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Editor's Note
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Investing in the Czech Republic

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Introduction

Historically, foreign investors have often used intermediate holding companies in other countries when investing in the Czech Republic. Foreign holding companies have also been used by Czech resident investors. These holding structures used to be driven by Czech income tax applicable to dividends and capital gains on the sale of shares. However, this is no longer the case.

Holding Companies in the Czech Republic

Presently, the Czech Republic benefits from quite a broad participation exemption regime applicable to both dividends and capital gains. Specifically, the exemption applies with respect to participation in EU-based companies if at least 10 percent of shares are held for at least 12 months (subject to other conditions).

In the case of participation in companies residing outside the EU, exemptions can also be claimed under the same rules if (i) the Czech Republic has entered into a tax treaty with the country where the company is considered to be a tax resident, and (ii) the company is subject to a corporate income tax rate of at least 12 percent.

The above conditions also apply to nonresident company tax exmptions (including taxation by means of withholding) in the Czech Republic.

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The Czech Republic has also implemented the EU Interest and Royalty Directive where interest and royalty payments from the Czech Republic abroad are exempt from Czech withholding taxes in the case of at least 25 percent direct ownership existing for at least 24 months (subject to other conditions).

The above shows that the Czech Republic is trying to stop the ongoing outflow of Czech-based investment abroad for the purposes of establishing a holding company. Although the traditional holding company locations (e.g., the Netherlands or Luxembourg), may be a better choice in certain cases (to a large extent in the non-tax area, as also highlighted below), the principal tax features of a holding company are competitive in the Czech Republic.

Why It Is Still Imporant to Consider Other Holding Company Jurisdictions

Participation Exemption

As mentioned above, the positive amendments to the Czech tax regime over the years increasingly lead to the question concerning why investors would continue to make use of holding companies in traditional holding regimes like the Netherlands, Luxembourg or Cyprus. Although differences are not substantial, other countries sometimes offer more beneficial regimes in terms of ownership thresholds (10 percent in the Czech system), minimum holding periods (12 months in the Czech system) or subject-to-tax tests (12 percent limit for non-EU participation in the Czech system).

Withholding Tax Planning

Another important point is the application of the EU Interest and Royalty Directive. As noted above, this Directive in the Czech Republic, like in many other countries, is implemented in such way that indirect ownership of an entity does not provide protection against source taxes on interest and royalties.

In such cases, application of double tax treaties continues to be an important tax planning tool. The table below provides for the withholding tax rates on interest and royalties in the various treaties the Czech Republic concluded with other traditionally used tax planning jurisdictions.

	Netherlands	Luxembourg	Cyprus
Interest	0%	0%	0%
Royalties	5%	10%	10%

An intermediate holding company may also play an important role if dividends need to be distributed outside the EU and do not qualify for exemption from the Czech dividend withholding tax.

Non-tax Reasons

Naturally, selection of a holding company jurisdiction may also be influenced by a variety of non-tax factors, including:

- Stability of political environment and legal system
- Quality of local service providers
- Access to bilateral investment treaties (BITs)
- Access to a reputable stock exchange (if listing is considered)

How to Invest in the Czech Republic

Acquisition Structures

The most typical acquisition structure that has been used in the past is a legal merger of the acquisition company with the target, as follows:

- A Czech special-purpose acquisition vehicle ("HoldCo") draws an acquisition loan from a bank and/or a group company
- HoldCo enters into a share-purchase agreement whereby it purchases the shares in the target ("target")
- HoldCo and target merge together as a result of which (i) the acquisition loan and (ii) the income-generating business appear on a single balance sheet.

The merger can generally be done as up-stream (HoldCo being the surviving entity, most commonly used), down-stream (Target being the surviving entity) or a new entity can be created while both HoldCo and target cease to exist.

The interest accrued on the acquisition loan can generally be treated as tax deductible as of the decisive date of the merger (the date as of which the merger is deemed to be effective for accounting and income tax purposes). Although this conclusion is not directly derived from the law, it has been supported by the official Decree of the Czech Ministry of Finance and has also been successfully tested in disputes with tax authorities.

In general, it is critical that the Target's book value of assets is increased to its fair market value (this is usually the case if upstream merger is selected) which increases the equity of the new company after the merger. The reason for this is that the merger accounting rules require that shares in the Target are excluded from the opening balance sheet against equity which may result in a significant decrease in equity.

Low (or even negative) equity after the merger may have an adverse impact on deductibility of interest arising from shareholder loans due to applicable thin-capitalization limitations (4:1 debt-to-equity ratio).

Another possible way to achieve deductibility of interest accruing on the acquisition loan against the Target's is to change the Target's legal form into a partnership (general or limited, HoldCo being the general partner). As a result, the share in the Target's profit that is attributable to HoldCo (general partner) would not be subject to tax at the Target (partnership) level, but rather at the level of HoldCo. Consequently, HoldCo could deduct the acquisition loan interest against such profit. However, there are corporate limitations connected with this structure, which is why it is not widely used (unlimited liability for partnership debts, complicated corporate procedure upon exit from partnerships).

Czech Fund Regime

Foreign investors may also consider taking advantage of the current tax regime applicable to investment funds in the Czech Republic.

Czech investment funds are generally subject to corporate income tax at a special reduced rate of 5 percent.

The investment funds can either have a legal form of a joint stock company (a.s.) or can be established as mutual funds without legal personality. The first option involves applying benefits arising from the EU Parent-Subsidiary Directive, while the latter option does not (although benefits can be claimed at least from some double-taxation treaties on the basis that it is effectively subject to income tax).

Leaving aside investment funds established for retail investment (funds in line with the UCITS Directives, i.e., "standard funds," or other "special funds" collecting investments from public), the funds can also be established as funds for qualified investors only. Such option is subject to significantly lighter regulation by the Czech National Bank compared to retail funds, and this option enables the fund tax regime to be applied to investments of a preselected group of investors. A fund of qualified investors may be set up by at least two investors (maximum 100), theoretically also from the same group. In any case, the regulator (the Czech National Bank) must issue a license to any investment fund prior to its establishment andmay, as part of the licensing process, impose further conditions and restrictions.

The 5 percent tax rate is not applicable to any subsidiaries of the fund. As a result, the fund regime does not bring any tax advantage to holding structures whereby its investments (e.g., real estate) are shielded in special-purpose vehicles (except for tax rate arbitrage on any shareholder debt financing provided by the fund to the subsidiaries). In order for the reduced tax rate to result in any benefits, the profit-generating assets must be held by the fund directly.

The Czech government is currently proposing that investment funds are subject to 0 percent tax in the future (as opposed to the currently applicable 5 percent), while any distributions by the fund would be fully taxable by the investors. If such proposal is approved, it may increase the effective tax burden from the investors' perspective in the case of certain qualified investor funds. Currently, the investors may (subject to conditions) benefit from the EU Parent-Subsidiary Directive exemptions, i.e., distribution of the fund's profits (after paying the 5 percent tax at the fund level) may be fully exempt from taxation. If the amendment is approved, the 5 percent tax burden is abolished but investors would pay 15 percent to 19 percent tax from any distributions. The amendment, if approved at all, should be effective from 2013.

As a comparison to the above, establishing a branch of an EU-based fund in the Czech Republic may prove to be a better option from a tax perspective, rather than establishing a Czech fund after the amendment becomes effective: Czech branches (permanent establishments) of EU funds may be subject to 0 percent tax in the Czech Republic (if the amendment is approved, subject to conditions) and distributions by the Czech branch to the headquarters of the fund would not be subject to any Czech withholding tax (on the basis that it is a payment between two organizational units of the same legal entity).

Inbound Investments Made by Nonresident Investors

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Over the past months, in view of reducing public deficit, three Finance Amendment Laws for 2011 law n° 2011-900 published on 29 July 2011, law n° 2011-1117 published on 19 September 2011 and law n° 2011-1978 published on 29 December 2011 and the Tax Bill for 2012 (law n° 2011-1577 published on 29 December 2011) have been adopted.

Major tax changes have been introduced which may negatively impact France's attractiveness to foreign companies that have made investments in France or are willing to invest through a French holding entity.

The tax trend in France is clearly to increase tax pressure with immediate effect on companies established in France (i.e., including taxation on profits or gains already realized at the time the new measures are enacted, to the extent they have not yet been taxed).

A temporary contribution on corporate tax will increase the tax burden of profitable French companies, the use of tax losses is now limited; the level of taxation of capital gains on shareholding has been increased; and new restrictions apply to the deduction of financial interest incurred by French holding companies to finance the acquisition of subsidiaries. All together, these measures will have a direct impact on inbound investments in France.

Temporary Contribution on Corporate Tax

A temporary contribution on corporate tax has been adopted for the largest companies, i.e., companies with an annual turnover of over €250 million and, for tax-consolidated groups, when the aggregate turnover of the tax-consolidated companies exceeds €250 million. The French corporate income tax rate is currently 33.33 percent, already increased by a 3.3 percent social contribution on the portion of yearly corporate income tax exceeding €763,000. Those companies are already taxed at an effective rate of 34.43 percent. The temporary contribution is equal to 5 percent of the gross corporate income tax (before application of any available tax credits). Consequently, the effective corporate tax rate for those companies will be up to 36.1 percent. This temporary contribution will apply to profits realized for fiscal years closed between 31 December 2011 and 30 December 2013 (representing two calendar years) but could be extended until the public debt falls below 3 percent of GDP. In practice, we understand that the tax surcharge relating to profits realized during the fiscal year 2011 would be fully paid at the time the balance amount of corporate income tax will be liquidated (for instance 15 April 2012 for FYs closing on 31 December 2011).

Tax Losses Carried Forward

In accordance with the Finance Amendment Law adopted on 19 September 2011, with immediate effect for fiscal years closed as of 21 September 2011, new rules apply to the effective use of tax losses carried forward. The amount of tax losses remains unlimited and can still be carried forward indefinitely. But their use is now restricted for each fiscal year to €1 million plus 60 percent of taxable profit of the company over €1 million. This threshold applies to companies taxed on a stand-alone basis and to tax groups on their consolidated taxable result. This means that when a company is profitable on a yearly basis and its taxable profit does not exceed €1 million, the tax losses carried forward can be used to entirely offset the profit realized and no corporate tax is due. However, when the yearly taxable profit exceeds €1 million, at least 40 percent of the company's profit exceeding this amount remains subject to tax regardless of the amount of tax losses carried forward. The amount of unused tax losses can still be carried forward indefinitely. This measure may impact the cash balance of profitable companies even when they have significant inventory of tax losses. According to the carry-back mechanism, tax losses may also be carried back to offset taxable profits realized over the past years and already subject to tax. The carry-back generates a tax credit with regard to the French tax treasury. Carry-back used to be possible over the previous three fiscal years and with no limit in terms of amount. The period is now reduced to the taxable profit of only the previous fiscal year and the amount of losses usable is limited to €1 million.

Participation Exemption on Long-term Captial Gains from Participation Shares

Starting in 2007, France implemented a participation exemption on long-term capital gains from participation shares, i.e., shares representing at least 5 percent of the share capital of a company or qualifying as such for accounting purposes and held for at least two years at the time of their disposal. Under this regime, the gain is tax-exempt, except for the portion treated as deemed expenses with respect to shareholding. The taxable portion was 5 percent of the gross amount of the gain, resulting in an effective taxation of the gain of about 1.72 percent (i.e., 34.43 percent*5 percent). In accordance with the Finance Amendment Law adopted on 19 September 2011, the taxable portion is now equal to 10 percent (instead of 5 percent) resulting in an effective taxation equal to 3.44 percent of the gain (i.e., 34.43 percent *10 percent). This measure has immediate effect and includes gains realized in fiscal years starting from 1 January 2011.

