McDermott Will & Emery

DECEMBER 2016

Focus on Tax Strategies & Developments

Table of Contents

2 Section 409A Considerations in Light of Tax Rate Reform

5 SALT Implications of Final Section 385 Debt-Equity

9 UK Tax Strategy Legislation

11 Final Regulations Define “Real Property” for REITs

Significant Changes in US Tax System Likely

Thomas W. Giegerich

In the short time since the surprising election of Donald J. Trump as the 45th president of the United States, much already has been written about the likelihood and likely direction of changes in US tax law. Clues primarily are drawn from the policy proposals of candidate Trump, the "House Blueprint" and the Portman-Schumer proposals.

In broad terms, likely changes include significant reductions in both individual and corporate tax rates (with corporate tax rates potentially to be set markedly lower than individual tax rates), coupled with some broadening of the tax base, and an overhaul of the US international tax system: abandoning the current worldwide taxation of US multinationals in favor of a territorial or “modified” territorial system that in general exempts active foreign earnings from US taxation (subject to safeguards against base erosion). The House Blueprint would include an even more fundamental change, moving to a destination-based corporate cash flow tax that would exempt exports and disallow deductions for imported inputs. There is likely to be a tax—at a heavily discounted rate and payable over a period of years—on the previously accumulated offshore earnings of US multinationals under a “deemed repatriation” regime. Some form of “Innovation Box” taxing qualifying income at highly preferential rates may be enacted. It is possible capital investments generally will be rewarded with full expensing (as suggested in the House Blueprint, which proposes moving towards a “cash flow” system of taxation), albeit at the potential price of an elimination of the deduction for net interest expense. Some interesting twists in the taxation of the income of pass-through entities may be introduced.

In addition, Senator Orrin Hatch has under development a corporate integration proposal the centerpiece of which is a dividends-paid deduction offered as solution to a wide range of tax policy issues. The proposal includes an increase in the dividend tax rate and calls for the imposition of a broadly applicable dividend withholding tax.

At the moment, there is considerable uncertainty as to the ultimate contours of the tax reform that is coming, but it seems fairly clear that changes along the lines outlined above are indeed impending. It is not clear whether these sweeping reforms will be accomplished in the first year of a Trump administration, or will require more time to be developed and enacted into law. There are procedural hurdles on the Senate side to the passage of tax legislation, given the slim Republican majority, but there already has been a fair amount of discussion regarding resort to the budget reconciliation process to overcome that.

IMPLICATIONS TO TAX PLANNING

Given the clear thrust of the likely changes, however, taxpayers may be well served, where possible, to defer income recognition events into next year (or later) and accelerate deductions into this year. Also, while there are many fronts on which international tax planning (and implementation) should and will proceed despite the change in the prospects for the kind of tax reform described above, some taxpayers may conclude that in their circumstances it may be advisable to wait for things to sort themselves out on the legislative front before launching a major new international tax planning initiative. Whereas the current US tax system has created incentives for multinationals to engage in inversion transactions and implement earnings stripping, IP migration and similar planning initiatives, not surprisingly (given that the proposals in circulation are explicitly intended to eliminate those incentives), a reformed US tax system may suggest resort to different, or additional, planning choices. Therefore, among the key undertakings entering 2017 will be to identify the new paradigms for such tax planning.

Section 409A Considerations in Light of Tax Rate Reform

William R. Pomierski

OVERVIEW

Following the recent presidential election, tax professionals are busy analyzing predicted (and hoped for) tax reform proposals, including the potential reduction in the top marginal rates for individuals. Obviously it is unclear whether and when rates will be reduced, if at all, and how soon thereafter rates may creep up again.

Tax rate proposals invariably lead to discussions relating to the timing of compensation payments, including payments with respect to existing arrangements. A reduction in the top marginal rate, not to mention the potential repeal of the surtax imposed on wages and certain self-employment income under Obamacare, can significantly enhance a service provider’s after-tax compensation. On the other hand, compensation expense deductions could become less valuable from the service recipient’s perspective.

Planning for, or altering, the timing of compensation payments, such as by potentially deferring from a current year to the following year (depending on the effective date of a rate reduction) must be carefully vetted under the nonqualified deferred compensation rules of section 409A of the IRS Code. As outlined below, section 409A limits the ability to either delay or accelerate scheduled compensation payments. This article is intended as a cautionary note with respect to the section 409A issues that must be considered before altering the timing of compensation payments.

SECTION 409A: IN GENERAL

Section 409A generally provides that if a nonqualified deferred compensation arrangement fails to meet certain requirements, compensation deferred under the arrangement must be included in the service provider’s taxable income at the first time the deferred amount is no longer subject to a substantial risk of forfeiture (*i.e.*, the amount is taxable when the compensation first vests regardless of when paid). Deferral arrangements that violate section 409A also result in an additional tax of 20 percent on the service provider (which is in addition to the service provider’s regular federal income taxes), and in certain cases can result in an interest toll-charge.

A service provider is broadly defined for these purposes to include an individual or an entity performing services as an employee, and also includes certain independent contractors.

