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Expanded U.S. Reporting Requirements for Taxpayers with Foreign Assets and New Voluntary Disclosure Program

Expanded U.S. Tax Reporting Requirements

The Foreign Account Tax Compliance Act ("FATCA"), enacted in 2010 as part of the Hiring Incentives to Restore Employment ("HIRE") Act,[1] added section 6038D to the Internal Revenue Code. This section requires any U.S. individual taxpayer ("Taxpayer") holding interests in "specified foreign financial assets" that exceed in the aggregate a certain value threshold to attach newly issued IRS Form 8938 to the Taxpayer's annual income tax return. Reporting applies for specified assets held in taxable years beginning after March 18, 2010. For most taxpayers, reporting will begin for their 2011 tax return to be filed during the 2012 tax-filing season. Failure to report specified foreign financial assets on Form 8938 may result in a penalty of $10,000 (and a penalty up to $50,000 for continued failure after IRS notification). Further, underpayments of tax attributable to non-disclosed foreign financial assets will be subject to an additional substantial understatement penalty of 40 percent.

The new Form 8938 filing requirement is in addition to, and does not replace or otherwise affect, a taxpayer's obligation to file a Report of Foreign Bank and Financial Accounts ("FBARs"), due on June 30, 2012.

A Taxpayer includes (i) residents under U.S. domestic law who claim to be nonresidents under an income tax treaty; and (ii) nonresident aliens who file joint U.S. tax returns with their U.S. taxpayer spouses. It is anticipated that these rules will be expanded to require filing by various U.S. entities, but those rules will not take effect until the Form 8938 reporting is due for the 2012 tax year, at the earliest.

For purposes of section 6038D, a specified foreign financial asset is any financial account maintained by a foreign financial institution and, to the extent not held in an account at a financial institution: (i) any stock or security issued by any person other than a U.S. person; (ii) any financial instrument or contract held for investment that has an issuer or counterparty that is not a U.S. person; and (iii) any interest in a foreign entity. For each custodial or depository account with a foreign financial institution, a Taxpayer is required to disclose the maximum value of the account, the name and address of the foreign financial institution and the account number of such account. For each stock or security, a Taxpayer is required to disclose the maximum value of the stock or security, describe the stock or security and disclose the name and address of the issuer of such stock or security. For other assets, the Taxpayer is required to disclose the maximum value of such other asset, describe the asset and disclose the name and address of the issuers or counterparties, or both, of such other asset.

Assets used in a trade or business, rather than being held for investment, are not specified foreign financial assets. Moreover, stocks or securities held by a domestic financial institution are not specified financial assets and do not have to be reported on Form 8938. A beneficial interest in a foreign trust or a foreign estate is not a specified financial foreign asset of the Taxpayer unless the Taxpayer knows, or has reason to know based on readily accessible information, of the interest. Receipt of a distribution from the foreign trust or foreign estate is deemed for this purpose to be actual knowledge of the interest.

Form 8938 is required when the total value of specified foreign assets exceeds certain thresholds. For example, a married couple living in the United States and filing a joint tax return would not file Form 8938 unless their total specified foreign assets exceed $100,000 on the last day of the tax year, or more than $150,000 at any time during the tax year. The thresholds for Taxpayers who reside abroad are higher. For example, a married couple residing abroad and filing a joint U.S. return would not be required to file Form 8938 unless the value of specified foreign assets exceeds $400,000 on the last day of the tax year, or more than $600,000 at any time during the year.

Form 8938 is not required of Taxpayers who do not have an income tax return filing requirement. In addition, specified foreign financial assets that were properly reported on Form 3520, "Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts;" Form 3520-A, "Annual Information Return of Foreign Trust With a U.S. Owner;" Form 5471, "Information Return of U.S. Persons With Respect To Certain Foreign Corporations;" Form 8621, "Return by a Shareholder of a Passive Foreign Investment Company

or a Qualified Electing Fund;" Form 8865, "Return of U.S. Persons With Respect To Certain Foreign Partnerships;" or Form 8891, "U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans" do not have to be reported on Form 8938, although the Form 8938 itself must be filed by such Taxpayers to cross-reference the filing of the other forms.

New Voluntary Disclosure Requirements

On January 9, 2012, the IRS announced a third voluntary disclosure program ("OVDP") designed to bring offshore money back into the U.S. tax system, and help people with undisclosed income from hidden offshore accounts become current with their taxes.[22] This third offshore program comes as the IRS continues working on a wide range of international tax issues and follows ongoing efforts with the Justice Department to pursue criminal prosecution of international tax evasion. Unlike the 2009 and 2011 programs, this program will be open for an indefinite period until otherwise announced.

Under the OVDP, participants with undisclosed foreign accounts or unreported foreign income may be able to avoid criminal prosecution and limit their potential exposure to civil penalties by making a voluntary disclosure of such undisclosed accounts or unreported income to the IRS. Such persons generally will be required to: (i) file delinquent FBARs and amended returns for an 8-year period (such as tax years 2004 through 2011); (ii) pay the tax and interest due in connection with such amended returns, along with a 20% accuracy penalty and delinquency penalties, if applicable; and (iii) pay a miscellaneous "offshore" penalty equal to 27.5% (or in limited cases 12.5% or 5%) of the highest aggregate balance in the undeclared foreign accounts during the years 2004 through 2011.

For many taxpayers with undeclared foreign accounts or unreported foreign income, the specified penalty structure under the OVDP may be extremely favorable in comparison with the civil penalties that could otherwise be imposed. Each case is different, however, and the advantages and disadvantages of a voluntary disclosure must be carefully analyzed for each taxpayer based upon his individual facts and circumstances.

IRS Commissioner Shulman has sent the following message to noncompliant taxpayers: "As we've said all along, people need to come in and get right with us before we find you. We are following more leads and the risk for people who do not come in continues to increase."[3]

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[1] Pub. L. No. 111-147. §§ 501, 511.
[2] News Release IR-2012-5.
[3] *Id.*

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RECENT DEVELOPMENTS IN THE APPLICATION OF THE ECONOMIC SUBSTANCE DOCTRINE TO TAX CREDIT TRANSACTIONS

The common law "economic substance" doctrine was developed to prevent taxpayers from recognizing the tax benefits of transactions that, despite technical compliance with the language of the Internal Revenue Code ("Code"), were not the type of transactions Congress intended to encourage when it enacted a provision of the Code.[1] In March 2010, as part of the "Health Care and Education Affordability Reconciliation Act of 2010," section 7701(o)[2] codified the economic substance doctrine. Effective for transactions entered into after March 30, 2010, the new law defines economic substance and imposes a penalty on taxpayers for transactions that lack economic substance. The penalty is 20% of the underpayment if the transaction is disclosed on the taxpayer's return, or a 40% penalty if the transaction is not disclosed.[3]

For certain taxpayers, the codification of the doctrine raises questions about the consequences of entering into certain transactions where the objective is to earn tax benefits granted by other provisions of the Code. In particular, the codification of the economic substance doctrine raises questions of whether taxpayers entering into transactions intended to generate renewable energy production and investment tax credits would be subject to scrutiny. If a tax credit transaction is determined not to have economic substance, then some or all of the credits (and related deductions) may be disallowed. In addition, the applicable penalty would be imposed. However, as discussed below, recent administrative, judicial and legislative developments have concluded that tax credit transactions should not generally be subject to the economic substance doctrine.

