a result of an event related to the credit or performance of the swap counterparty. The parties expected that, if the swap counterparty were to be in default at a time when it is owed a termination payment, the collateral would not be sufficient both to redeem the Noteholder and to pay the swap counterparty. The flip clause contained in Condition 44 was intended to protect the Noteholder from that risk by providing that the Noteholder would be paid prior to the swap counterparty. For similar reasons, many existing transactions provide that swap counterparties have senior rights to payments and collateral for so long as they are not in default, but then subordinate the swap counterparties’ rights should they default in their obligations or become insolvent. These provisions are intended to protect noteholders against counterparty credit risk and are important to obtaining required credit ratings. The Bankruptcy Court’s ruling defeats the intent of the parties and the rating agencies.

As a result of the cloud over these provisions

created by the Bankruptcy Court’s ruling, the rating agencies are now reviewing existing transactions that contain similar provisions for possible downgrade. Depending on a variety of factors, including whether the applicable documents require an early replacement of the swap counterparty in the event that its own credit rating declines, and the importance of the swap to the transaction, it may well be that many transactions that contain flip clauses akin to Condition 44 may not be able to maintain a rating greater than that of the swap counterparty.

**The Bankruptcy Court rejected each of BNY’s arguments and found that Condition 44 was an unenforceable ipso facto clause and that any action taken by BNY to enforce the provision would violate the Bankruptcy Code’s automatic stay.**

With respect to future transactions, it may be that entities subject to the U.S. Bankruptcy Code may be precluded from acting as swap providers in transactions that rely on shifting priorities of payment. To the extent that transactions employ such provisions the transaction parties may require that any swap provider be subject to more favorable laws, such as the laws of England as evidenced by the rulings of the High Court and the Court of Appeal. Also, commercial banks and insurance companies are not subject to the U.S. Bankruptcy Code. It is therefore unclear whether banks and insurance companies acting as swap counterparties will face the same scrutiny from rating agencies as swap counterparties that are subject to the U.S. Bankruptcy Code.

Another possible approach that market participants may consider will be to specifically build the shifting priority and subordination provisions in the swap documents themselves or to state that the relevant provisions contained in the various operative documents are incorporated into the swap documents and together form a swap agreement for purposes of the protections of Section 560 of the Bankruptcy Code. The swap documents might also recite that the shifting priority and subordination provisions constitute a contractual

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# Structured Finance

## *The Dante Ruling, from page 8*

right to liquidate, terminate or accelerate the swap agreement. While the Bankruptcy Court did not reach the issue, Lehman had argued that the flip clause contained in Condition 44 was not a right to liquidate, terminate or accelerate one or more swap agreements or to “offset or net out” positions that is protected by Section 560. As a result, whether such an approach would ultimately succeed is unclear.

**The most immediate practical consequence of the Bankruptcy Court’s ruling is that it puts BNY in a very difficult position as it is now subject to the conflicting rulings of the Court of Appeal and the Bankruptcy Court.**

Other approaches, some of which could well affect the pricing of the swap, include altering the parties’ rights to termination payments or adjusting the operation of the relevant waterfall.

For example, the parties could disclaim the right to receive a termination payment in all circumstances or in circumstances in which the swap counterparty is the defaulting party or upon the occurrence of a credit related event affecting the swap counterparty. Alternatively, the parties might place the right to receive termination payments by a swap counterparty at the bottom of the waterfall under all circumstances. Another idea would be to subordinate the rights of the swap counterparty to receive payments as part of the “standard” waterfall, but to grant the swap counterparty a more senior position if the transaction goes into default or early liquidation at a time when the swap counterparty is not in default of any of its obligations. Whether a court would view this latter approach as a disguised ipso facto clause is uncertain.

## **The Future**

BNY’s appeal will be heard by the United States District Court for the Southern District of New York, which will have authority to review all aspects of the Bankruptcy Court’s ruling. The District Court could uphold the ruling or, because of the complexity of the issues and the lack of existing guidance, it is also entirely possible that the District Court could reverse the Bankruptcy Court on any one of the issues discussed above. But it is certain that parties to existing and future transactions containing clauses like Condition 44 will be watching this case very, very closely. □

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*Dave Krohn is a Partner based in the firm’s Washington DC office. Mr. Krohn focuses his practice on representing financial institutions, hedge funds, and other parties to complex financing transactions. He has over 25 years of experience in structured finance, commercial finance, derivatives and the development of innovative financial products. His experience includes a broad range of asset classes and financial products. (david.krohn@dlapiper.com) William M. Goldman is a Partner in the Corporate and Securities and the Finance practices, based in DLA Piper’s New York office. For more than 25 years his practice has focused on corporate reorganization and bankruptcy. (William.m.goldman@dlapiper.com) Marc A. Horwitz is a Partner based in the firm’s Chicago office. Mr. Horwitz regularly advises domestic corporations and multinational financial institutions on all aspects of derivatives and structured financial products. (marc.horwitz@dlapiper.com)*

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# Snapshots

BY REUTERS

## **Bahrain**

### **Islamic Finance Industry Launches Derivatives Standard**

A template for an over-the-counter Islamic derivative contract was launched this week and offered a channel for the emerging industry to better hedge itself against risks.

The contract will create a standard legal framework for derivatives in the Islamic market. It is expected to pave the way for quicker and cheaper Islamic risk management and more frequent cross-currency transactions by offering a template that is accepted by Islamic scholars.

The contract was developed by the International Islamic Financial Market, an Islamic finance industry body, and the International Swaps and Derivatives Association (ISDA). It is backed by banks such as Bahrain's Arab Banking Corporation, Credit Agricole CIB and Standard Chartered. Ijlal Alvi, chief executive of the IIFM, said the standard was expected to be mostly used for profit rate and currency swaps.

## **Brazil**

### **Brazil Banking Group to Monitor Derivatives**

Brazil's banking industry will monitor companies' exposure to derivatives contracts in hopes of avoiding a repeat of the crisis that hampered some corporations at the end of 2008, a banker said. The Brazilian Banking Federation, or Febraban, will launch a council in April that will match derivatives positions of customers that are registered with both local clearinghouse Cetip and BM&FBovespa. Data from the council, the Derivatives Exposure Center, or CED, can only be used by financial institutions, said Marcelo Maziero, a banker with Itau BBA who will form part of the council. Shareholders from the companies being monitored will not be given access to the information.

Creation of the council is the latest in a series of efforts by Brazil to make its derivatives markets more transparent. Unlike most developed nations, where derivatives contracts are mostly unregulated, companies and banks in Brazil must register their transactions in a local clearinghouse.

The move "will forbid many from taking on huge leverage," Jorge Sant'Anna, head of business development at Cetip, said at a Sao Paulo event.

## **China**

### **IMF Says China Should be More Flexible on Yuan**

China should be more flexible on its currency and encourage more domestic consumption, a senior International Monetary Fund (IMF) official said, as pressure builds on Beijing to revalue the yuan.

IMF deputy managing director Murilo Portugal called for flexibility as he responded to questions at a business gathering in Sydney, and said there was a need to generate internal demand to reduce a dependency on exports for growth.

