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SALES TAXATION OF DAILY DEALS

Daily Deals Present Novel State Sales Tax Issues

Deal of the Day Companies, such as Groupon and LivingSocial, have transformed discount shopping by bringing impulse buying to the consumer’s e-mail inbox in the form of on-line vouchers (“Daily Deals”). One estimate claims there are more than 600 Deal of the Day Companies,¹ generating billions in savings for discount-savvy consumers.² The typical Daily Deal works by soliciting consumers to purchase vouchers directly from Deal of the Day Companies. Each voucher allows a consumer to obtain discounted goods or services from a particular vendor. For example, a Daily Deal could allow a consumer to pay \$50 to obtain a voucher worth \$100 of goods or services. Deal of the Day Companies retain a portion of the \$50 paid as a commission-type fee and remit the remainder to the participating vendor.

Although innovative in form, Daily Deals conjure up familiar and recurring questions regarding appropriate application of sales tax laws, questions that several states have recently confronted. First, should the sale of such vouchers be subject to sales tax? Second, which amount should be taxed: the amount paid by the consumer, or the

full retail value of the goods or services obtained? The answer will have important implications for consumers, local merchants, Deal of the Day Companies, and state departments of revenue.³ The combined state and local sales tax rate now averages 9.6%.⁴ If tax is imposed on the full retail value of the voucher, a Daily Deal entitling the consumer to pay \$50 to receive goods valued at \$100 will result in \$9.60 of tax – 19.2% of the cost of the deal.⁵ If tax is imposed on the discounted price paid by the consumer, however, the tax will be only \$4.80 -- 9.6% of the cost of the deal.

In answering these questions, states have attempted to classify Daily Deals under well-settled rules for taxing traditional discount coupons and gift cards, while paying attention to subtle distinctions among various forms of Daily Deals.

Sales Taxation of Traditional Discount Coupons and Gift Cards

Traditional discount coupons fall into two broad categories: (i) retailers' coupons, and (ii) manufacturers' coupons.⁶ Retailers' coupons are issued by the retailer and, essentially, are equivalent to the retailer marking down goods for clearance. Manufacturers' coupons allow the consumer to pay a discounted price, but the retailer receives a reimbursement from the manufacturer for the amount of the discount. Because most state statutes measure sales tax against the seller's gross receipts or sales prices, it makes sense that sales tax traditionally applies to the reduced price when retailers' coupons are used and to the pre-discount total price when manufacturers' coupons are used. The key difference is that retailers' coupons signify true price reductions, whereas manufacturers' coupons do not reduce prices, from the seller's perspective.⁷

Although sales tax is increasingly imposed on sales of certain services, it traditionally applies to sales of tangible personal property only. Accordingly, states generally do not tax gift card sales, since gift cards represent an intangible right to purchase personal property or services in the future. When the consumer uses the gift card to purchase taxable goods or services, sales tax is imposed as if the consumer paid with cash.

Recent Approaches to Sales Taxation of Daily Deals

The New York Department of Taxation and Finance recently published guidance detailing the application of sales tax to Daily Deals.⁸ New York's analysis differs depending on whether the voucher is redeemable for (i) a specifically stated product or service, such as a pizza from a particular restaurant, or (ii) a specifically stated face value, such as \$25 worth of food from a particular restaurant. New York defines "specifically stated product or service voucher" to include Daily Deals in which the normal or regular selling price is stated on the face of the voucher. In such a case, the amount subject to sales tax is the total price paid to the Deal of the Day Company by the consumer for the voucher (i.e., the discounted sale price). On the other hand, a "specifically stated face value voucher" is essentially equivalent to a gift card

redeemable at a particular vendor, but not limited to particular goods or services. For specifically stated face value vouchers, New York computes sales tax on the full retail value of the underlying taxable goods or services before the voucher is applied against the purchase price.

In Kentucky and Iowa, the amount taxed depends on whether the voucher specifically states the amount paid by the consumer to purchase the voucher.⁹ If the voucher indicates its purchase price, sales tax is charged against the discounted amount only. If the voucher does not state the amount paid by the consumer, then the full retail value of goods or services that can be redeemed with the voucher is subject to sales tax.

California adopted the most taxpayer-friendly approach, electing to charge sales tax on the amount paid by the consumer only, regardless of the form of the voucher.¹⁰

Streamlined Sales and Use Tax Agreement (“SSUTA”)

In light of the uncertainty regarding proper sales taxation of Daily Deals, the Streamlined Sales Tax Governing Board¹¹ has solicited comments on proposals to amend the SSUTA definition of “sales price” to account for such vouchers. A motion submitted to the Streamlined Sales Tax Board by Tennessee proposes that a Daily Deals sales price exclude the discount if the voucher identifies the price the consumer paid and the merchant is not reimbursed by any third party.¹² Accordingly, Tennessee’s suggested approach focuses on whether the sales price is reduced from the seller’s perspective, such that Daily Deal vouchers would receive the same treatment that retailers’ and manufacturers’ coupons receive. Nebraska’s proposal contains two alternative approaches: (1) adopting New York’s full-retail-value taxation when the voucher has a specifically stated face value, and (2) taxing vouchers as retailers’ coupons if the amount the consumer paid for the voucher is known.¹³

Conclusion

Although many states have yet to weigh in on the issue, three aspects of Daily Deals should be non-controversial. First, states will most likely refrain from taxing the sales of Daily Deals since, like gift cards, Daily Deals represent an intangible right to purchase tangible personal property or services in the future. Second, transactions involving Daily Deals should not be subject to sales taxation unless the underlying goods or services obtained with the voucher are taxable under state law. Last, it appears that the form of the Daily Deal voucher will influence how it is taxed. States will likely examine factors such as whether the seller is reimbursed by a third party for the discount and whether the voucher more resembles a discount coupon or a gift card.