Restrictions on the Deduction of the Financial Expenses

New restrictions on the deduction of the financial expenses apply according to the third Finance Amendment Law for 2011 in order to combat situations where a French entity is chosen to acquire shares although the target entity is controlled and managed from abroad. Only the acquisition of shares whose price exceeds €1 million is concerned. In this respect, the restriction will apply to the deduction of financial expenses in connection with the acquisition of participation shares when the French acquiring entity cannot demonstrate that it effectively takes decisions concerning the target entity or that it effectively controls it. In order to avoid such restrictions, it may become crucial to ensure that French holding entities have sufficient means to exercise control over and make decisions concerning their subsidiaries. Otherwise, financial expenses connected with the acquisitions may become non-deductible (i.e., a ratio of the financial expenses of the holding company equal to the acquisition price divided by the total amount of debt of the holding company). The reinstatement will apply to the fiscal year during which the acquisition occurred and the following eight fiscal years. For acquisitions realized prior to 2012 (made since 2004), the new rules may also apply. The test will then be made during the first fiscal year opened in 2012 and if the holding entity does not meet the conditions, the restrictions will apply to financial expenses incurred in 2012 and in the following fiscal years up to the end of the eighth fiscal year after the acquisition.

European Court of Justice: German WHT on Dividends Paid to EU/EEA Minority Shareholders Violates Free Movement of Capital

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In the infringement proceeding *C-284/09 European Commission vs. Germany*, the European Court of Justice (ECJ) decided on 20 October 2011 that the German taxation of dividends paid to foreign corporate shareholders domiciled in the European Union (EU) or the European Economic Area (EEA) violates the free movement of capital agreed upon in the Treaty on the Functioning of the European Union (TFEU) and the EEA Agreement.

Current Taxation of Dividends Under German Tax Law

Dividend payments of a German corporation to both resident corporate shareholders and corporate shareholders domiciled in the EU/EEA are subject to German withholding tax (WHT) at the general tax rate of 25 percent (plus 5.5 percent solidarity surcharge thereon, resulting in an overall tax withholding of 26.375 percent).

In the course of the corporate income tax assessment procedure, corporate shareholders resident in Germany will be granted a tax credit for the WHT levied. At the same time, the dividends

received by corporate shareholders are effectively 95 percent tax exempt according to the German participation exemption regime (the German Corporate Income Tax Act provides for a 100 percent tax exemption, however, 5 percent of the dividends are deemed to be nondeductible business expenses). As a result, the WHT is effectively refunded, unless the shareholder generates additional income other than dividends that lead to a tax liability.

By contrast, foreign resident corporate shareholders are not given a comparable WHT refund. In general, they are only entitled to claim a tax refund of two-thirds of the WHT (10 percent) in order to reduce the WHT burden for foreign corporate shareholders to the level of the German corporate income tax rate (15 percent). Any further reduction, refund or exemption from WHT may only be granted if the EU Parent-Subsidiary Directive or a double-taxation treaty apply. However, this usually requires a minimum shareholding (e.g., 10 percent under the EU Parent-Subsidiary Directive). If foreign shareholders do not reach such a participation threshold, the remaining WHT becomes final and a real cost.

Decision of the ECJ

With respect to dividends received, based on the conclusion that the situation of non-German corporate shareholders is comparable to that of German corporate shareholders, the ECJ held that different treatment of German and foreign (minority) shareholders constitutes a restriction of the free movement of capital provisions outlined in Art. 56 TFEU and—with respect to dividends distributed to shareholders resident in Iceland and Norway—in Art. 40 of the EEA Agreement. The ECJ found that such restriction cannot be justified.

The decisive factor for the ECJ was that German resident corporations receiving dividends suffer no tax burden as a result of the withholding tax, whereas non-domestic corporate shareholders generally do. In this context, the 5 percent portion of the dividend, which is treated as a non-deductible business expense for German corporate income tax purposes and, thus, subject to German taxation, was not even considered by the court. According to the reasoning of the ECJ, the additional fact that domestic dividends may potentially be subject to German trade tax—which may vary depending on the municipality in which the trade or business of the German shareholder is located—between 7 percent and 17 percent cannot offset the disadvantageous treatment of outbound dividends for corporate income tax purposes. Further, the ECJ dismissed the argument that EU/EEA shareholders might be eligible for tax credits in their respective countries of residence.

Impact for taxpayers

As the ECJ ruling does not only apply to future but also to past dividends, all EU/EEA corporations that suffered a definitive German WHT on dividends should be entitled to claim a refund of WHT. However, such claims may be restricted by the applicable procedural rules in Germany. With respect to future dividends, it should be applied for an exemption from German WHT.

In addition to dividends, the ECJ decision may also cover distributions under certain equity-type instruments and income from liquidations and certain reorganizations. In cases where German domestic law does not apply the EU Parent-Subsidiary Directive to such income items, any foreign shareholders—regardless of the 10 percent participation threshold—may be affected.

The ECJ did not address whether shareholders resident outside the EU/EEA could also rely on its decision. However, it must be considered that the provisions on the free movement of capital under the TFEU, in general, also apply to non-EU/EEA residents holding portfolio investments.

The reaction of the German tax authorities and the German legislator to the ECJ judgement should be carefully monitored. German WHT rules may be amended by giving foreign shareholders access to the participation exemption regime in the course of tax assessment procedures. Another possibility discussed is to the introduction of a minimum shareholding requirement (e.g.,10 percent) for domestic shareholders also. In any case, tax structuring regarding inbound (portfolio) investments within Germany (and possibly other jurisdictions) will be significantly influenced by the ECJ decision.

Brief Update on the Hungarian Tax Climate

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In the last couple of years, taxpayers in Hungary have been experiencing turbulent times in terms of tackling the global downturn, domestic political frays and the unpredictable trends of fast-changing legislation, which all affect the tax environment as well as many other areas concerning their businesses.

Long gone are the times when the Hungarian Offshore Company was a regular tool in the hands of international tax planners. The accession of Hungary to the European Union in 2004 required the country to consolidate its tax legislation with the European standards, and one of the first steps along that line was the abolition of the offshore tax regime. Despite the clear need for a "facelift" of the Hungarian tax regime, decision makers endeavored to keep or even develop the position of Hungary in the international tax planning industry as much as possible to compensate for the lost offshore regime and to keep Hungary in the international tax competition following the offshore era.

Along with a competitively low corporate income tax rate of 16 percent, popular incentives were introduced in 2004, permitting taxpayers to reduce their corporate income tax base by 50 percent of the royalty income received, allowing a considerable reduction in the effective tax rate of companies receiving royalty (this incentive is still available to taxpayers as of today) and to reduce their corporate income tax base by 50 percent of the interest spread on related party loans (this incentive is no longer available). Companies were given participation exception on dividends and, in certain cases, on capital gains. Most importantly, the absence of domestic withholding taxation on dividend, interest and royalty payments made to foreign corporate recipients created a jurisdiction that could be well-considered when the location for a holding company was sought.

The trends of taxpayer and industry-friendly approaches, however, changed in 2006 due to the accumulated budget deficit, leading to an introduction of a 4 percent solidarity surtax that was levied on top of the 16 percent corporate income tax until the end of 2009. The outbreak of the global recession did not leave Hungary unaffected, naturally. The state budget was soon showing a soaring deficit which has been in desperate need of mending ever since. The Hungarian government , not alone among the leaders of other troubled countries, at first reached out for changes in the tax legislations rapidly in order to generate much needed funds.

In 2009, the last full year prior to the general election held in May 2010, the socialist government urgently tried to find some quick fixes to the country's problems, hoping that the results would persuade the voters at the polls. Incentives available for related party financing were abolished, the corporate income tax rate was increased to 19 percent and, unexpectedly, a 30 percent withholding tax was introduced on all interest, royalty and service fee payments made to tax residents in non-treaty countries, affecting the Hungarian holding company environment significantly. The CFC regulations were also aggravated at the same time, bringing jurisdictions like Cyprus and Ireland under the scope of the regulations. Although these provisions were only in effect for one year, these measures broke the historic trend established by the old offshore regime and the efforts to create an appealing holding and investment-friendly jurisdiction in Hungary.

Following the landslide election victory of the current government party, FIDESZ, in May 2010, which brought the party a two-thirds majority in Parliament, Hungary has experienced the most uncertain and unpredictable times as far as tax law changes are concerned. The new government picked up the task of tackling the state deficit with great momentum and has not slowed down a notch since.

As one of the first measures, sector-specific surtaxes were introduced affecting telecom companies, energy suppliers and certain retail market participants. Certain R&D incentives were also restricted, affecting pharmaceutical companies. Although the surtax of telecom companies has been disputed before the European Commission, a final decision has not yet been reached. The surtax is an income tax, based on the net turnover the taxpayer achieves from qualifying activities. The rate of the surtax varies between 0.1 – 2.5 percent for retailers, 4.5 – 6.5 percent for telecom companies and 0.3 – 1.05 percent for energy companies, depending on the amount of their net turnover. The surtax was meant to be a temporary measure, aiming to help restore balance to the national budget, and therefore, the extraordinary tax payment liability was intended to be limited to the 2010 to 2012 tax years, although rumor suggests that it will not be abolished by 2013 after all.

The sector-specific surtaxes were introduced towards the end of 2010, with retroactive effect, as the taxes were already payable with respect to the tax year of 2010. The affected taxpayers, naturally, tried to appeal against such decision before the Constitutional Court, but have fallen victim to the Government's aspirations to strip the Constitutional Court of its restraining powers. The Government restricted the authority of the Constitutional Court by amending the Constitution, leaving the Constitutional Court powerless against unconstitutional tax legislation generally by limiting its powers only to cases where specified fundamental rights are breached (i.e., the rights to life and human dignity, protection of personal data, the freedom of thought, conscience and religion, or the rights derived from Hungarian citizenship). Following this change in legislation, any tax legislation introduced against the general principles of the rule of law preventing the introduction of disadvantageous legislation with retroactive effect, and ensuring that there is sufficient time to adapt to any new legislation, may not be annulled by the Constitutional Court, nor will certain other unconstitutional measures be remedied.

Parallel to the introduction of its less popular measures, the Government declared its intention to create a competitive jurisdiction for investors in the CEE region, and some steps have indeed been taken in the right direction.

As a start, in order to bring down labor costs, a flat-rate personal income tax was introduced, applying 16 percent personal income tax to all types of income realized by private individuals. The consolidated tax base of the taxpayer is calculated as the aggregate income from independent and dependent activities and other income, multiplied by 127 percent, resulting in the effective tax rate of 20.37 percent. The multiplier will not need to be applied to the part of the income not exceeding HUF 2.4 million (approximately €8,000) from January 2012.

Social security charges payable on employment income are still rather high, adversely affecting businesses in Hungary. Employees are obligated to pay a 10 percent pension, 6 percent health insurance contribution (7 percent from next year) and 1.5 percent unemployment contribution. Employers are liable to pay a 27 percent social security and 1.5 percent vocational contribution on gross wages, resulting in an overall 46 percent burden from the various social charges payable by the employers and employees.

Last year, the corporate income tax rate was lowered to 10 percent on the first HUF 500 million (approx. €1.6 million) taxable base. The rate remained 19 percent above this threshold. The original intention of the government was to abolish the 19 percent tax rate altogether and have the 10 percent rate to apply generally, but it has become clear in the past 18 months that such plans are currently unrealistic.

The Hungarian Parliament also passed legislation that introduced a new type of real estate business, the Regulated Real Estate Investment Company ("SZIT"), commonly known as the Real Estate Investment Trust in the international real estate market. The SZIT is exempt from corporate income tax and local business tax, and profits are only taxable at the level of the participants, provided that the SZIT distributes 90 percent of its distributable profit between the shareholders as dividends. A favorable real estate transfer tax regime applies to SZITs and their project companies as the acquisition of real estate or participation in a company that holds domestic real estate by a SZIT is subject to 2 percent transfer tax as opposed to the generally applicable 4 percent. The SZIT must be a public company limited by shares, listed on the stock exchange with a registered capital of at least HUF 10 billion (approximately €33 million). At least 25 percent of the SZIT's shares must be held by investors with shareholdings lower than 5 percent. The participation of banks and insurance companies is limited, and may not exceed 10 percent in aggregate. At the time of its introduction, the Government expected the vehicle—which is unique in the region—to be competitive with the popular foreign regimes and to give momentum to the real estate market by facilitating equity raising in the real estate industry, despite the high start-up capital requirement, which will most probably limit the number of companies that may seize this new opportunity.