**Unlike most developed nations, where derivatives contracts are mostly unregulated, companies and banks in Brazil must register their transactions in a local clearinghouse.**

He said the United States also needed to invest in the tradeables sector, rather than depend on domestic consumption to help its way out of an economic slump.

## **EU/Vietnam**

### **EU, Vietnam Agree to Launch Free Trade Talks**

The European Union has agreed to start negotiations with Vietnam on creating a free-trade agreement between the 27-nation bloc and the southeast Asian country, the EU's executive said. The European Commission said both sides were working on setting a formal start and agreed on framework for the negotiations, but did not specify a date. EU bilateral trade with Vietnam, which rose by 12 percent between 2004-2008, stood at nearly 12 billion euros (\$16.23 billion) in 2008.

## **France**

### **France Urges Looser EU Competition Rules**

The EU's competition policy is preventing

**continued on page 10**

**Snapshots, from page 9**

the creation of strong European companies and needs to be more flexible, French President Nicolas Sarkozy said.

He made his comments as he unveiled new policies aimed at halting the decline in French industry. He promised a more active government role in companies where the state is a shareholder, but said competition policy should be looked at on a European level. Sarkozy said Europe had lost the battle for consumer goods contracts and was facing increasing competition on major industrial contracts. The creation of "big European groups" was essential to conquering export markets, he said.

**Regulatory reform aimed at preventing banks from building up toxic assets could make it more expensive and harder for banks to fund exports, said Marc Auboin, the World Trade Organization's trade finance expert.**

France has fallen foul of EU competition rules several times in recent years.

**Global**

**Regulatory Reform Could Hurt Trade Finance**

Regulatory reform aimed at preventing banks from building up toxic assets could make it more expensive and harder for banks to fund exports,

said Marc Auboin, the World Trade Organization's trade finance expert. Auboin told Reuters that draft regulatory reforms known as Basel III, which make it more expensive for banks to hide assets off their balance sheets, would also push up the cost of funding trade.

Under the existing regulations, banks must set aside capital to cover roughly 20 percent of the value of letters of credit, because they have long been seen as so safe.

But the Basel III proposals, which require banks to cover liquidity as well as capital risks, state that banks must cover 100 percent of off-balance-sheet assets -- a five-fold increase. Banks hold letters of credit off balance sheet while they verify them, and typically 75 percent are rejected before they are confirmed.

**Taiwan**

**Taiwan to Let Brokers, Investors Buy Hong Kong Red Chips**

Taiwan will allow brokerages and retail investors to buy Hong Kong red chip shares directly in a further easing of business ties with China. The island's brokerages will be able to trade red chips and take orders from their local clients to trade the shares, the Financial Supervisory Commission said.

Red chips are stocks of Chinese companies incorporated outside the mainland and listed on the Hong Kong stock exchange. Taiwan investors have been able to buy red chips through Hong Kong brokers, though the Taiwan government had never officially permitted such trade. □

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# Foreign Exchange

## Pacific Exchange Rate Services Exchange Rates for the Dollar as of March 11, 2010

The table below gives the rates of exchange for the U.S. dollar against various currencies as of March 11, 2010. All currencies are quoted in foreign currency units per U.S. dollar except in certain specified areas. All rates quoted are indicative. They are not intended to be used as a basis for particular transactions. Pacific Exchange Rate Services (<http://pacific.commerce.ubc.ca>) does not assume responsibility for errors.

