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# GUIDANCE ISSUED FOR FATCA COMPLIANCE

In an effort to combat tax evasion by U.S. persons, Congress enacted the Foreign Account Tax Compliance Act ("FATCA") in 2010.[1] FATCA is intended to stop tax evasion by encouraging foreign financial institutions ("FFIs") to enter into agreements with U.S. authorities or suffer a 30 percent withholding penalty described below. Pursuant to these agreements, the FFI is required to provide U.S. authorities with information regarding the financial accounts at the FFI controlled by U.S. persons (a "U.S. account"). In addition, requiring certain non-financial foreign entities ("NFFEs") to provide U.S. authorities information about their substantial U.S. owners.

Alternatively, if the U.S. government and the FFI's (or NFFE's) host country enter into an agreement and the FFI (or NFFE) reports its U.S. accounts to the host country tax authority, then the FFI would not be required to enter into agreements to report the U.S. account information to the U.S. authorities. The U.S. has already entered into an agreement with the U.K. and is negotiating agreements with several other countries.[2] The Treasury Department has prepared a model reciprocal agreement and a model non-reciprocal agreement.

A FFI is an entity organized outside the United States that generally accepts deposits in the ordinary course of a banking or similar business, a substantial part of its business consists of holding financial assets for the account of others, is engaged in the business of investing,

reinvesting or trading in securities, or is an insurance company.[3]

FATCA seeks to encourage compliance by imposing significant withholding penalties on non-compliant FFIs and NFFEs. Specifically, if a FFI or NFFE fails to comply with FATCA, then payors (including other FFIs) making "withholdable payments" to the non-compliant FFI or NFFE are required to withhold thirty percent of the payment.[4]

Withholdable payments include U.S. source fixed or determinable, annual or periodic gains, profits and income including gross proceeds from U.S. sources that produce fixed or determinable, annual or periodic gains, profits and income.[5] Amounts withheld are generally refundable to the beneficial owner.

The Department of the Treasury recently issued proposed regulations implementing the FATCA regime. Among other things, these proposed regulations (i) refine the definition of a financial account, (ii) expand the number of categories of FFIs that are deemed to be in compliance with FATCA ("deemed compliant FFIs"), and (iii) provide guidance regarding the diligence procedures FFIs are required to undertake in order to identify U.S. accounts and to verify compliance. The Department of the Treasury expects to finalize these regulations and the agreements to be entered into with FFIs later this fall.

**Definition of Financial Account**

The definition of financial account has been modified in an attempt to more narrowly focus on traditional bank, brokerage, money market accounts and interests in investment vehicles.[6]

**Deemed Compliant FFIs**

Deemed compliant FFIs are not required to enter into agreements with U.S. authorities and consist of (i) registered deemed compliant FFIs, (ii) certified deemed compliant FFIs, and (iii) owner-documented FFIs.

A registered deemed compliant FFI is required to register with the IRS every three years and certify that it satisfies the requirements of the applicable category. The categories of registered deemed compliant FFIs are (i) local FFIs, (ii) non-reporting members of a participating FFI group, (iii) qualified collective investment vehicles, and (iv) restricted funds.[7]

Certified deemed compliant FFIs are non-registering local banks, retirement plans, non-profit organizations, and low-value account FFIs. Certified deemed compliant FFIs are not required to register with the IRS. Instead, the certified deemed compliant FFI is only required to certify to the relevant payor that it satisfies the requirements of its applicable category of certified deemed compliant FFI. Such certification is made using IRS Form W-8.[8]

An owner documented FFI is a FFI that does not accept deposits in the ordinary course of business, does not hold financial assets for the account of others and is not an insurance company (and is not affiliated with such a FFI). In addition, owner documented FFIs cannot maintain financial accounts for non-participating FFIs and cannot issue debt in excess of $50,000 to any person. Owner documented FFIs are not required to register with the IRS, but are required to provide the payor (or withholding agent) sufficient documentation regarding the owner documented FFI's owners.[9]

**Diligence Procedures**

The recently issued proposed regulations provide guidance regarding the diligence steps a FFI is required to undertake to identify U.S. accounts. A FFI that complies with these diligence steps will be deemed to have complied with the requirement that such FFI identify any U.S. accounts. If a FFI does not undertake these steps, such FFI may be strictly liable if it fails to identify U.S. accounts.

For pre-existing accounts of individuals, the FFI is not required to review accounts with a balance or value of $50,000 or less ($250,000 for cash value insurance or annuity contracts). For accounts with a balance or value between $50,000 and $1,000,000, the FFI should review the electronically searchable data for information suggesting the account is held by a U.S. person. Such information includes (i) a U.S. place of birth, (ii) a U.S. address, (iii) a U.S. telephone number, (iv) standing instructions to transfer funds to an account maintained in the United States, (v) a power of attorney granted to a U.S. person, (vi) a U.S. "in-care-of" address, or (vii) an indication that the person is a U.S. person. If the electronic search does not turn up such information, then no further investigation is required. If the account exceeds $1,000,000, then the bank should review both electronic and non-electronic files for any information regarding whether the holder is a U.S. person. Review of non-electronic files is not required if the electronic files contain sufficient information about the account holder.[10]

For pre-existing entity accounts, FFIs should review the information previously provided by the entity under the existing anti-money laundering and know your customer rules to determine whether the entity is a U.S. person. If the entity is a passive investment entity and has an account balance in excess of $1,000,000, then the FFI should either obtain information from the entity regarding its substantial U.S. owners (if any) or a certificate from the entity that it does not have substantial U.S. owners.[11]

For new individual accounts, the FFI should review the information provided under the anti-money laundering and know your customer rules for indicia that the account is being opened by a U.S. person. If this information suggests the individual is a U.S. person, then the FFI should obtain additional documents to determine whether the individual is a U.S. person.[12]

For new accounts opened by passive entities, the FFI is required to determine whether the entity has any substantial U.S. owners. New accounts opened by other FFIs or by entities actively engaged in a non-financial trade or business are exempt from documentation requirements.[13]

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1 I.R.C. § 1471 and 1472.
2 *See* U.S. Department of the Treasury, FATCA Resource Center, *available* at http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx.
3 I.R.C. § 1471(d)(5).
4 I.R.C. § 1471(a).
5 I.R.C. § 1473.
6 Prop. Reg. § 1.1471-5(b)(1).
7 Prop. Reg. § 1.1471-5(f)(1).
8 Prop. Reg. § 1.1471.5(f)(2).
9 Prop. Reg. § 1.1471-5(f)(3).
10 Prop. Reg. § 1.1471-4(c)(2), (c)(4).
11 Prop. Reg. § 1.1471-4(c)(2) and (3).
12 Prop. Reg. § 1.1471-4(c)(2), (c)(4).
13 Prop. Reg. § 1.1471-4(c)(2) and (3).

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# REITs AND DISTRESSED DEBT

**Introduction**

Due to the significant decline in value of real estate that was experienced as the recession deepened through 2008, 2009 and 2010, many real estate investment trusts (REITs) that held mortgages secured by real estate were faced with the prospect of failing to satisfy certain REIT qualification tests as they began exploring alternatives for restructuring such mortgages in an effort to rehabilitate the property and maximize their recoveries with respect to their investment. In addition, REITs considering making a possible investment in these depressed or troubled mortgage loans, either to hold for investment, or to acquire the underlying real estate, faced similar concerns. Further, there was uncertainty regarding the application of the "prohibited transaction" rules to restructurings and dispositions of such mortgage loans.

On January 1, 2011, the IRS issued Revenue Procedure 2011-16[1] in an effort to provide a measure of relief in complying with the REIT qualification tests to a REIT that holds and agrees to the modification of a troubled mortgage loan and, in some instances, to the acquisition of a troubled mortgage loan at a significant discount. While the relief is certainly welcome, not all actions that a REIT may take in connection with the acquisition and/or restructuring of a troubled mortgage loan will produce the desired results under the various income and asset tests applicable to a REIT. As such, prior to taking such actions, REITs and their tax advisers should take care to map out the various income tax consequences (including not only ongoing compliance with the REIT qualification tests, but also the implications under the 100-percent tax on prohibited transactions) of the acquisition and/or modification of a troubled mortgage loan.

