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IRS Legal Memorandum Rules that Deemed Interest Payments May Be Recharacterized as Dividend Distributions

Ruling Affects Payments to Related Foreign Entities

by Peg O'Connor, Michael Mundaca, Arlene Fitzpatrick and Carlos Probus (Ernst & Young)

Executive Summary

On November 14, 2006, the Internal Revenue Service (IRS) released ILM 200645018 finding that Treas. Reg. Section 1.894-1(d)(2)(ii)(B) may be applied to recharacterize deemed interest payments by a U.S. corporation to a related foreign entity as dividend distributions. The ILM considered whether a transaction treated for U.S. tax purposes as a secured financing arrangement between a U.S. corporation, its domestic subsidiary and a foreign lender, could be subject to further recharacterization under Section 894. The taxpayer asserted that under U.S. tax principles, its transaction should be treated, contrary to its form, as a secured financing transaction resulting in non-deductible dividend payments from the U.S. subsidiary to the U.S. corporation, followed by deductible interest payments from the U.S. corporation to a related foreign lender. Although the U.S. corporation was a domestic reverse hybrid for purposes of the regulations under Section 894, the taxpayer apparently asserted that the regulations under Section 894 should not apply to the transaction as recast.

The IRS disagreed, determining that although the taxpayer could recast the transaction and treat it in accordance with its substance, as opposed to its form, the resulting deemed interest payments could then be recharacterized as dividend distributions under the Section 894 regulations. As a result of that second recharacterization, no interest deductions would be permitted and, in addition, the resulting dividend payments would be subject to U.S. withholding tax.

Detailed Discussion

Background Facts

Country A Parent, a publicly traded corporation, wholly owns Country A Corporation, which in turn wholly owns Country A Sub 1 and Country A Sub 2. All of the Country A entities participate in Country A group relief provisions. Country A Sub 1 and 2 own U.S. Parent. U.S. Parent is a partnership that elected to be taxed as a corporation for U.S. tax purposes, but is treated as a fiscally transparent entity under the laws of Country A. Thus, pursuant to Treas. Reg. Section 1.894-1(d)(2)(i), U.S. Parent is a domestic reverse hybrid entity (DRH). U.S. Parent wholly owns U.S. Subsidiary, a U.S. corporation. U.S. Subsidiary was included on U.S. Parent's consolidated federal income tax return for the taxable periods at issue in the memorandum.

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U.S. Parent, U.S. Subsidiary and Country A Corporation entered into a secured financing arrangement pursuant to a series of agreements and transactions whereby U.S. Subsidiary issued a share of its preferred stock (Preferred Share) to Country A Corporation in exchange for an amount of cash. Country A Corporation agreed not to sell the Preferred Share to any third parties, and further agreed that

The secured financing arrangement should be characterized under the principles of U.S. law rather than the law of the foreign jurisdiction of the entity receiving the payment.

U.S. Parent would have the right to buy back the Preferred Share for the same amount paid by Country A Corporation to acquire the share. Finally, it was agreed that in the event that U.S. Parent did not buy back the Preferred Share within a certain period of time, Country A Corporation could require U.S. Parent to buy the Preferred Share.

The parties to the arrangement intended that the arrangement be treated for U.S. tax purposes as a secured loan by Country A Corporation and a secured borrowing by U.S. Parent.[1] Further, it was intended that U.S. Parent would be treated as owning the Preferred Share, and, consistent with the treatment of the transactions as secured financing, that payments made by U.S. Subsidiary directly to Country A Corporation with respect to the Preferred Share would be treated as non-deductible deemed dividend payments from U.S. Subsidiary to U.S. Parent, followed by deemed interest payments from U.S. Parent to Country A Corporation. Such deemed interest payments were to be treated for U.S. tax purposes as deductible payments by U.S. Parent.[2] Finally, the parties intended that the deemed interest payments from U.S. Parent to Country A Corporation would be exempt from U.S. withholding tax under the applicable Treaty. For Country A purposes, the transactions were treated as direct payments made by U.S. Sub to Country A Corporation that were taxable dividends for Country A tax purposes.

Law and Analysis

Treas. Reg. Section 1.8941(d)(2)(ii)(B)(1) provides a general rule that applies when: *(i)* a domestic entity makes a payment to a related DRH that is treated as a dividend under either U.S. law or the laws of the jurisdiction of a related

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New U.S.-UK Competent Authority Agreement Provides Relief from Mirror Legislation Rule in Dual Consolidated Loss Regulations

by Diana L. Hickey (Baker & McKenzie)

On October 6, 2006, the Treasury Department announced that the United States and the United Kingdom competent authorities have entered into an agreement that will allow certain taxpayers with dual consolidated losses (DCLs) to elect to use those losses to offset income of their affiliates in either the United States or the United Kingdom. This agreement is the first of its kind, providing taxpayers welcome relief from the draconian mirror legislation rule in the current final and proposed DCL regulations.