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- ¹ Jessica Mintz, *How Many Groupon Rivals? Try 600*, msnbc.com (Aug. 26, 2011, 9:37 AM) (<http://www.msnbc.msn.com/id/44261461/ns/business-retail/t/how-many-groupon-rivals-try/>).
- ² Local Offer Network, Inc., *The Daily Deal Phenomenon: A Year in Review 7* (March, 2011) (<http://groupbuyingcanada.com/wp-content/uploads/2011/04/LON-Deals-Industry-Report-03-11.pdf>).
- ³ In addition, although beyond the scope of this article, it should be noted that the impact of unclaimed property laws will also affect the economics of Daily Deals from the perspectives of all parties involved. In particular, state escheatment laws raise questions as to the escheatable value of unused Daily Deals and the proper allocation of responsibility for remitting such value to the state. For more information, see John A. Biek, *Daily Deal Vouchers Present Consumer Protection and Unclaimed Property Issues*, Journal of Passthrough Entities, Sept.-Oct. 2011, at 49.
- ⁴ Vertex Inc., *Press Release: Vertex Report Shows Modest Decline in Combined Average Sales Tax Rate and Number of Rate Changes* (Jan. 30, 2012) (<http://www.vertexinc.com/PressRoom/PDF/2012/vertex-2011-sales-tax-rate-report.pdf?ref=rss>).
- ⁵ Janet Novack, *24 States Moving Towards Decision On Taxing Groupon, LivingSocial Deals*, Forbes.com (Mar. 26, 2012) (<http://www.forbes.com/sites/janetnovack/2012/03/26/24-states-moving-towards-decision-on-taxing-groupon-livingsocial-deals/>).
- ⁶ Walter Hellerstein, *State Taxation*, § 17.06 (3d ed. 2012).
- ⁷ *Id.* at § 17.06[2].
- ⁸ Taxpayer Guidance Division of the New York State Department of Taxation and Finance, *Sales Tax Treatment Relating to the Sale and Redemption of Certain Prepaid Discount Vouchers*, Technical Memorandum TSB-M-11(16)S, Sept. 19, 2011.
- ⁹ Kentucky Department of Revenue, *Kentucky Sales Tax Facts: A Revenue Publication for the Business Owner* (Dec. 2011) (<http://revenue.ky.gov/NR/rdonlyres/3AE1FCEB-309A-438E-82E2-E1DAEA004DE7/0/SalesTaxFactsDec2011.pdf>); Iowa Department of Revenue, *Groupons – Iowa Sales Tax*, (<http://www.iowa.gov/tax/business/groupons.html>) (last visited June 14, 2012).
- ¹⁰ California State Board of Equalization, *Special Notice: Application of California Sales Tax to Deal-of-the-Day Instruments* (Nov. 2011) (<http://www.boe.ca.gov/news/pdf/l297.pdf>).
- ¹¹ The Streamlined Sales Tax Governing Board was organized in 2000 in an effort to bring simplicity and uniformity to state sales taxation and to reduce substantially the burden of tax compliance. Today, twenty-four states have adopted the SSUTA. The Streamlined Sales Tax Governing Board, Inc., *About Us: The Streamlined Sales Tax Governing Board* (<http://www.streamlinedsalestax.org/index.php?page=About-Us>) (last visited June 14, 2012).
- ¹² Tennessee Department of Revenue, *A Motion by Tennessee to Adopt an Interpretive Rule Relating to the Sales Price Definition and Prepaid Vouchers*, RP12005 (April 19, 2012) (http://www.streamlinedsalestax.org/uploads/downloads/Rule%20Amendment/2012/RP12005%20Sales%20Price%20Voucher%20Rule%20327_10.pdf).
- ¹³ Nebraska Department of Revenue, *A Motion by Nebraska to Adopt an Interpretive Rule Relating to the Sales Price Definition – Vouchers*, RP12004 (April 19, 2012) (http://www.streamlinedsalestax.org/uploads/downloads/Rule%20Amendment/2012/RP12004%20Sales%20Price%20Voucher%20Rule%20327_10%20NEB.pdf).

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OVERSTATEMENT OF BASIS DOES NOT EXTEND TIME FOR IRS TO ASSESS DEFICIENCY

On April 25, 2012, the United States Supreme Court handed down a taxpayer-friendly decision that prevents the Internal Revenue Service (“IRS”), in certain cases, from having extra time to charge for unpaid taxes. In cases where a taxpayer has overstated its basis in property sold, even if by more than 25%, the statute of limitations for the IRS should be no more than three years from the date the taxpayer filed its return. The decision, *U.S. v. Home Concrete & Supply, LLC*,¹ serves to emphasize a distinction between an overstatement of basis and an understatement of income.

As a general rule, the IRS has three years from the time of filing of a tax return to assess a deficiency against a taxpayer.² When the taxpayer omits more than 25% of gross income reported, the period is extended to six years.³ The issue before the Supreme Court in *Home Concrete & Supply* was whether an overstatement of basis was an amount omitted from gross income, and the Court ruled with a resounding “no.”

Briefly summarized, the facts and law in *Home Concrete & Supply* were as follows: Several taxpayers filed their 1999 tax returns in April 2000. The returns overstated the basis of certain property the taxpayers sold and consequently understated the gross income that the taxpayers received from the sale. The understatement exceeded the 25% threshold and the Commissioner assessed the deficiency within the extended six-year period, but outside the three-year period. Unless the six-year statute of limitations applied, the Government could not have assessed the deficiency. The Court ruled that the six-year statute of limitations did not apply because an overstatement of basis is not an amount omitted from gross income. In so holding, it relied primarily on *Colony, Inc. v. Commissioner*.⁴ In *Colony*, the Supreme Court interpreted a provision of the Internal Revenue Code of 1939 containing language materially indistinguishable from the language at issue in *Home Concrete & Supply*. It held that a taxpayer’s misstatements resulting in the overstatement of basis in property did not fall within the statute’s scope. The Court recognized that such overstatement wrongly understated the taxpayer’s income, but concluded that the phrase “omits... an amount” limits the statute’s scope to situations in which specific receipts are left out of income computations. The Court in *Home Concrete & Supply* further noted that while the statute’s language was not unambiguous, the statutory history revealed Congressional intent to restrict the extended period to situations where a taxpayer “failed to disclose” or “left out” items of income. Interpreting the statute differently, the Court stated, would require overruling *Colony* and constitute a course of action contrary to *stare decisis*.

Notable dicta in *Home Concrete & Supply* indicated that the Supreme Court may refuse to respect an agency interpretation of even an ambiguous statute when that statute lacks any

“gap” for the agency to fill. When the IRS pointed to a Treasury Regulation that departed from *Colony* and interpreted overstatements of basis as constituting omissions of income,⁵ the Court responded that the regulation did not trump *Colony* because the Court in *Colony* “thought that Congress had ‘directly spoken to the question at hand,’ and thus left ‘[no] gap for the agency to fill.’”⁶ The Court conceded that an agency may be entitled to *Chevron* deference⁷ where Congress explicitly left a statutory gap, but added that where Congress used ambiguous language without intending a “gap,” an agency interpretation will not trump the Court’s.

¹ 132 U.S. 1836 (2012).

² I.R.C. § 6501(a). Unless otherwise indicated, all references to “I.R.C.” refer to the Internal Revenue Code of 1986, as amended.

³ I.R.C. § 6501(e).

⁴ 357 U.S. 28 (1958).

⁵ Treas. Reg. § 301.6501(e)-1(a)(1)(iii). The regulation states that “an understated amount of gross income resulting from an overstatement of unrecovered cost or other basis constitutes an omission from gross income.”

⁶ *Home Concrete & Supply, supra*, citing *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

⁷ *Chevron* deference refers to the canon of legislative interpretation that if a statute administered by an agency is ambiguous with respect to a specific issue, the courts should defer to the agency’s reasonable interpretation of the statute. See *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

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PROPOSED SEC. 337(d)-7 REGULATIONS ADDRESS CERTAIN TRANSFERS OF PROPERTY FROM C CORPORATIONS TO RICs/REITs

Introduction

The IRS recently issued proposed regulations (the “Proposed Regulations”) that provide certain modifications to existing regulations issued under Section 337(d) of the Internal Revenue Code of 1986, as amended, relating to transfers of property from a C corporation to a regulated investment company (“RIC”) or a real estate investment trust (“REIT”). Under Treasury Regulation Section 1.337(d)-7 as currently enacted (the “Final Regulations”), if the property of a C corporation is transferred to a RIC or REIT, either by qualification of the C corporation as a RIC or REIT or a transfer of the C corporation’s property to a RIC or REIT, the transferee RIC or REIT would be subject to Code Section 1374 built-in gain tax treatment (or the property of the C corporation would be subject to immediate deemed sale treatment). The Proposed Regulations, however, provide an exception to this treatment contained in the Final Regulations to the extent the transfer to the RIC or REIT qualifies for non-recognition treatment under Code Sections 1031 or 1033. In addition, the Proposed Regulations also add a provision that excludes certain “tax-exempt entities” from the definition of a C corporation and the application of the Final Regulations.