The three principal REIT qualification tests that could impact a REIT that owns, acquires and/or restructures a troubled mortgage loan are the annual 75-Percent and 95-Percent Income Tests and the quarterly 75-Percent Asset Test.

**The 75-Percent and 95-Percent Income Tests**

At least 75 percent of a REIT's annual gross income (not including gross income from prohibited transactions) must be derived from, among other specified sources (such as qualified rents from real property), interest on obligations secured by mortgages on real property and gain from the sale or other disposition of interests in mortgages on real property, which is not property described in Code Section 1221(a)(1).[2] Prior to 1981, the interest income earned on all mortgage loans that were secured by both real and personal property was subject to apportionment and treated, in part, as interest income derived from a loan made with respect to real property and, in part, as interest income derived from a loan made with respect to personal property for purposes of the 75-Percent Income Test.[3] The impact of this apportionment requirement was mitigated in 1981, when a regulation was issued requiring apportionment only

in the case where the amount of the obligation exceeds the value of the underlying real property securing the mortgage loan.[4] Once determined, the apportionment ratio for determining the amount of interest income that was qualifying gross income remained constant so long as the security for the loan was not modified.[5]

In the case of a loan secured by both real and personal property, the apportionment rules for determining the amount of interest income attributable to the real property generally worked to a REIT's advantage in periods where real property values as a whole were rising or at least relatively stable. So long as the principal amount of the loan did not exceed the fair market value of the underlying real property at origination, purchase or at the time when the terms of the loan were substantially modified, 100 percent of the interest income from the loan was qualified income for purposes of the 75-Percent Income Test (and 95-Percent Income Test[6]). For example, under these rules, if the principal amount of a mortgage loan was $200 and the fair market value of the real property securing the mortgage loan was $225 at the time the loan was originated, then all of the interest income realized with respect to the mortgage loan was attributed to the real property and none of the interest income was attributed to the personal property securing the mortgage loan.[7] This mortgage loan's initial apportionment ratio remained constant throughout the REIT's holding period so long as the loan was not modified or restructured (which was seldom the case when the value of the underlying real estate was generally appreciating, and a relatively small percentage of loans became troubled). In addition, any gain from the disposition of such mortgage loan was (and still is) qualifying gross income for purposes of the 75-Percent Income Test (and 95-Percent Income Test). However, in periods of declining real estate values during which a much larger percentage of real estate mortgage loans are troubled and require restructuring, the amount of interest income derived by a REIT from a troubled mortgage loan (or gain from the disposition of such note that was previously acquired at a discount to face) that is qualified gross income for purposes of the 75-Percent Income Test can be substantially less than 100 percent after the application of the apportionment rules set forth above upon a restructuring of the terms of such loan. For example, if the principal amount of the mortgage loan is $200 and the fair market value of the real property securing the mortgage loan is $120 at the time the loan is acquired by the REIT,[8] then only 60 percent of the interest income realized with respect to the mortgage loan is treated as qualified gross income for purposes of the 75-Percent Income Test.[9]

The IRS issued Revenue Procedure 2011-16 to provide relief under the income tests with respect to mortgage loans held by a REIT that are modified or restructured, or which are acquired at a discount by a REIT.[10] However, the relief provided in the revenue procedure is basic and limited, leaving a number of situations possibly unanswered. Further, very little relief is provided to a REIT considering the purchase of a mortgage loan at a significant discount to face. In fact, a REIT considering an investment in a troubled mortgage loan may have difficulty meeting the 75-Percent Income Test unless the REIT intends to either negotiate a modification of the troubled mortgage loan or acquire the underlying real property through foreclosure shortly after acquiring such mortgage loan.

## Application of the Relief Provided by Rev. Proc. 2011-16

Borrowing from guidance provided in the case of certain modifications of mortgage loans held by a real estate investment mortgage conduit ("REMIC"), the ability to take advantage of the relief provisions in Rev. Proc. 2011-16 in determining the amount of interest income from such a troubled loan for purposes of the 75-Percent and 95-Percent Income Tests requires that any modification of such a loan be either occasioned by (1) a default of the troubled loan or (2) a reasonably foreseeable default of the troubled loan, and the REIT or servicer reasonably believes that the modified loan presents a substantially reduced risk of default as compared to the pre-modified loan.[11] If either condition is met, then the REIT will not be required to treat the modification of the troubled loan as being a commitment to make or purchase a "new" loan, which would require the re-determination of the underlying value of the real property securing the troubled loan under Treasury Regulation Section 1.856-5(c)(2), for purposes of determining the appropriate percentage of interest income realized from such loan that may be treated as interest income from a mortgage loan.[12] Further, the modification of the troubled loan will not be treated as a prohibited transaction under Code Section 857(b)(6).[13] Presumably, a REIT that acquires a troubled mortgage loan at a discount that is already in default can take advantage of the relief provided in Rev. Proc. 2011-16. As will be shown below, while the relief provisions may not help the REIT meet the 75-Percent Income Test, the relief in exempting any subsequent modification from prohibited transaction taxation may protect a REIT from taxation on a subsequent modification of a troubled mortgage loan that it acquired at a discount.

Rev. Proc. 2011-16 provides two examples to show how the relief provisions work.[14] In the first example, REIT X made a $100 mortgage loan (secured by both real and personal property) in 2007 when the real property had a fair market value of $115. Thus, 100 percent of the interest income on the mortgage loan was considered to be qualified interest income for purposes of the 75-Percent Income Test under the apportionment rules. However, by the start of 2009, the loan was in default, the value of the real property had decreased to $55 and the personal property had a value of $5. REIT X and the borrower agreed to modification of the terms of the mortgage loan in 2009 that amounted to a significant modification of the mortgage loan under Treasury Regulation Section 1.1001-3. Since the loan was in default, the REIT could then choose to treat the modification of the mortgage loan as not being a commitment to make or purchase a new loan, and the fair market value of the modified mortgage loan for purposes of determining the portion of any interest income earned on the loan after modification could be determined as of the original commitment date of such mortgage loan.[15] Accordingly, 100 percent of any interest income realized on the modified mortgage loan will be considered qualified mortgage interest for purposes of the 75-Percent Income Test going forward.

The second example borrows the facts from example 1 and provides further that REIT Y purchased the $100 mortgage loan from REIT X in 2010 for $60, the loan's value. The example provides that, since REIT Y committed to purchase the modified mortgage loan at a time when the underlying value of the real estate was only $55 and the principal amount of the loan was

still $100, the apportionment ratio under Treasury Regulation Section 1.856-5(c)(2) going forward that would be applied to any interest income realized on the mortgage loan by REIT Y that would be considered to be qualified mortgage interest for purposes of the 75-Percent Income Test would be only 55 percent. Despite the fact that the underlying real property represents more than 90 percent of the underlying value securing the mortgage loan, the IRS applied the long-standing regulation as written to determine the apportionment ratio, even though the personal property securing the loan clearly does not represent 45 percent of the value of the mortgage loan. The justification for the apportionment ratio established by the regulation presumably is that an under-collateralized mortgage loan is akin to making two loans, a fully-secured mortgage loan and an unsecured loan. However, at least in the current market, a property being under-collateralized does not necessarily equate to the source of the funds used to pay any principal and interest as being from a source other than (or mostly other than) real property. Nevertheless, given the deference generally accorded long-standing regulations, sustaining a challenge to such a regulation can be difficult.[16] In any event, any REIT purchasing and holding a significant portfolio of mortgage loans hoping for above-market returns if the real estate market improves likely will have a difficult time satisfying the annual 75-Percent Income Test unless they can successfully challenge these apportionment rules.[17]

Although not answered in the revenue procedure, presumably, REIT Y could negotiate further modifications to the mortgage loan that would include a reduction in the principal amount of the loan due, which would improve the ratio of interest income considered to be qualified mortgage interest for purposes of the 75-Percent Income Test. Section 4.01(1) of the Revenue Procedure provides that a REIT may treat a modification of a mortgage loan as not being a new commitment to make or purchase a loan for purposes of ascertaining the loan value of the real property under Treasury Regulation Section §1.856-5(c). Thus, a modification that reduces the principal amount of a mortgage loan that was purchased by a REIT (similar to the facts in example 2) should increase the ratio of qualifying mortgage interest income for purposes of the 75-Percent Income Test.