Section 7701(o) treats a transaction as having economic substance only if (1) that transaction changes the taxpayer's economic position in a meaningful way (apart from any federal income tax benefits), and (2) the taxpayer has a substantial business purpose for entering into the transaction. The determination of whether the economic substance doctrine is relevant to the transaction is to be made in the same manner as if the doctrine had not been codified. Accordingly, section 7701(o) does not change the current applicable standards utilized by the courts. If a court determines that a tax credit transaction fails both of these tests, then the entire credit or a portion of the credit and all related deductions will be disallowed, and the appropriate penalty will apply.

The second test under the codified doctrine may be of particular concern for taxpayers involved in tax credit transactions. A court may take into account the profit potential of a transaction when considering whether or not the taxpayer has a substantial business purpose for entering into that transaction. Generally, the analysis hinges on whether the present value of the expected pre-tax profit from the transaction is substantial compared to the present value of the

expected net tax benefits allowed if the transaction were recognized.[4] As a result, taxpayers who take tax credits into account as part of overall anticipated returns when entering into transactions may face onerous results if those anticipated returns are relatively small compared to the net tax benefits of the credits.

Recent developments indicate that tax credit transactions will not be automatically subject to economic substance analysis. In *Historic Boardwalk Hall, LLC v. Commissioner*,[5] the Tax Court held that a tax-motivated investment in a real estate rehabilitation project had economic substance. In the case, an investor contributed money to a partnership and received the historic rehabilitation tax credits, along with a 3% preferred return. The IRS argued that the arrangement should be disregarded because it lacked economic substance. According to the IRS, the fact that the investor's only return (without taking into account the tax credits) was the 3% preferred return demonstrated that the arrangement lacked economic substance. Holding in favor of the taxpayer, the court concluded that, in determining whether a transaction has economic substance, it was reasonable to consider tax benefits that have been provided by Congress for the specific purpose of changing investor conduct.[6] In addition, the court took the rehabilitation tax credits into account in determining that the taxpayer had materially altered its economic position. The court noted that both parties assumed certain risks associated with the project, including, among other things, the taxpayer's risk that the project would not be completed as anticipated and would fail to generate rehabilitation tax credits.[7]

The Tax Court's decision in *Historic Boardwalk* is consistent with the Joint Committee on Taxation's "Technical Explanation of the Revenue Provisions of the 'Reconciliation Act of 2010,' as amended, in combination with the 'Patient Protection and Affordable Care Act'" (the "Technical Explanation"), that addresses the economic substance doctrine and its relevance to tax credits. The Technical Explanation provides that the codification is not intended to change the judicial standards in determining when to utilize an economic substance analysis, and it is not intended to alter the tax treatment of certain basic business transactions that are respected under longstanding judicial and administrative practice, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. More important is footnote 344 of the Technical Explanation which specifically addresses the application of the doctrine to tax credits. The footnote provides that, if the realization of the tax benefits of a transaction is consistent with the congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that the tax benefits be disallowed. Therefore, certain credits, such as the low-income housing credit (section 42), production tax credit (section 45), rehabilitation credit (section 47), and the energy credit (section 48) -- all of which have the same purpose of encouraging taxpayers to participate in certain activities or make certain investments -- should not be immediately subject to the economic substance doctrine. However, taxpayers should still be cognizant that the IRS may challenge their tax credit transactions if they depart from what Congress intended to allow. The Technical Explanation suggests that the IRS may bifurcate the transaction to separate tax-

avoidance objectives (such as including additional parties or fee arrangements) from non-tax objectives.

In recent guidance to field auditors, the IRS has indicated that it intends to follow the principles outlined in footnote 344. In LB&I 4-0711-015, entitled "Guidance for Examiners and Managers on the Codification of the Economic Substance Doctrine and Related Penalties" (the "Directive"), the IRS identifies a number of facts and circumstances for examiners and managers to consider in applying the economic substance doctrine. Among other things, the Directive provides that the economic substance doctrine is not appropriate for a transaction that generates targeted tax incentives that are consistent with congressional intent in providing the incentives.

Pursuant to the foregoing authorities, it appears that transactions involving tax credits, including renewable energy investment and production tax credits, will not automatically be subject to the economic substance doctrine. However, the protection given to tax credits generally may not assure that every tax credit transaction will be immune from the economic substance doctrine because other elements of the transaction, including the manner in which the transaction is structured or the use of other tax attributes, may subject the transaction to scrutiny. Even under the recent authorities, the transaction must be "consistent with" the congressional intent or purpose that the tax benefits were designed to effectuate. A transaction may be at risk if it involves additional fees or arrangements that go beyond Congress' intent. In the case of renewable energy and related investment tax credits, the language in the Technical Explanation protecting transactions relying on other judicial or administrative pronouncements may protect certain transactions, such as those structured in reliance on Rev. Proc. 2007-65, as modified by Rev. Proc. 2009-69. In addition, it remains to be seen whether the Third Circuit, in its consideration of the IRS's appeal of *Historic Boardwalk*, will uphold the Tax Court's determination that the transaction at issue had economic substance. Accordingly, taxpayers and their advisors should apply the doctrine as an additional test when structuring transactions to ensure that their motives are consistent with the motives of Congress.

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[1] *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).
[2] All section references are to the Internal Revenue Code of 1986, as amended.
[3] I.R.C. § 6662(i).
[4] I.R.C. § 7701(o)(2)(A).
[5] 136 T.C. 1 (2011).
[6] In reaching its decision, the Tax Court relied on *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995), which held that the absence of pre-tax profitability does not show whether the transaction had economic substance beyond the creation of tax benefits, where Congress purposefully used tax incentives to change investors' conduct.

[7] In April 2011, the IRS appealed the decision in *Historic Boardwalk* to the Court of Appeals for the Third Circuit.

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DOMESTICALLY CONTROLLED REITS AND LEVERAGED CORPORATE BLOCKER STRUCTURES

Background

Real estate funds and real estate investment sponsors must consider a number of tax, corporate, finance and even privacy issues when seeking foreign capital for their U.S. real estate investments. These issues necessitate careful planning and implementation of any foreign investment in U.S. real property. This article considers a few of the many U.S. tax issues associated with two structures: domestically controlled REITs and corporate blockers. Specifically, this article first considers "domestically controlled" REIT ("DCR") structures that might, in some limited cases, be used in planning for the ultimate sale of U.S. real property – including addressing the Foreign Investment in Real Property Tax Act ("FIRPTA")[1] issues that arise. This article then contrasts the use of a DCR structure against "leveraged corporate blocker" ("LCB") structures. As discussed below, in many cases, the use of an LCB structure may prove beneficial to a foreign investor.