DEFERRAL OF COMPENSATION

Section 409A applies broadly to any nonqualified plan or arrangement providing for the deferral of compensation. The US Department of Treasury regulations under section 409A (the 409A Regulations) state that a plan or arrangement generally provides for the deferral of compensation if, under its terms and the relevant facts and circumstances, a service provider has a legally binding right arising during one taxable year to compensation that is or may be payable to (or on behalf of) the service provider in a later tax year. As a result, section 409A extends beyond traditional deferred compensation programs and can apply to bonus arrangements, severance compensation, SERPs and change of control and retention arrangements, to name a few. An exception from certain—but not all—of the section 409A requirements is provided for in the case of short-term deferrals providing for payment no later than 2.5 months following the end of the tax year in which vesting occurs.

Importantly, equity arrangements that are subject to section 83 (such as restricted stock awards and profits interests) are outside of section 409A. Stock options, however, as well as contractual equity-based compensation arrangements, such as stock units and stock appreciation rights, are subject to section 409A (although options and stock appreciation rights are potentially eligible for the stock-rights exception to section 409A).

SECTION 409A REQUIREMENTS

In order for a nonqualified deferral arrangement to avoid the penalties imposed by section 409A, the following 409A Requirements must be met:

- *Permissible Distribution Events*. Compensation deferred under the arrangement may not be paid any earlier than upon the occurrence of one or more of the following "Permissible Distribution Events" (as defined): (1) termination of the service provider's service relationship; (2) the service provider's disability; (3) the service provider's death; (4) at a specified time or pursuant to a fixed schedule specified at the time the arrangement is entered into; (5) upon a change in the ownership or effective control of the service recipient, or in the ownership of a substantial portion of its assets; or (6) upon the occurrence of an unforeseeable emergency.
- *No Provisions for the Acceleration of Payments*. The arrangement may not permit the acceleration of the time or schedule of any payment thereunder, except as permitted in the regulations.
- *Timing of Elections*. If elections are made by a service provider with respect to the deferral of compensation and/or with respect to the form or timing of any payments thereunder, such elections must be made in accordance with the timing of election requirements of section 409A.
- *Rabbi Trusts*. If a nonqualified deferred compensation arrangement is funded with a rabbi trust, certain limitations are imposed on the terms of the trust itself.

Note that the 409A Regulations restrict the time period within which a payment must be made following the designated payment event by providing that if a payment is scheduled to be made within a designated period following the occurrence of the specified event, the period must be objectively determinable and nondiscretionary at the time the event occurs and must either (1) begin and end within the same taxable year of the service provider, or (2) be limited to not more than 90 days following the event and the service provider cannot have a right to designate the taxable year of payment.

ANTI-ACCELERATION RULE

Although much of the focus of section 409A is on deferrals, an anti-acceleration rule generally prohibits making payments earlier than the time at which they are otherwise scheduled to be paid. The anti-acceleration rule may be a critical roadblock to altering the timing of compensation payments in many cases.

The 409A Regulations include 13 limited exceptions to this anti-acceleration rule. One important exception that may become a focal point for planning in connection with a rate reduction is the plan termination exception, which is subject to the following requirements:

- The plan termination does not occur proximate to a downturn in the financial health of the service recipient;

- The service recipient terminates all agreements, methods, programs and other arrangements sponsored by the service recipient that would be "aggregated" with any terminated and liquidated agreements, methods, programs and other arrangements under the 409A Regulations;
- No payments in liquidation of the terminated plan are made within 12 months of the date the service recipient takes all necessary action to irrevocably terminate and liquidate the plan (except for payments that would otherwise be made if the termination had not occurred);
- All payments with respect to the terminated plan are made within 24 months of the date the service recipient takes all necessary action to irrevocably terminate and liquidate the plan; and
- The service recipient does not adopt a new (successor) plan that would be aggregated with any terminated and liquidated plan under the 409A Regulations within three years following the date the service recipient takes all necessary action to irrevocably terminate and liquidate the plan.

DEFERRAL ELECTIONS

The 409A Regulations include strict limitations on the timing of deferral elections and the ability to alter elections once made.

Under the general initial deferral election rules, an election satisfies section 409A only if the election to defer compensation for services to be performed during a service provider's taxable year is made—and becomes irrevocable—not later than the last day of the prior year. Limited relief from the timing of an initial deferral election is provided for in the case of certain qualifying performance-based compensation.

The 409A Regulations also provide rules for the timing of deferral elections with respect to short-term deferrals. Specifically, in the case of compensation that would otherwise meet the short-term deferral exception (absent an election to defer), a deferral election may be made in accordance with the further deferral requirements (described below), applied as if the scheduled payment date for the amount is the date the substantial risk of forfeiture lapses.

FURTHER DEFERRAL CONSIDERATIONS

Although much of the planning around the timing of compensation payments intended to take advantage of rate reductions may be focused on accelerating payments that are otherwise scheduled to be made in the future, any such planning must also be mindful of the fact that the 409A Regulations generally prohibit further deferrals beyond the tax year in which a payment is otherwise scheduled to be made. Note that there is a limited exception that provides that a payment will be treated as having been made at the time specified under the arrangement (and thus in compliance with section 409A) if the payment is in fact made at a later date within the same taxable year of the service provider or, if later, within 2.5 months following the date specified for payment and further provided that the service provider cannot be permitted, directly or indirectly, to designate the taxable year of payment. As such, this rule may, under the right circumstances, allow payment to be made in the tax year following the year in which the distribution event occurred.