Also unanswered in the revenue procedure is how to view various types of modifications that may be agreed to by the REIT and the borrower. For example, what if, under the facts in the revenue procedure, REIT Y and the borrower agree to further modify the mortgage loan by dividing the loan into two notes, both secured by the real and personal property, with the first note providing for amortization of principal and interest at a stated interest rate and having a stated principal amount of $60, and a second note, which is subordinated from a cash flow perspective to new, unsecured debt that is used to improve the property, that has a maximum principal amount, and payments of principal and interest that are contingent on cash flow and/or sale proceeds from the property? Can the approximately 91.3 percent (i.e., 55/60ths) of the interest income realized on the first note be treated as qualifying mortgage interest for purposes of the 75-Percent Income Test, or must the two notes be treated as a single combined note? If the two notes must be treated as a single note, can the contingent amount due under the second note be disregarded under the principles of Treasury Regulation Section 1.1275-4(c)

until the principal payment becomes fixed or otherwise due? Obviously, there are any number of terms that can be agreed to by the parties that can impact the tax analysis, a detailed discussion of which is beyond the scope of this article. Given the complexity of terms that are accompanying the restructuring of troubled mortgage loans, it is doubtful that the relief provided in Rev. Proc. 2011-16 is of much help to a REIT in determining whether it is in compliance with the 75-Percent Income Test if it is engaging in the purchase of troubled mortgage loans and the restructuring and holding of such restructured mortgage debt for investment.

**The 75-Percent Asset Test**

In addition to the income tests, a REIT must have at least 75 percent of the value of its total assets invested in real estate assets, cash, cash items and government securities, measured as of the close of each quarter of its tax year.[18] The term "real estate assets" includes an interest in a mortgage loan secured by real property.[19] It has long been accepted that if the mortgage loan is secured by both real and personal property, only that portion of the loan secured by the real property is treated as a qualified real estate asset, even though the rules requiring apportionment can be found only in the Treasury Regulations addressing whether interest income on a mortgage loan is qualifying interest for purposes of the 75-Percent Income Test and are not included in the Treasury Regulations addressing qualified assets for purposes of the 75-Percent Asset Test.[20] The determination of whether apportionment of a mortgage loan is required is made based on the relative fair market values of the real and personal property securing the loan at the time the commitment to make or purchase the loan is made by the REIT, the same basis used in apportioning for purposes of the income tests.[21] As discussed previously, the impact of the apportionment requirement was mitigated in 1981 when a regulation was issued requiring apportionment only in the case when the amount of the obligation exceeds the value of the underlying real estate assets securing the mortgage loan.[22]

Again, as one might expect, the apportionment rules could be quite problematic in the case of a modification of a troubled real estate loan absent the relief provided in Rev. Proc. 2011-16. The mere change or decline in market value of real estate mortgage loans owned by a REIT due to such loans becoming "troubled" will not cause a violation of the 75-Percent Asset Test unless the REIT subsequently acquires securities or other nonqualifying assets.[23] However, absent the relief in Rev. Proc. 2011-16, only a portion of a troubled real estate mortgage loan owned by a REIT that is substantially modified would be considered a qualified real estate asset for purposes of the 75-Percent Asset Test if the loan is under-collateralized. For example, under the facts in example 1, only 55 percent (i.e., the value of the underlying real property divided by the principal amount of the loan) of the value of the mortgage loan held by REIT X would be treated as a qualifying real estate asset for purposes of the 75-Percent Asset Test after its modification in 2009 based on the rules in the regulations. However, Rev. Proc. 2011-16 allows REIT X to use the lesser of (1) the apportioned value of the real estate loan as of the original commitment date (i.e., as if the modification is not a commitment to make or purchase a new loan) or (2) the value of the loan on the measuring date (which, presumably, prevents an

artificial inflation of the amount of qualifying assets since in most, if not all, instances the value of the underlying real estate on the original commitment date will be greater).

The relief in Rev. Proc. 2011-16 in the case of a REIT purchasing a troubled real estate mortgage loan does not appear to be as generous. In example 2 in the revenue procedure, REIT Y purchased a modified real estate mortgage loan at a time when the principal amount of the loan was $100, the loan's value was $60 and the value of the underlying real estate was $55. The revenue procedure allows the REIT to treat the lesser of the loan's value ($60) or the value of the underlying real estate ($55) as a qualifying asset for purposes of the 75-Percent Asset Test. While this is not a particularly harsh result, what if the troubled real estate mortgage loan had been purchased by REIT Y prior to its modification? Under the apportionment rules contained in the Treasury Regulations, the portion of the mortgage loan that would be considered to be a qualifying asset for purposes of the 75-Percent Asset Test would be only 55 percent. Again, many of the same questions raised above in the discussion of the 75-Percent Income Test are equally applicable here. Is this result justified simply because the troubled real estate loan is under-collateralized? Should the REIT be required to modify the mortgage loan in order to avoid a violation of the asset test if the loan is mostly nonrecourse and the underlying real property represents a substantial portion (well in excess of 75 percent) of the secured value?

**The 100-Percent Prohibited Transactions Tax**

A tax equal to 100 percent of the net income derived from prohibited transactions during a tax year is imposed on a REIT.[24] The term "net income derived from prohibited transactions" means the excess of the gain from prohibited transactions over the deductions that are directly connected with such prohibited transactions.[25] The term "prohibited transaction" means a sale or other disposition of property described in Code Section 1221(a)(1) which is not foreclosure property.[26] Property that is described in Code Section 1221(a)(1) is property that is stock in trade of the taxpayer (i.e., inventory) or other property of a kind that would be included in the inventory of a taxpayer if on hand at the close of the tax year, or property held by a taxpayer primarily for sale to customers in the ordinary course of his trade or business.[27]

There is a myriad of case law addressing when property, for example, a real estate mortgage loan held by a REIT, is property that is primarily held for sale to customers in the ordinary course of a trade or business.[28] So much so that substantial uncertainty existed requiring Congress to enact rules providing certain safe harbors for REITs from the 100-percent prohibited transaction tax in the case of certain sales of property by a REIT. The safe harbor provides that gains from the sale of property otherwise held for sale by a REIT will be exempted from the 100-percent tax on prohibited transactions if, among other requirements, the property has been held for more than two years and all sales of property that are otherwise held for sale by the REIT during such tax year either (1) do not exceed seven, (2) the aggregate bases of all such disposed of properties do not exceed 10 percent of the aggregate adjusted bases of all of

the REIT's properties as of the beginning of the year, or (3) the aggregate fair market value of all such disposed of properties does not exceed 10 percent of the fair market value of all of the REIT's properties as of the beginning of the year.[29]

Rev. Proc. 2011-16 again provides a measure of relief (or at least a measure of clarity) by stating that the modification of a mortgage loan that falls within the scope of Section 3 of the revenue procedure will not be treated as a prohibited transaction under Code Section 857(b)(6). Presumably, in most cases in which the troubled real estate mortgage loan was originated by the REIT, a modification of the mortgage loan would result in a loss, and the exemption from the prohibited transaction tax in many cases would not be needed.[30] However, again, a number of questions remain unanswered. For example, what if a REIT acquires the troubled mortgage loan prior to any modification and then subsequently modifies such mortgage loan? It is possible that a gain could result from any subsequent modification since the loan most likely was purchased at a significant discount to its principal amount. Further, it may be that the loan may not have been held for more than two years, one of the requirements for being exempted under the safe harbor discussed above. Presumably, so long as the reasons for such modification fall within the scope set forth in Section 3 of the revenue procedure (i.e., a default or reasonable belief of a risk of default and that modification substantially reduces such risk), a REIT that recognizes a gain on the purchase and modification of a mortgage loan at a discount can take advantage of the exemption from the prohibited transaction tax provided in the revenue procedure. On the other hand, what if the REIT is simply purchasing the troubled mortgage loan in order to acquire the underlying real property? Since the mortgage loan is being purchased at a substantial discount to the principal amount of the mortgage loan and gain or loss is recognized by the REIT upon foreclosure in an amount equal to the difference between the fair market value of the underlying real and personal property and the REIT's basis in the mortgage note, it is possible that the REIT could recognize gain at the time of foreclosure. Presumably, the troubled mortgage loan is not being acquired by the REIT as property held for sale to customers in the ordinary course of the REIT's trade or business (i.e., Code Section 1221(a)(1) property), so the prohibited transaction tax arguably should not apply. Not surprisingly, however, the revenue procedure does not answer that question since it does not address the tax consequences to a REIT that acquires a troubled mortgage loan for purposes of securing ownership of the underlying property.