In favor of international groups, companies are permitted to keep their books in euro and may choose any other currency as well if that is the functional currency of the company. Also, from the beginning of next year, any taxpayer may choose at its discretion a business year other than the calendar year (except for financial institutions, financial undertakings and insurance companies).

Other important and significant changes are to come into effect from January 2012, which will definitely have a great impact on foreign businesses operating or planning to operate in Hungary. For example, Hungary has a very flexible approach to the utilization of tax losses carried forward, which will change significantly in 2012.

Currently, as a general rule, tax losses (negative tax base) can be carried forward indefinitely and used to offset the positive corporate income tax base freely, provided that the loss-making entity has carried out its activity according to the principles of the rule of law and the losses have been incurred in spite of that conduct.

From the beginning of next year the following new rules will apply:

- Tax losses of previous tax years may only be utilized to reduce the before-tax profit of the taxpayer up to 50 percent of the tax base in the given tax year, meaning that if the taxpayer has a positive tax base without taking the losses into account, there will always be a tax payment obligation regardless of the amount of available tax losses to offset it.
- In case of a company transformation, the successor company may only utilize the tax losses of the predecessor company carried forward from previous tax years if (i) the members having direct or indirect majority control in the predecessor company on the day prior to the date of the transformation, or the related parties of such members, acquire/own direct or indirect majority control in the successor company, and if the successor company realizes sales revenues in the two tax years following the transformation from at least one activity that the predecessor used to carry on (except holding activity).
- A taxpayer would not be permitted to utilize tax losses following a change-of-control if a new owner acquiring direct or indirect majority control in a company had not been a related party to the taxpayer or its predecessor continuously during the two tax years preceding the acquisition. This prohibition does not apply if the company or its majority owner is traded on a regulated stock exchange, or if following the change-of-control, the company carries on its activity for at least two tax years with the nature of the activity remaining the same and realizes sale revenues from such activity in both tax years. The change in nature of activity means, in particular, the change of services provided, goods sold or assets held, the change of market, client base, and the case when the taxpayer start to carry on holding activity instead of sale, production or service provision.

Another change that greatly affects businesses is the increase of the general VAT rate to 27 percent. This second increase within the past 18 months—the first took place in July 2010 from 20 to 25 percent—will result in the highest VAT rate in the world.

As part of the participation exemption regime for so called "reported shares," capital gains realized on the sale of so-called "reported shares" held by a shareholder having at least 30 percent ownership for at least one year is exempt from corporate income tax. As a similar concept, the term of reported immaterial assets is being introduced. The profits realized in relation to reported intangible assets will also be exempt from corporate income tax next year, making Hungary an even more favorable jurisdiction for companies collecting royalty on their intellectual property.

Even legislators have realized that no matter how appealing the tax rules may be, without predictability and certainty in interpretation, they will not help attract investment, and in many cases, uncertainty of the interpretation of tax legislation may prevent taxpayers from a business conduct considered lawful by the tax authorities. To help achieve certainty, a new institution has been recently introduced called the "notification of uncertain tax position." On the basis of making a notification in its tax return and paying a fee between HUF 0.1 million and HUF 5 million (€330,000 – 16,600) the taxpayer will be released from the obligation to pay a tax penalty after the tax shortage resulting from mistaken legal interpretation and may be obligated to pay only default interest. The subject of the notification may not be VAT, duties or the determination of the fair market price. Along with the notification procedure, a so-called "permanent advance tax ruling" procedure is also being introduced, through which tax rulings concerning corporate tax may be applied for a period of three years, regardless of any future legislative changes.

Seeing the intent in introducing tools that may help taxpayers better navigate today's fluid tax environment gives us some hope that the Hungarian tax system will become more stable once conceptual changes have been introduced and in time it will allow sound, more sophisticated, well-tested and predictable practices to develop both on the side of tax authorities and in courtrooms.

Cross-border Merger Taxation in Japan

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Introduction

As the world economy has become more integrated, global M&A has become an important strategic option for multinational corporations. Japan introduced qualified triangular mergers, qualified triangular stock exchanges and qualified triangular stock transfers ("qualified triangular mergers, etc.") in 2007 with anticipation of more investments into Japan by foreign corporations. The most well-known case is the 2008 Nikko Cordial Corporation and Citibank triangular stock transfer, where a US bank acquired a Japanese securities brokerage house without paying cash. After sub-prime issues and with excessive liquidity in China, Chinese companies acquired several Japanese companies using triangular mergers to make them wholly owned subsidiaries of Chinese-controlled companies. Today, with a strong yen exchange rate and weak domestic consumption, Japanese companies are considering cross-border M&A using qualified triangular mergers.

Under the Japanese Company Act, no direct merger is possible between Japanese corporations and non-Japanese corporations. Thus a merger exists where a Japanese operating corporation merges with a Japanese subsidiary of a foreign corporation in exchange for the shares in the foreign parent corporation, instead of shares in a Japanese subsidiary.

Qualified Merger of Corporation

Pursuant to Corporate Tax Law, in the case of a merger other than a qualified merger ("nonqualified merger"), a corporation that will cease to exist after the merger ("merged corporation") transfers its assets and liability at market price to a corporation that will exist after the merger ("surviving corporation"). Thus, capital gain or loss must be included in the last accounting year's income (i.e., the year that includes the day preceding the date of merger) of the merged corporation.[1] The merged corporation is treated as transferring to its shareholders new shares or other assets of the surviving corporation soon after it ceases to exist, having acquired such assets at market price from the corporation to be merged.[2] Therefore, in the case of a nonqualified merger, capital gain or loss accrues to the merged corporation and taxable constructive dividends are recognized by its shareholders.[3]

To be treated as a qualified merger under the Corporate Tax Law, assets other than shares of the transferee corporation or 100 percent parent company of the transferee corporation (boot) may not be distributed to the merged corporation,[4] and one of the following conditions must be satisfied:

- Following the merger, either the merged corporation or the surviving corporation must hold 100 percent of the issued shares of the other corporation, directly or indirectly, or the two must be related in certain ways.
- Following the merger, either the merged corporation or the surviving corporation must hold more than 50 percent and less than 100 percent of the issued shares of the other corporation, directly or indirectly, or the two must be related in certain ways, and the following two additional requirements must be met: (a) approximately 80 percent or more of the employees of the merged corporation must continue working for the surviving corporation (if the merger is followed by another qualified merger, this requirement must also be met by the corporation surviving after the second qualified merger); and (b) the main business of the merged corporation is expected to continue by the surviving corporation (if the merger is followed by another qualified merger, this requirement must also be met by the corporation surviving the second qualified merger).
- Following the merger, either the merged corporation or the surviving corporation must hold 50 percent or less of the issued shares of the other corporation and the purpose of the merger must be for the two corporations to conduct business jointly.

In the case of a qualified merger, the assets transferred from the merged corporation to the surviving corporation are deemed to be transferred at book value at the end of the liquidating corporation's last accounting year in calculating income after the merger.[5] Therefore, as the capital gain or loss of the merged corporation is not recognized at this stage, the taxation of capital gain or recognition of capital loss is deferred until the assets are transferred by the surviving corporation.

Tax on the shareholders of the merged corporation is deferred because the acquisition price of the shares distributed to the shareholders is equivalent to the merged corporation's transferred assets accounting year book price minus the book value of transferred liabilities, plus profit reserves transferred to the surviving corporation by the merged corporation.[6] Constructive dividends on the shares distributed to the shareholders of the liquidating corporation are not taxed.[7]

In the case of a qualified merger, the following tax attributes are carried over from the liquidating corporation to the surviving corporation: profit reserves;[8] special accounts regarding governmental subsidies;[9] various allowance accounts;[10] various reserves;[11] and losses.[12]

Qualified Exchange of Stock

Under Corporate Tax Law, the shareholders involved in a qualified exchange of stock may defer the tax on capital gains realized on the exchange of stock until the shares are disposed of. An exchange of stock will qualify if the wholly owned subsidiary's shareholders only receive shares of the wholly owned parent corporation (no boot may be exchanged),[13] and the exchange of stock falls into one of the following categories:

- A single party holds 100 percent of the issued shares of the subsidiary or parent corporation, directly or indirectly, including a stock exchange where prior to the stock exchange, either the subsidiary or parent corporation, or a separate single entity holds more than 50 percent of the shares in the other corporation, directly or indirectly, and this relationship is anticipated to continue subsequent to the stock exchange.

- Following the stock exchange, either the subsidiary or parent corporation holds more than 50 percent and less than 100 percent of the issued shares of the other corporation, directly or indirectly, or holds a certain relationship therein and satisfies the following two requirements: (a) it is anticipated that approximately 80 percent or more of the employees of the subsidiary will continue working for the surviving corporation; and (b) it is anticipated that the main business of the subsidiary will be continued by the surviving corporation.

- Where the stock exchange is for the purpose of the joint enterprise of the subsidiary andparent corporation, and all of the following conditions are met: (a) a proximate relationship exists between the subsidiary and parent corporation, including with respect to the nature of their business; (b) the size of either the subsidiary or parent corporation with respect to sales proceeds, employee count, or related items does not exceed five times that of the other party or none of the officers of the subsidiary retires subsequent to the stock exchange; (c) it is anticipated that approximately 80 percent or more of the employees of the subsidiary will continue working for the subsidiary; (d) it is anticipated that the business of the subsidiary will be continued by the surviving corporation; (e) the shareholders of the subsidiary receiving the parent corporation's shares hold 80 percent or more of the subsidiary's shares (except when the number of the subsidiary's shareholders is greater than 50); and (f) it is anticipated that all of the outstanding shares of the subsidiary will be held by the parent subsequent to the stock exchange.

Qualified Stock Transfer

Under Corporate Tax Law, the shareholders involved in a qualified stock transfer may defer tax on capital gains realized until the shares are disposed of. For a stock transfer to qualify, the wholly owned subsidiary's shareholders must only receive shares of the wholly owned parent corporation (no boot may be transferred),[14] and the stock transfer must fall into one of the following categories:

- A single party holds 100 percent of the issued shares of the subsidiary or parent corporation, directly or indirectly, where one entity becomes the sole transferee subsequent to the transfer and it is anticipated that the transferor will become the wholly-owned parent of the transferee.

- Following the stock transfer, either the transferor or transferee holds more than 50 percent and less than 100 percent of the issued shares of the other corporation, directly or indirectly, or holds a certain relationship therein, and satisfies the following two requirements: (a) it is anticipated that approximately 80 percent or more of the employees of the transferee will continue working for the transferee subsequent to the transfer; and (b) it is anticipated that the main business of the transferee will be continued by the transferee.

- Where the stock transfer is for the purpose of the joint enterprise of the transferor and transferee and all of the following conditions are met: (a) a proximate relationship exists between the transferor and transferee, including the nature of their business; (b) the size of either the transferor or transferee with respect to sales proceeds, employee count or related items does not exceed five times that of the other party, or none of the officers of the transferor or transferee retires subsequent to the stock transfer; (c) it is anticipated that approximately 80 percent or more of the employees of the subsidiary will continue working for the subsidiary; (d) it is anticipated that the business of the transferor and the transferee will be continued by the transferee; (e) the shareholders of the transferee receiving the transferor's shares hold 80 percent or more of the transferee's shares (except when the number of the subsidiary's shareholders is greater than 50); and (f) it is anticipated that all of the outstanding shares of the transferee will be held by the transferor subsequent to the stock transfer.