Background

The *General Utilities*¹ doctrine provided a common law and statutory exception to the general corporate tax principle of double taxation² by allowing a corporation to liquidate without paying a corporate level tax on the net built-in gains in its property. The Tax Reform Act of 1986 (the “Act”), however, repealed the *General Utilities* doctrine by amending Code Sections 336 and 337 to generally require C corporations to recognize gain on appreciated property upon complete liquidation.³ In other words, realized gain occurring at the corporate level upon liquidation would no longer escape the corporate level of tax.⁴

Code Section 337(d) empowers the Secretary of the Treasury to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the Act. However, as opposed to the commonly seen general mandate of authority often given to the Secretary of the Treasury under other Code Sections, this mandate specifically identifies certain objectives, including ensuring that RICs, REITs and tax-exempt entities are not used to circumvent the purposes of the Act relating to the repeal of the *General Utilities* doctrine.⁵ The IRS first announced its intention to issue regulations pursuant to this mandate in Notice 88-19 (the “Notice”).⁶ The Notice outlined a default rule to be included in the regulations under which the transferor C

corporation would be treated as if it had sold its property at fair market value and then immediately liquidated.⁷ The regulations were to equally apply where the property was transferred via the qualification of the C corporation as a RIC or REIT, or a “carryover basis transaction” to such an entity.⁸ Under the Notice, the term “carryover basis transaction” refers to transactions or events that result in the transfer of ownership of a C corporation’s assets to a RIC or REIT and in which the basis of the assets is determined by reference to the C corporation’s basis.

Temporary regulations implementing the rules outlined in the Notice were first issued in 2000,⁹ followed by revisions in 2002¹⁰ and the issuance of the Final Regulations in 2003.¹¹ In a departure from the Notice, the Final Regulations refer to “conversion transactions” and forego the reference to “carryover basis transactions.”¹² A “conversion transaction” is defined as “the qualification of a C corporation as a RIC or REIT or the transfer of property owned by a C corporation to a RIC or REIT.”¹³ Further for purposes of the Final Regulations, the term “C corporation” is defined as a corporation which is not an S Corporation, RIC or REIT.¹⁴ In the preamble to the Final Regulations and a subsequent IRS Revenue Ruling, the IRS recognized the possibility that a tax-exempt entity could be treated as a C corporation and, therefore, fall within the purview of the Final Regulations.¹⁵

Concerns with the Existing Regulations

The Final Regulations generated a considerable amount of editorial commentary, and the issues contained therein were included in the IRS’ 2008-2009, 2009-2010, and 2010-2011 Priority Guidance Plans.¹⁶ In particular, one such commentary, a letter to the Commissioner from the American Bar Association Section of Taxation (the “ABA”) entitled *Comments Concerning Final Regulations Under Section 337(d) Relating to Conversion Transactions*, outlined certain concerns with the Final Regulations that have largely formed the basis for the revisions contained in the Proposed Regulations.¹⁷

Specifically, the ABA noted in the letter that the use of the term “conversion transactions” in the Final Regulations (rather than the term “carryover basis transactions” as contemplated in the Notice) served to greatly expand the scope of the transactions covered.¹⁸ Specifically, the ABA pointed out that the Final Regulations require application of Code Section 1374 (or deemed sale treatment) to property acquired in certain non-recognition transfers (i.e., transfers that do not constitute “carryover basis transactions”) between a C corporation and a RIC or REIT where the basis of the property received by the C corporation is determined by reference to the basis of the property transferred to the C corporation.¹⁹ For example, where a C corporation receives property in a transfer that otherwise would qualify for non-recognition treatment under Code Sections 1031 or 1033, the transfer would constitute a “conversion transaction” under the Final Regulations and, therefore, require application of Code Section 1374 (or deemed sale treatment) with respect to the property acquired by the RIC or REIT.²⁰ The ABA concluded that the application of the Final Regulations to such transactions (i.e., transaction that are

“exchanged basis transactions”) was inappropriate because the built-in appreciation in the asset received by the C corporation remained subject to the corporate level tax and, thus, does not circumvent the purposes of the repeal of the *General Utilities* doctrine.²¹ Echoing these concerns, other commentators have pointed out that such transactions, such as a transfer of real property by a C corporation to a REIT in a Code Section 1031 like-kind exchange, are “commonplace” and “non-abusive.”²²

In addition, the ABA expressed its concern regarding the inclusion of tax-exempt entities within the definition of a “C corporation,” particularly in situations where property is transferred by a partnership to a RIC or REIT and the partnership’s partners include both taxable and tax-exempt corporations.²³ If the partnership makes the deemed sale election under the Final Regulations, the tax-exempt partners will pay no tax, however, the taxable corporate partners’ gain will be accelerated.²⁴ If the partnership does not make the deemed sale election, the rules of Code Section 1374 will apply imposing Code Section 1374 treatment on the RIC or REIT by reference to the amount of deemed gain that would be allocated to all partners, including tax-exempt entities.²⁵ Including tax-exempt entities within the definition of a “C corporation” (and, thus, within the scope of the Final Regulations) was viewed by the ABA as overreaching because most transfers of property by tax-exempt entities to REITs or RICs do not present the same potential avoidance of *General Utilities* repeal as do other transfers involving taxable corporations.²⁶ This is because, in most cases, the tax-exempt entity would have been exempt from tax on gain recognized in connection with the sale of the property that it otherwise transfers to a RIC or REIT in a “conversion transaction.”²⁷ The ABA noted, however, that an exception to this rule does exist in the case where gain from the sale of property by a tax-exempt entity would be characterized as unrelated business taxable income under Code Section 511.²⁸

Changes in the Proposed Regulations

Exchanged Basis Transactions

The preamble to the Proposed Regulations acknowledges the commentators’ concerns that the Final Regulations may expose property transferred in certain “exchanged basis” transactions (i.e., like-kind exchanges and involuntary conversions) to the application of Code Section 1374 (or deemed sale treatment) despite the fact that circumvention of *General Utilities* repeal was not present.²⁹ To address this concern, the Proposed Regulations provide an exception for a transfer of property by a C corporation to a RIC or REIT to the extent that the transfer otherwise qualifies for non-recognition treatment under Code Sections 1031 or 1033.³⁰ In such a transaction, the C corporation transferor’s basis in the property it receives is determined by reference to the basis in the property it transferred (i.e., exchanged basis), and thus reflects the built-in gain. At the same time, as the preamble points out, the basis of the transferee RIC or REIT in the converted property has no relation to the C corporation transferor’s basis therein. Thus, the Proposed Regulations prevent the application of the Final Regulations to such transactions (i.e., transaction that are “exchanged basis transactions”) in part because the built-

in appreciation in the asset received by the C corporation remains subject to corporate level tax and, thus, does not circumvent the purposes of the repeal of the *General Utilities* doctrine. The preamble notes, however, that the changes contained in the Proposed Regulations are *not* intended to apply to all “exchanged basis transactions.”³¹