Domestically Controlled REITs

A real estate investment trust ("REIT") is often used as a tax-efficient vehicle to invest in U.S. real property assets. At its most basic level, a REIT is a corporation or trust that: (i) has elected to be taxed as a REIT;[2] (ii) satisfies the qualification requirements of Code Sec. 856;[3] and (iii) meets the minimum distribution requirements of Code Sec. 857(a). Because Code Sec. 857(b)(2)(B), in qualifying cases, provides a "dividends paid deduction" ("DPD"), a REIT is a tax-efficient vehicle to hold real estate and debt instruments secured by real estate. This special deduction generally allows a REIT to avoid the double-level of tax imposed on other C corporations to the extent the REIT pays dividend income. REIT shareholders include the dividends received from the REIT in income, either as ordinary income,[4] capital gains (depending on the REIT-level characterization of the distributions) or as a return of capital in excess of the foreign investor's basis in its DCR shares.[5]

In most cases, distributions from REITs to foreign investors are generally subject to taxation under FIRPTA, regardless of whether the REIT qualifies as a DCR. Dividend distributions by a REIT to foreign investors that are payable out of current and accumulated earnings and profits of the REIT, but not attributable to capital gains and not effectively connected with the foreign investor's trade or business, are treated as ordinary income subject to a U.S. withholding tax of 30%.[6] To the extent a REIT makes distributions to a foreign investor in excess of current and accumulated earnings and profits, the distributions will be subject to a 10% withholding tax if the REIT's common stock constitutes a United States Real Property Interest ("USRPI").[7] Distributions by a REIT to foreign investors that are attributable to gains from the disposition of

real property ("capital gains distribution") are treated as effectively connected income to the foreign investor and taxed at applicable U.S. tax rates.[8] The REIT must withhold 15% from capital gains distributions payable to foreign investors who are individuals and 35% from capital gains distributions payable to foreign investors that are corporations.[9] Foreign investors that are corporations also may be subject to the Branch Profits Tax ("BPT") with respect to a capital gains distribution.[10]

The disposition of REIT shares will be considered the disposition of a USRPI subject to FIRPTA, unless the REIT is publicly traded[11] or the REIT qualifies as a DCR.[12] A disposal of shares in a DCR does not trigger FIRPTA tax or filing obligations. A DCR, however, must be structured to demonstrate domestic control – specifically, U.S. investors must hold *more than 50%* of the capital of the REIT.[13]

The DCR structure is a relatively common approach for foreign investors to utilize for U.S. real estate investments in closely held and negotiated deals, or deals where the foreign investor has enough negotiating strength to exercise a significant amount of control on the structure and exit of the investment. Basically, if the fund's foreign investors are able to exit the investment through a sale of DCR shares, the foreign investors should avoid U.S. income tax because a sale of the DCR shares is not subject to FIRPTA or other U.S. income taxes.[14] However, in the real estate investment fund context, the tax benefits for a qualifying DCR often never come to fruition. This is because, in many cases, a real estate investment fund is much more likely to be able to negotiate a sale of the fee simple real estate interest rather than a sale of shares in a DCR. As noted above, FIRPTA still applies when a DCR (or any partnership or other passthrough entity owned by the DCR) sells U.S. real estate and distributes the gain from the sale to its foreign investors. Technically, a real estate investment fund could attempt to manage this result by holding each real estate asset in a separate DCR and disposing of the shares of each DCR separately. However, even assuming a purchaser would be willing to purchase DCR shares rather than a fee simple real estate interest, the cost of implementing and managing such a cumbersome and complex multi-DCR structure might outweigh the tax savings benefits. In addition, at times, a fund might not be able to match the appropriate percentage of domestic investors with the appropriate amount of foreign investors (at least 50.1% domestic funds must be present) to qualify as a DCR. Given these limitations, in some cases, it may be better to utilize a LCB structure instead of a DCR.

Leveraged Corporate Blocker Structures as an Alternative

Whether a particular LCB structure reduces a foreign investor's effective U.S. tax rate on a U.S. real estate investment depends on a number of factors, each of which is specific to a particular investment. Generally speaking, the primary structuring components for reducing such taxes is: (i) the U.S. interest payment deduction associated with a leveraged investment that the LCB uses to reduce the amount of income subject to U.S. tax; and (ii) the ability to repatriate dividends via a reduced rate of withholding under an applicable income tax treaty.

The LCB structure is intended to work as follows: Foreign investors form a Delaware (or other U.S.) corporation and capitalize it with a mix of debt and equity. Upon exit, the real estate fund disposes of its real estate asset and distributes the proceeds to its investors, including the LCB. The LCB pays out the proceeds from its investment in the fund to its owners as a mix of debt repayment, dividends and return of capital. The LCB is taxed on its share of the fund's income at regular U.S. tax rates applicable to corporations and files federal and state income tax returns (the foreign investors in the LCB are thus shielded from the U.S. tax filing requirement). The portion of the distributed proceeds that are attributable to repayment of interest on the LCB's debt should be deductible by the LCB and result in a reduction in the effective U.S. income tax rate paid by foreign investors. Return of capital (principal on debt and equity invested) is distributed tax-free.[15] Dividend payments the LCB makes to the foreign investors attract a 30% withholding tax that may be reduced under a tax treaty (for example, 15% (or in some cases, lower) under each of the income tax treaties the U.S. has with France, Germany, Ireland, the Netherlands and the UK, among others).[16]

It is important to note, however, that the disposition of LCB shares will, in most cases, be considered the disposition of a USRPI subject to FIRPTA, which requires the purchaser of the foreign investor's LCB shares to withhold 10% of the amount realized by the foreign investor from the sale of the LCB shares.[17] FIRPTA further requires the foreign investor to file a U.S. tax return with respect to the income resulting from the disposition. The tax withheld by the purchaser of the LCB shares is credited against the taxes owed by the foreign investor.[18]

A two-tiered LCB structure may be a viable option and may provide better tax results, in some cases, when compared to a single-tiered structure. In a two-tiered structure, the foreign investors own stock of a foreign corporation that owns 100% of the stock in a U.S. corporation that invests in the U.S. real property. The only asset of the foreign corporation is the stock of the U.S. corporation. The U.S. corporation is capitalized by the foreign corporation with a combination of debt and equity with a market-based debt-to-equity ratio. This two-tiered LCB structure provides the following advantages over a single-tiered LCB: (i) no disclosure of the foreign investors to the IRS will be required, regardless of the amount of stock in the foreign corporation that is owned by the foreign investor;[19] (ii) the foreign investors will not be subject to FIRPTA taxation or tax filing requirements with respect to the disposition of shares in the foreign corporation;[20] (iii) no U.S. tax withholding applies with respect to dividends from the foreign corporation to the foreign investors;[21] (iv) in some cases, the two-tiered LCB structure may also allow repatriation of funds to the foreign corporation on a tax-free basis if the interest paid with respect to the debt financing qualifies as "portfolio interest;"[22] and (v) the foreign corporation shares owned by the foreign investors will not be considered U.S. assets for U.S. estate tax purposes.[23]

Further, impediments to obtaining favorable tax treatment through the LCB structure include the inability to secure the right mix or number of investors to ensure that the LCB can deduct

against its income interest paid to the foreign investors[24] or the unwillingness of investors to share the potentially high upfront costs in establishing the structure.

Conclusion

In each case, where a foreign party is considering investing in U.S. real property, consideration should be given to the use of a DCR structure or an LCB structure, keeping in mind the advantages and limitations of each structure and the specific facts and flexibility of the capital stack relating to the project at hand. Often, preparation of an after-tax cash flow and disposition model will prove beneficial in determining if either a DCR or LCB structure fits the investors' objectives. As always, given the cost and complexity of these structures, practical business considerations and the potential need for flexibility on exit should be a primary consideration when evaluating the potential tax savings.