The 409A Regulations also permit so-called further deferral elections, but only if the further deferral election is made at least one year prior to the date the first payment is otherwise scheduled to be made absent the new election, and the further deferral election must also result in payment being deferred for a period of not less than five years from the date such payment would otherwise have been paid.

PRACTICAL OBSERVATIONS

Assuming tax rates may be lower over the next couple of years and then will increase again, it is likely that strategies will focus on causing compensation payments to be made during this window. As described above, these strategies will have to run the section 409A gauntlet, including in particular the anti-acceleration rules and the timing of election rules.

The other challenge to be addressed will be the balance between preserving (from the employer's perspective) vesting and forfeiture conditions imposed on a variety of compensation arrangements while at the same time potentially allowing service providers to take advantage of rate reductions. Often these goals will be mutually exclusive. Employer's also will have to factor in the "cost" of accelerating compensation payments to the extent the tax benefit of the related deduction is lower.

SALT Implications of Final Section 385 Debt-Equity Regulations

Peter L. Faber

BACKGROUND

The US Department of Treasury (Treasury) has released final regulations under section 385 of the Internal Revenue Code dealing with the circumstances under which related company debt will be classified as equity for income tax purposes. Regulations under this provision had been proposed in April. (For prior coverage of the proposed regulations click here.) The proposed regulations caused a considerable amount of consternation in the corporate taxpayer community. Although section 385 (enacted in the Tax Reform Act of 1969) was arguably intended merely to require Treasury to list factors that would be taken into account in determining when purported debt should be reclassified as equity, the proposed regulations prescribed absolute rules, not just factors. If a debt instrument failed to meet the requirements of the proposed regulations, in many cases it was automatically reclassified as equity regardless of whether it would have been respected as debt under the well-accepted rules that had been laid down in dozens of federal court cases.

Treasury's principal concern was with preventing US corporations from diverting income to foreign affiliates via payments on debts owed to the foreign affiliates. This was, in turn, an offshoot of Treasury's concern about inversions, under which US corporations moved abroad, by merger or otherwise, in manners that reduced their federal tax liability.

Although designed to address an international tax issue (one that has been of concern to foreign governments as well as to Treasury), the proposed regulations were not limited to the diversion of income offshore and applied to purely domestic transactions as well. They had implications for state and local taxation, although, obviously, Treasury had not focused on that. These implications were discussed in an earlier article that can be found here. This article is a follow-up to that article and will comment on the final regulations with particular emphasis on the changes from the proposed regulations. The proposed regulations were controversial and reportedly generated roughly 29,600 comments. Treasury, to its credit, seriously considered those comments and addressed many of them in the final regulations. The final regulations significantly narrow the scope of the proposed regulations in many respects. Still, they are sweeping and are likely to have many unintended consequences, including in the state and local tax area.

FINAL REGULATIONS

The final regulations, like the proposed regulations, set forth certain rules under which debt will automatically be reclassified as equity or will be presumed to be equity. An important point to keep in mind is that satisfying the rules of the final regulations does not mean that a particular debt instrument gets a free pass and will necessarily be respected as debt for income tax purposes. It only means that the debt will not automatically be reclassified as equity under the regulations. It still must pass the traditional tests that have been laid down in the federal case law. For example, although the final regulations except from their scope debt issued by certain regulated financial corporations and insurance companies, that debt will still have to pass muster under the criteria specified in the federal case law.

The final regulations generally apply only to debt between related corporations (albeit they also apply in the case of certain corporate "controlled partnerships" (not discussed here)). The universe that is subject to these rules is defined as the "expanded group" of corporations, which generally is similar to the definition of "affiliated group" in section 1504(a), dealing with eligibility to file consolidated federal returns, except that the 80 percent test is measured by vote or value. The definition of "expanded group" is modified in the final regulations by excluding S corporations, non-controlled regulated investment companies and non-controlled real estate investment trusts.

A major change from the proposed regulations is that foreign issuers of debt also are excluded from the definition. Treasury has reserved on this issue and may address it later, but for now, debt issued by foreign corporations will not be subject to the final regulations. This is consistent with Treasury's principal concern about preventing US corporations from deducting interest paid to their foreign affiliates. The problem does not arise with respect to interest paid by a foreign corporation to a US affiliate.

Section 385(a) specifically provides that the regulations can prescribe circumstances under which a debt instrument will be treated as part debt and part equity and the proposed regulations contained detailed bifurcation rules. The bifurcation rules of the proposed regulations were subject to significant criticisms and the concept has been dropped from the final regulations. Once again, however, it is certainly possible that the Internal Revenue Service in an audit could treat a particular instrument as being part debt and part equity under traditional common law principles.

The proposed regulations contained detailed documentation rules that had to be complied with for an instrument to be respected as debt. These rules applied only to large corporate groups. They applied only if the stock of any expanded group member was publicly traded, the expanded group had total assets exceeding $100 million or the expanded group had total annual revenue that exceeded $50 million.