Tax-Exempt Entity Transactions

Again acknowledging the commentators’ concerns, the preamble notes that the application of the Final Regulations to transactions involving tax-exempt entities only furthers the purposes of *General Utilities* repeal to the extent that those entities would have been subject to tax had a deemed sale election been made.³² To avoid the unintentional imposition of tax on tax-exempt entities, the Proposed Regulations amend the definition of “C corporation” to specifically exclude certain tax-exempt entities.³³ “Tax-exempt entity,” for purposes of “conversion transactions” in the Proposed Regulations, means an entity described in Treasury Regulation Section 1.337(d)-4(c)(2) that would not be subject to tax with respect to any gain (if any) resulting from a deemed sale election made pursuant to Treasury Regulation Section 1.337(d)-7(c)(5).³⁴ Thus, where property is transferred by a partnership to a RIC or REIT, the Proposed Regulations would only apply to the extent of any gain or loss in the converted property that would be allocated to a C corporation (as defined in the Proposed Regulations) if the partnership sold the converted property to an unrelated party at fair market value on the deemed sale date.³⁵ For example, if a partnership in which a tax-exempt C corporation is a partner transfers property to a RIC or REIT in a “conversion transaction,” and the tax-exempt entity would not have been subject to unrelated business income tax under Code Section 511 or to tax under any other provision of the Code had the partnership made a deemed sale election, the transfer would be excluded from the scope of the Final Regulations to the extent of the tax-exempt entity’s distributive share of the built-in gain or loss in the converted property.³⁶

Additional Changes

In addition, the Proposed Regulations also add definitions for the terms RIC, REIT and S corporations.³⁷ While the preamble notes that the meanings of these terms are “both self-evident and unambiguous,” it explains that the Proposed Regulations add the explicit definitions for “clarification and ease of use.” Adding nothing new to the commonly used and understood definitions of RIC, REIT and S corporation, the Proposed Regulations define such terms by reference to Code Sections 851(a), 856(a) and 1361(a)(1), respectively.³⁸

Conclusion

Acknowledging the concerns of the ABA and other commentators, the Proposed Regulations seek to rectify applications of the Final Regulations that unintentionally and improperly impose tax in situations where *General Utilities* repeal is not subject to circumvention. By specifically carving out the problematic situations from the Final Regulations, and doing so largely

consistent with the manner proposed by the commentators, the Proposed Regulations appear to provide an effective solution to the improper imposition of tax under the Final Regulations.

1 *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935).
 2 Under the principle of double taxation, a C corporation's income and gains are subject to two levels
 of taxation, the corporate level and the shareholder level.
 3 American Bar Association Section of Taxation, *Comments Concerning Final Regulations Under*
Section 337(d) Relating to Conversion Transactions, 3, available at
<http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2008/080501commentsconcerningfinalregsundersec337dconversiontransactions.authcheckdam.pdf>, May 1, 2008 [*hereinafter* ABA
 Letter]
 4 *Id.*
 5 I.R.C. § 337(d)(1).
 6 Notice 88-19, 1988-1 C.B. 486 (Feb. 4, 1988).
 7 *Id.* The Notice did, however, note that such immediate gain recognition could continue to be avoided
 should the transferee entity elect to be subject to the rules of Code Section 1374 (i.e., treatment of
 built-in gains under the same rules as if a C corporation had elected to be treated as an S
 corporation).
 8 *Id.*
 9 Treas. Reg. § 1.337(d)-5T.
 10 Treas. Reg. §§ 1.337(d)-6T and -7(T).
 11 Treas. Reg. § 1.337(d)-7.
 12 Treas. Reg. §§ 1.337(d)-6(a)(1) and -7(a)(1); *cf.* Notice 88-19. The ABA assumed that the
 elimination of the reference to carryover basis transactions and the adoption of the exceptions in the
 regulations were likely intended to avoid duplication of the corporate level tax with respect to the
 same gain in situations where other provisions applied (e.g., Code Section 351(b)). ABA Letter,
supra note 3, at 5.
 13 Treas. Reg. §§ 1.337(d)-6(a)(2)(ii) and -7(a)(2)(ii).
 14 Treas. Reg. §§ 1.337(d)-6(a)(2)(i) and -7(a)(2)(i). The regulations refer to the definition of C
 corporation found in Code Section 1361(a)(2).
 15 See T.D. 9047, 68 Fed. Reg. 12817-01 (2003); see also Rev. Rul. 2003-69, 2003-1 C.B. 1118.
 16 The IRS Priority Guidance Plans for current and past years are available on the IRS' website:
<http://www.irs.gov/foia/article/0,,id=181687,00.html>. The Treasury Department's Office of Tax Policy
 and IRS use the Guidance Priority List each year to identify and prioritize the tax issues that should
 be addressed through regulations, revenue rulings, revenue procedures, notices, and other
 published administrative guidance. *Id.*
 17 Other commentators have expressed their agreement with the concerns outlined by the ABA. See,
e.g., National Association of Real Estate Investment Trusts, *Notice 2011-39: 2011-2012 Guidance*
Priority List Recommendations, available at <http://www.reit.com/Portals/0/IRSBusinessPlan2012.pdf>,
 May 26, 2011 [*hereinafter* NAREIT Letter].

18 ABA Letter, *supra* note 3, at 4. The ABA does note, however, that the regulations do contain an exception for “any conversion transaction to the extent that gain or loss is otherwise recognized on such conversion transaction,” and that this exception would provide some limitation to the potential expansiveness of the definition of conversion transaction. *Id.*

19 ABA Letter, *supra* note 3, at 5.

20 *Id.*

21 *Id.* at 5-6. The ABA notes that this concern was accepted in the Final Regulations in connection with transfers of all, or substantially all, of a C corporation’s property to a tax-exempt entity. *Id.* at 6 (citing T.D. 8802).

22 NAREIT Letter, *supra* note 17, at 5.

23 ABA Letter, *supra* note 3, at 9.

24 Code Sec. 1374 treatment does not apply to the extent the deemed sale election is made. Instead, a C corporation that makes such an election recognizes gain and loss as if it sold the property to an unrelated third party at fair market value on the deemed sale date. Treas. Reg. § 1.337(d)-7(c)(1).

25 ABA Letter, *supra* note 3, at 9.

26 *Id.* at 7-8.

27 *Id.* at 8. The ABA notes that another Code Section 337(d) regulation recognizes this conclusion, effectively cutting off the appreciation of property upon transfer by a taxable corporation to a tax-exempt entity. See Treas. Reg. § 1.337-(d)-4(a)(1).

28 *Id.* at 9.

29 Notice of Proposed Rulemaking, Fed. Reg. Vol. 77, No. 73, p. 22516 (Apr. 16, 2012) [*hereinafter* Preamble].

30 The exception is accomplished through the addition of a new paragraph to the existing regulations. Prop. Reg. § 1.337(d)-7 proposed to add the following paragraph (d)(3) to Treas. Reg. § 1.337(d)-7: “(d)(3) *Special rules for like-kind exchanges and involuntary conversions.* (i) In general. Paragraph (a) of this section does not apply to a conversion transaction to the extent that a C corporation transfers property with a built-in gain to a RIC or REIT and the C corporation’s gain is not recognized by reason of either section 1031 or 1033. (ii) Clarification regarding exchanged property previously subject to section 1374 treatment. Notwithstanding paragraph (d)(3)(i) of this section, if, in a transaction described in paragraph (d)(3)(i) of this section, a RIC or REIT surrenders property that was subject to section 1374 treatment immediately prior to the transaction, the rules of section 1374(d)(6) will apply to continue section 1374 treatment to the replacement property acquired by the RIC or REIT in the transaction.”