In practice, exchange of shares are more often used for both mergers and acquisitions than only mergers. In a merger, it is necessary to obtain administrative licenses owned by a merged company which has been merged into a new subsidiary. In an exchange of stock, an operating company *may* maintain administrative licenses.

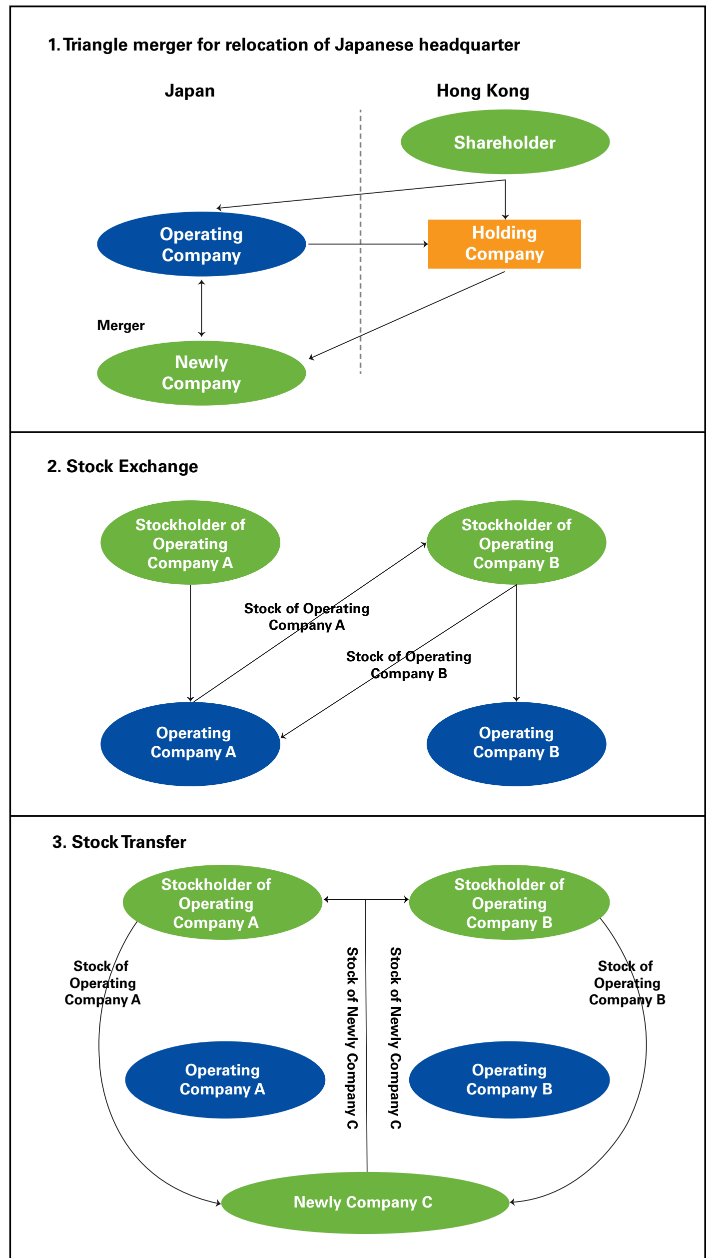
Cross-Border Merger

In the case of a merger, stock exchange and stock transfer, the new company or surviving company may distribute the parent company's shares instead of its own shares. If the parent company is located outside of Japan, the operating company will become a subsidiary of the foreign company and the shareholders will become the shareholders of the foreign company. Therefore, a triangular exchange of stock is an attractive option for Japanese companies and shareholders, who can expect:

- the importance of relocating headquarters of a Japanese company to a more tax friendly jurisdiction in order to reduce their global tax burden;
- the economy in Asia is still growing, especially the Chinese market and low cost manufacturing countries, such as Thailand and Indonesia, are important for a global strategy. However, Japan still remains the premium products and technology center of the group; and
- family companies or founders of listed companies who are concerned about individual income tax and inheritance tax will make it impossible to maintain ownership in the companies.

In order to complete a cross-border merger without taxation, certain additional conditions need to be satisfied:

- Headquarters should not be located in a tax haven where the effective tax rate is 20 percent or lower. UK, Netherlands and PRC are the countries with effective tax rates higher than 20 percent and will not be considered as tax havens for Japanese tax purposes. In the case of Hong Kong or Singapore, both effective tax rates are lower than 20 percent. Therefore, headquarters in such countries need to satisfy the "substantial presence" test. Alternatively, even if the headquarters are located in low-tax jurisdictions, it is possible to increase the effective tax rate.



- A shareholder who is a nonresident of Japan will realize capital gains from the exchange of shares from a Japanese corporation to non-Japanese shares if they are considered to be "controlling shares". Controlling shares mean 25 percent or more of the total shares in the Japanese company. In order to avoid such capital gains, the shareholder may maintain shares in non-Japanese headquarters under the management of permanent establishment in Japan. If a tax treaty exempts capital gains from shares from the Japanese government without respect to the percentage in the company, such as a Japan-Hong Kong tax treaty, the shareholder may acquire a non-Japanese headquarter's share without Japanese tax on the capital gain.
- Some Japanese customers have experienced issues with "treasury stock" in countries such as Singapore, which do not allow issuance of Singapore parent shares to a Japanese subsidiary, in order to make the Singapore-based company the new headquarters of the Japanese company group. However, such issues can be easily avoided by proper structuring of a Japanese subsidiary at the outset.

1 CTL, Art. 62(1) and (2).
2 CTL, Art. 62(1).
3 ITL, Art. 25(1), item 1.
4 CTL, Art. 2, item 12-8.
5 CTL, Art. 62(2).
6 CTL, Art. 62-2(1) and Art. 61-2(2).
7 ITL, Art. 25(1), item 1.
8 CTL, Art. 2, item 18.
9 CTL, Art. 43(8), item 1.
10 CTL, Art. 52(7), item 1 and Art. 53(6), item 1.
11 STML, Art. 52-3(15) and Art. 55(11).
12 CTL, Art. 57.
13 CTL, Art. 2, item 12-16; Art. 62-9.
14 CTL, Art. 2, item 12-17; Art. 62-9.

Investing in Poland

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In-bound Investments

Foreign enterprises wishing to invest in Poland face a challenging task of having to analyze complex Polish tax regulations. However, the results of the analysis can prove to be quite beneficial as the Polish tax laws provide (directly or indirectly) for a number of tax-planning opportunities. These opportunities may stem either from a specific tax regime tailored to attract investors who bring added value to a business community or from regulations spread throughout the tax system, which allow for legitimate tax optimization. The article below describes two types of tax-planning opportunities in Poland.

Special Economic Zone (SEZ)

A Special Economic Zone (SEZ) is a part of Polish territory which is administered separately, allocated for the running of businesses on preferential terms. The SEZ is a place which is subject to special treatment and tax exemptions where an entrepreneur can establish a business on a specially prepared site and run it without paying income tax.

In an SEZ, an enterprise can obtain the following advantages:

- Income tax exemption
- A site fully prepared for development at a competitive price
- Free assistance in dealing with formalities in connection with the investment
- Exemption from property tax (on the territory of certain municipalities)

The exemption from income tax granted in the SEZ is regarded as publicly funded regional aid, which serves to speed up the development of the undeveloped EU regions by supporting new investments and creating new workplaces linked to these new investments.

Generally, the investments that are eligible for tax (and other) incentives are those in fixed and intangible assets or legal costs involved with the formation of a new business or the expansion of an existing business. The acquisition of an existing business may also—in certain circumstances—qualify as a new investment. The minimum level of investment enabling a firm to utilize public aid in an SEZ is €100,000.

As far as creating new jobs is concerned, new employees are those employed after the day on which acceptance of the new investment is granted, but no later than three years from that time. For the purposes of complying with the new jobs requirement, the number of employees is considered to include not only those employed full-time, but also those employed part-time and also seasonal workers, whose work is calculated on a full-time basis.

The permitted level of regional aid available to the entrepreneur is dependent on:

- The location of the investment
- The level of capital input
- The costs of employing new workers
- The size of the business seeking tax relief

The maximum level of aid permitted in each Polish region varies from 30 to 50 percent of the value of the new costs (consisting of costs of the new investment) or costs of work of newly employed workers over a two-year period, increased by the mandatory payments linked with their employment. There is also the possibility of utilizing both forms of aid simultaneously as long as the joint amount of aid does not exceed the permitted maximum.

The right of access to tax exemptions under the terms of a new investment in an SEZ may be granted to an entrepreneur on the condition that:

- There can be no transfer of any kind in the ownership of fixed assets, which are connected to the investment expenditure for a period of five years
- The business will be conducted for a period of no less than five years, and in the case of small- and medium-sized businesses, no less than three years
- New workplaces will be maintained for no less than five years, three years in the case of small- and medium-sized businesses

Investment funds

Under Polish tax law, for a number of years Polish investment funds have been exempt from income tax on all income generated. Taxation was designed to take place upon the distribution of income to the holders of investment certificates. Some businesses have been operating under fund structures; however, they suffered from the inflexible nature of the fund law (strict supervision, harsh diversification requirements, etc.). After heavy criticism from the European Commission, which deemed those provisions discriminatory (Polish funds were exempted while foreign funds were not), recently changed corporate income tax law extended the general tax exemption to foreign investment institutions, subject to several conditions:

- The fund must be subject to tax (be a tax resident) in the other country.
- The fund's only activity must be collective investment of cash—gathered through public or non-public offering of units/certificates—in securities, currency securities and other property rights.
- The fund must operate on the basis of permits issued by the relevant authority in the other country and must be externally managed.
- The fund's activity must be subject to supervision of the relevant authority in the other country.
- The fund must have a depositary storing its assets.
- There must be a legal title for the exchange of tax information with the country of residence of the fund.

Assuming the above criteria can be met, combined with careful structuring, investments via a foreign investment fund may provide invaluable benefits, even exceeding those available for Polish funds, such as:

- Flexibility of the foreign fund law (e.g., Luxembourg, the Netherlands, Cyprus)
- Exemption from income tax on investments realized via the funds (i.e., effectively the exemption of operating income from taxation)
- Exemption of cash distribution to fund holders from Polish withholding tax

New Proposed Treasury Regulations Clarify the Scope of the Exemption from US Taxation of Foreign Sovereigns

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Background

The US Treasury Department has recently issued proposed regulations under Section 892 of the Code[1] that provide welcome clarity with respect to whether non-US sovereigns and entities controlled by non-US sovereigns will be treated as engaged in commercial activity for US federal income tax purposes. Income of non-US sovereigns and their controlled entities from investments in shares of stock, bonds, other securities and income from investments in financial instruments held in the execution of governmental financial or monetary policy is generally exempt from US taxation. However, any such income derived by a non-US sovereign from the conduct of commercial activity and any income derived by a "controlled commercial entity" of a non-US sovereign is not eligible for the exemption from US taxation.[2] Thus, in order for the exemption from US taxation to apply, two criteria must be met: First, the income or gain realized must fall within the categories of income eligible for the exemption; that is, income and gain realized in respect of shares of stock, bonds, other securities and income realized from certain financial instruments held in the execution of governmental financial policy; second, the income or gain must not be derived by the non-US sovereign from the conduct of a commercial activity or, in the case of income or gain derived by a controlled entity of a non-US sovereign, the controlled entity must not be a controlled commercial entity. A controlled commercial entity is an entity that is controlled by a non-US sovereign, but that is engaged in commercial activity anywhere in the world.[3] A controlled commercial entity is ineligible for the exemption from US taxation under Section 892 of the Code for all of its income.[4]

Under the prior Treasury Regulations, it was uncertain whether various transactions gave rise to commercial activity, whether a controlled entity would be treated as engaged in commercial activity as a result of engaging in certain activities and whether a controlled entity that has engaged in commercial activity can cure such "taint". The proposed Treasury Regulations under Section 892 of the Code broadly address these issues and provide helpful guidance on the rules relating to commercial activities and the exemption under Section 892 of the Code. Although the recent guidance is issued only in the form of proposed Treasury Regulations, the notice issuing the proposed Treasury Regulations states that taxpayers may rely on the provisions of the proposed Treasury Regulations until further guidance is issued in the form of final Treasury Regulations.