	Currency	Value of U.S. Dollar	Country	Currency	Value of U.S. Dollar	Country	Currency	Value of U.S. Dollar
Afghanistan	Afghani	47.8	Georgia	Lari	1.7195	Norfolk Islands	Aus. Dollar	1.0951
Albania	Lek	102	Germany	Euro*	1.3646	Norway	Krone	5.8778
Algeria	Dinar	72.791	Ghana	Cedi	1.414	Oman Sultanate	Rial	0.385
Andorra	Euro*	1.3646	Gibraltar	Br. Pound*	1.5017	Pakistan	Rupee	84.32
Angola	Kwanza	88.57	Greece	Euro*	1.3646	Panama	Balboa	1.00
Antigua	E.Car. \$	2.7	Greenland	Dan. Krone	5.4538	Papua N.G.	Kina	2.7586
Argentina	Peso	3.8559	Grenada	E.Car. \$	2.7	Paraguay	Guarani	4698.80
Armenia	Dram	361.75	Guadeloupe	Euro*	1.3646	Peru	Nuevo Sol	2.8385
Aruba	Guilder	1.79	Guam	US\$	1.00	Philippines	Peso	45.718
Australia	Dollar	1.0951	Guatemala	Quetzal	8.0528	Pitcairn Island	NZ Dollar	1.432
Austria	Euro*	1.3646	Guinea Republic	Franc	5030.00	Poland	Zloty	2.8635
Azerbaijan	Manat	4606.50	Guinea Bissau	CFA Franc	480.60	Portugal	Euro*	1.3646
Azores	Euro*	1.3646	Guyana	Dollar	204.70	Puerto Rico	US\$	1.00
Bahamas	Dollar	1.00	Haiti	Gourde	39.73	Qatar	Riyal	3.6388
Bahrain	Dinar	0.377	Heard/McDonald Is.	Aus. Dollar	1.0951	Rep. Yemen	Rial	199.00
Bangladesh	Taka	69.25	Honduras	Lempira	18.895	le de la Reunion	Euro*	1.3646
Barbados	Dollar	2.00	Hong Kong	Dollar	7.7597	Romania	Leu	3.0025
Belarus	Ruble	2951.00	Hungary	Forint	195.86	Russia	Ruble	29.499
Belgium	Euro*	1.3646	Iceland	Krona	127.18	Rwanda	Franc	572.88
Belize	Dollar	1.95	India	Rupee	45.611	Samoa (American)	US\$	1.00
Benin	CFA Franc	480.60	Indonesia	Rupiah	9195.00	San Marino	Euro*	1.3646
Bermuda	Dollar	1.00	Iran	Rial	9885.00	Sao Tome/Principe	Dobra	18299.00
Bhutan	Nguitrum	45.611	Iraq	Dinar	1169.00	Saudi Arabia	Riyal	3.7502
Bolivia	Boliviano	7.020	Ireland	Euro*	1.3646	Senegal	CFA Franc	480.60
Bosnia Herzegovina	Konv. Marka	1.380	Israel	New Shekel	3.7265	Serbia/Montenegro	Yug. N. Dinar	N/A
Botswana	Pula	6.7912	Italy	Euro*	1.3646	Seychelles	Rupee	11.75
Bouvet Island	Krone	N/A	Jamaica	Dollar	89.900	Sierra Leone	Leone	3859.00
Brazil	Real	1.7713	Japan	Yen	90.513	Singapore	Dollar	1.3984
Brunei	Dollar	1.3982	Johnston Island	US\$	1.00	Slovakia	Koruna	22.08
Bulgaria	Lev	1.4334	Jordan	Dinar	0.7083	Slovenia	Tolar	N/A
Burkina Faso	CFA Franc	480.60	Kazakhstan	Tenge	147.12	Solomon Is.	Solomon\$	8.2988
Burundi	Franc	1230.00	Kenya	Shilling	76.7	Somali Rep.	Shilling	1506.10
Cameroun	CFA Franc	480.60	Kiribati	Aus. Dollar	1.0951	South Africa	Rand	7.4557
Canada	Dollar	1.031	Korea, North	Won	1.18	Spain	Euro*	1.3646
Cape Verde Islands	Escudo	81.313	Korea, South	Won	1133.40	Sir Lanka	Rupee	114.01
Cayman Islands	Dollar	0.82	Kuwait	Dinar	0.2886	St. Helena	Br. Pound*	1.5017
Cent. Af. Republic	CFA Franc	480.60	Kyrgyzstan	Som	44.75	St. Kitts	E. Car. \$	2.7
Chad	CFA Franc	480.60	Laos	Kip	8479.50	St. Lucia	E. Car. \$	2.7
Channel Islands	Br. Pound*	1.5017	Latvia	Lat	0.5191	St. Pierre/Miq'lon	Euro*	1.3646
Chile	Peso	519.48	Lebanon	Pound	1506.80	St. Vincent	E. Car. \$	2.7
China	Renminbi	6.8266	Lesotho	Maloti	7.4496	Sate of Cambodia	Riel	4183.00
Christmas Islands	Aus. Dollar	1.0951	Liberia	Dollar	71.50	Sudan	Dinar	N/A
Cocos Islands	Aus. Dollar	1.0951	Libya	Dinar	1.2647	Suriname	Dollar	2.745
Columbia	Peso	1894.20	Liechtenstein	Sw. Franc	1.0716	Swaziland	Lilangeni	7.4496
Comoros Rep.	Franc	360.97	Lithuania	Litas	2.5302	Sweden	Krone	7.1273
Congo Republic	CFA Franc	480.60	Luxembourg	Euro*	1.3646	Switzerland	Franc	1.0716
Congo Dem Rep.	Franc	N/A	Macau	Pataca	7.9924	Syria	Pound	45.997
Costa Rica	Colon	543.75	Macedonia	Dinar	44.01	Taiwan	Dollar	31.785
Cote d'Ivoire	CFA Franc	480.60	Madagascar	Franc	8968.60	Tajikistan	Somoni	N/A
Croatia	Kuna	5.32	Madeira	Euro*	1.3646	Tanzania	Shilling	1364.00
Cuba	Peso	1.00	Malawi	Kwacha	150.80	Thailand	Baht	32.695
Cyprus	Pound	0.429	Malaysia	Ringgit	3.3197	Togo Rep.	CFA Franc	480.60
Czech Repub.	Koruna	18.751	Maldives Is.	Rufiyun	12.800	Tokelau	NZ \$	1.432
Denmark	Krone	5.4538	Mali Republic	CFA Franc	480.60	Tonga Island	Pa'anga	1.89
Djibouti	Franc	177.72	Malta	Lira	0.3146	Trinidad/Tobago	Dollar	6.3509
Dominica	E.Car. \$	2.7	Martinique	Euro*	1.3646	Tunisia	Dinar	1.3865
Domi. Rep.	Peso	36.18	Mauretania	Ouguiya	263.87	Turkey	Lira	1.5361
Dronning Maud.	Nor. Krone	5.8778	Mauritius	Rupee	30.45	Turkmenistan	Manat	14250.00
East Timor	US\$	1.00	Mexico	New Peso	12.613	Turks & Caicos	US\$	1.00
Ecuador	US\$	1.00	Moldova	Lei	12.58	Tuvalu	Aus. Dollar	1.0951
Egypt	Pound	5.4725	Monaco	Euro*	1.3646	Uganda	Shilling	2075.10
El Salvador	Colon	8.7475	Mongolia	Tugrik	1421.50	Ukraine	Hryvnia	8
Eq'tl Guinea	CFA Franc	480.60	Montserrat	E.Car. \$	2.7	United Kingdom	Br. Pound*	1.5017
Eritrea	Nafka	13.63	Morocco	Dirham	8.2171	Uruguay	Peso	19.7
Estonia	Kroon	11.465	Mozambique	Metical	31910.00	U.A.E.	Dirhan	3.6725
Ethiopia	Birr	13.431	Myanmar	Kyat	6.42	Uzbekhistan	Som	1543.40
European EMU	Euro*	1.3646	Namibia	Dollar	7.06	Vanuatu	Vatu	99.681
Faeroe Islands	Dan. Krone	5.4538	Nauru Is.	Aus. Dollar	1.0951	Vatican City	Euro*	1.3646
Falkland Islands	Br. Pound*	1.5017	Nepal	Rupee	72.94	Venezuela	Bolivar	4.29
Fiji	Dollar	1.9246	Neth. Antilles	Guilder	1.79	Vietnam	Dong	19068.00
Finland	Euro*	1.3646	Netherlands	Euro*	1.3646	Virgin Islands BR	US\$	1.00
Fr. Pacific Islands	Franc	87.286	New Zealand	Dollar	1.432	Virgin Islands US	US\$	1.00
France	Euro*	1.3646	Nicaragua	Cordoba	21.036	West Samoa	Tala	2.55
French Guiana	Euro*	1.3646	Nieue	NZ Dollar	1.432	Zambia	Kwacha	4650.00
Gabon	CFA Franc	480.60	Niger Rep.	CFA Franc	480.60	Zimbabwe	Dollar	N/A
Gambia	Dalasi	27.190	Nigeria	Naira	150.44			

(N/A) Not Available \* U.S. Dollar per national currency unit

## Foreign Exchange Rates and Forecasts For North and Latin America

CURRENCY FORECASTS ©  
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### North America

#### Canada

By mid-January, the Canadian dollar had strengthened by 28% against the US dollar from its low point in mid-March 2009, receding only slightly later in January and in early February. The rally in the loonie has been driven partly by increasing commodity prices, in particular oil prices. A broader decline in the US dollar resulted from a fall in demand for the safety of US assets as increased investor risk appetite was

an important factor in the initial stages of the appreciation. The US currency has also suffered against a broader set of currencies because of its wider use as a funding currency for carry trades, in which investors borrow in currencies with low interest rates and purchase assets in economies with higher yields. We forecast that the Canadian dollar will average C\$1.08:US\$1 in 2010, implying a slight depreciation from current levels. The start of monetary tightening in the US in the second half of 2010 will lead to the unwinding of US dollar-funded carry trades. The currency will also depreciate against the greenback in 2011 as weakness in the US and elsewhere causes a softening of commodity prices.