(g)(2)(i) Election

Section 1503(d) of the Code and the regulations thereunder generally provide that DCLs may not be used to reduce the taxable income of a U.S. affiliate unless the taxpayer makes an election ((g)(2)(i) election) under which the taxpayer certifies that no portion of the loss has been or will be used to offset the income of any other person under the relevant foreign income tax law. If a taxpayer that has made a (g)(2)(i) election engages in a transaction that constitutes a "triggering event" under the regulations including, among other things, a use of the loss to offset an affiliate's income under foreign law, the taxpayer must recapture the loss, plus an interest component, on its tax return for the year including the triggering event.

The current regulations as well as the proposed DCL regulations issued in May, 2006 include a so-called "mirror legislation rule," which generally provides that a dual resident corporation or separate unit is deemed to have used the loss to offset income of an affiliate in the foreign jurisdiction if such foreign jurisdiction has enacted legislation similar to the U.S. DCL rules that prohibit the use of the loss in the foreign jurisdiction. Thus, if a dual resident corporation is treated as a resident of a country that has a DCL-type rule such as the United Kingdom, the taxpayer is precluded from making a (g)(2)(i) election. In that case, it is possible that the taxpayer may be prohibited from using the loss to reduce any affiliate's income in both the United States and the United Kingdom.

Election of where to Use the Loss

Taxpayers, tax practitioners and commentators have criticized this rule as particularly harsh and demanded relief. The current and new proposed DCL regulations provide an exception to the mirror legislation rule and thus would allow taxpayers to make (g)(2)(i) elections where the taxpayer elects under Treas. Reg. § 1.1503-2(g)(1) to use the loss in the United States under an agreement entered into between the United States and the relevant foreign country that permits a taxpayer to elect which jurisdiction it wishes to use the loss. Until now, however, there have been no such agreements on which taxpayers could rely for relief from the mirror legislation rule.

Recognizing that the interaction between the mirror legislation rule in the U.S. DCL regulations and the UK DCL-type rules may result in double taxation inconsistent with the Business Profits and Relief of Double Taxation articles of the U.S.-UK tax treaty, the new competent authority agreement, or the first "G-1 Agreement" (by reference to the relevant provision in the current DCL regulations), allows taxpayers who meet certain conditions and follow certain procedures to make an annual, irrevocable election to use the DCL incurred in a particular year to reduce an affiliate's taxable income in any open year in either the United States or the United Kingdom, but not both. The G-1 Agreement does not apply to *(i)* dual resident corporations that are not UK permanent establishments; *(ii)* hybrid entity separate units; or *(iii)* separate units owned indirectly through a hybrid entity separate unit. Further, the G-1 Agreement provides that a taxpayer may only elect to use the DCL under the G-1 Agreement in a manner that is consistent with the domestic law generally applicable to the relief of losses of the country in which the taxpayer is seeking to use the loss. Moreover, if any part of a loss that has been relieved, used or claimed in one country under the G-1 Agreement subsequently is used in the other country in a manner inconsistent with the domestic law of the first country in which the loss was used, the taxpayer must recover or recapture the loss in accordance with the first country's laws.

Companies with dual consolidated losses can use the losses to offset income of affiliates in either the U.S. or the UK.

The election must be made in accordance with the procedures and conditions provided in the body and the annexes to the G-1 Agreement. Annex A, which sets forth the rules and conditions applicable to taxpayers who wish to elect to use the DCLs in the United States, requires electing taxpayers to file "modified (g)(2)(i) agreements." "Modified (g)(2)(i) agreements" are (g)(2)(i) elections (as provided under

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IRS Initiates 1441 Compliance Project

by Lou Carlow, Maria Murphy and John Manton (PricewaterhouseCoopers)

At recent tax conferences, officials announced that the IRS has initiated an extensive Compliance Initiative Project (CIP) to address noncompliance by taxpayers responsible for withholding income tax under sections 1441, 1442, and 1443. A CIP is an examination of specific taxpayers within a group, using internal and external data to identify potential areas of noncompliance within the group, for the purpose of correcting the noncompliance. The IRS initially has selected approximately 200 taxpayers for withholding tax examination, with a long-range goal of examining 300 taxpayers in each of the five industry groups falling within the jurisdiction of the Large and Mid-Size Business Division.