See Prop. Reg. § 1.337(d)-7(d)(3). The Proposed Regulations would also add a number of examples illustrating the application of the rules of paragraph (d)(3). See Prop. Reg. § 1.337(d)-7(d)(3)(iii).

31 For example, the Preamble specifically notes that the exception contained in the Proposed Regulations does not apply to exchanges that would otherwise qualify for non-recognition treatment under Code Section 351 “out of a concern that such an exemption could create opportunities to avoid corporate-level tax on built-in gains and would give rise to administrative difficulties that could be addressed only through extensive rulemaking.”

³² See Preamble, *supra* note 29. As the Preamble notes, a deemed sale election may create taxable income for an otherwise tax-exempt entity by generating unrelated business taxable income or adversely affecting the entity's qualification for tax-exempt treatment.

³³ Prop. Reg. § 1.337(d)-7(a)(2)(i).

³⁴ Prop. Reg. § 1.337(d)-7(a)(2)(vi). Treas. Reg. § 1.337(d)-4(c)(2)(i)-(viii) provides a list of entities that constitute tax-exempt entities, such as various entities described in Code §§ 115, 501(a), 529, 664(d), 7701(a)(18) and 7701(a)(40).

³⁵ Prop. Reg. § 1.337(d)-7(e)(1). Under the Final Regulations, the “deemed sale date” depends upon whether the transfer occurs via a (i) RIC or REIT qualification or (ii) some other conversion transaction. In the case of a RIC or REIT qualification, the deemed sale date is the last day of the C corporation's last taxable year before the first taxable year in which it qualifies to be taxed as a RIC or REIT. For other conversion transactions, the deemed sale date is the end of the day before the day of the transfer of the property from a C corporation to a RIC or REIT. See Treas. Reg. § 1.337(d)-7(c)(3)(i) and (ii), respectively.

³⁶ See Preamble, *supra* note 29. Note, however, to the extent the tax-exempt partner would have been subject to unrelated business income tax under or to tax under any other provision of the Code, the transferee RIC or REIT would be subject to tax on the built-in gain as if the RIC or REIT were an S corporation unless the transferring partnership elects deemed sale treatment.

³⁷ See Prop. Reg. § 1.337(d)-7(a)(2)(iii)-(v).

³⁸ *Id.*

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COURT PERMITS “QUICK PEEK” DISCOVERY IN TAX REFUND LITIGATION

On April 3, 2012, the IRS issued Chief Counsel Notice 2012-008, which prescribes coordination procedures for applying the economic substance doctrine and related penalties. The purpose of the notice is to limit application of the common law or codified economic substance doctrine and related penalties to “appropriate cases.”

The notice includes three key items: (1) instructions regarding IRS Chief Counsel’s role during an audit that involves the application of the economic substance doctrine under the common law or as codified in Internal Revenue Code section 7701(o), including related penalties; (2) instructions for reviewing a statutory notice of deficiency or a notice of final partnership administration adjustment if it is concluded that a transaction lacks economic substance; and (3) coordination procedures for litigating the economic substance doctrine, including any related penalties.

As a threshold matter, the notice directs the IRS to consider all substantive arguments and technical analyses reasonably relevant to the tax treatment of the transaction before applying the economic substance doctrine. Neither the common law nor codified economic substance doctrine should change how the IRS analyzes the tax treatment of a transaction under the Internal Revenue Code, Treasury Regulations, and other applicable law.

Procedures Governing IRS Audits, Statutory Notices of Deficiency and Notices of Final Partnership Administrative Adjustment

If requested to provide advice during an audit, IRS Chief Counsel is required by Chief Counsel Notice 2012-008 to provide timely assistance regarding the application of the economic substance doctrine and related penalties. Any advice provided by IRS Chief Counsel should generally take into consideration the relevant factors set forth in previous Large Business & International Division directives, as well as relevant case law. Although the directives address the economic substance doctrine as codified, IRS Chief Counsel should also take the directives into consideration where the common law economic substance doctrine alone applies.

Where the transaction at issue is the subject of a private letter ruling favorable to the taxpayer, the ruling (or any favorable determination letter issued to the taxpayer) should be reviewed and, if appropriate, revoked. Before proposing any adjustments to the transaction consistent with the economic substance doctrine, the IRS should first confirm that the ruling (or determination letter) has been, in fact, revoked. These procedures apply even where the private letter ruling does not discuss the economic substance doctrine. Similarly, the IRS should not issue any private letter ruling addressing whether the economic substance doctrine applies to a transaction.

Finally, where the underlying transaction is determined to lack economic substance, the IRS audit team should coordinate with Division Counsel and Associate Chief Counsel. Under Chief Counsel Notice 2012-008, the audit team, Division Counsel, and Associate Chief Counsel should work together in proposing a statutory notice of deficiency or a notice of final partnership administrative adjustment.

Litigation Procedures

Before the codified or common law economic substance doctrine and any related penalty is raised in litigation, IRS counsel is generally required by Chief Counsel Notice 2012-008 to coordinate with Division Counsel and the Office of the Associate Chief Counsel (Procedure and Administration).

Consistent with the guidelines governing audits, if the transaction at issue is subject to a favorable private letter ruling, the IRS must request that the Associate Chief Counsel office with jurisdiction over the transaction review and, if appropriate, revoke the applicable private letter ruling. Again, if the IRS revokes the ruling, it must confirm the revocation before raising the economic substance doctrine and related penalties. The IRS must follow these procedures even where the economic substance doctrine is not discussed in the private letter ruling.

Finally, Chief Counsel Notice 2012-008 requires that any brief, court filing or other submission addressing the economic substance doctrine be reviewed by the National Office prior to filing. This requirement applies to ongoing cases to the extent the brief, motion, defense or suit letter, or other court submission has not yet been filed.

Conclusion

In short, Chief Counsel Notice 2012-008 provides instructions to IRS counsel to ensure consistent application of the economic substance doctrine in the context of tax audits and litigation. Although the notice creates no rights for the taxpayer and provides no more guidance than previous Large Business & International Division directives, it will hopefully ensure a coordinated and consistent application of the doctrine.

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POSSIBLE TIGHTENING OF QUALIFICATION REQUIREMENTS FOR SOCIAL WELFARE ORGANIZATIONS

This past March 2012, critics from both major political parties called for changes to the rules governing what qualifies as a social welfare organization, also known as a 501(c)(4) organization. A social welfare organization is exempt from federal income taxation,¹ may conduct unlimited lobbying,² and may conduct limited campaign activities.³ It is often used as a vehicle for tax-exempt charitable organizations, which generally may not conduct campaign activities directly,⁴ to conduct campaign activities indirectly. The proposed changes would intensify the burden on entities seeking classification as 501(c)(4) organizations.