Canada	2010	2011	2012	2013	2014
C\$:US\$ (av)	1.08	1.13	1.09	1.06	1.04
Nominal appreciation of C\$ (%)	6.1	-4.4	3.4	2.8	1.9
Real appreciation of C\$ (%)	5.1	-5.1	2.6	2.3	1.5
C\$:US\$ (end period)	1.10	1.12	1.09	1.06	1.04
C\$:€ (av)	1.45	1.54	1.55	1.53	1.51
Nominal appreciation of C\$ (%)	9.9	-6.0	-0.4	1.4	1.2
Real appreciation of C\$ (%)	10.8	-5.7	-0.1	2.1	1.9
C\$:€ (end period)	1.45	1.58	1.56	1.53	1.51
C\$:¥100 (av)	0.99	1.05	1.03	1.01	1.00
Nominal appreciation of C\$ (%)	-0.5	-5.5	2.0	1.9	1.0
Real appreciation of C\$ (%)	1.3	-4.1	3.3	3.4	2.2
C\$:¥100 (end period)	1.01	1.05	1.03	1.01	1.00
Real effective exchange rate (1997=100)	99.5	106.1	111.6	117.9	123.6

Mexico	2010	2011	2012	2013	2014
Ps:US\$ (av)	13.1	13.8	13.9	13.7	13.5
Nominal appreciation of Ps (%)	3.4	-5.1	-0.7	1.4	0.9
Real appreciation of Ps (%)	6.4	-3.0	0.4	2.2	1.5
Ps:US\$ (end period)	13.9	14.0	13.1	12.6	11.5
Ps:€ (av)	17.6	18.8	19.7	19.7	19.6
Nominal appreciation of Ps (%)	7.1	-6.7	-4.4	0.0	0.2
Real appreciation of Ps (%)	12.2	-3.6	-2.1	2.0	1.9
Ps:€ (end period)	18.3	19.8	18.7	18.2	16.7
Ps:¥100 (av)	12.0	12.8	13.1	13.0	13.0
Nominal appreciation of Ps (%)	-3.0	-6.2	-2.1	0.5	0.0
Real appreciation of Ps (%)	2.5	-1.9	1.2	3.3	2.1
Ps:¥100 (end period)	12.8	13.2	12.4	12.1	11.0
Real effective exchange rate (1997=100)	116.4	109.9	114.4	114.7	112.7

United States	2010	2011	2012	2013	2014
US\$:US\$ (av)	1.00	1.00	1.00	1.00	1.00
Nominal appreciation of US\$ (%)	0.0	0.0	0.0	0.0	0.0
Real appreciation of US\$ (%)	-0.9	-1.1	-1.0	-0.4	0.0
US\$:US\$ (end period)	1.00	1.00	1.00	1.00	1.00
US\$:€ (av)	1.35	1.37	1.42	1.44	1.45
Nominal appreciation of US\$ (%)	3.6	-1.6	-3.7	-1.4	-0.7
Real appreciation of US\$ (%)	4.4	-1.7	-3.5	-0.5	0.4
US\$:€ (end period)	1.32	1.41	1.43	1.45	1.46
US\$:¥100 (av)	0.92	0.93	0.94	0.95	0.96
Nominal appreciation of US\$ (%)	-6.2	-1.1	-1.4	-0.9	-1.0
Real appreciation of US\$ (%)	-4.6	0.0	-0.3	0.8	0.6
US\$:¥100 (end period)	0.92	0.94	0.95	0.96	0.96
Real effective exchange rate (1997=100)	108.1	103.0	101.6	101.3	97.3

#### Mexico

Banxico is expected to oversee a gradual nominal weakening of the peso, intervening to smoothen volatility. In contrast to the currencies of other commodity-dependent economies, the Mexican peso is expected to remain significantly weaker in real terms than in 2008 (when it was not especially overvalued). This will reflect both capital account fundamentals and an official focus on supporting export competitiveness, provided this does not feed inflationary pressure. From its current trading value of Ps12.9:US\$1 we forecast a gradual weakening throughout 2010, to Ps13.9:US\$1 at the end of the year. Buoyant risk appetite and attractive interest rate differentials will sustain capital inflows for most of 2010, but a widening trade deficit and the fading of the impact of the US stimulus package will contribute to pressure on Mexico's currency in 2011, resulting in a weakening to Ps14:US\$1 at end-2011. Our central forecasts imply that the average real exchange rate will appreciate by 5.9% in 2010, before weakening marginally in 2011.

#### United States

The US dollar was on a clear downward trend between the strong point in March last year and the trough at US\$1.50:€1 in late November, but regained some strength in December and January this year. To some extent, the earlier depreciation was driven by an increasing

use of the greenback as a funding currency for carry-trades, in which investors borrow in low interest rate currencies and lend in currencies with higher returns, making big profits on the interest rate differential as long as exchange rates do not move against them. Traditionally, Japan had been the main funding currency, but now interest rates in the US are almost as low as they are in Japan. We expect the US dollar to fluctuate around the current slightly stronger levels. There is an increasing chance of further appreciation if the recent increase in risk aversion continues or reoccurs later in the year, for example as a result of greater sovereign risk concerns in emerging markets and some peripheral developed markets such as Greece.

## Latin America

### Argentina

Under our baseline forecast, the peso will depreciate in 2010-11, but by less than the average real depreciation of 10% in 2009. Central Bank intervention under the heavily managed float has allowed for peso stability during recent months, with dollar purchases in the second half of 2009 reducing appreciation pressures and dollar sales in recent weeks reducing depreciation pressures during a period of uncertainty surrounding the government's dispute with the Central Bank. But fundamentals continue to suggest that the Central Bank will oversee a moderate weakening of the peso in 2010-11, with imports recovering and capital inflows slow to return. This will bring the exchange rate to Ps4.04:US\$1 by end-2010 and to Ps4.27:US\$1 at end-2011 (implying an annual trade-weighted real depreciation of less than 1% per year). At these levels, the peso will be over 40% weaker than its average real trade-weighted value over the past 15 years, and more than 10% weaker than the average in the 2002-08 post-maxi-devaluation period. Nonetheless, particularly in the run-up to the presidential election in 2011, there is a risk of renewed bouts of capital flight and a sharper than forecast depreciation, given weak confidence in policymaking and heightened political uncertainty.

### Brazil

After rallying in 2009, the Real depreciated by 6% in January to R1.86:US\$1 as global risk appetite waned and investors digested a widening of Brazil's current-account deficit. But Brazil is still set to benefit from sizeable capital inflows seeking investment opportunities and interest rate arbitrage and we expect the Real

Argentina	2010	2011	2012	2013	2014
Ps:US\$ (av)	3.9	4.2	4.3	4.4	4.4
Nominal appreciation of Ps (%)	-4.5	-7.6	-3.2	-0.2	-1.5
Real appreciation of Ps (%)	1.2	-2.2	1.3	3.3	1.8
Ps:US\$ (end period)	4.0	4.3	4.3	4.4	4.5
Ps:€ (av)	5.2	5.7	6.2	6.3	6.4
Nominal appreciation of Ps (%)	-1.1	-9.1	-6.8	-1.6	-2.2
Real appreciation of Ps (%)	6.7	-2.8	-1.3	3.2	2.2
Ps:€ (end period)	5.3	6.0	6.2	6.3	6.5
Ps:¥100 (av)	3.6	3.9	4.1	4.1	4.3
Nominal appreciation of Ps (%)	-10.4	-8.6	-4.6	-1.2	-2.5
Real appreciation of Ps (%)	-2.5	-1.1	2.0	4.5	2.4
Ps:¥100 (end period)	3.7	4.0	4.1	4.2	4.3
Real effective exchange rate (1997=100)	51.2	48.7	49.9	49.9	49.3