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[1] *See* Code Secs. 897 and 1445. In general, FIRPTA imposes a tax on any gain from the disposition of U.S. real property interest ("USRPI"). A USRPI generally includes real estate located in the United States and stock in a U.S. corporation if more than 50% of the fair market value of its assets are USRPIs.
[2] Treas. Reg. Sec. 301.7701-3(c)(1)(v)(B). A REIT must make a timely election to be treated as a REIT. The REIT election is made by filing an income tax return on Form 1120-REIT. Because this form is not due until, at the earliest, March 15th following the end of the REIT's most recent tax year, the REIT does not make its election until after the end of its first year (or part-year) as a REIT. Nevertheless, if it desires to qualify as a REIT for that year, it must meet the various REIT qualification requirements during that year (with the exception of the 100 shareholder test and the 5/50 test, both of which must be met beginning with the REIT's second taxable year).
[3] Code Sec. 856's qualification requirements generally relate to the organization and ownership of the REIT, the REIT's sources of income and the type of assets held by the REIT.
[4] Treas. Reg. Sec. 1.875-6(a).
[5] Code. Sec. 857(b).
[6] *See* Code Secs. 1441 and 1442. Under these sections of the Code, the general 30% withholding tax rate described herein may apply to nonresident aliens and foreign corporations. The withholding tax rate may be reduced under an applicable tax treaty.
[7] Code Sec. 1445(e)(3).
[8] *See* Code Sec. 897(a). However, under Code Sec. 897(h)(1), any distribution by a REIT to a nonresident alien or foreign corporation on a class of stock that is regularly traded on an established securities market located in the United States is not treated as gain recognized from the sale or exchange of a USRPI if the shareholder did not own more than 5% of the class of stock at any time during the one-year period ending on the date of the distribution.
[9] Code Sec. 1445(e)(1).
[10] The BPT is essentially a tax imposed on the accumulated and current earnings and profits ("E&P") of a U.S. branch of a foreign corporation that is conducting a U.S. trade or business. The tax is deferred as

long as the E&P is reinvested in a U.S. trade or business. The BPT is imposed when current E&P is not reinvested in a U.S. trade or business, or when any accumulated E&P is withdrawn from a U.S. trade or business. *See* Treas. Reg. Sec. 1.884-1.
[11] *See* Note 8.
[12] Code Sec. 897(h)(2).
[13] Code Sec. 897(h)(4)(B).
[14] Code Sec. 897(h)(2).
[15] *See* Code Secs. 301(c)(1) through (3). To the extent a distribution of property by a corporation to its shareholders exceeds earnings and profits (and, thus, is not a dividend included in the recipient's gross income), such property is deemed to be distributed tax-free to the extent of the shareholder's basis in the stock. That portion of the distribution which is not a dividend and exceeds the adjusted basis of the stock is treated as gain from the sale or exchange of property.
[16] Certain other taxes may apply and should be considered. For example, a personal holding company tax equal to 15% of the undistributed personal holding company income may apply to the extent the LCB is a personal holding company. *See* Code Sec. 541 *et seq.* Further, if the LCB is formed or availed of for the purpose of avoiding income tax with respect to its shareholders (or the shareholders of any other corporation) by permitting earnings and profits to accumulate instead of being divided or distributed, the LCB may be subject to the 15% accumulated earnings tax. *See* Code Sec. 531 *et seq.*
[17] Code Sec. 1445(a).
[18] Treas. Reg. Sec. 1.1445-1(f)(1).
[19] Note, however, that the U.S. corporation must disclose to the IRS if a foreign investor owns more than 50% of its stock.
[20] Shares in a foreign corporation will not be treated as USRPI. *See* Code Sec. 897(c)(1), limiting the definition to certain interests in a "domestic corporation." As discussed previously herein, the sale of shares in a U.S. corporation by foreign investors will result in the application of FIRPTA and BPT. *See* Notes 1 and 10.
[21] Dividends from the U.S. corporation to the foreign corporation will be subject to a 30% withholding tax. *See* Note 6. As noted herein, withholding tax rate may be reduced under applicable tax treaty.
[22] *See* Code Sec. 881(c) and 871(h). Note that, generally speaking, to qualify for the "portfolio interest" exception, no shareholder can own more than 10% voting control.
[23] Code Sec. 2104(a).
[24] *See* Code Sec. 163(j) and Note 22.

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COURT PERMITS "QUICK PEEK" DISCOVERY IN TAX REFUND LITIGATION

Background

The U.S. Court of Federal Claims recently addressed a host of tax litigation discovery issues resulting from a tax refund claim involving a complicated transaction known as "STARS." In *Salem Financial*,[1] the IRS challenged foreign income tax credits and business and interest expense deductions generated by the STARS transaction entered into by the predecessor-in-interest of Salem Financial. The IRS issued a notice of deficiency and assessed taxes, penalties and interest to the tune of approximately $880 million. Salem Financial paid the assessment and, after the IRS denied its claim for refund, filed suit in the U.S. Court of Federal Claims seeking a refund of nearly $690 million. Discovery commenced and, characteristically, disagreements ensued over which documents should be produced. Specifically, the government sought discovery relating to tax reserve information, as well as documents Salem Financial withheld under the tax practitioner and attorney-client privileges. After Salem Financial declined to produce the requested documents, the government filed a motion to compel. The court granted the motion, in part, and, with respect to the documents allegedly covered by the attorney-client privilege, resolved the dispute by ordering a "quick peek" procedure.

Tax Reserve Information

The government first sought documents related to Salem Financial's tax reserves. Salem Financial refused to produce responsive documents on the basis that they were prepared "in anticipation of litigation" and thus protected by the work-product doctrine. The government countered by arguing that tax reserves are prepared for financial reporting purposes – not in anticipation of litigation – and, as such, tax reserves and related workpapers are not protected by the work-product doctrine. The government also argued that Salem Financial had waived the work-product doctrine by relying on advice from its outside auditor that the reserves were reasonable as a defense to IRS penalties. Salem Financial conceded that its reliance placed the tax reserves "at issue," but asserted that reliance, without more, could not eviscerate the work-product doctrine where its tax reserves were also based on independent information and analysis provided by its auditor unrelated to the STARS transaction.

The court acknowledged that the law is unsettled as to whether tax reserves and associated workpapers are prepared in anticipation of litigation, such that they fall within the protective scope of the work-product doctrine. The court also recognized public policy considerations which favor providing work-product protection to tax reserves. The court, however, determined that it did not need to decide the question because it found that Salem Financial waived any

protection it might have had under the work-product doctrine by relying on the advice of its auditors as a defense against the imposition of penalties. Moreover, the court held that by relying on its auditor's advice, Salem Financial not only waived its right to assert the work-product doctrine with respect to documents reflecting tax reserve information, but also with respect to all non-opinion work product concerning the same subject matter. The court justified this broad subject matter waiver by raising a fundamental fairness argument. Namely, the government would be prejudiced if Salem Financial were able to rely on favorable advice as a defense to penalties, while simultaneously shielding potentially unfavorable advice. The court categorically rejected Salem Financial's attempts to compartmentalize the advice received, finding that it was intertwined and could not be isolated as a separate subject matter.