The final regulations retain the documentation rules, but with some significant changes. Noncompliance with these rules with respect to an instrument generally results in the instrument being treated as equity for federal tax purposes; however, noncompliance results only in a rebuttable presumption that the instrument in question is equity for federal tax purposes if the taxpayer can show it is otherwise "highly compliant" with the documentation rules. This can be done by showing either that at least 90 percent of expanded group debt instruments meet the requirements or that the non-compliant debt instruments are not material, as specified in detailed rules included in the regulations. The presumption then can be overcome if the taxpayer can demonstrate that the instrument should be treated as debt under the traditional common law rules.

Among the documentation requirements is one that requires an analysis of the issuer's ability to repay the debt in accordance with its terms. This means that corporations will have to produce and maintain studies showing that the issuer's financial circumstances and prospects were such as to justify a reasonable expectation that the debt would be repaid. Although obviously banks and other professional lenders do this as a matter of course with respect to loans made to customers in the ordinary course of business, they do not do so with respect to related party debt and regular business corporations typically do not do this with respect to inter-company debt. Affected taxpayers will have to change their practices.

Fortunately for taxpayers, the effective date of the documentation rules has been delayed. The rules will only apply to debt instruments that are issued after December 31, 2017. This will give corporations time to develop systems to comply with the new rules.

Among the most controversial rules of the proposed regulations were the funding rules. These generally provided that debt issued in connection with a distribution, in exchange for the stock of a member of the expanded group, or as "boot" in an internal asset reorganization was automatically reclassified as equity if it was issued within three years before or three years after the transaction. The concept of the funding rule and, in particular, its application to all transactions within a six-year period, were criticized by many commenters. The final regulations retain the basic concept, but they soften it in a number of respects.

The proposed regulations contained an exception for certain transactions that occurred in the ordinary course of business. These were designed primarily to apply to routine purchases of goods and services within the expanded group that were not paid for immediately, but were funded by inter-company debt.

The final regulations expand the scope of the ordinary course exemption to include traditional cash pooling arrangements and short-term debt instruments. Under the final regulations, the funding rule does not apply to "qualified short-term debt instruments," which are defined to include short-term funding arrangements, ordinary course loans, interest-free loans and cash pool arrangements.

The proposed regulations provided that the amount of transactions subject to the funding rules was reduced by the amount of the issuer's current-year earnings and profits. The current year limitation was criticized for a number of reasons, including that it was typically impossible to determine them before the end of the year, and that it would create an artificial incentive to "use" current year earnings and profits by making premature distributions. The final regulations expand the earnings and profits limitation to include all earnings and profits of a corporation accumulated during its membership in

an expanded group provided they were accumulated in taxable years ending after April 4, 2016 (the date when the proposed regulations were issued).

The proposed regulations provided that debt would not be reclassified as stock if at the time of issuance the aggregate issue price of all instruments that would otherwise be treated as stock under the proposed regulations did not exceed $50 million. The final regulations modified this rule by eliminating the "cliff" effect and allowing the exclusion of the first $50 million of expanded group debt even if the aggregate amount of expanded group debt exceeded $50 million.

In a major change, the final regulations except from their requirements debt issued by certain regulated entities such as insurance companies or financial institutions. Covered debt instruments do not include instruments issued by regulated insurance companies that are subject to risk-based capital requirements under state law. The preamble states that the regulatory requirements mitigate the risk that tax avoidance transactions would be done. The exception is limited to insurance companies that engage in regular issuances of insurance to unrelated persons. Captive insurance companies are not included in the exception. Further, the exception does not apply to members of an expanded group that includes an insurance company that are not themselves insurance companies. The same principles apply to debt issued by regulated financial institutions, including those with specific regulatory or capital requirements such as bank holding companies, members of the Federal Reserve System, registered broker-dealers, companies subject to a determination by the Financial Stability Oversight Council and Federal Home Loan banks.

Instruments issued by regulated insurance companies and financial institutions are treated as meeting the documentation rules if they contain terms that satisfy regulatory requirements.

The proposed regulations treated members of a consolidated return group as a single corporation, which in effect meant that debt instruments issued by one consolidated return group member to another were not subject to the rules. This general concept has been retained, with slight modifications. Under the final regulations, members of a consolidated group are treated as one corporation but only for purposes of the general and funding rules. With respect to the documentation rules, the final regulations do not treat the members as a single corporation, but they provide that obligations between consolidated group members are not subject to the documentation rules. As a practical matter, this may not be a significant change. An important point to remember is that the exception for intra-group debt does not apply to debt issued to related corporations that do not join in the consolidated federal return.

SALT IMPLICATIONS

A basic issue that will be of concern to SALT practitioners is whether, and the extent to which, the principles of the final regulations will apply for state and local tax purposes. State statutes typically base state taxable income on federal taxable income with changes to reflect differences between federal and state tax policies. Will states that generally conform to the Internal Revenue Code be required to adopt the final regulations or their principles? In my article on the proposed regulations, I argued that this was not the case. Although the final regulations have been adopted pursuant to a statutory mandate, they are not part of the Internal Revenue Code. While regulations adopted pursuant to a statutory authorization are entitled to greater deference than normal interpretative regulations, they are not part of the law and are subject to judicial review. Even provisions of the consolidated return regulations, where it is clear that Congress has delegated rule-making authority to Treasury, have been declared invalid by the courts on occasion. State revenue departments have made it clear that they believe that they are not bound by IRS determinations or interpretations of other Code provisions. In fact, most states do not automatically conform to the consolidated return regulations, even though, as indicated above, they represent an express delegation of rule-making authority by Congress to Treasury. Some state revenue departments follow the consolidated return regulations with respect to corporations filing combined returns, but most do not address the issue.