Understanding the proposed changes first requires some background information. Section 501(c)(4) of the Internal Revenue Code, in relevant part, provides for an exemption for “[c]ivic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.” With respect to the meaning of “exclusively,” the regulations provide “[a]n organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community.”⁵ Campaign activities are permitted to the extent they do not constitute a primary engagement, and the organization should maintain 501(c)(4) tax-exempt status so long as it files and the IRS approves a Form 1024. By contrast, a 501(c)(3) charitable organization generally may not conduct any campaign activity,⁶ while a section 527 “political committee” may engage in unlimited campaign activity.⁷ It is not uncommon for a 501(c)(3) charitable organization to form a 501(c)(4) affiliate and for a 501(c)(4) to form a 527 affiliate. Using that structure, a charitable organization may effectively be active politically while maintaining tax-exempt status. Furthermore, a Schedule of Contributors that all three types of organizations must file annually is not open for public inspection in the case of a 501(c)(4) organization. Thus, creating a 501(c)(4) organization can facilitate donor anonymity.

On March 12, 2012, a group of seven Senate Democrats led by Charles E. Schumer wrote a letter to the IRS. They requested that the IRS (i) adopt a bright line rule for what “primarily” means (and suggested that 51% is not consistent with the word “exclusively”), (ii) require 501(c)(4) organizations to “show their math” to demonstrate that their social welfare activities are primary, and (iii) require 501(c)(4) organizations to tell potential donors what percentage of a donation, if any, may be taken as a business deduction. The letter concluded that, if the IRS fails to take administrative action regarding these issues, legislation would be introduced to do so.

On March 14, 2012, a group of twelve Senate Republicans led by Orrin Hatch wrote their own letter to the IRS commissioner. They requested clarity on the Form 1024 approval process and the questions to be asked as part of that process. The letter was motivated by concerns regarding “selective enforcement and the duty to treat similar taxpayers similarly.”

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A Broader Perspective

On March 27, 2012, the House Oversight Committee launched an investigation into IRS review of Forms 1024 filed by conservative organizations. House Democrats have called on the IRS to scrutinize certain Republican-affiliated 501(c)(4)s to determine whether those organizations have engaged in excessive political activity.⁸

At this point, it is not clear whether the calls for action will lead to any changes in the substance of 501(c)(4) law or the procedure for reviewing and governing 501(c)(4) organizations or Form 1024s. The cries may be nothing more than political posturing against the backdrop of the upcoming Presidential election. Nonetheless, they are worth keeping an eye on because some of the changes, if enacted, could have a big impact on 501(c)(4) organizations.

¹ I.R.C. § 501(c)(4). The terms “I.R.C.” and “Internal Revenue Code,” as used anywhere in this article, refer to the Internal Revenue Code of 1986, as amended.

² Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii).

³ *Id.*

⁴ I.R.C. § 501(c)(3).

⁵ Treas. Reg. § 1.501(c)(4)-1(a)(2)(i).

⁶ I.R.C. § 501(c)(3).

⁷ I.R.C. § 527.

⁸ Representative Peter Welch announced he is leading 32 of his colleagues in this regard. 2012 TNT 62-37 (March 30, 2012). If a 501(c)(4) organization has violated the limits on political activities, it faces loss of exempt status, tax under Section 527, and possible late fees if loss of exemption is retroactive.

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U.S. TAX AND EMPLOYEE BENEFITS CONSIDERATIONS IN FOREIGN STRUCTURING

This article will provide a general overview of the U.S. tax and employee benefits considerations in structuring an entity to conduct the foreign aspects of a business (“Foreign Operations”).

I. U.S. Tax Considerations

Principal among the U.S. tax considerations are whether Foreign Operations are expected to generate taxable income or loss and whether any such income would be subject to a local country income tax at a rate at or below the U.S. statutory rate of 35%.¹ An additional consideration is whether earnings from the Foreign Operations are intended to be repatriated to the United States or whether the earnings will remain with a foreign entity that conducts the Foreign Operations to expand such Foreign Operations. These considerations will determine a number of structuring issues, such as what type of entity to utilize and how to finance the newly formed entity.

a. **Choice of Entity**

A U.S. corporation (e.g., through a branch) or a foreign or domestic flow through entity can be utilized to conduct the Foreign Operations. If such entities are used, any income, gain, loss, deduction or credit will be subject to current U.S. taxation and, thus, the subsequent repatriation of any previously taxed earnings will not result in additional U.S. tax.² Any foreign income taxes would be permitted as a foreign tax credit in the year paid or accrued (a “Direct Credit”).

Alternatively, if a foreign corporation (which does not have a U.S. tax presence or is not a flow through entity) conducts the Foreign Operations, any income or gain properly attributed to that entity will be taxed only when actually or deemed repatriated to the United States (subject to certain anti-deferral rules). Likewise, losses, if any, generated by the Foreign Operations would not be available to offset non-foreign income earned by a U.S. taxpayer. Any foreign income taxes paid by the foreign corporation would be permitted as a tax credit against U.S. tax only at the time of an actual or deemed repatriation of the foreign earnings (an “Indirect Credit”) to a U.S. corporate shareholder (subject to various limitations).

A foreign holding company (“Foreign Holding Entity”) may also be utilized to either conduct Foreign Operations or hold interests in entities that conduct Foreign Operations. A Foreign Holding Entity is most often utilized where Foreign Operations are expected to generate income subject to a low local country tax rate and such income is intended to be utilized to expand foreign operations rather than be repatriated to the United States. Therefore, a Foreign Holding Entity should generally be organized in a low or zero tax jurisdiction and, preferably, one that

has a favorable tax treaty for the Foreign Operations country and the United States. In addition, a Foreign Holding Entity, treated as a foreign corporation, may also help to facilitate the timing and utilization of any foreign tax credits.³

b. Anti-Deferral Rules

Under Subpart F of the Internal Revenue Code,⁴ a “U.S. Shareholder” of a “controlled foreign corporation” must include in gross income its pro rata portion of any “subpart F income” whether or not such income is distributed to its U.S. Shareholder.⁵ Accordingly, if Foreign Operations are conducted by a foreign corporation, income earned by such Foreign Operations may constitute subpart F income.

c. Financing the Newly Formed Entity

The capitalization of an entity conducting Foreign Operations with debt (whether from a related party or a third party lender) versus equity will depend on a number of tax considerations including: (i) whether the Foreign Operations’ earnings are intended to be repatriated to the United States or redeployed outside the United States; (ii) whether any distributions will be subject to a local country withholding tax; (iii) whether an interest deduction provides a local country tax benefit; and (iv) whether the Foreign Operations are expected to generate foreign taxes.

d. Other Tax Considerations

The above summary provides only a high level overview of tax considerations in structuring an entity to conduct Foreign Operations. There are a multitude of other activities which may affect the ultimate decision on how to best structure such an entity for U.S. purposes, such as (i) whether there will be a transfer or use of U.S. owned intellectual property by a foreign entity, (ii) the nature of any related party transactions and whether a transfer pricing study is necessary, (iii) withholding rates in the country of organization, and (iv) the applicability of any income tax treaty between the United States and the country of organization. Furthermore, the current U.S. taxation of foreign earnings may be subject to modification under legislative proposals and should be closely monitored.