## Conclusion

In conclusion, the relief provided in Rev. Proc. 2011-16 is certainly welcome, but is limited to only the most basic of restructurings of troubled real estate mortgage loans that may be held or purchased at a discount by a REIT. More often than not, a REIT that holds or purchases troubled mortgage loans and that in an effort to rehabilitate the mortgaged property is looking to restructure the loan in an effort to rehabilitate the property will be faced with a complex tax analysis in determining the consequences to the REIT due to the complexity of most financing structures being used to rehabilitate troubled real property in today's market.

[1] Rev. Proc. 2011-16, I.R.B. 2011-5, 440.
[2] I.R.C. §§ 856(c)(3)(B) and (C).
[3] *See* Treas. Reg. § 1.856-3(c); I.R.S. Priv. Ltr. Rul. 7107290210A (Jul. 29, 1971).
[4] Treas. Reg. § 1.856-5(c)(2)(ii); I.R.S. Priv. Ltr. Rul. 8223054 (Mar. 10, 1982).
[5] Treas. Reg. § 1.856-5(c)(2)(ii).
[6] All income that is qualifying income for purposes of the 75-Percent Income Test also qualifies for purposes of the 95-Percent Income Test. In addition, all interest income, whether or not secured by a mortgage on real property is generally qualifying income for purposes of the 95-Percent Income Test. I.R.C. § 856(c)(2)(B). Thus, in most cases, interest income on a modified loan should continue to be qualifying income for purposes of the 95-Percent Income Test, even if a significant portion of interest income on the modified loan no longer qualifies for the 75-Percent Income Test. For income tax purposes, a substantial modification of a debt instrument is treated as or deemed to be an exchange for federal income tax purposes of the original indebtedness for the newly modified indebtedness. Treas. Reg. § 1.1001-3(b). In addition to the recognition of gain or loss under I.R.C. § 1001, such an exchange ordinarily would require the computation of a new apportionment ratio under Treas. Reg. § 1.856-5(c).
[7] Treas. Reg. § 1.856-5(c)(2)(i).
[8] Obviously, a nonrecourse mortgage loan would not be originated based on this set of facts, but these facts very likely could exist in the case where a troubled mortgage loan is purchased at a discount by a REIT, or in the event of a modification of such a mortgage loan where the principal amount of the debt is reduced, but the reduction does not decrease the principal to below the real property's fair market value.
[9] Treas. Reg. § 1.856-5(c)(2)(ii). Again, as noted in note 6, supra, the 95-Percent Income Test is not likely to be impacted, since all the interest income earned on the note should continue to be qualifying income for purposes of this test.
[10] Rev. Proc. 2011-16, 2011-5 IRB 440.
[11] *Id.* at §§ 2.08 and 3.01.
[12] *Id.* at § 4.01(1).
[13] *Id.* at § 4.01(2).
[14] *Id*. at §§ 5.01 and 5.02.
[15] *Id*. at § 5.01 *example* 1.(1).
[16] Consistent with the U.S. Supreme Court's recent decision in *Mayo Found. for Med. Educ. and Research, et al.*, 131 S. Ct 704 (2011), under the two-step standard established in *Chevron, USA, Inc. v. Natural Res. Def. Counsel, Inc.*, 467 U.S. 837 (1984), unless Congress has directly addressed the precise question, the regulations will stand unless it is arbitrary or capricious in substance, or manifestly contrary to the statute.
[17] Further, this does not address other ancillary rules that could impact the purchase by a REIT of a troubled mortgage loan at a deep discount to the principal amount of such loan, such as, for example, the rules deferring the deduction of interest allocable to accrued market discount under I.R.C. § 1277, all of which are beyond the scope of this article.
[18] I.R.C. § 856(c)(4)(A).
[19] I.R.C. § 856(c)(5)(B).

[20] I.R.C. § 856(c)(5)(B); Treas. Reg. §§ 1.856-3(b), (c), and (d); and I.R.S. Priv. Ltr. Rul. 7107290210A (Jul. 29, 1971).

[21] Treas. Reg. § 1.856-5(c)(2).

[22] Treas. Reg. § 1.856-5(c)(2)(ii); and I.R.S. Priv. Ltr. Rul. LTR 8223054 (Mar. 10, 1982).

[23] *See* the "flush language" at the end of I.R.C. § 856(c)(4).

[24] I.R.C. § 857(b)(6)(A).

[25] I.R.C. § 857(b)(6)(B)(i).

[26] I.R.C. § 857(b)(6)(B)(iii).

[27] I.R.C. § 1221(a)(1).

[28] *See, e.g., W. Malat*, 383 U.S. 569 (1966); *Suburban Realty Co.*, 615 F.2d 171 (5th Cir. 1980), *cert. denied,* 449 U.S. 920 (1980); *F.E.J. Farley*, 7 T.C. 198 (1946); *Hollywood Baseball Ass'n*, 423 F.2d 494 (9th Cir. 1970).

[29] I.R.C. §§ 857(b)(6)(C), (D), and (E).

[30] Losses on a disposition of property considered to be prohibited transaction property generally cannot be offset against income or gain from a prohibited transaction (I.R.C. § 857(b)(6)(B)(ii)), so it is doubtful that the inclusion of this provision in the revenue procedure was intended as a backstop to the prohibited transactions tax.

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# IRS Issues Temporary Regulations Under Section 7874 Establishing Bright-Line Rule for Substantial Business Activities Test

On July 9, 2012, the IRS issued new temporary and proposed regulations under Section 7874 of the Internal Revenue Code.[1] These regulations, which are effective as of June 12, 2012, provide guidance regarding whether a foreign corporation has substantial business activities in the foreign country in which, or under the law of which, the foreign corporation is created or organized.

Under Section 7874(a), a tax is imposed on the inversion gain of an "expatriated entity." Inversion gain generally means the income or gain recognized in connection with the transfer of stock or other property by an expatriated entity, as well any income received or accrued as part of a Section 7874(a)(2)(B)(i) acquisition.

In turn, an expatriated entity is a domestic corporation or partnership, or any U.S. person related to the domestic corporation or partnership, with respect to which a foreign corporation is a surrogate foreign corporation. A surrogate foreign corporation is a foreign corporation if, pursuant to a plan (or a series of related transactions), it meets the following three requirements:

(1) the entity completes after March 4, 2003 the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership;

(2) after the acquisition at least 60% of the stock (by vote or value) of the entity is held— (I) in the case of an acquisition with respect to a domestic corporation, by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation, or (II) in the case of an acquisition with respect to a domestic partnership, by former partners of the domestic partnership by reason of holding a capital or profits interest in the domestic partnership; and

(3) after the acquisition the expanded affiliated group which includes the entity does not have substantial business activities in the foreign country in which, or under the law of which, the entity is created or organized, when compared to the total business activities of such expanded affiliated group.[2]

The recently issued temporary and proposed regulations help determine whether a foreign corporation has substantial business activities in a foreign country for purposes of determining

whether it is a surrogate foreign corporation. In the new temporary regulations, the IRS has adopted a bright-line rule. The bright-line rule now deems that an expanded affiliated group will have substantial business activities in the foreign country only if at least 25% of the group employees, group assets and group income are located or derived in the relevant foreign country, determined as follows:

**Group Employees**

The temporary regulations provide two tests for calculating group employees, both of which must be satisfied. The first test is calculated as the number of group employees, which includes the number of employees of members of the expanded affiliated group, based in the relevant foreign country divided by the total number of group employees. The first test is measured with respect to the applicable date, which the IRS defines in the regulations as either the date on which the acquisition is completed or the last day of the month immediately preceding the month in which the acquisition is completed. The second test is calculated as the dollar amount of employee compensation with respect to group employees based in the relevant foreign country divided by the total employee compensation with respect to all group employees determined during the one-year testing period. The applicable date definition is also used to determine the testing period.

**Group Assets**

The group assets test is calculated as the value of the group assets located in the relevant foreign country divided by the total value of all group assets determined on the applicable date. The term group assets generally encompasses tangible personal property or real property used or held for use in the active conduct of a trade or business by members of the expanded affiliated group. Group assets also consist of rental property held for use in the trade or business. Rental property is valued at eight times the net annual rent paid or accrued.