In my view, the states will not be required to adopt the final regulations or their principles and will be free to reject them entirely, to accept parts of them and not others and to modify them as applied to their own laws. I should mention, however, that this view is not universally shared. In an exchange at the meeting of the American Bar Association Section of Taxation's Committee on State and Local Taxes in Boston on September

30, Michael Fatale of the Massachusetts Department of Revenue, disagreed with this view and voiced that he thought that the states would be required to adopt the regulations when ultimately issued under section 385 (the final regulations had not been yet released). We will see how the states come down on this.

Even if state revenue departments do not consider themselves to be bound by the terms of the final regulations, they may look to them for guidance, and it can be expected that they will be a factor in state and local tax audits. As pointed out in my article on the proposed regulations, I have had cases in which state auditors agreed to be bound by the results of an IRS audit of a debt-equity issue, even though this meant keeping the statute of limitations open only for that issue. Further, relying on federal regulations would be an easy way for state revenue departments to avoid having to make their own detailed examinations of the many factors that the courts have taken into account in making debt-equity determinations. I have been advising clients that it would be prudent to meet the requirements of the final regulations, even with respect to debt that is not literally subject to those regulations (for example, because the companies are too small or because they are filing consolidated federal income tax returns).

One option open to the states would be to adopt comparable regulations that conform to the basic principles of the final regulations, but that part company with them with respect to certain details. For example, comparable state regulations might have lower thresholds for the size of affected corporations or debt or have no thresholds at all. A state revenue department could also retain the minimum size threshold concept but reduce the thresholds so as to apply the state's regulations to more corporations.

A fundamental question discussed in my earlier article was whether state revenue departments will apply the regulations or their principles to corporations that are not subject to the federal regulations because they are members of a federal consolidated return group but that file separate state returns. This is a common situation because many corporations that file consolidated federal returns are not engaged in a common unitary business and hence file separate returns in one or more states. It is possible that a state revenue department could assert that the principles of the federal regulations should apply for state tax purposes in those situations even though the federal regulations do not apply. Presumably, the potential for tax avoidance that Treasury has concluded is present when related corporations file separate federal returns would be present for state purposes in those situations. In some states, this is required by statute. For example, the Louisiana and Maryland statutes specifically provide that corporations that file consolidated federal income tax returns must be treated for state income tax purposes as if they had filed separate federal income tax returns. (*See* LA. Rev. Stat. Ann. Section 47:287.733.A; and Md. Code Ann. Section 10-811.)

Conversely, some corporations file state combined returns even though they file separate federal returns. For example, in New York, corporations can file combined returns even though the stock of both corporations is owned by an individual. These corporations could not file consolidated federal returns because a federal consolidated return group must have a common corporate parent. Further, In New York, combined returns can be required or permitted if the common ownership exceeds 50 percent, whereas the federal common ownership level is 80 percent. In those situations, could taxpayers argue that, even though the federal regulations literally apply and require a certain debt instrument to be treated as equity, a similar determination should not be made for state purposes because they are filing combined state returns and if the same filing profile had existed for federal purposes the regulations would not have applied? Such an argument would be strengthened if the state adopted the federal rules on elimination in intra-group transactions under the federal consolidated return regulations.

In my article on the proposed regulations, I pointed out that the exception for distributions from earnings and profits could be applied differently for state and local tax purposes than for federal tax purposes because state and local earnings and profits are not necessarily the same as federal earnings and profits. If state revenue departments apply this rule, will they apply it to federal earnings and profits or to state earnings and profits? The right approach would seem to be to use state earnings and profits as the measure, even though that could result in an instrument being treated differently for federal and state purposes.

Another implication of the regulations is that corporations that are paying franchise taxes based on the amount of their capital, and not on the amount of their net income, may find that their capital-based taxes increase if debt is reclassified as equity.

As indicated above, the final regulations exclude debt issued by S corporations from their scope. How will the states treat corporations that are S corporations for federal income tax purposes but that are C corporations for state income tax purposes? In New York, a federal S corporation must elect to be treated as an S corporation for state tax purposes. If it fails to do so, it will be treated as a C corporation. Under the New York City general corporation tax, S corporations are mandatorily treated as C corporations. The New York tax authorities will have to decide how they are going to treat these entities.

CONCLUSION

The proposed regulations were controversial and gave rise to much criticism. Indeed, the concept was attacked by many members of Congress. Nevertheless, Treasury has issued them in final form and they are now part of the tax landscape. State and local tax practitioners, both in-house and in professional firms, will have to address the implications of the regulations and, more importantly, will have to make their business and federal tax colleagues aware that these regulations have state and local tax consequences that must be taken into account.

UK Tax Strategy Legislation

Matthew Herrington

INTRODUCTION

The United Kingdom has recently introduced legislation that will require covered businesses (see below) to prepare and publish (publicly) an annual statement about their UK tax strategy.