The Proposed Treasury Regulations—An Overview

The proposed Treasury Regulations set forth, among other things, the extent to which a non-US sovereign, a sovereign wealth fund and other entities controlled by non-US sovereigns will be exempt from US tax on their investments in the United States. Particularly, these proposed Treasury Regulations describe certain activities that will not constitute "commercial activity" within the meaning of Section 892 of the Code and address the repercussions if an entity inadvertently engages in commercial activity. The proposed Treasury Regulations do not, however, affect the determination of whether income or gain earned by such controlled entities is of a type eligible for the exemption from US taxation, only whether the

activity generating such income or gain constitutes commercial activity. Thus, transactions that were not exempt from tax prior to the issuance of the proposed Treasury Regulations continue not to be exempt.

Principally, the proposed Treasury Regulations provide that:

- Commercial activity conducted by a limited partnership generally will not be attributed to the limited partners in the partnership.
- Commercial activity does not include disposition of a US real property interest or investment in financial instruments.
- Testing of an entity's status as a controlled commercial entity is done on an annual basis and is subject to a *de minimis* exception.
- Solely being a partner in a partnership that conducts trading activity for its own account (and is not otherwise engaged in commercial activity) will not cause such partner to be treated as engaged in commercial activity.

Commercial Activity in General

The proposed Treasury Regulations provide significant clarification with respect to whether a non-US sovereign or its controlled entities will be treated as engaged in commercial activity. Commercial activity is defined broadly under current law and the proposed Treasury Regulations include generally "all activities (whether conducted within or outside the United States) which are ordinarily conducted for the current or future production of income or gain."[5]

Exclusions from Commercial Activity

Despite the general inclusionary nature of the definition of commercial activity, specific exceptions exclude certain items of income and gain from such definition.

Certain Investment and Trading Activities

The Treasury Regulations provide that certain investment activities (e.g., investing in shares of stock, bonds, other securities, and in financial instruments held in the execution of government financial or monetary policy) and certain trading activities (e.g., effecting transactions in shares of stock, securities or commodities for a non-US sovereign's or its controlled entity's own account—but not if undertaken as a dealer—and effecting transactions in financial instruments in the execution of government financial or monetary policy) are not commercial activity[6] and income derived therefrom is exempt from taxation.[7] The proposed Treasury Regulations reiterate this rule and further clarify that investment in certain financial instruments (including forward, futures, options contracts, swap agreements and similar instruments) will not be considered to be commercial activity irrespective of whether or not such instruments are held in the execution of governmental financial or monetary policy.[8] Income from investment in such financial instruments, however, will continue to qualify for exemption from US taxation only if such instruments are held in the execution of governmental financial or monetary policies.

Dispositions of US Real Property Interests

The proposed Treasury Regulations limit the scope of commercial activity by providing that dispositions (deemed or actual) of "US real property interests" will not constitute commercial activity.[9] An actual disposition of a US real property interest would include a direct disposition of US real property, disposition of shares or other equity interests in entities that are treated as US real property holding corporations, and a disposition of a partnership interest in a partnership that holds a US real property interest. A "deemed" disposition of a US real property interest would include a disposition by a partnership (in which the non-US sovereign is a partner) of a US real property interest or the receipt by the non-US sovereign of a REIT distribution, to the extent attributable to gain from the sale or exchange by such REIT of a US real property interest.[10] The US Internal Revenue Service currently takes the position that gain resulting from a disposition of a US real property interest by a REIT is not eligible for the exemption under Section 892 of the Code,[11] and the proposed Treasury Regulations do not alter this position. Thus, a non-US sovereign in a partnership that has invested in a US real property interest or that has invested in a US real property holding corporation (including a REIT) will not be treated as engaged in commercial activity upon the partnership's disposition of the US real property interest, the sovereign's disposal of shares in the corporation or upon the REIT or other US real property holding corporation disposing of a US real property interest and distributing the proceeds to the sovereign investor.

Annual Testing and Inadvertent Commercial Activity of Controlled Entities

Annual Testing

The proposed Treasury Regulations provide that the determination of whether an entity is a controlled commercial entity is made on an annual basis.[12] Thus, the fact that an entity may engage in commercial activity in a particular year will not cause it to lose the exemption under Section 892 of the Code for subsequent years.

De minimis Commercial Activity

A *de minimis* test applies when a controlled entity conducts "inadvertent commercial activity"; in such case, the controlled entity will not be considered to be engaged in commercial activity.[13] This *de minimis* exception applies when (i) the failure to avoid conducting the commercial activity is "reasonable," (ii) the commercial activity is "promptly cured," and (iii) the entity meets certain "record maintenance" requirements.

i. *Failure to Avoid Commercial Activity Is Reasonable.* Reasonableness is determined on a facts and circumstances basis and is satisfied only if an ongoing diligence process is in place (and is followed and enforced) whereby adequate written policies and operational procedures are used to monitor an entity's worldwide activities.[14] In lieu of the facts and circumstances test, the proposed Treasury Regulations offer a safe harbor under which, provided the diligence requirements noted above and certain recordkeeping requirements are met, the failure to avoid conducting commercial activity will be deemed to be reasonable. To qualify for the safe harbor, an entity's assets attributable to, and income from, such commercial activity cannot exceed five percent of the total balance sheet assets and income statement gross income, respectively, of the entity for financial accounting purposes for the relevant taxable year.

ii. *Prompt Cure.* An entity must discontinue the conduct of the commercial activity within 120 days of discovery of such activity to "cure" under the proposed Treasury Regulations. The proposed Treasury Regulations do not specify how such activity must be discontinued, but divestiture of an asset and discontinuation of the activity are suggested as examples.[15]

iii. *Adequate Record Maintenance.* Lastly, an entity must maintain and retain "adequate records" of each discovered and subsequently purged commercial activity, and the means whereby it was purged, for as long as such documentation may become material with regard to the exemption under Section 892 of the Code.[16]

Partnership Attribution Rules to Limited Partners and Participation in Trading Partnerships

Limited Partner Exception

The proposed Treasury Regulations create a broad exemption from commercial activity for passive limited partners in entities classified as partnerships for US federal tax purposes. The commercial activity of a partnership will not be attributed to a limited partner if such partner does not have the right to participate in the management or conduct of the partnership's business at any time during the partnership's taxable year.[17] A non-US sovereign's or its controlled entity's distributive share of the partnership's commercial activity income will still be subject to US taxation despite the application of the limited partner exception.

Partners in Trading Partnerships

In addition, non-US sovereigns will not be treated as engaged in commercial activity solely as a result of holding an interest in a partnership that trades in stocks, bonds, other securities, commodities or financial instruments.[18] However, this exception does not apply in the case of a partnership that is a dealer in stocks, bonds, other securities, commodities or financial instruments.

Unresolved Issues and Need for Clarification

The proposed Treasury Regulations do not provide clarity with respect to all ambiguities in the current Treasury Regulations and, in fact, raise certain new inconsistencies that will require future clarification. For example, the rule contained in the current Treasury Regulations that provides that a controlled entity of a non-US sovereign may be treated as a controlled commercial entity where greater than 50 percent of the controlled entity's assets are US real property interests has not been changed by the proposed Treasury Regulations[19] The failure to modify this provision leads to an inconsistency with the position stated in the proposed Treasury Regulations to the effect that a disposition of a US real property interest does not result in commercial activity.[20] As such, the US Internal Revenue Service should clarify that a controlled entity whose assets are more than 50 percent US real property interests will not constitute a controlled commercial entity.

The proposed Treasury Regulations introduce, but do not elaborate upon, the continuing due diligence requirement for satisfying the *de minimis* commercial activity test.[21] The proposed Treasury Regulations require that "adequate written policies and operational procedures" be in place to satisfy the diligence requirement; however, without further guidance, a sovereign or its controlled entity cannot efficiently dedicate resources to and appropriately budget for administrative costs associated with such diligence.

Additionally, the *de minimis* test contained in the proposed Treasury Regulations should provide greater clarity with respect to when a cure will be considered timely. A cure will be timely only if it occurs within 120 days of "discovery." Yet "discovery" is uncertain when applied to an entity; questions arise as to which persons within controlled entities must have knowledge of the activity or issue before discovery will be imputed. Further, the

requirement that the cure itself be effectuated within 120 days of discovery is problematic. Depending on the nature of the specific investment, and taking into account the time necessary for successfully negotiating and closing on a sale or other transfer of the investment, actual disposition may not be possible within such a time frame. Further, assuming disposition can be accomplished within 120 days, such a limited time frame may have a punitive effect on a party's bargaining position if a potential purchaser is aware of the non-US sovereign's requirement to dispose of the investment within the short time frame.

Lastly, the limited partner exception to commercial activity should be clarified as to its scope. As drafted, it is not apparent whether the exception would apply if a limited partner participated on an advisory committee to the partnership or if contractual arrangements among partners have been entered into that provide additional rights to specified limited partners.

Conclusion

The proposed Treasury Regulations represent a major step forward in the clarification of an admittedly complex set of rules. While many questions posed with regard to the prior Treasury Regulations are answered by the proposed Treasury Regulations, certain issues remain outstanding. The comment period with respect to the proposed Treasury Regulations is open until February 1, 2012, and we would expect that some of the unresolved issues should be addressed before Final Treasury Regulations are issued.

1 References to the Code are to the Internal Revenue Code of 1986, as amended.

2 *See* 26 USC. § 892(a).

3 Treas. Reg. § 1.892-5T.

4 Id.

5 Prop. Reg. § 1.892-4(d).

6 Treas. Reg. § 1.892-4T.

7 Treas. Reg. § 1.892-3T.

8 Prop. Reg. § 1.892-4(e)(1)(i). The aproposed Treasury Regulations do not clarify whether investments in derivatives in shares of stock and other securities would be treated as non-commercial activity.

9 Prop. Reg. § 1.892-4(e)(1)(iv). US real property interests generally include most non-creditor direct interests in US real estate and shares in US real property holding corporations, including most equity REITs. See Code § 897(c).

10 Code § 897(h).

11 *See* IRS Notice 2007-55.

12 Prop. Reg. § 1.892-5(a)(3).

13 Prop. Reg. § 1.892-5(a)(2)(i).

14 Prop. Reg. § 1.892-5(a)(2)(ii)(A). The IRS will consider the number of activities constituting commercial activity that are conducted in the current and previous taxable years, as well as the amount of income earned from, and assets used in the conduct of the commercial activity in relationship to an entity's total income and assets, respectively.

15 Prop. Reg. § 1.892-5(a)(2)(iii).

16 Prop. Reg. § 1.892-5(a)(2)(iv).

17 Prop. Reg. § 1.892-5(d)(5)(iii). Such participation (determined under local law) by limited partners does not include certain rights in the case of extraordinary events such as dissolution, admission/expulsion of a partner, certain major asset dispositions and related events.

18 Prop. Reg. § 1.892-5(d)(5)(ii). This rule applies irrespective of whether the limited partner exception applies.

19 *See* Prop. Reg. § 1.892-5 (reserving subsections (b) through (d)(4) and referring to Treas. Reg. 1.892-5T(b) through (d)(4) for interim guidance).

20 Prop. Reg. § 1.892-4(e)(iv).

21 *See* Prop. Reg. § 1.892-5(a)(2)(ii)(B).