**Group Income**

Finally, the group income test is calculated as the group income derived in the relevant foreign country divided by the total group income determined during the one-year testing period. Group income includes gross income of members of the expanded affiliated group from transactions occurring in the ordinary course of business with customers that are not related persons. Group income is considered to be derived in a foreign country only if the customer is located in that foreign country.

In sum, although the temporary regulation's bright-line test provides clarity when determining whether a foreign corporation is a surrogate foreign corporation and, ultimately, whether certain gains will be subject to inclusion under Section 7874, it also presents obstacles because the IRS's new bright-line test replaces the previous facts and circumstances standard. For

example, it is possible to meet two of the three requirements, but narrowly miss satisfying the final requirement. As a result, a surrogate foreign corporation would not be treated as having substantial business activities in the relevant foreign country and any applicable inversion gain would be subject to current inclusion under Section 7874.

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[1] T.D. 9592, REG-107889-12, July 9, 2012, I.R.B. 2012-28.
[2] I.R.C. § 7874(a)(2)(B).

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# THE IRS FINALLY APPROVES DEDUCTIBILITY OF CONTRIBUTIONS TO LLCS WHOLLY OWNED BY DOMESTIC SECTION 501(C)(3) ORGANIZATIONS

Tax practitioners have long believed that donations could be made to single member LLCs wholly owned by Section 501(c)(3)[1] organizations on the theory that, for tax purposes, the donation was treated as made to the charity and not the LLC. The IRS, in long awaited guidance, has finally agreed with tax practitioners and approved the deductibility of such contributions. The conclusion comes approximately 12 years after the IRS announced that it would not rule on donations to LLCs wholly owned by charitable organizations.[2]

Section 170 allows as a deduction any contribution to a charitable organization, including those described in Section 501(c)(3).

Section 7701 and the regulations thereunder describe entity classification rules. Under Treasury Regulation Section 301.7701-2, a business entity that has a single owner and that is not a corporation is disregarded for federal tax purposes as an entity separate from its owner (i.e., a disregarded entity). If an entity is disregarded, the entity's activities are treated in the same manner as a sole proprietorship, branch or division of the owner. Following these rules, the IRS announced, in Ann. 99-102, that an LLC wholly owned by a charitable organization would be treated as a disregarded entity of the charitable organization. Accordingly, the charitable organization is required to include, as its own, information pertaining to the finances and operations of the disregarded entity in its annual information return. The LLC is not required to submit an annual tax return or an application for exemption from tax.

Notwithstanding that the LLC's activities, including contributions, would be reported on the Section 501(c)(3) organization's tax return, the IRS did not provide that contributions to such wholly owned LLCs would be eligible for a charitable contribution deduction. The IRS, in 2001 CPE text,[3] further acknowledged that the disregarded entity (which includes a single-member LLC) is to be treated as part of its exempt owner for purposes of Subchapter F (Section 501 et seq.), Chapter 42 and UBIT reporting purposes. However, it further stated that it was considering whether the same treatment applies for purposes of Section 170. It also promised guidance on the issue in the near future.

Finally, in Notice 2012-52 (the "Notice"),[4] the IRS provided such guidance and agreed to treat contributions to disregarded domestic single-member LLCs that are wholly owned by a domestic charitable organization as made directly to the charitable organization for purposes of Section 170. The IRS also stated that, to avoid unnecessary inquiries by the IRS, the charitable organization is encouraged to disclose, in the donor acknowledgement letter or other statement,

that the single-member LLC is wholly owned by a domestic charitable organization and treated by the charitable organization as a disregarded entity.

The Notice is effective for charitable contributions made on or after July 31, 2012. However, taxpayers are permitted to rely on the Notice prior to its effective date for taxable years for which the period of limitation on refund or credit under Section 6511 has not yet expired. Practically, this means that if a taxpayer made a contribution to a domestic, single-member LLC of a charitable organization and did not claim a charitable contribution deduction, it may file an amended return claiming the deduction.

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[1] All Section references contained herein are to the Internal Revenue Code of 1986, as amended (the "Code"), and the regulations promulgated thereunder.

[2] Announcement 99-102, 1999-2 C.B. 545 (Oct. 14, 1999).

[3] IRS Continuing Professional Education Text for fiscal year 2001, "Limited Liabilities Companies As Exempt Organizations—Update."

[4] Notice 2012-52, 2012-35 I.R.B. 317 (July 31, 2012).

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# NOTICE 2012-39 PROVIDES NEW RULES FOR OUTBOUND TRANSFER OF INTELLECTUAL PROPERTY

On July 13, 2012, the Internal Revenue Service (the "IRS") issued Notice 2012-39 (the "Notice"), which provides guidance on the tax treatment of certain outbound transfers of intellectual property under Section 367(d).[1] As part of the Notice, the IRS announced its intention to issue regulations reflecting the guidance outlined in the Notice. Such regulations will apply to outbound transfers of intellectual property occurring on or after July 13, 2012.

**General Background**

Section 361 provides that a corporation which is a party to a reorganization will not recognize gain or loss on the exchange of property for stock or securities in another corporation that is also a party to the reorganization.[2] If a corporation receives property other than stock ("Boot") from another corporation that is a party to the reorganization, the receiving corporation recognizes gain in an amount that does not exceed the fair market value of the Boot (collectively, a "Section 361 Exchange").[3]

Under Section 367, however, if a U.S. corporation transfers property to a foreign corporation in a Section 361 Exchange, the foreign corporation is not treated as a corporation for purposes of the Section 361 non-recognition rules. Moreover, the U.S. transferor will also recognize gain or loss on the outbound transfer unless an exception applies.[4]

**Law**

One such exception is Section 367(d), which applies to a transfer of intangible property from a U.S. corporation to a foreign person. This section treats the U.S. corporation as having sold intangible property in exchange for payments that are contingent upon such property's productivity, use or disposition.[5] The U.S. transferor corporation is also treated as receiving amounts which reasonably reflect the amount that either would have been received over the useful life of the property or, in the case of a later disposition, at the time of the disposition.[6] The amounts that are taken into account under Section 367(d) must be commensurate with the income attributable to the intangible and are treated as ordinary income in the same manner as if the inclusion were a royalty.[7]

Temporary regulations currently provide additional guidance on the tax treatment of outbound transfers of intellectual property under Section 367(d). Such regulations provide that if a U.S. corporation transfers intangible property subject to Section 367(d) to a foreign corporation, the

U.S. corporation is treated as selling the intangible property in exchange for annual payments contingent on the productivity or use.[8] Therefore, the U.S. corporation will, over the useful life of the property, annually include in income an amount that reflects an approximate arm's-length charge as determined under general Section 482 principals for the use of such intangible property.[9] If the U.S. corporation subsequently disposes of the stock of the foreign corporation to an unrelated person during the useful life of the property, the U.S. corporation is treated as having simultaneously sold the intangible property to the unrelated person acquiring the stock of the transferee foreign corporation for the fair market value of the intangible property.[10] The U.S. corporation recognizes gain (but not loss) in an amount equal to the difference between the fair market value of the transferred intangible property on the date of the subsequent disposition and the U.S. corporation's adjusted basis in the intangible property on the date of the initial transfer.[11] If the U.S. corporation instead disposes of stock of the foreign corporation to a related U.S. person during the useful life of the property, the related U.S. person must annually include in income a proportionate share of the contingent annual payments that would otherwise be deemed to have been received by the U.S. transferor.[12] Any amounts which must be taken into income but not actually received can be used to establish an account receivable from the transferee foreign corporation equal to the amount deemed paid.[13]

**Target Abuses**

The IRS is aware that taxpayers are engaging in transactions intended to repatriate earnings from foreign corporations without the appropriate recognition of income. For instance, U.S. parent, a domestic corporation ("USP"), owns 100% of the stock of U.S. transferee, a domestic corporation ("UST"). USP's basis in its UST stock equals its value of $100x. UST's sole asset is a patent with a tax basis of zero. UST has no liabilities. USP also owns 100% of the stock of a foreign corporation ("TFC"). UST transfers the patent to TFC in exchange for $100x of cash and, in connection with the transfer, UST distributes the $100x of cash to USP and liquidates. The taxpayer takes the position that neither USP or UST recognizes gain or dividend income on the receipt of the $100x of cash. USP then applies the Section 367(d) regulations to include amounts in gross income in subsequent years. USP also applies the Section 367(d) regulations to establish a receivable from TFC in the amount of the aggregate income USP included. USP takes the position that TFC's repayment of the receivable does not give rise to income. Accordingly, the transactions have resulted in a repatriation in excess of the $100x because there was $100x received at the time of the reorganization and then additional amounts are repatriated through repayment of the receivable in the amount of USP's income inclusions over time. However, there is only recognition of the income in the amount of the USP's income inclusions over time.