The legislation came into force in September 2016 and applies to financial years beginning on or after September 15, 2016. Affected groups with a December year end will therefore need to publish their first UK tax strategy by the end of 2017.

The new legislation is expected to create additional compliance burdens for covered businesses and should (from a practical perspective) be taken into account by them as part of their annual compliance reviews given the requirement to publish an updated strategy each year.

All taxpayers affected by the new rules should be considering their impact and ensuring that they prepare a timely submission in accordance with the detailed requirements of the new legislation.

As the UK tax authorities (HMRC) have indicated that they will not give clearances in relation to whether or not a draft statement complies with the new rules, it is important for covered businesses to take legal advice on the preparation of their statements in order to ensure that all requirements of the legislation are considered and a coherent and consistent position is articulated in what will be a public statement to the world at large.

OVERVIEW

The new legislation has the following key features:

- The rules apply to any company or affiliated group of companies (1) with turnover exceeding £200 million or balance sheet assets exceeding £2 billion, or (2) whether or not satisfying these metrics, that are within the scope of country-by-country reporting ("covered businesses").
- The rules will apply equally to covered businesses that have UK tax-resident parent companies and those that are non-UK parented. Accordingly, for example, the new rules may apply to US-parented multinational groups with UK-based operations.

CONTENT OF THE UK TAX STRATEGY STATEMENT

The rules set out detailed requirements in relation to the content of the UK tax strategy, which must be published annually on the internet and must be available to the public free of charge.

The key requirements are broken down into four specific areas, namely: the covered business's approach to UK tax risk management and governance, its attitude towards UK tax planning, an explanation of how it approaches risk in relation

to UK tax and a statement concerning how it interacts with HMRC.

HMRC has published draft guidance on the application of the new rules (most recently in June 2016), which will almost certainly form the basis on which HMRC inspectors will assess compliance with the legislative requirements.

From a practical perspective, the guidance should therefore be given close consideration by taxpayers, noting in particular that HMRC has indicated very clearly that it will not give clearances on whether or not a draft statement prepared by a taxpayer satisfies the requirements of the new legislation.

In practical terms, we anticipate some flexibility being likely on this requirement, given that both taxpayers and HMRC will need to familiarize themselves with the new rules (and HMRC will need to ensure that penalties and corrective actions are being appropriately targeted). Indeed, we note that the rules themselves do provide a facility for "warning notices" to be issued, rather than automatically resulting in a penalty where HMRC considers a statement not to have met the requirements of the new legislation.

As noted above, the strategy must set out:

- The approach of the taxpayer to risk management andgovernance arrangements in relation to UK taxation. HMRC's guidance suggests that this is likely to include:
  - How the business identifies and mitigates inherent tax risk because of the size, complexity and extent of change in the business;
  - The governance framework that the business uses to manage tax risk;
  - The levels of oversight and involvement of the board of the business; and
  - A high-level description of any key roles and responsibilities, and systems and control in place, to manage tax risk.
- The attitude of the taxpayer towards UK tax planning. In its draft guidance, HMRC suggests that this is likely to include:
  - Details of any code of conduct regarding tax planning;
  - An outline of the drivers of tax planning and the weighting given to these in formulating tax strategy;
  - The group's approach to structuring tax planning; and
  - An explanation of why tax planning advice might be sought externally.
- The level of risk in relation to UK taxation that the taxpayer is prepared to accept. In its draft guidance, HMRC suggests that this is likely to include an explanation of whether internal governance is prescriptive of levels of acceptable risk and, if so, whether this is quantified, and how it is affected or influenced by stakeholders.
- The approach of the taxpayer to its dealings with HMRC. In its draft guidance, HMRC suggests that this is likely to include an explanation of how the covered business:
  - Works in partnership with HMRC to meet statutory and legislative tax requirements; and
  - Is transparent or works with HMRC on current, future or retrospective tax risks, events or interpretation of the law across all relevant taxes and duties.

There is no requirement to notify HMRC when the strategy is published; however, from a practical perspective, it would be worth covered businesses notifying their Customer Relationship Managers at HMRC when their draft statements go live on the internet. If nothing else, this will be a good practice feature of open and collaborative engagement with HMRC and should help to guard against penalties for non-compliance.

HMRC has confirmed that the strategy does not have to contain commercially sensitive information. However, great care clearly needs to be taken by taxpayers in relation to the content of the statement. In particular, it will be important to ensure that:

- Privilege is not inadvertently waived by the publication of the statement. For example, where a taxpayer has previously taken legal advice on its position, it would be critical not to refer to that advice, as such a reference could constitute a 'collateral waiver' of privilege. Great care will need to be taken in this regard in relation to the section of the UK tax strategy that covers the basis on which the group takes advice from outside advisers.
- Prior year positions are not prejudiced by inconsistent descriptions (especially where there is a currently ongoing dispute or investigation in relation to a prior year, or where the taxpayer is currently involved in formal litigation in relation to prior year positions).

As the statement will be binding in practical terms (given its public nature), taxpayers need to ensure that the statement receives appropriate backing from a wide range of stakeholders internally.