Tax Practitioner Privilege

The government also sought to compel production of a number of documents Salem Financial claimed to be protected by the statutorily based tax practitioner privilege.[2] Salem Financial refused to produce the documents on the basis that the requested documents contained legal advice provided by KPMG after the close of the STARS transaction regarding proposed changes in law and the unwinding of the STARS transaction. The government, on the other hand, sought production of the documents on the basis that they were created in connection with the "promotion" of a tax shelter. The government also claimed that Salem Financial waived the tax practitioner privilege by relying on advice provided by KPMG as a defense against penalties.

The court first addressed the government's argument that the documents were prepared in connection with the "promotion" of a tax shelter, at its heart, a question of statutory interpretation. Salem Financial argued that only marketing or soliciting activities encompassed "promotion" within the plain language of the statute. By contrast, the government suggested that the statute should be read broadly, such that any activity that was "in connection with promotion" of the tax shelter would constitute "promotion," no matter when the activity occurred. The court rejected the government's argument, explaining that the statute addresses only promotion, not promotion and *implementation*.

Nevertheless, the court ultimately agreed with the government's waiver argument. Because Salem Financial had relied upon KPMG's advice as a defense against penalties, it had waived its right to assert the tax practitioner privilege with respect to those documents. The court reiterated that Salem Financial could not use the tax practitioner privilege to shield unfavorable advice, while simultaneously relying on favorable advice as a defense against penalties. According to the court, once the favorable advice was used as a defense against penalties, the government was entitled to any unfavorable advice as a matter of fairness.

Attorney-Client Privilege

Finally, the government sought to compel production of documents Salem Financial claimed to be protected by the attorney-client privilege. The government argued that the documents were not privileged because they contained: (1) non-legal advice; (2) purely legal advice; or (3) advice from a person acting in a non-legal capacity.

With respect to the first category of documents, those the government claimed were discoverable because they contained non-legal advice and for which Salem Financial had not waived the attorney-client privilege, the court found that the attorney-client privilege would attach, so long as the documents were prepared for the purpose of obtaining legal advice. To resolve the parties' dispute, the court implemented a "quick peek" procedure. This procedure would allow the government to review each document and designate those documents it wants to be produced, and those it no longer seeks. More importantly, the "quick peek" procedure would allow the parties to avoid wasting time and money on document review and, in the event of further disputes, costly motion practice. The court confirmed that the mere act of the government taking a "quick peek" at the relevant documents would not operate to waive the attorney-client privilege.

The second category of documents sought by the government allegedly contained purely legal advice that, the government argued, was not subject to the attorney-client privilege. In contrast to the Fourth, Ninth and Tenth Circuits, the Federal Circuit has held that the attorney-client privilege does not protect all communications from an attorney to a client. Rather, it protects only those communications containing the "substance of a confidential communication." To reconcile the parties' divergent views on whether the documents at issue contained purely legal advice, the court found – and the parties agreed – that application of the "quick peek" procedure would be appropriate.

Finally, the government sought documents allegedly containing advice from an individual acting in a non-legal capacity. The court disagreed with the government and found that the advice provided was, in fact, in the form of legal advice. Because the attorney-client privilege was not otherwise waived, the court denied the government's motion with respect to this last class of documents.

Conclusion

In sum, the court's opinion in *Salem Financial* demonstrates that, in some cases, the "quick peek" procedure can provide a cost-effective and flexible resolution to an otherwise expensive and time-consuming discovery dispute. As a general rule, courts are loathe to expend limited judicial resources adjudicating discovery battles, petty or otherwise. For this reason, the parties are often better off resolving discovery disputes out of court. In light of *Salem Financial*,

taxpayers involved in litigation with the government should therefore be mindful of this informal alternative and, where appropriate, benefit from it.

[1] *Salem Financial, Inc. v. U.S.*, No. 10-192T (Claims Court Jan. 18, 2012).
[2] I.R.C. 7525(a)(1).

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§ 107 Parsonage Allowance Exclusion Limited to One Home

The United States Court of Appeals for the Eleventh Circuit recently ruled that the parsonage allowance exclusion from gross income contained in section 107 of the Code is limited to the rental value of providing a single home.[1] The case involved a minister who claimed the parsonage allowance for both his principle residence and his lake house. In addition to turning back a minister's expansive use of the parsonage allowance, the Eleventh Circuit's decision addressed important issues related to the interpretation of ambiguous provisions of the Code.

The text of section 107(2) limits the parsonage allowance exclusion to the rental allowance paid to a minister to the extent used to rent or provide "a home." The controversy turned on the question of whether the phrase "a home" should be given a singular or a plural application. In a closely divided opinion, the Tax Court had rejected the argument by the IRS that the exemption should be limited to a single home, holding that nothing in the legislative history or regulations under section 107 required the court to rewrite the phrase "a home" to mean a "single home" or "one home."[2]

In its decision reversing the Tax Court, the Eleventh Circuit advanced three arguments in support of its conclusion that that phrase "a home" should be limited to a single home.

First, the court rejected the Tax Court's reliance upon the Dictionary Act[3] for the proposition that singular terms in the Code also include their plural forms. Although section 7701(p)(1)(1) of the Code contains a list of cross references to the Dictionary Act, including one for the definition of "[s]ingular as including plural," the Eleventh Circuit relied on section 7806(a) of the Code, which states that cross references "are made only for convenience, and shall be given no legal effect." In addition, the court noted that the Supreme Court has held that the Dictionary Act does not apply if "the context indicates otherwise."[4] Therefore, the Dictionary Act would apply only if the context of section 107(2) reasonably supported such an application. After consulting Webster's Dictionary, the court concluded that the word "home" has singular connotations.

Second, the court noted that the legislative history associated with the Internal Revenue Code of 1954 contains references to "a dwelling house," "a home" and "the home," and concluded that Congress intended for the parsonage allowance exclusion to apply only to one home. While acknowledging that the phrase "a home" may be used to refer to "no particular home," the court again consulted Webster's Dictionary and concluded that the word "a" maintains a singular connotation when the context indicates a singular meaning, as it does in section 107.

Finally, the court relied on the principle articulated by the Supreme Court that income exclusions should be "narrowly construed."[5] The Tax Court had rejected a similar argument, finding that, without unequivocal evidence of legislative purpose, a general rule of statutory construction

should not be used to change the phrase “a home” to read “a single home” or “one home.” The Eleventh Circuit disagreed and declined to construe any ambiguity in section 107(2) to favor a more expansive reading of the parsonage allowance income exclusion.

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[1] *Commissioner v. Driscoll*, 2012 U.S. App. LEXIS 2403 (11th Cir. 2012).
[2] *Driscoll v. Commissioner*, 135 T.C. 557 (2010).
[3] 1 U.S.C. § 1.
[4] *United States v. Hayes*, 555 U.S. 415, 422 n.5 (2009).
[5] *Commissioner v. Schleier*, 515 U.S. 323, 328 (1995).