The IRS realizes that other transactions may be structured to have a similar effect, including, for example, transactions that involve TFC's assumption of liabilities of UST. Similar results may also be achieved in cases where a controlled foreign corporation uses deferred earnings to fund an acquisition of all or part of the stock of a domestic corporation from an unrelated party for

cash, followed by an outbound asset reorganization of the domestic corporation to avoid an income inclusion under Section 956. Therefore, as the IRS believes that these transactions, as well as other similar transactions, raise significant policy concerns, the IRS issued the Notice in order to change the manner in which income is recognized in Section 361 transactions to which Section 367(d) applies.

**Impact of the Notice**

The Notice and the forthcoming regulations are designed to ensure that, with respect to all outbound Section 367(d) transfers, the total income to be taken into account under Section 367(d) is either included in income by the U.S. transferor in the year of the reorganization or over time by one or more "qualified successors." A qualified successor is a domestic corporation that is the shareholder of the U.S. transferor that receives stock of the transferee foreign corporation in the transfer. The Notice (and forthcoming regulations) will govern over the prior regulations.

First, in an outbound Section 367(d) transfer, the U.S. transferor will take into account as a prepayment a percentage of the money and the fair market value of other property received by the "qualified successor" in exchange for, or with respect to, the stock of the U.S. transferor, reduced by the portion of any U.S. transferor distributions received by the qualified successor. This amount is included in income regardless of the productivity of the transferred Section 367(d) property in the year of the transfer or in subsequent years. The U.S. transferor will also take into account income in an amount equal to the product of the sum of the ownership interest percentages of all non-qualified successors, if any, multiplied by the amount of gain realized on all of the Section 367(d) property transferred in the Section 361 Exchange.

A qualified successor will take into account the income attributable to a proportionate share of the contingent annual payments that the U.S. transferor would have been treated as receiving under Section 367(d) had the U.S. transferor remained in existence and retained the qualified stock received in the reorganization and had the U.S. transferor not recognized any income. The income attributable to the contingent annual payments is excluded from gross income to the extent such income that is attributable to the qualified successor is included by the U.S. transferor pursuant to the Notice. This amount is known as the "credit amount." The qualified successor is permitted to establish an account receivable for any contingent annual payments included in gross income by the qualified successor under the Notice.

Any income taken into account under the Notice is treated as ordinary income and, for purposes of applying Section 904(d), in the same manner as if such amount were a royalty.

[1] All Section references contained herein are to the Internal Revenue Code of 1986, as amended (the "Code"), and the regulations promulgated thereunder.
[2] I.R.C. § 361(a).
[3] I.R.C. § 361(b).
[4] *Id.*
[5] I.R.C. § 367(d)(1), (2).
[6] I.R.C. § 367(d)(2)(A).
[7] Temp. Treas. Reg. § 1.367(d)-1T(c)(1).
[8] *Id.*
[9] *Id.*
[10] Treas. Reg. § 1.367(d)-1T(d)(1).
[11] Temp. Treas. Reg. § 1.367(d)-1T(d)(1).
[12] Temp. Treas. Reg. § 1.367(d)-1T(e)(1).
[13] Temp. Treas. Reg. § 1.367(d)-1T(g)(1)(i).

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# SETTING UP A BUSINESS IN THE UK: BASIC RULES AND RATE OF UK TAXATION

Companies looking to set up an operation in the UK can do so in a number of ways. The two most common ways are to establish either a subsidiary or a permanent establishment. Alternatively, an individual or overseas entity may (i) look to acquire an established business in the UK, (ii) set up a joint venture company, (iii) enter into a partnership agreement, or (iv) simply appoint an agent or a distributor.

## Buying a Company; Tax Considerations

Stamp duty is a transfer tax levied on documents. The purchaser of shares in a company incorporated in the UK will pay stamp duty on the value of the shares transferred at 0.5%.

Where shares are acquired, the purchaser is not able simply to cherry-pick the desired assets, but must also assume the historic liabilities of the business. Typically, a purchaser will require protection for such liabilities and, in general, tax warranties together with a tax indemnity will be provided by the vendor in favour of the purchaser. The warranties are designed to flush out information about the target company. The tax indemnity apportions tax liabilities between the purchaser and the vendor such that, generally speaking, the purchaser will be responsible for post-completion tax liabilities and the vendor will be responsible for pre-completion tax liabilities (together with any specific "post-completion" liabilities suffered by the target company for which the vendor will accept financial responsibility).

## Tax Implications of a UK Presence

### *Corporation Tax*

Companies resident in the UK, and non-UK resident companies carrying on a trade in the UK through a "permanent establishment", will, in general, be liable to corporation tax on the profits (i.e., "income") of their business. Capital gains (referred to as chargeable gains for corporation tax purposes) are computed separately from income but are included within the total profits chargeable to corporation tax. A UK subsidiary of an overseas company (like any other UK resident company) will pay corporation tax on its worldwide profits (subject to double tax relief for foreign taxes). The basic rule is that all companies that are incorporated in the UK and all companies whose central management and control is exercised in the UK are resident in the UK for tax purposes.

A non-UK resident company will only be subject to UK corporation tax if it carries on a trade in the UK through a UK permanent establishment. In certain instances and with careful

consideration of the facts, it may be possible to create a presence in the UK without creating a permanent establishment. In this manner, there would be no requirement to pay corporation tax on such activities. This is possible when the activities carried out in the UK are of a preparatory and auxiliary nature or if there is no fixed place of business, provided that certain additional criteria are satisfied. UK domestic rules do not provide for permanent establishments to benefit from the lower rate of corporation tax. This, however, is subject to any non-discrimination articles contained in an applicable double tax treaty, and to the concessions afforded by HM Revenue & Customs ("HMRC") who, in general, accept that a permanent establishment can claim the small companies rate (subject to all other criteria being satisfied).

The main rate of corporation tax is chargeable on income and chargeable gains and is currently charged at 24% when profits exceed £1,500,000 for the current financial year which runs from 1 April 2012 to 31 March 2013. A lower rate of 20% applies when the company's annual profits do not exceed £300,000. Marginal relief is available on profits up to £1,500,000, which provides (in effect) a sliding scale rate of corporation tax. A reduction of 1% per annum in the rate of corporation tax has been proposed for each year until 2014 when it is expected that the rate of corporation tax will be reduced to 22%. If the company has associated companies, the threshold figures are reduced according to the relevant number of associated companies. These threshold rules can sometimes encourage the establishment of a UK branch operation, rather than a separate UK subsidiary company.

***Taxation of Dividends***

Dividends declared and paid by a UK resident company are not subject to withholding tax. Withholding tax is a tax on a payment that is collected by a payer and that represents the payee's tax liability on that payment. Withholding taxes are imposed for many reasons, e.g., to save the taxing authorities time and money and to target tax evasion.

Where profits are repatriated by the UK subsidiary, by way of dividend to a company or to an individual resident outside the UK, the applicable tax laws in the jurisdiction of the recipient will determine how the recipient is taxed on receipt of the dividend.

A foreign parent company may benefit from a participation exemption that will exempt dividends received from the UK subsidiary from tax in the foreign jurisdiction. Under the terms of most double tax treaties, where dividends are taxable, the underlying corporation tax will normally be allowed as a foreign tax credit.

The dividend will carry a tax credit of an amount equal to one-ninth of the amount of the dividend. It is possible, depending on the provisions of the relevant double tax treaty, that the recipient may be able to reclaim a very small proportion of the tax credit. If there is no double tax treaty or there is no such provision within the treaty, no tax credit will be available to a non-resident shareholder.