It will therefore be critical for affected taxpayers to implement an internal process whereby the drafting, maintenance, updating and annual approval of the UK tax strategy statement becomes part of their annual compliance reviews.

Such a process might include internal education for groups outside the tax function, close coordination with the compliance/risk teams, internal checks and balances, a timeline to filing, key milestones and a process for substantive feedback and sign-off to be provided by other departments within the group (*i.e.*, so that the statement is not owned solely by the tax function).

Indeed, HMRC has indicated in its draft guidance that it expects businesses to follow the same internal approvals processes in relation to the UK tax strategy statement as they would apply to any public statements they make (including in relation to the requirement for board approval).

A consistent internal approach will also be especially important where other jurisdictions introduce similar legislative requirements, and great care also will need to be taken to ensure that a consistent position is articulated in relation to compliance with other already existing legislative requirements such as local/master files and country-by-country reports in the transfer pricing space.

CONCLUSION

This is an important new legislative development in the United Kingdom, which is likely to drive greater public awareness of the approach that large groups take to their UK tax affairs. Affected taxpayers should bear in mind the public nature of the statement, particularly given the heightened public sensitivity to the tax affairs of multinationals.

It will be critical for affected taxpayers to ensure that a consistent and robust position is articulated in their statements, and to ensure that the drafting of the statements receives full stakeholder buy-in and support from all interested functions internally.

Final Regulations Define "Real Property" for REITs

Madeline Chiampou Tully and Bradford E. LaBonte

On August 31, 2016, the Internal Revenue Service (IRS) and US Department of the Treasury issued final regulations (Final Regulations) under section 856 of the Internal Revenue Code to clarify the definition of "real property" for purposes of sections 856 through 859 relating to real estate investment trusts (REITs). The Final Regulations largely follow proposed regulations issued in 2014 (Proposed Regulations) by providing a safe harbor list of assets and establishing facts and circumstances tests to analyze other assets.

BACKGROUND

Section 856 sets forth the requirements for a taxpayer to qualify as a REIT for federal income tax purposes. One of the requirements is that at the close of each quarter of the taxable year, at least 75 percent of the value of the REIT's assets must be represented by real estate assets, cash and cash items (including receivables) and government securities.

Section 856 defines "real estate assets" to include real property and interests in real property. Treasury Regulations section 1.856-3(d), promulgated in 1962, defined real property as "land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures)," and also included "interests in real property."

Between 1969 and 1975, the IRS issued various revenue rulings addressing whether certain assets qualify as real property for purposes of section 856. Since then, REITs have sought to invest in a variety of other types of assets that are not directly addressed by those revenue rulings, and have sought and received private letter rulings from the IRS with respect to assets such as a data center and related infrastructure, boat slips and end ties in a marina and outdoor advertising signs. Given that private letter rulings are limited to their particular facts and may not be relied upon by other taxpayers, the IRS and Treasury recognized the need to provide updated published guidance on the definition of real property under sections 856 through 859.

On May 14, 2014, the IRS and Treasury published in the Federal Register a notice of proposed rulemaking to define "real property" solely for purposes of sections 856 through 859 and provisions that reference the definition of real property in section 856 and the regulations thereunder.

Click here for a detailed summary of the Proposed Regulations.

FINAL REGULATIONS

The Final Regulations follow the Proposed Regulations in defining "real property" to include land and improvements to land—*i.e.*, inherently permanent structures (IPSs) and their structural components. The Final Regulations also follow the Proposed Regulations by providing safe harbor lists of assets and establishing facts and circumstances tests to analyze other assets.

The Final Regulations apply only in determining whether the assets held by a REIT qualify as real property, and provide neither explicit nor implicit guidance regarding whether income derived from such assets is "good" REIT income under sections 856(c)(2) and (3).

Land

Land is treated as real property and includes water and air space superjacent to land, as well as natural products and deposits that are unsevered from the land. The preamble to the Final Regulations clarifies that air space and water space superjacent to land each qualify as land even if the REIT owns only the air space or water space and does not own an interest in the underlying land.

Inherently Permanent Structures

IPSs include permanently affixed buildings and other inherently permanent structures (OIPSs). The Proposed Regulations stated that to qualify as an IPS, a distinct asset must be permanently affixed, and that if the affixation is reasonably expected to last indefinitely based on all the facts and circumstances, the affixation is considered permanent. The Final Regulations retain this requirement, with the preamble clarifying that the IRS and Treasury do not intend the term "indefinitely" to mean "forever."

The Final Regulations add motels, enclosed stadiums and arenas and enclosed shopping malls to the "safe harbor" list of assets that are treated as buildings. The IRS and Treasury declined to add outdoor sports stadiums, amphitheaters and unenclosed parking garages to this list; however, the preamble notes that many of these structures would satisfy the definition of an OIPS under the Final Regulations. No additions were made to the safe harbor lists of OIPSs and structural components set forth in the Proposed Regulations.