II. Employee Benefits Aspects of Employee Transfers from the United States to Foreign Operations

Historic U.S. employees are often utilized when a U.S. business is setting up an entity to conduct Foreign Operations. This section will provide an overview on ways of dealing with the requirements of internationally mobile employees and their benefits.

a. Considerations Based on Employment Type

Where the employee(s) in question are on a short-term assignment (i.e., up to 5 years) or secondment, a typical approach is for those employees to be retained in the U.S. benefits structure where permissible under foreign law. This would include participation in equity plans, pension plans, social security and welfare plans. An important aspect of the process is assuring that the U.S. plans are drafted appropriately to permit continued coverage of such individuals while on assignment without inadvertently covering other employees whom the employer would like to exclude. Further, retaining U.S. citizens on assignment on a U.S. payroll effectively implements the typical approach to the provision of benefits to such individuals. When a U.S. citizen on assignment must be localized, retention of such individual in all U.S. plans (e.g., a 401(k) plan) may be administratively impracticable, and alternative benefits or additional compensation must sometimes be provided.

Alternatively, you may have an employee who is a “globalist” (i.e., employed on a series of short-term assignments without any expectation of a return to the United States). If these employees are truly international, then they will normally warrant an international approach to both pay and benefits involving off-shore benefit arrangements.

b. Developing an International Employee Benefits Policy

By definition, the management of international employee benefits is inherently complex because it requires an understanding of legislation and practice in multiple jurisdictions. It also requires consideration of local culture and market conditions. Therefore, the benefits policy should be developed in consultation with the business or human resources managers in the various local jurisdictions where the company has operations. The first step in establishing a workable policy is to define its objectives. Key considerations to take into account in doing so are outlined below.

i. Identify each market of operation and the employees working in them

The first consideration in establishing a benefits policy is to identify the relevant labor market to which it will apply. It is important to recognize that a company will compete for different segments of the labor market in different jurisdictions. For example, if the entire workforce is sales and marketing staff, it will only be competing in that segment. In another location the local employer could be competing for employees in the production segment of the workforce.

ii. Identify the intended market position with respect to remuneration for each market

In general, a company with “competitive” pay or benefits is providing total remuneration to employees at or near the market average. Many companies seek to set their pay and benefits at this level, although some will pay below, with additional elements contingent on individual or group performance.

iii. Identify the elements of remuneration considered to be employee benefits

It should be recognized that not all benefits will be relevant in each country. For example, in the United States the provision of medical insurance is an important part of the employee benefit package; in the United Kingdom this is not the case for most employees, because there is almost universal healthcare coverage provided under the National Health Service which is funded by compulsory employer and employee contributions. Therefore, the best way to assess whether a form of benefit is relevant is to consider it on a country-by-country basis. If it is relevant it then becomes a question of whether some or all of the employees should be covered.

iv. Consider if there is any requirement for consistency across the business locations

Developing an international benefits policy requires consideration of whether it is desirable to achieve the same level of consistency in pay practices across borders. The approach to benefit design and delivery may be consistent without necessarily providing that benefits should be the same in different jurisdictions. One approach is to simply target a competitive level of benefits by reference to the local labor markets and tailor benefits accordingly. Another approach is to adopt an above-market position in all countries to attract the best staff and facilitate the movement of employees along lines that transcend local market conditions.

v. Recognize the need for compliance with local legislation

Although legislation in different countries may contain common themes, the details are often different. It is therefore possible to encounter situations where the laws of the parent company’s home jurisdiction will conflict with the laws governing a subsidiary’s jurisdiction. This is a frequent problem in relation to secondments and when a company wishes to establish a benefit policy in multiple jurisdictions.

¹ In general, a U.S. corporation is subject to U.S. federal income tax on its worldwide taxable income at a maximum rate of 35%. A U.S. corporation files a separate Form 1120, U.S. Corporation Tax www.bryancave.com *A Broader Perspective*

Return, or if a member of a consolidated group its operations are included in the consolidated Form 1120 filed on behalf of the consolidated group. A U.S. corporation may also be subject to state and local income tax.

² Any distribution from a foreign branch, however, could create a foreign currency gain or loss.

³ In general, the distribution of earnings would entitle a 10% corporate shareholder to an indirect foreign tax credit with respect to any foreign taxes paid to which such earnings relate at the time of the distribution.

⁴ I.R.C. §§ 951 – 964.

⁵ This rule operates as an exception to the general rule that a shareholder in a foreign corporation is not taxed on the earnings of that corporation until distributed as a dividend.

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THE PATENT BOX REGIME

The UK government has been making a concerted effort in recent years to create what it hopes will be one of the most competitive corporate tax systems in the G20. It has been trying to make the UK a more attractive location for investment generally, and one specific area of focus is intellectual property. It is hoped that the new Patent Box Regime will encourage more businesses to hold their IP or research and development centres in the UK.

On 6 December 2011, the UK government published draft Patent Box legislation. The Patent Box Regime will tax a UK company on its worldwide income that arises from existing as well as new patents at a rate of 10% (with full benefits phased in over five years), rather than 23% (which will be the rate of corporation tax from 1 April 2013). Qualifying UK businesses who take advantage of the Patent Box Regime will be able to benefit irrespective of how they use their patents.

During the phasing in period, a company's patent related income will be taxed at 40% for the 2013 financial year, 30% for the 2014 financial year and 20% for the 2015 financial year with the full 10% tax rate being available for the 2016 financial year.

Does the company want to be in the Patent Box Regime?

An IP holding company has to elect into the Patent Box Regime. It can only do so if certain conditions are satisfied as the Patent Box Regime is only open to "qualifying companies" that hold relevant patent interests.

Does the company qualify to be in the Patent Box Regime?

Briefly, a company will qualify if it holds qualifying IP rights or if it holds an exclusive licence in respect of qualifying IP rights and it receives income from those rights. For a company to be within the Regime, it must be actively involved in the exploitation of a patent or be actively managing it, and it must receive income from the IP rights. A passive IP holding company will not qualify for the Regime. UK subsidiaries of foreign owned groups may find the exclusive licence provision particularly helpful.

In a group scenario, if a company is managing the IP rights, it must undertake a significant amount of management activity. Although the company does not have to make all of the decisions relating to the IP's management (it should form plans and make some of the decisions), it is hoped that it will be reasonably clear in practice whether the company's management activity is "significant" or not.

Companies will be allowed to opt out of the Patent Box Regime if they so desire. However, if the decision is made to opt out of the Regime, companies will not be allowed to go back into the Regime for five years.

What sort of patent will qualify?

The patent must be granted by the UK Intellectual Property Office or the European Patent Office. Companies will also benefit from the Patent Box Regime if the patent is granted by specified EEA countries which have similar examination and patentability criteria as the UK. The Patent Box Regime will not be extended to patents authorised by the US Patent and Trademark Office.

The Patent Box Regime will apply to existing as well as new IP, and also to acquired IP on the basis that the company has further developed the IP or the product which incorporates it. The company must have made a significant contribution to the creation or development of the invention claimed in the patent or a product incorporating this item; otherwise the Patent Box Regime will not apply.

How are the relevant IP profits in the Patent Box calculated?

It is important to note that the Patent Box Regime and the reduced rate of tax applies to profits rather than gross income. To qualify for the reduced rate of tax the profits have to fall within one of the following categories:

1. profits from worldwide sales of the patented item or a product that derives its value (or some of it) from the patent;
2. worldwide licence fees and royalties generated by third party use of the patented product;
3. profits from the sale or disposal of the patent rights;
4. payments generated by third-party infringement; and
5. any other compensation, for use of the patent.