Where the double tax treaties that the UK has entered into provide credit for the underlying tax paid by a UK company, a corporate recipient of a dividend paid by a UK company will benefit from a foreign tax credit currently at 24%. To the extent that the rate of tax payable in the foreign jurisdiction exceeds 24%, a further amount of tax will be payable. If the rate of tax payable in the foreign jurisdiction is lower than 24%, no further tax is payable.

Dividends received by a UK resident company from both resident and non-UK resident subsidiaries (or indeed from portfolio investments) should generally be exempt from corporation tax, unless they fall within certain anti-avoidance rules.

***Tax on Interest***

The basic rule is that any company resident in the UK that makes yearly payments of interest to a non-UK resident must withhold tax on interest at a rate of 20%. Where interest is paid to a company resident in a country that has a double tax treaty with the UK, such interest payments may be exempt from withholding tax or the tax may be reduced.

**Research and Development ("R&D") Incentives**

In general, companies are able to deduct all expenditures that are not capital in nature and which are wholly and exclusively paid for the purposes of the trade.

R&D is defined for tax purposes as occurring when a project is undertaken to achieve an advance in science or technology. For small and medium sized enterprises ("SMEs"), the R&D tax credit is claimed as a deduction (from the company's taxable income) at a rate of 225% of the qualifying R&D expenditure incurred on or after 1 April 2012. Expenditure incurred prior to 1 April 2012 will benefit from a deduction of 200%. If the company does not make a profit it can surrender the R&D credit in return for a cash payment which is equivalent to 24.75 pence for every £1 spent on qualifying expenditure, for the year ended 31 March 2013. Large companies are entitled to a tax credit of 130%, but cannot claim a cash payment if the company is loss making.

**The Patent Box**

The UK Government has confirmed its intention to introduce the "Patent Box" and has published draft clauses for the Finance Bill 2012. The new legislation, once enacted, will introduce a 10% rate of corporation tax in respect of income generated from patents. It will apply to patents commercialised after 29 November 2010, but only to income generated from those patents from 2013 onwards.

## Incentives to Invest in Small Companies

There are two schemes that are designed to encourage investment in unquoted small and medium-size enterprises in the UK. These are as follows:

- Enterprise Investment Scheme ("EIS"): The EIS provides relief from capital gains tax for qualifying shareholders on a disposal of shares provided that the shares have been held for three years and all other conditions are satisfied. Relief is also available against income tax for funds used to subscribe for new shares. EIS provides for a 30% reduction in the income tax liability on an annual investment limit of £1 million from 6 April 2012.

- Venture Capital Trusts ("VCT"): The VCT scheme allows individuals to invest in a special type of quoted investment vehicle. The VCT invests, in turn, in unquoted trading companies that satisfy certain criteria. The individual investors in the VCT are entitled to income tax relief at a rate of 30% where funds are used to subscribe for new shares. There is an annual investment limit of £200,000. Relief is also provided from income tax on dividends received in respect of the shares held (up to the limit of £200,000) and against capital gains tax on the disposal of shares.

A new form of venture capital scheme, the Seed Enterprise Investment Scheme ("SEIS") has been introduced with effect from April 2012. The SEIS is designed to help start-up companies attract initial investment. Investors in the new qualifying companies will receive upfront income tax relief at 50% on their investment and capital gains relief on the disposal of shares. This relief is limited to very small businesses and it has low financial limits; the annual investment limit is £100,000.

## Tax Implications When Selling a Business

Any gain made by a UK company on the disposal of a business (shares or assets) will be chargeable to corporation tax. Where the selling company is resident outside the UK the tax treatment of the sale will be governed by the rules of the country in which the selling company is resident.

Capital gains tax ("CGT") on asset disposals is, broadly, payable by individuals who are UK resident in the year of disposal of the relevant asset. The tax on the gain is charged at a rate of 28% for those paying income tax at the higher and additional rates, and 18% for all other tax payers.

### *Disposals of Substantial Shareholdings*

A company's net realised chargeable gains are subject to corporation tax at the relevant corporation tax rate. If a company subject to UK corporation tax makes a disposal of a "substantial shareholding" (i.e., a 10% holding of the ordinary shares) in a trading company or a holding company of a trading group, there is an exemption from the charge to tax on the disposal by a company to qualify for the relief the disposing company must have held the shares in the target company for at least one year and must continue to be a trading company (or the holding company of a trading group) immediately after the disposal.

### *Entrepreneurs' Relief*

Disposals of a limited category of assets may qualify for "Entrepreneurs' Relief", which can reduce the CGT rate to an effective 10% on £10 million of qualifying gains (this is a lifetime limit). This relief applies to various qualifying disposals (for example, shares or securities in a trading company, or the whole or part of a business) provided that certain other criteria are satisfied.

### *Individuals*

Individuals who are resident in the UK are generally liable to UK taxation on their worldwide income and gains. "Residence" is a question of fact and there is detailed guidance published by HMRC, describing the basis on which they will regard an individual as being resident in the UK for a tax year or for a part of a tax year. Special rules apply to resident but non-UK domiciled individuals – (see below).

Non-resident individuals will generally only incur UK taxation on income and gains relating to a trade carried on in the UK, or, in the case of income from employment, to the extent such income is attributable to duties of the employment performed in the UK. As regards income from investments, tax will normally only be charged (if at all) to the extent that tax is collected via deductions or withholdings made from payments of such income.

Income tax is charged on bands of income, principally at 20% and then at 40%, on taxable income for the tax year in excess of £34,370 (for the tax year 2012-2013). The top rate of income tax of 50% is payable on taxable income in a tax year in excess of £150,000.

Employees and employers also pay social security charges, known as "national insurance contributions". The employee's contributions are deducted from salary along with the income tax due. The employer's contributions are currently charged at the rate of 13.8% on, broadly, the employee's gross pay.

The UK also has an Inheritance Tax regime, whereby most gifts of assets during lifetime (unless the donor survives 7 years from the date of gift) or on death are subject to inheritance tax at rates up to 40%. Where chargeable gifts (or cumulative chargeable gifts if more than one, including those made on death) do not exceed a threshold figure, currently £325,000, tax is charged at a nil rate, only the excess above £325,000 is charged at 40%. Gifts of assets between spouses or civil partners are, in most cases, exempt from inheritance tax. In addition, certain business assets, including shares in many trading companies, can enjoy 100% relief from inheritance tax in certain circumstances.

For individuals who are not “domiciled” in the UK (domicile being a different concept from residence, concerned with where one’s true or ultimate home is or will be), the UK offers an attractive tax regime. Non-UK domiciled individuals are, generally, only liable to income tax and capital gains tax on their income and gains from overseas investments and assets to the extent such income or gains are “remitted” to (i.e., brought back into, or otherwise enjoyed in) the UK. However, for non-UK domiciled individuals who are long-term residents of the UK (resident for at least seven out of the nine previous tax years) this remittance basis of taxation, in the case of overseas assets, is now only available for any tax year if the individual elects to pay, for that year, a £30,000 additional tax charge.

With effect from April 2012, the remittance basis charge is £50,000 for individuals who have been UK resident for 12 years or more. Initially there was doubt as to whether US taxpayers resident in the UK could claim a credit for the remittance basis charge; fortunately, the IRS ruled in August 2011, that US citizens resident in the UK would be able to claim such a credit.

Non-UK domiciled individuals are only liable to UK inheritance tax on gifts of assets which are situated in the UK. However, for inheritance tax purposes only, a non-UK domiciled individual who has been resident for at least 17 out of the last 20 tax years will thereafter be deemed to be UK domiciled (and hence subject to inheritance tax on his worldwide assets).

***Partnerships***

Partnerships (whether a general partnership, a limited partnership or a limited liability partnership) are generally treated as transparent for UK tax purposes. Accordingly, where the member of a partnership is the member company or an individual, the member will be taxed on its share of the profits as if they accrued to the member directly. In the event that a non-resident company is a partner or a member in a partnership that carries on a trade in the UK, the non-resident company will be considered to have a permanent establishment in the UK such that that partner/member’s profits will be subject to UK corporation tax at 24%, unless an alternative arrangement has been agreed with HMRC.

## Double Tax Treaties

It is important to consider the impact of any applicable Double Tax Treaty. Such a treaty may cut across the basic rules above, for example, to enable a resident of another country coming to the UK on a short term work assignment (not exceeding six months) to be exempt from UK employment taxes.