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ANALYSIS OF YAHOO!'S POTENTIAL CASH-RICH SPLIT-OFF

Yahoo!, the international internet giant, is contemplating disposing of its interest in Yahoo! Japan Corporation ("Yahoo! Japan") and Alibaba.com, a Chinese e-commerce company. Among the different alternatives Yahoo!'s new CEO, Scott Thompson, is considering to accomplish such division is a transaction commonly referred to as a cash-rich split-off. Cash-rich split-offs are not unheard of in the Mergers and Acquisitions world and have become increasingly popular in the past decade. However, if Yahoo! decides to utilize this structure, it will likely be the largest cash-rich split-off to date. Such structure would allow Yahoo! to sell or dispose of its high-value assets, totaling approximately $13 to $17 billion, without incurring $4 billion in taxes.

Section 355[1] governs the tax treatment of split-offs. In a typical split-off, a shareholder in a corporation ("Distributing Corporation") exchanges its Distributing Corporation stock for stock in a subsidiary of Distributing Corporation ("Controlled Corporation") without incurring taxes, provided certain statutory and judicial requirements are met. The policy behind non-recognition is that split-offs are not deemed to be a taxable event since the transactions only rearrange the corporation's assets within the corporate form. In the instant Yahoo! transaction, Yahoo! Japan and Alibaba.com will be the Distributing Corporations and a newly formed corporation will be the Controlled Corporation. A cash-rich split-off is unique in that the Controlled Corporation contains a high percentage of liquid assets. However, the Internal Revenue Code still provides non-recognition treatment for a cash-rich split-off so long as the requirements of Section 355 are satisfied.

The first statutory requirement that must be satisfied to receive non-recognition under Section 355 is commonly referred to as the "active trade or business requirement." This requirement mandates that the Controlled Corporation and the Distributing Corporation contain at least one trade or business that has actively been conducted for five years prior to the split-off.[2] There is no requirement that the trade or business be a specific percentage value of the Controlled Corporation's assets. Of interest in Yahoo!'s proposed cash-rich split-off is that Yahoo! has the opportunity to select the active trade or business that will be distributed to it. This essentially gives Yahoo! Japan or Alibaba.com the opportunity to acquire a new business through the Controlled Corporation, which it will later distribute as part of the cash-rich split-off.

However, the expansion doctrine will limit the type of business Yahoo! Japan or Alibaba.com can purchase while still having Section 355 govern the tax treatment of the cash-rich split-off. The expansion doctrine allows a newly acquired trade or business to meet the five-year requirement if such newly acquired business is in the same line of business as one the acquiring corporation had previously conducted for the prior five years.[3] There is no limit,

however, on the size of this expansion. If the newly acquired business fits within the expansion doctrine, then it will tack onto the prior business, even if the newly acquired business was acquired in a taxable transaction.[4] Thus, any newly acquired business would have to be in the same line of business as Yahoo!.

The second statutory requirement that must be satisfied to receive non-recognition treatment under Section 355 is that the transaction cannot be a device to distribute earnings and profits.[5] This requirement arises due to the perceived abuse that Section 355 transactions can potentially be structured to distribute earnings and profits to shareholders without the imposition of dividend taxes. In fact, some tax experts still question the Service's behavior with respect to Section 355 transactions because they see these transactions as simply an alternative route to declare a dividend. In order to determine whether the transaction is similar to a dividend, the Service considers the facts and circumstances of each Section 355 transaction. A strong corporate business purpose is helpful to meet this requirement. However, split-offs generally do not encounter problems in meeting the non-device requirement because the transaction, if taxable, would be an exchange rather than a dividend. Thus, while not a huge challenge, the proposed Yahoo! cash-rich split-off would also have to overcome this hurdle.

The third statutory requirement is that the Distributing Corporations must have control of the Controlled Corporation immediately prior to the distribution.[6] Control is defined under Section 368(c) as ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of each class of non-voting stock.[7] Thus, for purposes of the Yahoo! split, Yahoo! Japan and Alibaba.com must own at least 80% of all the voting stock and at least 80% of each class of non-voting stock of the Controlled Corporation.

The final statutory requirement is that the Distributing Corporation must distribute all of its stock or securities in the Controlled Corporation or distribute an amount sufficient to constitute control.[8] Control is defined in the same manner as it is for the third requirement, discussed above.[9] However, if Yahoo! Japan and Alibaba.com, the Distributing Corporations, do not distribute all the stock or securities of the Controlled Corporation, then the Distributing Corporations will be required to show that the retention of the remaining Controlled Corporation stock was not for the principal purpose of tax avoidance.[10] As above, with respect to the active trade or business requirement, there is no requirement for the percentage of value that must be distributed. Thus, Yahoo! Japan and Alibaba.com would be allowed to distribute a business worth $13 to $17 billion dollars, without regard to its value as a whole, when evaluating Yahoo!'s corporate group.

As is evident, these transactions allow for a wide spectrum of potential abuses. One common abuse arises with respect to the amount of cash distributed. This abuse was brought to the forefront when DST Systems and Janus Capital Group engaged in the first notable cash-rich split-off in 2003 by exchanging almost 90% cash for Controlled Corporation stock in the

transaction. In 2005, in response to this potential abuse, Congress passed a law that limited both the amount of cash that could be exchanged in a split-off and the size of interest any one person could hold in the Distributing or Controlled Corporations after the exchange. Currently, the general limits are that cash and other investment assets cannot comprise more than 2/3 or 66% of the exchanged assets and one person cannot hold a 50% or greater interest in the Distributing or Controlled Corporation after the exchange if they did not previously hold such an interest in either corporation.[11] If both conditions are satisfied, the split-off is ineligible to receive non-recognition under Section 355. As commentators have noted, this provision does not outlaw the use of cash-rich split-offs entirely but, rather, makes the structuring of such transactions less flexible. Thus, in the proposed Yahoo! cash-rich split-off, the amount of cash contributed must be less than $8.5 to $11.1 billion dollars or the transaction must be structured so that one person does not hold a 50% or greater interest in the Distributing Corporation or the Controlled Corporation after the exchange. The remaining amount of assets would be required to meet the other Section 355 requirements.

As previously mentioned, Yahoo! will also need to consider the application of the judicial doctrines to its proposed cash-rich split-off. Specifically, the transaction must satisfy the “continuity of interest” and “continuity of business enterprise” tests, have a corporate business purpose and be done pursuant to a plan of reorganization.[12] Yahoo! would likely need a strong business purpose to show the cash-rich split-off was not done primarily to avoid taxes as the amount of non-recognition is substantial.

If Yahoo! were successful in its proposed cash-rich split-off, the result may be advantageous to a taxpayer looking to avail itself of the benefits of non-recognition under Section 355, while still distributing large amounts of cash. Specifically, if permitted by the Service, it could allow for more flexibility in the types of transactions a taxpayer can utilize for the distribution of controlled businesses and the amount of cash that can be used in such transactions.

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[1] All references to “Section” or “§” are to sections of the Internal Revenue Code of 1986, as amended (the “Code”), and all references to “Treasury Regulations” or “Treas. Reg.” are to the regulations promulgated pursuant to the Code.
[2] I.R.C. § 355(a)(1)(C).
[3] Treas. Reg. § 1.355-3(b)(3)(iii).
[4] *Id.*
[5] I.R.C. § 355(a)(1)(B).
[6] I.R.C. § 355(a)(1)(A).
[7] I.R.C. § 368(c).
[8] I.R.C. § 355(a)(1)(D).