Brazil	2010	2011	2012	2013	2014
R:US\$ (av)	1.85	1.92	1.99	2.04	2.09
Nominal appreciation of R (%)	8.2	-3.9	-3.4	-2.4	-2.4
Real appreciation of R (%)	10.4	-2.1	-2.0	-1.1	-1.0
R:US\$ (end period)	1.88	1.96	2.01	2.06	2.11
R:€ (av)	2.5	2.6	2.8	2.9	3.0
Nominal appreciation of R (%)	12.1	-5.5	-7.0	-3.7	-3.0
Real appreciation of R (%)	16.4	-2.7	-4.5	-1.2	-0.6
R:€ (end period)	2.5	2.8	2.9	3.0	3.1
R:¥100 (av)	1.70	1.79	1.88	1.94	2.01
Nominal appreciation of R (%)	1.5	-5.0	-4.8	-3.3	-3.3
Real appreciation of R (%)	6.3	-1.0	-1.3	0.0	-0.4
R:¥100 (end period)	1.73	1.84	1.91	1.97	2.03
Real effective exchange rate (1997=100)	52.7	55.0	67.9	76.6	82.9

Chile	2010	2011	2012	2013	2014
Ps:US\$ (av)	503.4	515.1	509.1	493.0	481.3
Nominal appreciation of Ps (%)	11.4	-2.3	1.2	3.3	2.4
Real appreciation of Ps (%)	10.0	-1.7	1.3	3.4	2.6
Ps:US\$ (end period)	508.9	519.9	498.9	487.1	475.4
Ps:€ (av)	677.0	704.4	723.0	709.9	697.9
Nominal appreciation of Ps (%)	15.4	-3.9	-2.6	1.8	1.7
Real appreciation of Ps (%)	15.9	-2.3	-1.3	3.2	3.0
Ps:€ (end period)	671.8	733.0	713.5	703.9	692.2
Ps:¥100 (av)	463.0	479.2	480.3	469.5	462.8
Nominal appreciation of Ps (%)	4.5	-3.4	-0.2	2.3	1.5
Real appreciation of Ps (%)	5.9	-0.6	2.0	4.5	3.3
Ps:¥100 (end period)	469.1	488.2	472.9	466.1	457.1
Real effective exchange rate (1997=100)	76.1	80.6	85.2	89.7	88.3

to average R1.85:US\$1 in 2010 and R1.92:US\$1 in 2011. These levels will be over 10% stronger than the Real's average real trade-weighted value over the past 15 years, weighing on the competitiveness of manufactures and some agricultural exports. A renewed rise in risk aversion, sharp fluctuations in Brazil's commodity export prices or weaker Chinese growth would hit the Real. As there is little risk of major policy shifts and as Brazil enjoys solid fundamentals, the election contest is unlikely to be a source of significant volatility.

### Chile

A recovery in copper prices has helped to drive an appreciation in the peso in recent

continued on page 14

# Foreign Exchange

Foreign Exchange Rates, from page 13

<b>Colombia</b>					
	2010	2011	2012	2013	2014
Pes:US\$ (av)	2,011	2,079	2,122	2,147	2,159
Nominal appreciation of Ps (%)	7.3	-3.3	-2.0	-1.2	-0.6
Real appreciation of Ps (%)	7.2	-1.5	-0.6	0.1	0.8
Pes:US\$ (end period)	2,055	2,100	2,141	2,152	2,165
Pes:€ (av)	2,705	2,843	3,013	3,092	3,131
Nominal appreciation of Ps (%)	11.1	-4.9	-5.6	-2.5	-1.3
Real appreciation of Ps (%)	13.0	-2.1	-3.2	0.0	1.2
Pes:€ (end period)	2,713	2,961	3,061	3,110	3,152
Pes:¥100 (av)	1,850	1,934	2,002	2,045	2,076
Nominal appreciation of Ps (%)	0.6	-4.4	-3.4	-2.1	-1.5
Real appreciation of Ps (%)	3.3	-0.4	0.1	1.2	1.4
Pes:¥100 (end period)	1,894	1,972	2,029	2,060	2,082
Real effective exchange rate (1997=100)	66.3	72.4	82.4	81.0	90.5

  

<b>Venezuela</b>					
	2010	2011	2012	2013	2014
Bs:US\$ (av)	4.3	5.4	5.5	6.9	8.4
Nominal appreciation of Bs (%)	-50.1	-20.4	-1.8	-20.0	-17.9
Real appreciation of Bs (%)	-35.9	9.0	36.9	6.3	8.4
Bs:US\$ (end period)	4.3	5.5	5.5	7.0	8.5
Bs:€ (av)	5.8	7.4	7.8	9.9	12.1
Nominal appreciation of Bs (%)	-48.3	-21.7	-5.4	-21.1	-18.5
Real appreciation of Bs (%)	-32.4	8.3	33.4	6.1	8.8
Bs:€ (end period)	5.7	7.8	7.9	10.1	12.4
Bs:¥100 (av)	4.0	5.0	5.2	6.5	8.1
Nominal appreciation of Bs (%)	-53.2	-21.3	-3.2	-20.8	-18.7
Real appreciation of Bs (%)	-38.2	10.2	37.9	7.5	9.1
Bs:¥100 (end period)	4.0	5.2	5.2	6.7	8.2
Real effective exchange rate (1997=100)	105.7	103.2	101.1	107.5	115.1

months, to Ps507:US\$1 at end-January, despite cuts in the target interbank rate totaling 775 basis points by the Banco Central de Chile (BCC, the Central Bank) during the first seven months of 2009, and we forecast a further moderate appreciation in 2010 in real trade-weighted terms. With the exchange rate averaging Ps503:US\$1 in 2010, the peso will be 6% stronger than its 2004-08 average, and we expect some adjustment in 2011 as strengthening import growth yields a renewed depreciation and an average exchange rate of Ps515:US\$1. Nevertheless, continued firm copper prices and rising investment inflows will support the peso in 2011.

## Colombia

Despite some volatility (particularly around election time) we expect the exchange rate will average just over Ps2,000:US\$1 in 2010 as the peso will continue to be underpinned by strong

reserves and capital inflows. However, a rise in risk aversion towards the end of this year will put some pressure on the peso. After stabilizing near Ps2,000:US\$1 in November-December, as a result of a government intervention package, the peso strengthened in January and early February to around Ps1,990:US\$1, following trends in global equity markets. However, a large financing requirement will eventually produce some depreciation pressures, causing the peso to end 2011 at around Ps2,100:US\$1. After overshooting, like most global currencies, against the US dollar as the global credit crisis escalated, the peso rallied from February 2009, strengthened by an increase in risk appetite, the IMF deal and strong foreign-exchange inflows. But after reaching a high of Ps1,826:US\$1 in mid-October, the peso has depreciated slightly. A government intervention package has helped to bring the rate closer to Ps2,000:US\$1, where it should remain during the first half of this year, despite some fluctuations, before depreciation picks up pace. The main risks are an unexpected victory for a leftist candidate in the May elections, which could undermine confidence in economic policy and security, and/or a stronger than expected rise in global risk aversion.