Common Transaction Structures Utilized by Non-US Investors in US Real Property

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Introduction

Current market conditions present favorable opportunities for non-US persons to invest in US real property. However, potential investors must be mindful of the US federal income tax consequences that may result from such investments. Part II of this article briefly summarizes the basic US federal income tax principles that apply to offshore investments in US real property. Part III of this article outlines common transaction structures utilized by a non-US investor in US real property and briefly summarizes the US federal income tax consequences of each investment applicable to such investor. As always, White & Case is happy to advise concerning the alternative transaction structures available for non-US investors based on each investor's particular circumstances.

Summary of Basic US Federal Income Tax Principles Applicable to Non-US Investors in US Real Property

While non-US investors generally are exempt from US federal income tax on capital gains derived from investments in the United States, gain treated as effectively connected with the conduct of a US trade or business is subject to US federal income tax on a net basis at tax rates applicable to US persons (generally 35 percent in the case of non-US corporate investors). Under US federal income tax law and, in particular, Section 897 of the Internal Revenue Code of 1986, as amended (the so-called "FIRPTA" rules), gain from the disposition of US real property interests is treated as income effectively connected with the conduct of a US trade or business, and therefore such gain is subject to US federal income tax (the "FIRPTA tax"). A "US real property interest" is broadly defined as a direct interest in real property located in the United States or the Virgin Islands, an interest in a partnership meeting certain US real property interest ownership tests, or an interest in a US corporation that has been a "US real property holding corporation" at any time within the 5-year period ending on the date of the disposition of such interest. In general terms, a "US real property holding corporation" is a corporation incorporated in the United States in which the fair market value of its US real property interests equals or exceeds 50 percent of the fair market value of all real property assets and other assets of the corporation used in the conduct of a trade or business. If a partnership (whether organized within or outside the United States) disposes of a US real property interest, non-US partners of such partnership generally are subject to the FIRPTA tax.

In addition to being subject to the FIRPTA tax, a non-US investor that is subject to FIRPTA also is required to file US income tax returns and is subject to US taxing jurisdiction, including the investigatory power of the US Internal Revenue Service ("IRS"). If a non-US investor disposes of a US real property interest, a portion of the amount realized on the disposition generally is subject to US withholding tax. Such withholding tax is credited against the tax due on the US tax return filed by the non-US investor. Thus, it is important to structure investments in US real property in a manner that minimizes the level of US taxation and avoids additional US federal income tax return filing requirements.

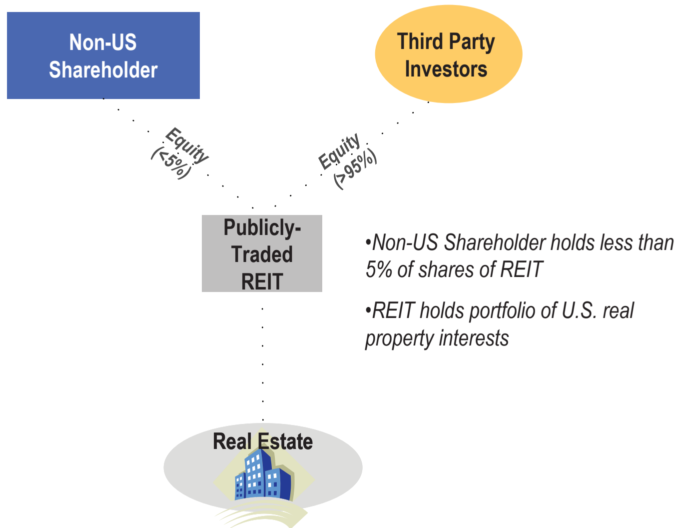
Common Structures for Investment by Non-US Investors in Real Property

This part briefly illustrates common transaction structures utilized by non-US investors in US real property interests and summarizes the US federal income tax consequences applicable to such investors. For purposes of the discussion below, a "Non-US Shareholder" (or, in some cases, a "Non-US Investor") is a non-US investor that is a corporation for US federal income tax purposes and, accordingly, the FIRPTA tax is assumed to apply at a rate of 35 percent of the gain realized on such investor's disposition of a US real property interest (non-US individual investors are subject to the FIRPTA tax on gains, but at a rate that may be less than 35 percent).

Structure 1: Non-US Shareholder Owns Less Than 5 Percent of a Publicly Traded REIT

A real estate investment trust ("REIT")[1] is a corporation or business trust combining the capital of many investors to acquire, own and, in most cases, operate income-producing interests in real estate to generate income such as rental income and interest income from mortgages. In general, the operating income of a REIT (e.g., rents, interest on mortgages) is subject to US withholding tax at a rate of 30 percent when paid out to REIT shareholders as a dividend, unless such withholding is reduced or eliminated under an applicable income tax treaty between the shareholder's jurisdiction and the United States. The capital gains arising from a REIT's disposition of its US real property interests generally is subject to FIRPTA and a Non-US Shareholder of a REIT generally is required to pay tax at a rate of 35 percent on its share of the gains realized from such disposition. A Non-US Shareholder generally is subject to a 35 percent tax on the gain resulting from the disposition of its shares of the REIT.

However, there is an exemption from the FIRPTA tax for gain realized from the sale of shares of a REIT if the REIT shares are "publicly traded" and the Non-US Shareholder holds less than 5 percent of the total outstanding shares of the "publicly traded" REIT. This transaction structure is illustrated as follows:



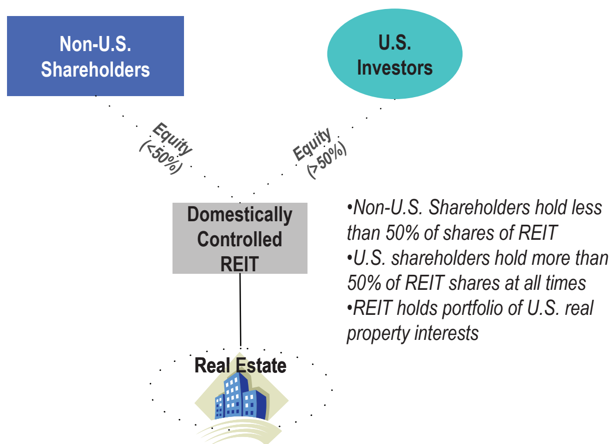
In such a case, the Non-US Shareholder would be subject to the following US federal income tax consequences as a result of its investment:

- **Distributions of Operating Income:** Income earned by the publicly traded REIT, such as rental income or interest income, generally is subject to withholding tax at a rate of 30 percent when paid from the REIT to the Non-US Shareholder as a dividend, unless such withholding is reduced or eliminated under an applicable income tax treaty between the jurisdiction of the Non-US Shareholder and the United States.
- **Distributions of Capital Gain Income:** Generally, a REIT is subject to corporate-level tax on any net capital gain recognized during the taxable year unless it elects to declare and pay a capital gain dividend. Distributions from a publicly traded REIT to the Non-US Shareholder attributable to gain from the disposition of its US real property interests is treated as ordinary dividends of operating income, subject to the rules discussed above under "Distributions of Operating Income." The Non-US Shareholder is not required to file a US federal income tax return for the taxable year if such shareholder otherwise is not required to file a return for such year.
- **Disposition by the Non-US Shareholder of REIT shares:** Gain realized by the Non-US Shareholder from the sale or disposition of the shares of the publicly traded REIT is not subject to FIRPTA.

A publicly traded REIT generally means a REIT if its shares are regularly traded on an established securities market located in the United States. From a US federal income tax perspective, this ownership structure may be preferred for Non-US Shareholders interested in investment in a publicly traded REIT and focused on the exit from their investment through the sale of REIT shares, or if such shareholders are subject to an applicable income tax treaty that would reduce or eliminate withholding on dividends paid by the publicly traded REIT, including dividends of proceeds from the sale by the REIT of US real property interests.

Structure 2: Non-US Shareholder Invests in a Domestically Controlled REIT

In addition to the "publicly traded REIT" exception to FIRPTA, discussed above, there is an exception to the FIRPTA tax on gains arising from the disposition of REIT shares if the REIT is a "domestically controlled" REIT. A domestically controlled REIT is a REIT more than 50 percent of the shares of which have been owned by US persons at all times during the shorter of (i) the 5-year period ending on the date of the relevant transaction and (ii) the period during which the REIT was in existence. An illustration of this transaction structure is as follows:



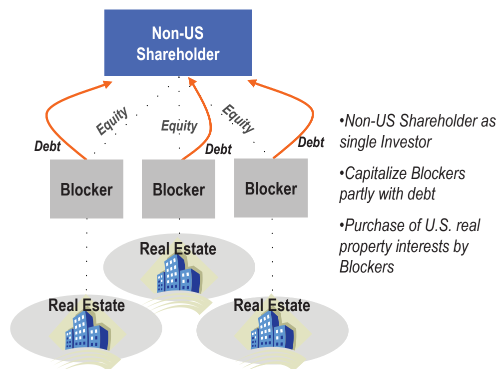
If the Non-US Shareholder holds shares of a domestically controlled REIT, such shareholder would be subject to the following US federal income tax consequences as a result of its investment:

- **Distributions of Operating Income:** The Non-US Shareholder is subject to a 30 percent withholding tax imposed on distributions of the operating income of a REIT, unless an applicable income tax treaty reduces or eliminates such withholding.
- **Distributions of Capital Gain Income:** The Non-US Shareholder is subject to the 35 percent FIRPTA tax on gain attributable to the disposition by the REIT of US real property interests held by the REIT.
- **Disposition by the Non-US Shareholder of Domestically-Controlled REIT Shares:** The Non-US Shareholder's disposition of the shares of a domestically controlled REIT generally is not subject to FIRPTA tax if such shareholder is not otherwise considered to be engaged in a trade or business in the United States.

As discussed above, from a US federal income tax perspective, gain realized by Non-US Shareholders from the sale of domestically controlled REIT shares generally is exempt from the FIRPTA tax. Accordingly, Non-US Shareholders would benefit from the utilization of this transaction structure if such shareholders contemplate exiting their investment by selling their shares in the domestically controlled REIT and the Non-US Shareholders had a measure of comfort that the REIT would not sell or otherwise dispose of its interests in its US real property.

Structure 3: Non-US Shareholder Invests in Wholly Owned Leveraged Delaware Corporations

A Non-US Shareholder may choose to invest in US real property interests through a wholly owned leveraged Delaware corporation or corporations (the "Blockers"). In this case, the Non-US Shareholder could capitalize each Blocker with a combination of debt and equity so that, subject to the limitations imposed under the so-called thin capitalization (or, as referred to in US parlance, "earnings-stripping") rules and assuming that the terms of the debt comply with other requirements to ensure that the debt portion of the capital is treated as debt for US federal income tax purposes, interest paid by a Blocker to the Non-US Shareholder on the debt portion of the investment could be deductible from income of the Blocker. An illustration of this structure is as follows:



Generally, interest paid by a Blocker to the Non-US Shareholder on the debt portion of the investment would be deductible against the Blocker's income for US federal income tax purposes. However, the earnings-stripping rules would apply to limit current interest deductions available to the Blocker so that the taxable income of the Blocker is not reduced to an amount that is less than 50 percent of the income amount that roughly corresponds to EBITDA. The remaining interest deductions that are not available as a current deduction as a result of the imposition of the earnings-stripping rules are carried forward and treated as an interest expense in the following year and each subsequent year until the interest deductions can be used. Subject to the earnings-stripping limit described above, any unutilized interest deductions may be used to offset gain realized in a subsequent year.