[9] I.R.C. § 368(c).
[10] I.R.C. § 355(a)(1)(D)(ii).
[11] I.R.C. § 355(g).
[12] *See* Treas. Reg. § 1.368-1(b)-(e) Treas. Reg. § 1.368-2(g).

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SWIFT V HMRC : UK TREATMENT OF DELAWARE LLCS

Background

For the purposes of deciding how a member is to be taxed on the income they derive from their interest in an entity, HM Revenue & Customs ("HMRC"), classifies various foreign entities as either fiscally "transparent" or "opaque."

In the case of a transparent entity, *e.g.*, a partnership, the profits and losses are treated as accruing to the members of the entity as they arise (rather than to the entity itself). The result of this treatment is that the individual members are subject to tax on the underlying profits of the entity regardless of whether the entity actually distributes them.

In the case of an opaque entity, the profits and losses accrue to the entity itself, and not its members, for tax purposes. The members will be taxed on the amount of profits that are distributed to them by the entity.

There is no single test to determine whether an entity will be regarded as fiscally transparent or opaque. Taxpayers and tax advisers alike must currently rely on HMRC guidance and case law, predominantly the *Memec* case,[1] to provide details of the factors that are considered relevant when classifying an overseas entity for UK tax purposes.

HMRC's current guidance, which is based on the decision of the Court of Appeal in *Memec*, states that the following issues should be considered when deciding whether an overseas entity is transparent or opaque:

- Does the entity have a legal existence separate from that of its members?
- Does the entity issue share capital or something else serving the same function as share capital?
- Is the business of the entity carried out by the entity itself rather than its members?
- Are the entity's members entitled to share in its profits as they arise, or do the members' profit shares depend on a decision by the entity or its members, after the profits have arisen, to make distributions?
- Is the entity or its members responsible for the debts incurred as a result of carrying on the business?

- Do the assets used for carrying on the business belong beneficially to the entity or to its members?

HMRC has generally regarded Delaware LLCs as being "opaque" for UK tax purposes and the initial decision in *Swift v. HMRC*[2] caused much consternation and raised some interesting questions. By way of background, for UK tax purposes, HMRC regards other US entities in the following manner: partnerships, limited partnerships and limited liability partnerships are all transparent, and S corporations, and real estate investment trusts (together with LLCs) are regarded as opaque.

<u>Swift v. HMRC : UK tax treatment of Delaware LLCs</u>

The Issue

Mr. Anson (originally known as "Swift" as he wanted to remain anonymous) was a UK resident individual who was a member of a Delaware LLC called Harbour Vest Partners LLC. It goes without saying that for US tax purposes a Delaware LLC is a transparent entity or a partnership. As such, the tax paying members of the Delaware LLC are personally liable for US federal and state taxes on their share of the US source profits.

Mr. Anson had, therefore, suffered US taxes on his profits of the Delaware LLC's business and had sought to claim credit against his UK tax for the US tax that he had already suffered. HMRC challenged Mr. Anson's tax credit claim and opined that this was not a double tax charge on the same income as it was not the same income -- in fact the US tax was paid on the profits arising to the LLC as they were earned, and the UK tax was paid on the distribution of those profits. HMRC argued that those two types of profits were not the same income.

Mr. Anson argued that the LLC was akin to a partnership (as it would be treated in the US) and that, therefore, he should have suffered tax on his share of the LLC's profits as they arose, and, thus, should have received a tax credit against the UK tax due.

The Decisions

The First Tier Tribunal (the lowest level UK Tax Court) in *Swift v. HMRC* decided that Mr. Anson was entitled to double tax relief and should receive a UK tax credit for the US tax that he had already paid.

The First Tier Tribunal held that:

- the membership interests in the Delaware LLC were more like partnership interests (rather than share capital in a company);
- the profits of the Delaware LLC belonged to its members as they arose; and

- the Delaware LLC was fiscally transparent.

The First Tier Tribunal's decision was considered by commentators and practitioners alike to be inconsistent with HMRC's current practice, which provides that Delaware LLCs are capable of having "issued ordinary share capital." This caused much concern as the decision cast doubt on HMRC's established treatment of Delaware LLCs, with the result that various UK tax grouping rules and the availability of various reliefs and exemptions were called into question.

This decision could have produced far-reaching and significant consequences. Thankfully, HMRC appealed.

The Upper Tribunal (a higher level UK Tax Court) reversed the decision of the First Tier Tribunal in *Swift v. HMRC* and concluded that a Delaware LLC was not transparent for tax purposes and that a UK resident individual would not benefit from double-tax treaty relief on the UK taxpayer's share of the profits of a Delaware LLC.

Practical Consequences

Delaware LLCs are very common in UK/US cross-border group structures and the initial *Swift* decision was unhelpful as it cast doubt over the tax status of the Delaware LLCs from a UK perspective, and also cast doubt over the following:

- the availability of group relief;
- capital gains tax grouping;
- the substantial shareholding exemption (akin to a participation exemption); and
- the foreign distribution exemption.

Fortunately, the Upper Tier Tribunal's decision confirms HMRC's consistently held view of the Delaware LLCs as opaque entities for UK tax purposes. This is a welcome development for the many groups who originally planned their affairs on the understanding that a Delaware LLC would be treated as opaque by the UK Tax Authorities.

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[1] *Memec plc v. IRC* [1998] STC 754.
[2] [2010] UK FTTOO 399.

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PAYERS OF THE PRC CORPORATE INCOME TAX

All enterprises and other income-receiving organizations within the territory of the People's Republic of China are required to pay the Enterprise Income Tax ("EIT"). There are three types of foreign investment enterprises in China: equity joint ventures; cooperative joint ventures; and wholly foreign-owned enterprises. Equity joint ventures and wholly foreign-owned enterprises are liable to pay the EIT. In respect of cooperative joint ventures, if the joint venture is incorporated, it will be liable for the EIT as an entity itself. If it is not incorporated, the partners in the joint venture are each treated as a separate EIT payer and each partner is responsible for paying tax on its respective profit. In addition, the above enterprise types are further classified as resident enterprises and non-resident enterprises.[1]

Tax Resident Enterprise ("TRE")

A "resident enterprise" refers to an enterprise which is established within the territory of China pursuant to Chinese laws or an enterprise established within the territory of another country, or other tax region pursuant to that country or that region's laws, and whose "effective management" or control is located in China.[2] Resident enterprises are required to pay EIT for income sourced within and outside of China.[3] "Effective management" refers to establishments that execute substantial and overall management and control over the manufacturing and business operations, personnel, accounting, properties, etc. of an enterprise.[4]

Enterprises established within the territory of China pursuant to Chinese laws include enterprises, business units, social organizations and other organizations that earn revenue, and which are established within the territory of China in accordance with Chinese laws and regulations. Enterprises established pursuant to laws of foreign countries include enterprises and other organizations that earn revenue, which are established pursuant to laws of foreign countries.[5]

Overseas Registered Chinese-capital Controlled Tax Resident Enterprises ("CCCFC")