## Venezuela

Even though the devaluation of the fixed exchange rate in January has helped reverse some of the real appreciation (80%) that had occurred since the previous devaluation in 2005, a massive increase in local-currency liquidity (with the authorities printing money to boost the value of dollar-denominated oil export earnings) will sustain supply/demand imbalances in the foreign currency market. This will place further downward pressure on the value of the black-market exchange rate (which is forecast to average BsF7.9:US\$1 in 2010) in spite of official intervention in this market. With oil prices weakening in 2011 and the authorities gearing up for a presidential election in 2012, we expect a further devaluation in 2011. However, the government is likely to retain the BsF2.6:US\$1 rate for essential imports, instead only devaluing the rate for non-essential imports (currently standing at BsF4.3:US\$1). Although this rate is forecast to weaken to BsF5.5:US\$1, it will remain overvalued. □

## Understanding Brazil's New Thin Cap Rules: An Exclusive Interview with Jorge Gross (PricewaterhouseCoopers LLP)

CONDUCTED BY GARY BROWN AND SCOTT STUDEBAKER

**Q:** *We understand that in Brazil, thin capitalization rules were introduced on December 16<sup>th</sup> through a President's act. Please briefly explain what these rules are and their importance to multinationals.*

**Gross:** As you mentioned, on December 16<sup>th</sup>, the executive branch published Provisional Measure 472, which put into force thin capitalization rules ("thin cap"). Up until then, Brazil had been the largest Latin American jurisdiction without thin cap rules. This development took a lot of people, including ourselves, by surprise, because there was no indication that Brazil was even contemplating anything of the sort. The rules are somewhat harsh, not only in the ratios but also in their requirements. Basically the rules are broken up into two segments; payments of interest to recipients who are *not* residents of tax haven jurisdictions and payments of interest to recipients who *are* residents of tax haven jurisdictions. If the ratios are exceeded the excess interest is not deductible.

**Q:** *Is this rule effective immediately or one year after implementation?*

**Gross:** This provisional measure is in force until it is acted upon by the Brazilian Congress which has a 60 day period to either veto it, modify it or convert it into law. If the Congress does not act within that initial 60 day period, then the measure essentially expires unless it is extended for an additional 60 day period. Currently, we are within that initial 60 day period. As of the date of this interview the first 60 day period has not elapsed because the term was suspended for a period of time due to the holidays.

**Q:** *So, just to be clear, even if Congress enacted a new rule, you're not aware of anything that would require the need for a year to pass before the rule could become effective?*

**Gross:** Although the PM is effective as from Dec 16, 2009, we understand that the application of the ratio will be: (i) as from March 2010 for CSLL purposes (social contribution on net income) and (ii) as from January 2011 for IRPJ purposes (corporate income tax) if the PM is converted into law in 2010.

**Q:** *You indicate that the new rules were quite a surprise. What can companies do to cope with these new rules?*

**Gross:** We need to understand, first of all, what the

rules are, because there are still many questions as to how they are to be applied. For example, the law refers to "debt to equity ratios", but it also refers to the equity as participation in the net equity of the Brazilian entity. We think we know what that means but we are not exactly sure. Does the PM refer to net equity as only stock and paid-in capital or do we include the entire equity section, meaning that any retained earnings will also be included as part of equity for purposes of measuring this debt to equity ratio? We need to understand what the rules of the game are before we even begin to try to act upon them.

Additionally, there was no mention in the provisional measure as to whether or not debt that was in place prior to the issuance of the PM would be grandfathered so the rules would not apply. I would be surprised if that was the case but again that is still an open question. The more likely scenario is that interest payments after the effective date of the PM would simply be non-deductible if you exceed the debt to equity ratios prescribed.

**Q:** *Just to clarify: is this all debt or just debt to related parties?*

**Gross:** We are talking about related party debt but there is also a requirement that refers to total debt. Furthermore, it is not clear what is the definition of "related" party debt. I think it is clear that a loan by the Brazilian entity's shareholder is related party debt, but what about a loan from an affiliate within the group such a brother/sister company? We still are not clear on what is the definition of "related party debt" for purposes of these thin cap rules. encompasses

**Q:** *What are the rules contained in the Provisional Measure?*

**Gross:** When we're talking about the payment of interest to recipients that are not resident in a tax haven jurisdiction, there are basically three requirements to avoid disallowance of the interest expense for tax purposes. The first requirement is that the interest expense needs to be necessary for the activities of the local entity and it must be usual and customary for the generation of corporate income. So, for debt that is put in place, let's say, as a debt push down transaction, questions remain as to whether or not this type of indebtedness will be viewed as necessary,

continued on page 16

The law refers to "debt to equity ratios", but it also refers to the equity as participation in the net equity of the Brazilian entity. Does the PM refer to net equity as only stock and paid-in capital, or do we include the entire equity section, meaning that any retained earnings will also be included?

# Capitalization Rules

## **New Thin Cap Rules, from page 15**

usual and customary that was actually incurred for the operation and generation of income.

The second requirement is that the amount of debt granted by the related party cannot exceed twice the amount or 2:1 the amount of its participation in the net equity of the Brazilian entity.

The third requirement is that the total amount of the Brazilian entity's debt does not exceed twice the amount of the foreign related parties' participation in the Brazilian entity's net equity. So, if under either test a 2:1 ratio is exceeded the interest related to the amount of debt that exceeds the ratio will not be deductible for tax purposes. The rules also apply in the case of guarantees and representations so that any transaction that may not necessarily be direct with the related party but rather carried out with the Brazilian entity indirectly through the use of an intervening party will fall under the purview of these rules. This rule seems to imply that the authorities are going to try to pierce through the form of transactions that are structured as if they were not related party debt but in substance they are. A back to back loan with a third party bank might be a good example where an unrelated bank lends to the Brazilian entity but the loan is guaranteed by the foreign related party. Again. The definite of who is considered a related party still needs further clarification.

**Q:** *In a situation like this in other countries, like Mexico, it might be possible to get an advance ruling from the authorities. Would it be possible to get an advanced ruling about related parties in Brazil?*

**Gross:** Although not customary taxpayers in Brazil can submit formal consultations to tax authorities in order to clarify the understanding on the application of the legislation. It should be noted that the response (positive or negative) will be valid for the requesting entity only.

**Q:** *Would you say that this rule involves a pretty low debt to capital ratio?*

**Gross:** It is very low. There are a number of other countries in Latin America that do have 2:1 ratios; Argentina is a good example of that. However, while the ratio may be low, if the payments are made to a tax haven jurisdiction, the Brazilian rules are harsher than many other countries in the region. For example, for an interest payment to a tax haven jurisdiction, there are three conditions that must be met to avoid disallowance of the expense for tax purposes. The first one is similar to the one required for interest payments made to a non-tax haven jurisdiction; that is that the expense has to be usual and customary for the generation of corporate income. However, the second requirement is that the amount of the related party debt cannot exceed 30 percent of the Brazilian

entity's net equity and this ratio is the lowest of any country in the region.