The Patent Box Regime taxes qualifying profits generated from the relevant IP at 10%. In calculating the profits attributable to the patent, it is possible for the company to use a formulaic approach; the company can either allocate its profits between patent income and other income together with the appropriate expenses on a just and reasonable basis or simply apportion an amount to relevant IP income (using the ratio of IP income to gross income) in order to produce

an approximate (albeit reasonable) figure. Alternatively, a more bespoke calculation can be prepared.

Once the relevant IP profits have been calculated, the Patent Box Regime taxes those profits at a reduced rate. In practice, the relevant IP profits are reduced by an additional deduction in the company's corporation tax computation. The effect of this additional deduction is to reduce the rate of tax charged on the relevant IP income to 10%. If the Patent Box deduction reduces the relevant IP profits to a negative figure, then the rules specify how the losses will be used. Any losses will be ring-fenced and must be set-off against future Patent Box profits of the company or any other relevant IP profits of another group company.

What happens to income while the patent is pending?

The Patent Box Regime only applies to profits from patents that have been granted. However, income that is derived from a patent, or a product deriving its value from the patent, and that is earned in the period between application for and grant of a patent may benefit from the reduced rate of taxation under the Patent Box Regime in the year when the patent is granted. The company should calculate what the relevant IP profits would have been, for the period between application and grant. The aggregate amount for this period will be added to the relevant IP profits in the year in which the patent is actually granted. The benefit of the look-back provision will only extend to six years of relevant income. If it takes longer than six years to obtain the grant of a patent (following application) then the additional income will not be covered by the Regime.

Are there any anti-avoidance rules?

There are anti-avoidance rules to prevent unreasonable tax benefits arising from schemes that are designed to avoid certain provisions of the Patent Box legislation or to create a mismatch between the expenditure incurred in acquiring the IP rights (prior to electing into the Regime) and the income generated from the IP rights once the company has elected into the Regime (subject to the 10% rate of tax). The anti-avoidance rules are also designed to prevent the artificial inflation of the amount of relevant IP profits.

If a licence is granted and the licence is expressed to be "exclusive," it will not qualify for the Patent Box Regime if the exclusivity is "spurious" or the rights conferred are commercially irrelevant in an attempt to shoehorn any IP profits from a licence into the Patent Box Regime and ensure that any income generated qualifies for the 10% rate of tax.

Have the UK done enough?

The UK government is certainly taking steps to ensure that the UK is a more competitive jurisdiction, especially after recent years which saw certain high-profile businesses relocating to

Ireland and Zurich (amongst other destinations). Has the UK done enough to reward innovation? Other European countries already operate similar regimes. The Netherlands imposes a rate of 5% and Luxembourg imposes tax at 6% on profits arising from patents. Belgium also offers an attractive rate of tax for profits arising from patents and Ireland offers low tax rates in any event regardless of whether the income arises from the exploitation of patents. Only time will tell whether this new Regime together with other measures that have been taken by the UK government will be sufficient to promote business in the UK.

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TAX TRANSFER PRICING IN CHINA: REGULATIONS AND PRACTICE

On March 31, 2012, Bryan Cave’s Shanghai office held a seminar concerning transfer pricing. Two senior tax officers of the People’s Republic of China (“PRC”) were invited to make presentations. One Mr. Xia, Deputy Director of the Anti-Avoidance Division of the International Taxation Department of the Chinese State Administration of Taxation (“SAT”), presented a summary of viewpoints concerning PRC transfer pricing tax laws, regulations and practice. His points appear in the following paragraphs.

The SAT has been advocating a three-pronged approach of “administration, services, and investigation.” “Administration” refers mainly to voluntary adjustments made to transfer pricing arrangements, after reviews of taxpayers’ disclosure forms and transfer pricing documentation, and after follow-up efforts with previously-audited taxpayers urged to “review and refine” their transfer pricing. “Services,” including Advanced Pricing Agreement (“APA”) and Mutual Agreement Procedure (“MAP”) activities, are usually initiated by taxpayers. “Investigation” includes audits and investigations.

The Chinese tax authorities’ focus has shifted from traditional buy-sell transactions to transactions for services, intangibles, equity, and other items, and to increased enforcement. The automobile and pharmaceutical industries are key sectors for transfer pricing audits, and the SAT continues to strengthen centralized management of audits to regulate nationwide practice. The SAT requires that local tax bureaus obtain SAT approval for filing and closing cases, to ensure a uniform implementation standard and to avoid situations wherein audits of similar companies in different regions yield different results. During a transfer pricing investigation, any adjustments to operating profit due to differing levels of working capital employed might also require SAT approval. Furthermore, the SAT plans to increase joint audits of group companies and audits across selected industries, and to improve regulation of controlled foreign corporations (“CFCs”) and companies falling within China’s General Anti-Avoidance Rules (“GAARs”). Chinese tax authorities are actively involved in international collaboration regarding tax collection and management, as well as international anti-avoidance investigations. The SAT is participating in the drafting of the Practical Manual on Transfer Pricing for Developing Countries initiated by the United Nations, and will take measures against “dishonest” tax planning activities.

Chinese tax authorities have raised several issues relevant to safeguarding the interests of developing countries. It noted that countries with emerging markets, including China, hold unique competitive advantages over developed countries. Those advantages include continuously increasing purchasing power and cheap land and labor with nearly unlimited supply. The issues raised, all of which can impact a company’s transfer pricing, include:

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Location savings. Multinational companies earn excess profits by setting up low-cost factories in China. Since such profits stem from location savings, say Chinese tax authorities, Chinese subsidiaries should be entitled to the profit.

Market premium. As a country with an emerging market, competitive advantages, and purchasing power, China has contributed to the profitability of companies operating in the Chinese market. Chinese tax authorities believe that China should be entitled to tax excess profit derived from the China market.

Contract Research and Development (“R&D”). In most circumstances, contract R&D companies set up in China by foreign multinationals do not own the intellectual property rights generated from the R&D activities. These companies are usually compensated for their labor costs and relevant expenses, plus they receive a modest mark-up. In some situations, the tax authorities may consider such arrangements unfair and require that the Chinese companies be able to enjoy the benefits derived from the R&D activities, especially when the R&D companies are involved in R&D decision-making.

An important aspect of transfer pricing is which party to the transaction bears which risks, and Mr. Xia informed seminar attendees that, under PRC tax law and policy, selected enterprises established in China by multinational groups will not be responsible for market and business risks associated with the current financial crisis. Those enterprises are companies with limited functions and risks and which perform manufacturing, processing, distribution, or contract R&D activities only. They will maintain a reasonable profit margin commensurate with the functions performed and the risks undertaken.

Mr. Xia further informed seminar attendees of numerous other updates to Chinese transfer pricing law and regulation. For starters, the interquartile range is now used in testing profitability. Enterprises with profits below the median value will be subject to having their profits adjusted to median value. Also, in evaluating whether a company’s related-party transactions comply with the arm’s-length principle, Chinese tax authorities may use either public or nonpublic information. To this end, the tax authorities are trying to obtain support and cooperation from other governmental departments.

Amid the trend of tightening anti-avoidance rules, multinational companies should examine their tax arrangements and check whether those arrangements can be adapted to the changing tax environment in China. More and more multinational companies are applying for APAs to minimize transfer pricing risks as much as possible.

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