A CCCFC is an enterprise established under the laws of a foreign country, the main investor in which is a Chinese enterprise or corporate group, and the "effective management" of which is located in China. A CCCFC is regarded as a Chinese TRE and is subject to EIT on its worldwide income.[6]

Non-Tax Resident Enterprise ("non-TRE")

A "non-TRE" refers to an enterprise established within the territory of another country or other tax region pursuant to foreign laws whose actual management or control is located outside of China but which has an establishment in China, or, if it does not have an establishment in

China, has income derived from China.[7] Non-TREs are required to pay EIT on income sourced within China derived from its establishment in China, and on income sourced outside of China that is effectively connected with its establishment in China. Non-TREs without any establishment in China deriving income sourced in China, and Non-TREs having an establishment in China earning income sourced in China but not effectively connected with that establishment, are required to pay EIT on income sourced within China.[8]

Establishment

The "establishment," as cited in the Enterprise Income Tax Law of the People's Republic of China ("EITL"), refers to any establishment engaged in manufacturing and business operating activities within the territory of China, including:

- A place of management, operation or administration;
- A farm, factory or place of extraction of natural resources;
- A place where services are rendered;
- A place of construction, installation, assembly, repair, exploitation, etc.; and
- Other establishments engaged in manufacturing and business operating activities.

Where a non-TRE entrusts a business agent to engage in manufacturing and business operation activities within the territory of China, including where the entrusted entities or individuals sign contracts, or store and deliver commodities on behalf of the non-TRE on a regular basis, the business agent shall be regarded as an establishment of the non-TRE within the territory of China.[9]

Non-profit Making Organization

Qualifying income received by non-profit making organizations is exempt from EIT.[10] The tax-exempt income received by qualifying non-profit making organizations does not include income derived from profit-making activities by non-profit making organizations unless the government authorities of the State Council in charge of finance and taxation stipulate otherwise.[11] "Qualifying non-profit making organizations" are organizations which fulfill all the following criteria:

- Comply with certain registration procedures established for non-profit making organizations in accordance with relevant laws and regulations;
- Engage in charitable or non-profit making activities;

- Other than for reasonable expenses incurred with respect to the organization, use derived income only for charitable or non-profit making activities;
- Are prohibited from distributing assets and associated interests of the organization;
- Use remaining assets after de-registration within the registered scope or in accordance with the provisions of the Articles of Association for charitable or non-profit making purposes; or donate remaining assets along with public announcement to other organizations of a similar nature and mission;
- Founders are not permitted to keep or enjoy any property rights over the asset invested into the organization; and
- The salaries and welfare of employees shall be limited to a range, as stipulated, and shall not be used as a means to distribute the organization's assets.[12]

Controlled Foreign Corporation Rules ("CFC rules")

For an enterprise controlled by resident enterprises and/or individual residents of China and established in a country (region) where the effective tax rate[13] is significantly lower than 25%,[14] and which either (i) does not distribute profits or (ii) distributes less profits than it should, the portion of the profits attributed to the resident enterprises shall be included when computing the taxable income of the resident enterprise.[15] For example, if (i) Company A is a TRE and holds 80% of the shares of its foreign subsidiary Company B, (ii) Company B is taxed at 5% of the foreign corporate income rate, and (iii) the undistributed profit of Company B is RMB 100k, RMB 80k (*i.e.*, 100k*80%) would be included in the taxable income of Company A, and Company A should pay thereon EIT in accordance with the CFC rules.

"Individual residents of China" refers to individuals who have an Individual Income Tax ("IIT") obligation for their domestic and overseas income in accordance with the relevant provisions of the Individual Income Tax Law of the People's Republic of China ("IITL").[16] The term "controlled" includes:

- A resident enterprise or an individual resident of China directly or indirectly holding 10% or more of total voting shares, and such resident enterprise(s)/individual resident(s) jointly holding more than 50% of total shares of the foreign enterprise; or
- The shareholding percentage of resident enterprise(s) and individual resident(s) of China does not meet the percentage standard as stipulated

in the foregoing paragraph, but substantial control is formed over the foreign enterprise in respect of shareholding, financing, business, purchase, sales, etc.[17]

Sole Proprietorships and Partnerships

"Sole proprietorship enterprises" and "partnership enterprises" refer to sole proprietorship enterprises and partnership enterprises established pursuant to Chinese laws and regulations.[18] For partnership enterprises, every partner is a taxpayer. Where a partner of a partnership enterprise is a natural person, IIT shall be paid; where a partner is a legal person or any other organization, EIT shall be paid.[19] Sole proprietorships and partnerships are not under the purview of the EITL.[20] For sole proprietorships, IIT shall be paid.[21]

Consolidated Basis

When a resident enterprise within China sets up one or more operating units that are not separate legal entities, it shall combine the income of the units and pay the computed EIT thereon.[22] For example, Company C and its Branch D should compute their taxable income separately, and then combine their incomes together. Company C is the EIT payer under this scenario.

Unless otherwise stipulated by the State Council, enterprises shall not be allowed to pay EIT on a consolidated basis.[23] For example, Company E and its subsidiary Company F should each respectively pay their EIT. If Company E and Company F are allowed to pay EIT on a consolidated basis, the EIT shall be computed on a group basis (similar to the concept of a consolidated accounting report).

Non-resident enterprises deriving income shall pay tax at the location of its establishment. A non-resident enterprise which has two or more establishments in China may, upon approval of the tax bureau, select the principal establishment to handle the combined payment of tax.[24] The "principal establishment" refers to establishments which satisfy all of the following conditions:

- Taking on the responsibility of managing and supervising the manufacturing or business operations of the other establishments; and
- Keeping full and complete accounting records and supporting documents that accurately reflect revenue, cost, expenses and profits or losses of each establishment.[25]

[1] EITL, Article 2.

[2] *Id.*
[3] EITL, Article 3.
[4] Implementation Rules of Enterprise Income Tax Law of the People's Republic of China, 2007 ("IREITL"), Article 4.
[5] IREITL, Article 3.
[6] Guoshuifa [2009] No.82, the SAT Public Notice [2011] No.45.
[7] EITL, Article 2.
[8] EITL, Article 3.
[9] IREITL, Article 5.
[10] EITL, Article 26.
[11] IREITL, Article 85.
[12] IREITL, Article 84.
[13] Guoshuihan [2009] No. 37 provides that where Chinese resident enterprises or resident individuals can provide documents proving that the foreign enterprises under their control are established in the United States, Britain, France, Germany, Japan, Italy, Canada, Australia, India, South Africa, New Zealand or Norway, the profits of such foreign enterprises which are not distributed or reduced for distribution do not have to be included in the current income of the Chinese resident enterprises as distributed dividends.
[14] The "effective tax rate, being significantly lower than 25%," refers to the effective tax rate being lower than 50% of 25%. IREITL, Article 118.
[15] EITL, Article 45.
[16] IREITL, Article 116.
[17] IREITL, Article 117.
[18] IREITL, Article 2.
[19] Cai Shui [2008] No. 159.
[20] EITL, Article 1.
[21] Guo Fa [2000] No. 16.
[22] EITL, Article 50.
[23] EITL, Article 52.
[24] EITL, Article 51.
[25] IREITL, Article 126.

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