As illustrated above, this discussion assumes that each Blocker holds one US real property interest and that there is a single non-US investor holding the shares of stock in the Blocker. Accordingly, the Non-US Shareholder would be subject to the following US federal income tax consequences as a result of its investment:

- **Distributions of Operating Income:** The Blocker would be expected to apply the operating income earned from the US real property interest to make payments of accrued but unpaid interest and principal on the debt portion of the Non-US Shareholder's investment. The repayment of the principal on the debt is tax-free to the Non-US Shareholder, although the payment of interest to the Non-US Shareholder is subject to a 30 percent withholding tax (unless reduced or eliminated by an applicable income tax treaty). To the extent that operating income remains after all payments are made on the debt instrument, such amounts could be distributed by the Blocker to the Non-US Shareholder as dividends. Dividends paid to the Non-US Shareholder are subject to a 30 percent withholding tax (unless reduced or eliminated by an applicable income tax treaty).
- **Disposition of the US Real Property Interest:** Upon exit from the US real property investment, the Non-US Shareholder may choose to have a Blocker sell the underlying US real property interest. In such a case, the Blocker generally is subject to a 35 percent tax on gain from the sale, which gain may be reduced by the deferred interest deductions resulting from the application of the earnings-stripping rules (discussed above). No additional tax should be imposed on liquidating distributions from the Blocker to the Non-US Shareholder. If, instead, the Non-US Shareholder were to exit its investment by selling the shares of the Blocker, the Non-US Shareholder would be subject to the 35 percent FIRPTA tax on the gain from the sale of shares if the Blocker is a US real property holding corporation (as defined above). Therefore, under either exit scenario, the gain realized with respect to the US real property investment generally is subject to US taxation. However, gain realized by the Blocker upon sale of the US real property interest may be taxed at a net rate that is lower than the general 35 percent corporate interest tax rate as a result of the interest deductions that may be available.[2]

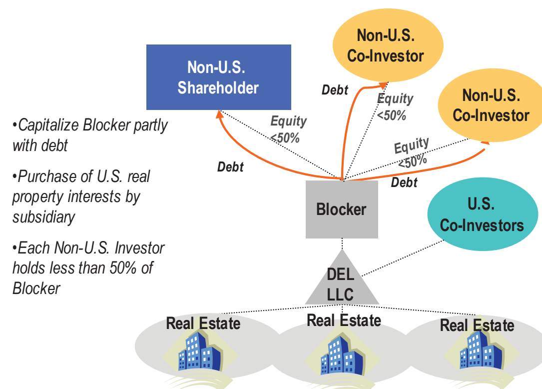
An additional US federal income tax benefit that will inure to the Non-US Shareholder from investing in US real property interests through a Blocker is that such shareholder would avoid being required to file a US federal income tax return for the taxable year (if such shareholder otherwise is not required to file a return for such year).

Modifications to this structure also may be made. For instance, a Blocker may be organized to own multiple US real property interests. In such case, the Blocker would receive the benefits of being able to consolidate operations of its various US real property investments and would be able to offset losses from one investment with income or gain from another investment. However, the sale of a US real property interest by a Blocker that is a "pooled vehicle" may result in both a 35 percent income tax on the gain realized with respect to the disposition and a further 30 percent US withholding tax imposed on a distribution through a dividend of the proceeds of the sale to the Non-US Shareholder. A Non-US Shareholder would, among other things, want to consider its likely exit scenarios of its US real property investments as well as the possibility of material losses in one or more of its investments when determining whether to structure its investments through individual Blockers or through a pooled vehicle. To the extent that the Non-US Shareholder would like to preserve the flexibility to exit each US real property investment at separate times and the Non-US Shareholder has a measure of comfort that there would not be material losses from one or more investments, gains from the pooled vehicle structure would likely not be preferred.

The Non-US Shareholder also could organize one or more non-US subsidiaries, which would own one or several Delaware corporations which, in turn, would each invest in separate US real property interests. Utilizing this structure, the Non-US Shareholder would be able to dispose of its ownership interests in the separate non-US subsidiaries without being subject to US federal income tax. However, a buyer likely would resist purchasing the shares of a non-US subsidiary in order to acquire an underlying US real property interest. Instead, a buyer likely would seek to structure the transaction in a manner that enables such buyer to acquire the US real property interest with a fair market value tax basis (to avoid inheriting the built-in gain in the underlying Delaware corporations). A buyer would also seek to avoid the complications that come from purchasing the US real property interest that is held by a non-US corporation. Therefore, utilizing this structure may not be advisable for most non-US investors.

Structure 4: Non-US Shareholder Co-Invests with Other Investors Through a Leveraged Delaware Corporation

As an alternative to investing in US real property through a wholly owned entity, the Non-US Shareholder may choose to invest in US real property on a joint venture basis with other US or non-US co-investors (the "Co-Investors"). As noted below, this structure may provide material tax advantages over the alternatives described in Structure 3. The co-invest structure is illustrated as follows:



As illustrated above, Non-US Co-Investors generally would prefer to join the investment through an ownership interest in the Blocker and US Co-Investors generally would prefer to join the investment through ownership of an interest in a fiscally transparent entity (the Delaware LLC). In such case, the Non-US Shareholders would be subject to the following US federal income tax consequences as a result of its investment:

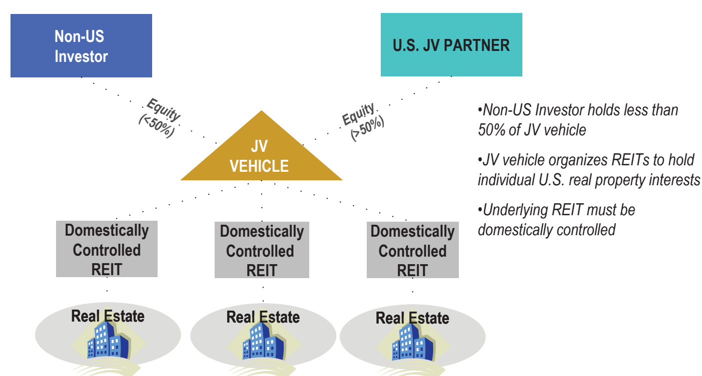
- **Distributions of Operating Income:** Dividend distributions from the Blocker to the Non-US Shareholders are treated in the same manner as in Structure 3. However, US withholding tax on the payments of interest from the Blocker to the Non-US Shareholder could be eliminated if each Non-US Shareholder owns less than 10 percent of the voting power of the shares of the Blocker (due to application of the portfolio interest exemption) or if a tax treaty provides an exemption from withholding on US source interest. Having other Non-US Co-Investors invest in the Blocker could enable a particular Non-US Shareholder who holds 10 percent or more of the economic interest in the Blocker to own less than 10 percent of the voting power of the Blocker if other Non-US Co-Investors hold a greater portion of the voting power of the Blocker. Such other Non-US Co-Investors could qualify for a treaty exemption or reduction from US withholding tax on interest payments to them.

- **Disposition of the US Real Property Interest:** Exiting the investment by having the Delaware LLC sell its US real property interests or by having the Blocker sell its Delaware LLC interests would subject the Blocker to a 35 percent tax on gain, which gain may be reduced by unutilized interest deductions attributable, for example, to the debt investment made by the Non-US Shareholder and Non-US Co-Investors (if such deductions were not used to offset operating income from the US real property interests prior to the year of sale). Liquidation of the Blocker after the taxable disposition by the Blocker of all US real property interests is not subject to additional US tax.

Similar to the conclusion with respect to Structure 3, the Non-US Shareholder would avoid a requirement to file US federal income tax returns for each taxable year in which the investment was held, provided that such shareholder otherwise is not required to file a return for such year. In addition, this co-invest structure has the dual advantage of providing (1) an opportunity to avoid the earnings-stripping limitations with respect to the interest deductions available at the Blocker level, and (2) an opportunity for the Non-US Shareholder to qualify for the portfolio interest exemption on interest payments made by the Blocker (which provides an advantage to a Non-US Shareholder that does not qualify for an exemption from US withholding tax on interest payments pursuant to an applicable income tax treaty).

Structure 5: Non-US Investor Owns Interest in Joint Venture That Holds REIT Shares

A Non-US Investor may choose to invest in US real property interests through joint venture vehicles (the "JV Vehicles"), which could be organized as partnerships for US federal income tax purposes. The JV Vehicles, in turn, would own shares in a series of domestically controlled REITs, each of which would hold individual US real property interests. An illustration is as follows:



In this case, the Non-US Investor should ensure that each underlying REIT is a domestically controlled REIT to avoid tax on the gain from the sale of REIT shares. The Non-US Investor would be subject to the following US federal income tax consequences as a result of its investment:

- **Distributions of Operating Income:** The Non-US Shareholder generally is subject to a 30 percent withholding tax on its attributable share of operating income distributed to the JV Vehicle from each domestically controlled REIT, unless an applicable income tax treaty reduces or eliminates such withholding.

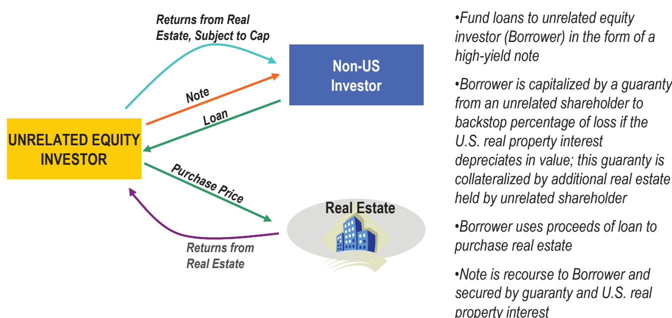
- **Distributions of Capital Gain Income:** The Non-US Shareholder is subject to the 35 percent FIRPTA tax on its share of the gain attributable to the disposition by each domestically-controlled REIT of the US real property interest held by such REIT.

- **Disposition of Domestically Controlled REIT Shares:** No FIRPTA tax on gain applies with respect to a disposition by the JV Vehicle of its shares in each domestically-controlled REIT.

Similar to the result in Structure 2, from a US federal income tax perspective, gain realized by a Non-US Shareholder attributable to the JV Vehicle's sale of domestically controlled REIT shares would be exempt from the FIRPTA tax. Accordingly, Non-US Shareholders would benefit from the utilization of this transaction structure if they contemplate exiting their investment in US real property by selling their shares in the domestically controlled REITs.[3] Possible disadvantages to utilizing this investment structure include added costs of setting up and maintaining individual REITs, which could be material.

Structure 6: Non-US Investor Makes a Debt Investment

A different approach also may be taken in structuring an investment by a non-US investor in a US real property interest, which may significantly increase the after-tax yield on the cash flow to such investors. In this case, the Non-US Investor lends the full amount of its US real property investment in the form of a debt instrument secured by a recourse collateralized guarantee from an unrelated party. The Non-US Investor does not take an equity ownership interest in the US real property, as illustrated as follows:



This transaction would be structured so that the Non-US Investor is treated as owning a debt instrument for US federal income tax purposes. In this case, all payments on the debt instrument (sourced either from earnings from operations or the ultimate disposition of the property) could be made to the Non-US Investor free from US federal income tax as interest payments that qualify for the portfolio interest exemption, provided that payments on the debt are not contingent on earnings from the property, the principal amount is fixed and payable unconditionally on a certain date, and other requirements of the portfolio interest exemption are met. In such case, the Non-US Investor could significantly increase its after-tax yield on its cash flow from the investment because of the absence of applicable US federal income taxes. In addition, the equity investor (the "borrower" in this case) would provide downside protection in an amount equal to its collateralized guarantee.

Any Non-US Investor should be aware that, upon default by the borrower, the Non-US Investor should transfer its debt obligation to a subsidiary that is a Delaware corporation before foreclosing on the collateral (resulting in the receipt by the Non-US Investor of a US real property interest) or before the occurrence of any modification of the debt instrument or other event that would result in the debt being treated as a US real property interest under FIRPTA.

However, a potential disadvantage to the Non-US Investor from utilizing this transaction structure is that the upside from the investment is capped at a fixed return, based on the yield of the debt instrument. For instance, if the investment generated returns significantly in excess of the baseline projections, then the borrower (an unrelated investor) would capture all gain in excess of the yield on the debt. However, the Non-US Investor's after-tax enhancement on the yield of its investment could outweigh the potential limitation on its sharing in possible upside returns. In addition, it could be possible to limit the borrower's upside in a manner that does not defeat treatment of the Non-US Investor's investment as debt for US federal income tax purposes through the issuance of an "out of the money" call over the equity investor's shares. The analysis of whether such a call would be feasible and determinations of the terms of any such arrangement would need to be made on a case-by-case basis.