The third requirement is similar to the non-tax haven debt requirement except for the debt to equity ratio. If the total amount of the Brazilian's entity's debt is held by any foreign party resident or domiciled in a tax haven jurisdiction, say the Cayman Islands or Bermuda, the total amount of debt with any foreign party resident or domiciled in a tax haven cannot exceed 30 percent of net equity. If the debt exceeds 30 percent of net equity, the interest related to the excess debt will be disallowed. Clearly, these rules are pretty harsh when it comes to tax haven loans. What's even more surprising is that the provisions apply to debt financing transactions whether or not they are registered with the Central Bank in Brazil. In Brazil, any time you bring in foreign currency, whether it be in the form of capital or debt, you need to register it with the Central Bank in order to be able to get the money out later. However, with respect to thin cap the authorities are including both registered and unregistered debt for purposes of calculating the ratios. It will be interesting to see if the same rules will apply to include capital not registered with the Central Bank in the ratio.

**Q:** *So, if you exceed these limitations and make a payment, it is treated as a dividend that is taxed?*

**Gross:** No, not treated as a dividend, it is disallowed as a tax deduction. That basically means that you have the financial expense but you cannot deduct it for tax purposes so presumably you created a book/tax difference. Different countries have different treatments of thin cap. Some disallow the deduction of the interest for tax purposes; some treat the excess interest as dividends; some basically tax it at a higher rate if you exceed the ratios. Thus, each country has its own version of thin cap and the treatments are not necessarily uniform throughout the region.

**Q:** *What are some options besides investing more in equity?*

**Gross:** Brazil still has the concept of "interest on equity", which is the Brazilian version of a hybrid instrument. In Brazil you can pay interest on your equity and get a tax deduction within certain limitations. In effect it is a deductible dividend when viewed from the recipient's perspective. The reason why it is viewed like a hybrid instrument is that in most countries that are the recipients of this interest on equity, the payment is generally treated as a dividend because there is no debt in place yet for Brazilian tax purposes it is treated as deductible interest.

So say, for example, if you were to capitalize a portion of your debt in order to create more equity and fall within the debt to equity ratios, one alternative

would be to then pay interest on equity. However, there are also rules that were introduced by this provisional measure with respect to deductibility of certain payments, if the payments are made to tax havens. These payments include such items as royalties, service fees and other types of payments. The three conditions that must be met for the payments to be deductible are:

- The first is that the (direct or effective) beneficiary of the payment is identifiable or identified.
- The second requirement is that there must be evidence that the recipient or beneficiary of the payment has “operational capacity”, which I interpret to be substance. So having, let’s say, an intervening company just for the sake of avoiding taxability of the payment by the recipient where that company has no real substance or purpose, it is not likely going to meet this requirement.
- The third requirement is that there be adequate documentation supporting the payment and the corresponding reason for the payment. In other words, if there was a payment for goods or services there has to be adequate supporting documentation that goods were shipped or that services were rendered.

**Q:** *What do you tell your clients who are asking what they should be looking as possible alternatives to reduce the hit that they would otherwise take when this rule goes into effect?*

**Gross:** At this point in time all you can do is play around with potential scenarios because we don’t know exactly what the rule is formally going to look like once enacted. As I mentioned before, there are still many areas of the PM that may be subject to different interpretations so until we have further clarification all you can do is “what if” calculations under all possible scenarios.

One area I would certainly advise my clients to look at is the possibility of capitalizing some of the debt and exploring the tax impact of making payments of interest on equity. What’s going to be interesting if this is an alternative that is explored is what the Brazilian definition of a tax haven will be. In the past Brazil has had a definition of tax haven for certain purposes of tax law that defined a country as a tax haven based on the rate of taxation in the tax haven jurisdiction. If it was less than a certain percentage the country was considered a tax haven. But we don’t know whether that’s a definition that the tax authorities are going to adopt or whether they’re going to use their black list of countries that they consider tax havens

**Q:** *How do you get guidance and the answers? Do the authorities come out with the equivalent of a revenue ruling?*

**Gross:** Yes, the authorities do come out sometimes with additional provisional measures that do clarify some of these ambiguities. A lot of times, we try to get answers from the government for further clarification as to what a rule means, but sometimes we are on our own.

**If the debt exceeds 30 percent of net equity, the interest related to the excess debt will be disallowed. Clearly, these rules are pretty harsh when it comes to tax haven loans.**

**Q:** *How widely are thin cap rules used in Latin America, in general?*

**Gross:** They are certainly more widely used today than maybe 10 years ago. Chile, Argentina, Mexico and Venezuela among others have them as well. It is interesting when you see the development of the tax systems in Latin America how countries tend to copy each other. Once one country incorporates a concept in its tax law, it seems to be almost like a wave, where others begin to also enact similar legislation. We saw that with transfer pricing. When Mexico first enacted transfer pricing right after NAFTA, then Argentina passed transfer pricing legislation and then Brazil passed it and now practically there is transfer pricing legislation in just about every country in the region. The same thing happened with substance over form. For years and years, Latin America was a much more form-driven region, and now the whole substance over form concept seems to be more widely applied in the region. The same thing is now happening with thin cap: one country passes thin cap rules, and then the next one, and the next one. Sooner or later, most of the countries will have thin cap rules. The problem, however, is that they are not uniform, just as transfer pricing is not uniform in the region. Each country has its own little twist, its own way of interpreting and applying their own rules.

**Q:** *As a practical matter, are we saying that in the future, foreign companies are going to have to be investing more in equity in Latin America?*

**Gross:** There are many factors that play into what is the correct capital structure for a company but thin cap rules will definitely influence a parent company’s decision as to whether debt or equity is the right funding mechanism for their Latin American subsidiaries now and in the future. □

*Jorge Gross (jorge.gross@us.pwc.com) is an International Tax Partner with PricewaterhouseCoopers LLP in Miami and is leader of the firm’s Latin American Tax (“LATAX”) Group.*

# Controlled Foreign Corporation

Revised Proposals, from page 1

## Overall Shape

- The new rules will operate on an entity basis: an overseas subsidiary will either be within the new rules or not, but the Government states that in appropriate cases (those where a "disproportionate result" would be given), its aim would be only to tax profits that represent an "artificial diversion" from the UK. Equally, as noted below, excess non-trading income within an otherwise trading entity would be within the charge, so some form of "streaming" of income within the subsidiary seems likely to be required. There is currently no intention to define the term "artificial diversion of profits". Parties at the stakeholder event on February 23 suggested that this would be necessary, but HMRC were insistent that it would not.

**Additional flexibility will be built in to exempt or partially exempt subsidiaries which "narrowly miss" one of the other exemptions or where one-off commercial transactions result in a test being failed.**

- The Government is proposing a number of objective tests to exclude subsidiaries where there is a low risk of artificial diversion of profits. Likely exclusions include:
  - companies that are in jurisdictions with similar statutory rates and a similar tax base to the UK. The Government is exploring a list of factors which would inform this. However, it is still consulting on how whether a "lower level of tax" test or a white list would be better approaches;
  - companies undertaking genuine trading activities. This could include intra-group transactions as long as those transactions do not pose a risk to the UK tax base. However, it will no longer be possible to avoid the application of the CFC rules to non-trading income by locating such income in a company with trading profits. The paper also discusses the "issue" of receipt of income from the holding of "un-commercial" levels of cash within trading companies in low tax jurisdictions. The Government proposes to deal with this by allowing interest on such "excess" cash to be exempt from the CFC charge only insofar as it is incidental or ancillary to the company's trading activities;
  - subsidiaries carrying on particular types of activity, such as reinsurance and property management.
- Specific proposals are put forward for offshore

group treasury and finance operations and intellectual property management activities (see below).