The Proposed Regulations contained a requirement that an OIPS must serve a passive function, such as to contain, support, shelter, cover or protect, and must not serve an active function, such as to manufacture, create, produce, convert or transport. The Final Regulations retain this requirement and add "provide a conduit or a route" to the list of permitted passive functions. The preamble clarifies that the IRS and Treasury intend the term "transport" to mean to cause to move, rather than to provide a conduit (such as in the case of a pipeline or electrical wire) or route (as in the case of a road or railroad track). The preamble to the Final Regulations also clarifies that the passive function requirement neither prohibits a tenant from using a passive asset, such as an office building, in the tenant's active business nor limits a REIT's ability to perform either the permitted services under section 856(d)(7)(C)(ii) or the permitted trustee/director functions under Treasury Regulations section 1.856-4(b)(5)(ii). The IRS and Treasury further state in the preamble that machinery and equipment that may serve both passive and active functions are excluded from the definition of an IPS.

Structural Components

A structural component means any distinct asset that (1) is a constituent part of and integrated into an IPS; (2) serves the IPS in its passive function; and (3) even if capable of

producing income other than consideration for the use or occupancy of space, does not produce or contribute to the production of such income.

The Proposed Regulations stated that a structural component would not qualify as real property unless the REIT's interest in the structural component is included with an "equivalent interest" held by the REIT in the IPS to which the structural component is functionally related. The preamble to the Final Regulations states that the IRS and Treasury intended that the "equivalent interest" requirement in the Proposed Regulations ensure that an asset did not qualify as a structural component unless that asset served real property in which the REIT also had an interest. Under the Final Regulations, the REIT is no longer required to hold an "equivalent interest" in the IPS. However, an interest in the IPS is still required. Specifically, the REIT must hold its interest in the structural component together with a real property interest with respect to the space in the IPS that the structural component serves. As such, differing interests (*e.g.*, an ownership interest in the structural component and a leasehold interest in the IPS) are permissible under the Final Regulations.

Distinct Asset

The Final Regulations retain the language in the Proposed Regulations regarding "distinct assets." To determine whether an asset is land, an IPS or a structural component, it is necessary to test first whether the item of property is a "distinct asset" based on all the facts and circumstances. The IRS and Treasury clarify in the preamble to the Final Regulations that for a distinct asset to be treated as a structural component, a REIT must hold a legally enforceable real property interest in the space in the IPS that the structural component serves, and that a leasehold interest is permissible.

Intangibles

The Proposed Regulations provided that an intangible asset is real property or an interest in real property if the asset derives its value from real property or an interest in real property, is inseparable from that real property or interest in real property, and does not produce or contribute to the production of income other than consideration for the use or occupancy of space. The IRS and Treasury state in the preamble that intangible assets that are separable from real property or an interest in real property should not qualify as real property. Therefore, the Final Regulations clarify that intangible assets that are related to services and that are separable from the real property do not qualify as real property. The Final Regulations also clarify that an intangible asset, such as a lease, may include an asset that is, in part, an interest in real property and, in part, an asset other than an interest in real property. The Final Regulations include a new example illustrating the application of these rules to an in-place above-market lease that produces income that qualifies as rents from real property under section 856(d)(1) and other non-qualifying income.

Examples

The examples in the Final Regulations illustrate the application of the rules to various types of assets, including an indoor sculpture, bus shelters, a cold storage warehouse, a data center, partitions, a solar energy site, a solar-powered building, a pipeline transmission system, a land use permit and a license to operate a business.

The Final Regulations retain and revise 12 of the 13 examples included in the Proposed Regulations. The excluded example (Example 11 of the Proposed Regulations) addressed whether goodwill established under GAAP as a result of the acquisition of stock of a corporation that owned a hotel qualifies as real property for purposes of sections 856 through 859. The example concluded that such goodwill is real property to the acquiring REIT when it acquires the stock of the corporation. The Final Regulations remove this example, because depreciated replacement cost is no longer the standard under GAAP for valuing property such as the hotel. In its place, the Final Regulations add a new Example 11, which involves an in-place above-market lease that is treated as an intangible asset under GAAP. The value of the above-market lease is partly attributable to rents from real property and partly attributable to income that does not qualify as rents from real property. The example concludes that the above-market lease can be treated as, in part, an interest in real property (with respect to the portion of the value that is attributable to rents from real property) and, in part, an asset other than an interest in real property (with respect to the portion of the value that is attributable to income that does not qualify as rents from real property).

Several examples in the Proposed Regulations involved a REIT that enters into long-term, triple-net leases of property. The Final Regulations revise these examples to refer generally

to "leases" (rather than long-term, triple-net leases) and to provide that the REIT neither operates the property nor provides services to the lessee.

The Final Regulations are generally consistent with the Proposed Regulations in their treatment of renewable energy assets: smaller-scale renewable energy systems that primarily serve buildings are generally REIT-eligible assets, whereas larger, utility-scale assets effectively are not eligible. The Final Regulations are also consistent with the Proposed Regulations in their treatment of transmission systems: despite the fact that a transmission system may serve an active function (*e.g.*, transporting natural gas), distinct assets within the system may nevertheless be an IPS if that asset does not perform an active function.

EFFECTIVE/APPLICABILITY DATE

The Final Regulations apply for taxable years beginning after August 31, 2016, although taxpayers may rely on them for quarters that end before that date. In addition, the preamble clarifies that to the extent a previously issued letter ruling is inconsistent with the Final Regulations, the letter ruling is revoked prospectively from the applicability date of the Final Regulations (*i.e.*, August 31, 2016).

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