The foregoing discussion presents a number of structuring possibilities for non-US investors to enter the US real property market. Other structures also are available to investors depending on the nature of the investment and the profile of a specific investor. White & Case is happy to advise potential investors as to the most efficient way to structure their US real property investments based on each investor's particular circumstances.

Pursuant to Internal Revenue Service Circular 230, we hereby inform you that any advice set forth herein with respect to US federal tax issues was not intended or written by White & Case to be used and cannot be used, by you or any taxpayer, for the purpose of avoiding any penalties that may be imposed on you or any other person under the Internal Revenue Code.

1 REITs are required to, among other things, (i) pay at least 90 percent of their taxable income to shareholders, (ii) derive most of their income from real estate held for the long term, and (iii) be widely held.

2 However, because it is expected that the earnings stripping rules would apply to reduce the portion of the gain realized by the Blocker upon the sale of its US real property interest, the effective tax rate on the gain realized upon the Blocker's sale of its US real property interest likely would be less than 35 percent. Even if the portion of the gain offset by the application of the earnings stripping rules is subject to a 30 percent withholding tax upon distribution to the Non-US Shareholder (unless reduced or eliminated by an applicable income tax treaty), such shareholder is at least afforded the benefit of the tax rate differential.

3 It should be noted that, if the Non-US Shareholder is a non-US sovereign, the non-US sovereign could be eligible for exemption from US tax upon the sale of REIT shares, whether or not the individual REITs are domestically controlled, provided that the non-US sovereign holds less than 50 percent of the ownership interests in the REITs.

Open for Business

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The United Kingdom has historically been a hub for international trade and investment. However, the domestic tax system has not always kept pace with the continued status of the United Kingdom as a global financial hub. The continuing global economic slow-down has resulted in the political ambition to relaunch the United Kingdom as "open for business" in order to counteract increasing tax competition (particularly in the European Union).

This political ambition is best capsulated by the statement of the Prime Minister to British Industry in 2010:

"It is absolutely vital for our economy that we attract the maximum amount of inward investment, and that we do everything we can to demonstrate that the British economy is open for business, open for trade and open for investment."

This note highlights some of the main steps the United Kingdom has recently taken to present itself as an attractive jurisdiction to invest in (from a business tax perspective) particularly in the context of ultimate or intermediate corporate investment into the United Kingdom by nonresidents.

Perception, as any half-intelligent brand manager will tell us, is everything. To change it is mighty difficult—perception, once entrenched, lingers on even when the object in question has changed its fundamental nature.

Take the United Kingdom for example—it has long been considered a high tax jurisdiction for businesses (and for that matter individuals but then this note focuses solely on business taxation[1]). Until not very long ago (2008), the headline corporation tax rate in the United Kingdom was 30 percent[2] (contrast this with neighboring Ireland where the headline corporation tax rate then was and continues to be now 12.5 percent), dividends received by United Kingdom tax resident companies from overseas companies were subject to United Kingdom corporation tax (albeit with the possibility of credit for any overseas tax paid on the dividends) and the UK-controlled foreign companies regime had been considerably extended since they were first introduced in 1984 beyond their original tax avoidance remit.

Unsurprisingly perhaps, the United Kingdom was perceived as a high tax jurisdiction with a significant tax compliance burden for foreign profits. This perception was confirmed and deeply entrenched in the corporate mindset when in the late 2000s, a number of high-profile United Kingdom-based multinational corporate groups (example Shire PLC, Informa Plc and WPP) announced their decision to relocate to lower tax jurisdictions like Ireland to simplify their tax affairs and reduce their tax liabilities in the United Kingdom (particularly in relation to foreign profits).

Notwithstanding the above, inbound investment into the United Kingdom continued (in the, what seems distant now, economic good times) because of the inherent attractiveness of the United Kingdom as an important financial market (attractive time zone, the security of English law, universality of language and access to a significant banking and capital markets) irrespective of the relative competitiveness (or lack thereof) of the United Kingdom tax system.

However, with the world economy becoming increasingly mobile and fast-moving and countries (particularly cash-starved western economies) engaged in intense competition for finite funds, the "*race to bottom*" began in real earnest (at least in the tax sphere) in the late part of the last decade. The continuing economic strife has meant that tax competition has only intensified with hitherto "*high tax jurisdictions*" like the United Kingdom reflecting recently on how best to respond to global tax competition.

This note highlights some of the main steps the United Kingdom has taken to present itself as an attractive jurisdiction to invest in (from a business tax perspective) particularly in the context of ultimate or intermediate corporate investment into the United Kingdom by non-residents[3] and concludes that the United Kingdom tax regime is increasingly becoming more tax competitive than it may commonly be perceived to be.

United Kingdom Corporate Tax Reforms—Part 1

United Kingdom governments (on both sides of the political divide) over the last decade have sought to make the United Kingdom corporate tax regime attractive to foreign investors by introducing a number of progressive measures.

The first wave of tax reforms was kick-started by the Labour Government in 2001—the key change to the United Kingdom tax system of benefit to corporate investors was the introduction of the substantial shareholding exemption from capital gains. Prior to 2002, in contrast to other European countries (such as the Netherlands) where gains made on the sale of shares in subsidiaries were generally exempt from tax (by reason of a "*participation exemption*" regime), the gain arising on a sale of shares by a United Kingdom tax resident company was subject to United Kingdom corporation tax. Since 2002, a gain arising on sale of shares by a United Kingdom tax-resident company has been exempt from tax where, generally, throughout a continuous 12-month period beginning not more than two years before the sale, the company selling the shares held a "substantial shareholding" (generally, a 10 percent or greater interest) in the company whose shares were sold, subject to various additional conditions being satisfied. As a matter of United Kingdom tax policy (and unlike the "*participation exemption*" regime applying in many other European countries), this exemption generally extends and applies only to "trading" (and not investment) groups.

A second wave of tax reforms was again begun by the Labour Government in 2007—these reform proposals were collectively referred to as "*Taxation of foreign profits of companies*" and focused on three key features of the United Kingdom tax regime:

Introduction of a tax exemption for foreign dividends received by United Kingdom tax-resident companies

Prior to 1 July 2009, United Kingdom dividends received by UK parent companies were exempt from United Kingdom corporation tax while foreign dividends received by such companies were subject to United Kingdom corporation tax (albeit with the possibility of credit for overseas tax suffered). This differentiation was successfully challenged in the European Court for breaching the EU principle of freedom of establishment and the UK government was forced to take corrective measures. Under the dividend exemption rules introduced then, from 1 July 2009, the specific exemption for all United Kingdom dividends were removed and a general exemption from United Kingdom corporation tax for all dividends (whether of a foreign or United Kingdom source) falling within certain defined exempt categories were introduced.

A worldwide debt cap on financing expense deductions

The quid pro quo for the introduction of dividend exemption rules (as mentioned above) coupled with the already relatively generous tax deductions for financing expenses given by the United Kingdom historically to corporates, which have long been one of the attractive features of the United Kingdom tax rules, was the introduction of a worldwide debt cap on financing expense deductions. The general principle underpinning this so-called "debt cap" is that United Kingdom corporation tax deductions for interest and other finance expenses claimed by members of a large group are restricted by reference to the group's consolidated finance costs to prevent disproportionate "debt dumping" by a multinational corporate group in the UK as well as to police upstream loans to the UK.

Reform of the United Kingdom Controlled Foreign Companies regime

See below.

United Kingdom Corporate Tax Reforms—Part 2

The arrival of the economic doom and gloom in late 2008 and the coming to power of the Conservative-Liberal Democrats Coalition Government (the "Coalition Government") in the United Kingdom accelerated the tax reforms begun by the previous government.

The Coalition Government's publicly stated policy is to create in the United Kingdom the most competitive corporate tax regime in the G20. To achieve this aim, the Coalition Government introduced the second wave of tax reforms in 2010 which it states "*send[s] out the signal loud and clear that Britain is open for business.*"

The key changes proposed to be made to the United Kingdom corporate tax regime following extensive consultation with business are as follows:

Rate of corporation tax in the United Kingdom

The measure that most visibly and obviously reflects the Coalition Governments intention to make the United Kingdom tax regime more attractive and competitive relates to the reduction in the main rate of corporation tax from the current rate of 26 percent to 23 percent by 2014. A corporation tax rate of 23 percent would make the United Kingdom more attractive (at least in headline rate terms) than most other European member states (including the Netherlands and Luxembourg).

Reform of the United Kingdom Controlled Foreign Companies regime

Reform of the United Kingdom Controlled Foreign Companies ("CFC") regime has frequently been identified by multinational businesses as a key priority in improving the United Kingdom's tax competitiveness.

The reform of the CFC regime has been one of the long-running soap operas of the United Kingdom tax world. The Labour Government began reform of this regime in 2007 and the Coalition Government decided to introduce what is now termed as the interim changes to the CFC rules in 2011. The Government has announced further changes to the CFC rules and wants to introduce what it calls "*a modernized CFC regime*" that strikes the right balance between making the corporate tax system more competitive and providing adequate protection of the UK tax base.

Draft legislation has now been published and it is expected that the final changes to the CFC regime will take effect sometime in 2012, the broad thrust of which is to reverse the previous presumption that all overseas-generated profits were prima facie within the charge to United Kingdom taxation, to one of respecting territoriality and only seeking to charge to United Kingdom tax profits which have been "*artificially diverted*" from the United Kingdom. It is also expected that, in line with representations from the business community, compliance processes relating to this regime will be significantly reduced.

Introduction of "foreign branches" exemption

An elective regime has been introduced allowing United Kingdom corporate taxpayers to opt out of United Kingdom taxation of profits earned by foreign branches.

The "Patent Box" regime

The UK government is currently consulting on a preferential taxation regime for profits arising from patents often referred to as the "patent box" regime. Under this regime (intended to apply from 2013), a preferential 10 percent rate of United Kingdom corporation tax will apply to profits arising from patents falling within the "patents box" regime. This regime is expected to be elective.

Conclusion

In contrast to the traditional United Kingdom's corporate taxation policy of subjecting companies tax resident in the United Kingdom to United Kingdom corporation tax on their worldwide income, profits and gains, the tax reforms outlined above reflect the United Kingdom's desire to move to a more territorial system of corporate taxation whereby the focus of the tax system is on profits of domestic activity in determining the tax base while protecting the United Kingdom tax base from artificial erosion. This marks a significant shift in the fundamental nature and basis of the scheme of UK corporate taxation.

The net effect of these measures (some of which have already been enacted while others are being consulted upon with a view to prompt enactment) is that the inherent attractiveness of the United Kingdom as an important ultimate or intermediate corporate investment destination should no longer be torpedoed by a less than competitive domestic tax regime.

With a low main rate of corporation tax, no tax on dividends received nor withholding tax on dividends paid, a relatively attractive interest deduction policy and a move towards a more reasonable CFC regime, the United Kingdom is, contrary to popular corporate perception overseas, emerging as an increasingly attractive and competitive corporate tax jurisdiction in Europe for ultimate or intermediate investment by overseas investors.

That said, perceptions (particularly deeply entrenched ones) take time to change—but if the United Kingdom continues on its stated path to be the most tax-competitive jurisdiction in the G20, its consideration as an investment destination (on a corporate tax basis) will be hard to ignore, whatever the popular perception may be.

1 The United Kingdom continues to be a high tax jurisdiction for individuals. In many ways, corporate tax reforms outlined in this note are being "subsidized" by high rate of United Kingdom income tax.

2 The main rate of United Kingdom corporation tax was 54 percent in the 1980s and 35 percent in the early 1990s.

3 Another stated objective of the steps outlined in this note is to encourage multinationals to remain/possibly relocate to the United Kingdom.

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