Where a person (whether a company or an individual) is resident in the UK (under UK rules) and in his home country (under local rules), and there is a Double Tax Treaty between the two countries, that treaty will normally have a residence "tie-breaker" provision. This will determine in which country the person is to be treated as resident for the purposes of allocating taxing rights between the two countries under the treaty.

Whilst, as mentioned above, the UK regards an LLC as opaque, in certain circumstances the UK/US Double Tax Treaty does contain provision to allow US resident members of an LLC to access treaty benefits with respect to UK source income of the LLC.

## Some Specific Matters

### *Employment Income*

In certain circumstances, individuals who come to live and work in the UK for a period of time, but not to settle permanently:

- may be able, notwithstanding being technically "resident" in the UK, to avoid UK income tax on that part of their earnings from employment (if any) which are attributable to duties of the employment performed outside the UK; and
- may be able to avoid being drawn into the UK's social security regime (under which the employee contributes, by deduction out of salary, national insurance contributions and the employer pays separate employer's national insurance contributions).

### *Companies Subject to Corporation Tax*

There is a degree of competition between corporate tax regimes in Europe, and one of the pressures on Governments is to enhance their own country's competitive position. Historically, tax factors which have been regarded as "positive", so far as the UK is concerned, include:

- a relatively competitive top rate of corporation tax, currently 24%;
- generous rules as to deductibility of interest expenses (although some restrictions have been introduced - see below);

- no withholding tax on dividends paid out to shareholders;
- an exemption from tax on capital gains on the disposal of trading subsidiaries and certain minority interests in trading companies (known as the "Substantial Shareholdings Exemption");
- an extensive network of double tax treaties and a comprehensive tax exemption regime to avoid double taxation of profits earned overseas and brought back to the UK; and
- an attractive tax regime for non-UK individuals (i.e., not UK domiciled) coming to base themselves in the UK.

The UK's interest deduction rules have been amended to introduce a "worldwide debt cap" for international groups of companies. This is designed to restrict the tax relief available to UK members of a worldwide group on their finance expense by reference to the external consolidated finance costs incurred by the group as a whole. There is, however, an important exemption for the financial services sector.

This new regime for corporations sits alongside both the UK's existing transfer pricing/thin capitalisation regime and the Controlled Foreign Companies ("CFC") legislation which itself is currently under further review.

***Value Added Tax***

The UK, as a member of the EU, operates the Value Added Tax system ("VAT"). In broad terms, a sale of goods or a supply of services by a business for a consideration may be – and; where vendor and purchaser are UK businesses, normally will be – subject to VAT. In certain industries, including financial services, insurance, gaming and healthcare, such sales or supplies are normally "exempt" from VAT. Some goods and services, including certain categories of foods, books and clothing, are "zero-rated".

The current "standard rate" of VAT is 20%. It is the responsibility of the vendor or of the person supplying the services (at least where he or she is UK-based) to account to the tax authority for VAT which arises on a transaction. Accordingly, a vendor or supplier must ensure his sale price reflects this (or is expressed to be "exclusive of VAT").

A business is obliged to register for VAT, and then charge VAT on its sales, if the value of its taxable turnover in the last 12 months has exceeded the registration threshold, currently £77,000, or if the expected value of its VAT taxable turnover (this only includes the goods and services that are sold on which VAT is charged) in the subsequent 30 days will exceed such threshold. If their turnover is below the threshold, businesses may register for VAT on a voluntary basis and it may often be advantageous to do so.

VAT is essentially a consumer tax. The idea behind the imposition of VAT is that it should be borne economically by the ultimate consumer of any goods and services supplied. A business that is trading in the UK will account to HMRC for the VAT that it charges on supplies (less an amount in respect of the VAT on supplies made to it). However, in those industries (see above) where sales to customers are "exempt" from VAT, the right to recover VAT incurred on purchases is restricted or prohibited.

In a cross-border context, UK VAT:

- is charged on most imports of goods into the UK (and for imports of goods from outside the EU, VAT, together with other Customs or Excise duties or tariffs, is generally paid at the point of import);
- is charged on the purchase of certain services by a UK business from businesses either in other EU countries or outside the EU – it is the UK business which has to account for such VAT under a special "reverse charge" rule;
- is normally "zero rated" on the export of goods to business (but not private) customers in the EU, or to any customer in a destination outside the EU; and
- is not charged on the supply of certain services by UK businesses to business customers in other EU countries or to customers generally who are outside the EU.

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# CHINA EXPORT TAX REFUND REGULATION UPDATE

China's tax authorities recently issued three important circulars regarding export tax refunds. The circulars most notably clarify the Value-added Tax ("VAT") treatment of zero-related services and introduce revisions to VAT refund policies. Below is a brief summary of the three circulars.

**Bulletin 13**

The State Administration of Taxation ("SAT") issued a circular ("Bulletin 13") on April 5, 2012,[1] providing detailed implementation guidance for the VAT treatment of zero-rated services. Under Circular 131, issued by the Ministry of Finance ("MOF") and the SAT and effective January 1, 2012,[2] the "Exempt, Credit and Refund" method is applicable to VAT zero-rated services. Bulletin 13 clarifies the scope of zero-rated services applicable for VAT refund, and provides the calculation method and related administrative requirements for the VAT refund for such services.

***The Scope of VAT Zero-rated Services***

According to Bulletin 13, the following services are not included in the scope of zero-rated "international transportation services", "R&D services" and "design services":

a) transportation services relating to the transport of cargo or passengers from domestic areas to special Customs supervision regions (or zones), or from special Customs supervision regions (or zones) to other domestic areas or other special Customs supervision regions (or zones); and

b) R&D or Design services provided to entities located in special Customs supervision regions (or zones).

The provision of the above services is not eligible for zero rating and will be subject to VAT.

***Calculation of Tax Refund***

Bulletin 13 explains in detail the calculation of the VAT refund, which is similar to calculation methods currently applied to the export of goods.

***Administrative Requirements***

To apply for the tax refund for zero-rated services, eligible service providers are required to satisfy certain tax compliance requirements set out by Bulletin 13.

a) Registration for export refund. Eligible service providers must register with the appropriate tax authority before applying for the "Exempt, Credit and Refund" method for a tax refund.

b) Refund filing and documentation requirements. Eligible service providers need to file the tax returns for the refund within the VAT filing period of the subsequent month (or quarter) after booking the service revenue for accounting purposes.

c) Monitoring period for new zero-rated service providers. This monitoring period lasts for six months starting from the date when the pilot taxpayer begins to provide eligible services.

**Circular 39 and Bulletin 24**

In addition to Bulletin 13, two new recently issued regulations will also affect China's tax policies for the export of goods and services. The MOF and the SAT jointly issued a tax circular, "Notice of VAT and Consumption Tax Policies for the Export of Goods and Services" ("Circular 39"),[3] and the SAT has separately issued guidance ("Bulletin 24")[4] that summarizes the VAT and Consumption Tax ("CT") administrative policies for the export of goods and services. Circular 39 and Bulletin 24 will consolidate previous regulations on the export VAT refund and introduce several significant revisions.

Circular 39 and Bulletin 24 clarify the conditions, scopes, taxable basis and tax refund rates of exported goods and services, the calculation of export tax refund/exemption, application procedures, deadlines and relevant documentation requirements. Specific revisions to China's current export tax policies under Circular 39 and Bulletin 24 include:

a) Changing the tax treatment of certain non-VAT refundable exports. The export of qualified goods and services on which export enterprises fail to apply for the export tax refund/exemption or fail to provide relevant outstanding documents within the prescribed time limit to the tax authorities after the above application will be exempt from VAT. Such exports were deemed as domestic sales and were subject to VAT before the promulgation of Circular 39.

b) The application deadline for the export tax refund is extended to the period from the month after the customs declaration of the export to April 30 of the following year.

c) Elimination of a "probation period". There is no probation period for small businesses and companies newly engaged in the export business. Previously, there was a 12 month prohibition period.

d) The VAT completion certificate issued by Customs is now included in the documentation requirements to apply for the export tax refund.

Circular 39 and Bulletin 24 replace a series of circulars/articles related to export tax refund/exemption, which are included in the two circulars as appendices.

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[1] SAT Bulletin [2012] No. 13.
[2] Caishui [2011] No. 131.
[3] Caishui [2012] No. 39.
[4] SAT Bulletin [2012] No. 24.

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