- The new regime will include a de minimis threshold for profits as of now, but this is likely to be in excess of the current £50,000 threshold. At the stakeholder meeting on February 23, HMRC said that they were considering different thresholds for different-sized companies but gave no indication as to what these might be.
- Where other exemptions are not available, a new motive test is proposed. It is proposed that this will be different from the current test, which requires the company to show that the reduction in UK tax was not a main purpose of the transactions in question. The discussion paper states that there will be a "re-designed" motive test, which will allow an overseas subsidiary to demonstrate the "non-tax related commercial rationale" for a specified transaction, and it will not be assumed that tax reduction is a main purpose just because more tax would have been payable had the activities taken place in the UK.
- The discussion paper also says that additional flexibility will be built in to exempt or partially exempt subsidiaries which "narrowly miss" one of the other exemptions or where one-off commercial transactions result in a test being failed.
- The Government recognizes that there may be some cases in practice where it might be appropriate for the application of the new rules to be suspended and seeks views on whether this should be in the legislation rather than guidance. The example given is of a UK company acquiring from a third party a new sub-group which has previously had no connection with the UK: this would mirror the "period of grace" clearance, which HMRC are prepared to give under existing practice.
- Capital gains will continue to be excluded from the new rules.

## Group Treasury Operations and Finance Companies

The discussion paper includes a separate section on how "monetary assets" might be treated. These are instruments giving rise to interest-like returns, including cash, cash equivalents, debt and debt equivalents. The Government's current focus is on groups outside the financial services sector.

The paper distinguishes between group treasury companies on the one hand and finance companies on the other. The Government accepts that normal treasury activities are unlikely to pose a risk to the UK tax base and therefore proposes an exemption for these companies.

As far as finance companies are concerned, the Government sees a risk of artificial diversion of profits where the finance company is funded through UK capital on which it does not earn a return (for example, where a UK parent borrows and then uses the funds raised to acquire equity in the subsidiary). It proposes:

- to exempt finance companies that are funded on an "appropriate basis" in terms of the mix of debt and equity, with a tax charge where the equity is "excessive", and
- is exploring the use of a specified debt: equity ratio test to determine when equity is excessive (i.e. a "thick capitalisation" test on similar lines to a "thin capitalisation" test). At the stakeholder meeting on February 23, HMRC said that they welcomed suggestions as to what this ratio should be, and also said that where subsidiaries are located in countries with specific thin capitalisation requirements, this would need to be taken into consideration when looking at compliance with any UK debt: equity requirements.

However, such a proposal is likely to need to be supported by some form of anti-avoidance rules to prevent the UK tax base being eroded by, for example, an exempt finance company then lending the money

to a UK group company. Two possibilities mooted in the discussion paper are (1) only to allow the exemption where the company makes no loans to the UK and (2) to provide that interest received by the finance company from the UK would not be eligible for exemption. The discussion paper also acknowledges that provisions would be needed to deal with the situation where the local jurisdiction requires a minimum equity funding in the subsidiary.

## Intellectual Property

The approach of the Government here is to reform the treatment of IP so as to prevent more effectively the erosion of the UK tax base where IP rights are migrated to a low tax jurisdiction. One of the strong messages that Government received from business as part of the earlier consultation exercise was that a new CFC regime should reflect the extent to which IP is actively managed overseas and that increases in value of the IP due to active management overseas should not be within a UK tax charge. Business also commented that the Government's desire to tax IP development in the UK, where this is subsequently migrated, should be addressed through the current exit tax and transfer pricing rules rather than CFC reform.

The Government's response to these comments is:

**HM Treasury is exploring the use of a specified debt: equity ratio test to determine when equity is excessive (i.e. a "thick capitalization" test on similar lines to a "thin capitalization" test).**

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# Controlled Foreign Corporation

## Revised Proposals, from page 19

- it remains concerned about relying on the transfer pricing (TP) and exit rules, but will consider further the extent to which those rules can deal with the perceived problem. It is also considering how the new rules will co-exist with the proposed new "patent box" rules;
- one circumstance where the Government is concerned that the TP and exit rules may not produce the right amount of tax (or at least not without considerable complexity and cost) is where the IP is migrated before its value can be properly determined. The Government suggest that one approach to this might be a specific tax charge in these circumstances where the IP increases in value significantly after it has left the UK;
- where an offshore company undertakes active management of the IP and there is minimal UK involvement, the Government proposes that the company would be exempt from a CFC charge, but where the management is carried out wholly or partly in the UK, a CFC charge would apply (but with partial exemption where management is split between the UK and overseas). The discussion paper says that this would require some sort of "substance" test to measure where active management is taking place (rather than just looking at numbers of personnel), and sets out a number of matters that could be taken into account, for example, development of the IP through specialist employees, developing a business model for

**Such a proposal is likely to need to be supported by some form of anti-avoidance rules to prevent the UK tax base being eroded by, for example, an exempt finance company then lending the money to a UK group company.**

exploiting the IP, and taking steps to protect the IP from various risks. The Government does, however, recognize that a modified approach might be appropriate for IP rich businesses that regionalize or contract out some activities.

Where IP is not actively managed overseas, the profits would in principle be subject to a CFC charge, but the Government suggests that the UK would only levy the charge where there has been an artificial erosion of the UK base, such as where it is equity funded from the UK. In this situation, the paper suggests a similar approach as for finance companies, i.e. looking at how the overseas subsidiary has been funded and its debt: equity ratio.

### Comment

The recognition of the distinction between active and passive IP management, as well as the distinction between different types of treasury and finance companies is welcome and should assist many businesses in structuring their overseas operations without falling foul of the new regime.

However, the retention of the existing entity-based system where businesses need to satisfy either a trading company exemption or a "motive test" could still be problematic for some businesses. It will be interesting, for example, to see how far from the existing "motive" test the new "re-designed" test will be.

It is probably too early at this stage, until we see the draft legislation, to say whether these reforms will be significant enough, and reduce uncertainty and complexity for business sufficiently, to stem the current interest in corporate inversions and relocations. Perhaps unsurprisingly, there were suggestions at the stakeholder meeting on February 23 that the proposal would still make the UK less competitive, although HMRC were keen to stress that this was a key consideration for them too. As always, the devil will be in the detail. □

*Simon Gough (simon.gough@dlapiper.com) and Paul Rutherford (paul.rutherford@dlapiper.com) are both Partners based in the firm's London office. Simon is the UK Head of Tax and advises on all aspects of tax including asset finance, structured finance, mergers and acquisitions, VAT, property and Inland Revenue investigations. David Thompson (david.thompson@dlapiper.com) is a Partner based in the firm's Manchester office. David advises on the tax aspects of acquisitions and disposals, mergers, demergers, group reorganisations and reconstructions, management buyout and buy-in transactions and other private equity transactions and on tax aspects of commercial agreements, joint ventures, flotations, international transactions, property and private finance initiative and public sector transactions.*

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