According to an IRS official responsible for this compliance effort, IRS computer audit specialists and international examiners have been analyzing information reported on Form 5471 (Information Return of U.S. Persons With Respect To Certain Foreign Corporations, and Form 5472, Information Return of a 25 Percent Foreign-Owned U.S. Corporation) to determine if reportable amounts reflected on those returns have been properly reported on Form 1042 (Annual Income Tax Return for U.S. Source Income of Foreign Persons). Numerous instances of non-filing have been discovered; the IRS will contact those taxpayers. Also included in the project are withholding agents in the following industries: personal services providers (e.g., accounting firms, law firms, architectural firms, etc.); real estate; heavy manufacturing; natural resources; entertainment; and pharmaceuticals.

Observations

The IRS has decided to undertake this initiative based on information uncovered during its administration of the Voluntary Compliance Program (VCP), which was available to withholding agents for the payment, withholding, and reporting of certain taxes due on payments to foreign persons. Under the VCP, a withholding agent could voluntarily disclose to the IRS any past noncompliance with the withholding tax regulations and not be subject to penalties.

Although the VCP ended on March 31, 2006, IRS officials have stated that taxpayers that voluntarily disclose noncompliance would be looked upon favorably when IRS considers assessing penalties. IRS officials also have stated that they would aggressively pursue penalties in instances where noncompliance with the withholding regulations is discovered.

Accordingly, companies filing Forms 5471 and 5472 should review those forms to ensure that payments subject to withholding are reported properly on Form 1042. Additionally, a review of accounts payable records should be conducted to ensure that payments to foreign entities are reported properly. ❑

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Tax Shelter Reporting Rules are Changing—Again

by Keith Martin (Chadbourne & Parke LLP)

The IRS requires that any deal possessing at least one of six features must be reported to the agency as a potential corporate tax shelter. Corporations participating in such transactions must report them to a special office at the IRS at the same time they file a return for the year the transaction occurred, and a form must be attached to each return on which benefits from the transaction are claimed. Lawyers, brokers and other "material advisers" must also report the deal to the IRS. Advisers are required to report within one month after the calendar quarter in which the deal closed.

The IRS keeps changing its view of what makes a deal a potential corporate tax shelter. The rules on what types of deals must be reported have undergone almost continuous revision since they were first issued in 2000. The IRS proposed more changes in early November.

As expected, significant differences in how a transaction is reported for book and tax purposes will no longer be a factor in whether it must be reported.

However, the agency added a new placeholder to the list. The agency said it will issue periodic announcements as it spots "transactions of interest" that will have to be reported. It has not yet announced any. Retroactive reporting may be required for transactions closed after November 1 this year that are labeled "transactions of interest" in the future.

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Six Features

After the latest revisions, there are six features that will require a deal be reported. They are if the deal is a "listed transaction," meaning that it appears on a list of transactions that the IRS has announced it does not believe work, the broker or adviser offering the deal insists that the structure must be kept confidential, the fees the taxpayer pays to anyone who makes an oral or written statement about the potential tax consequences from investing in the transaction are contingent on the tax benefits or subject to a full or partial refund if any of the benefits is denied, the deal is expected to throw off at least $10 million in losses that are not compensated by insurance in one year or at least $20 million in such losses in the aggregate, the deal has been identified by the IRS as a "transaction of interest," or it is expected to generate tax credits of more than $250,000 for holding an asset for 45 days or less.

For a short time, the IRS required that all deal papers contain an explicit statement that both the structure and tax treatment of the deal are not confidential. However, such statements are no longer required in the deal documents themselves. They are only needed in engagement letters with certain advisers.

The IRS is collecting comments on the new rules. Comments are due by January 31. (Treasury official Michael Desmond suggested at an American Bar Association luncheon in late October that the government may treat transactions that use a patented tax technique as "transactions of interest." The IRS is concerned about an upsurge in applications to the U.S. Patent Office to patent tax strategies, and it wants to learn more about what types of strategies taxpayers are asking to have patented and how such strategies are employed.) ❑

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foreign interest holder in the DRH and under the laws of the related foreign interest holder, the related foreign interest holder is treated as deriving its proportionate share of the payment; and *(ii)* the DRH makes a payment of a type that is deductible for U.S. tax purposes to the related foreign interest holder or to certain other related persons and for which a reduction in U.S. withholding tax would be allowed under an applicable income tax treaty. In such cases, Treas. Reg. Section 1.894-1(d)(2)(B)(1)(iii) provides that to the extent that the payment by the DRH does not exceed the sum of the portion of the payment made to the DRH (by the related domestic entity) treated as derived by the related foreign interest holder, the payment by the DRH will be treated for all purposes of the Internal Revenue Code and any applicable income tax treaty as a dividend distribution within the meaning of Section 301(a). Further, Treas. Reg. Section 1.894-1(d)(2)(ii)(A) provides that in general, an item of income paid by a DRH to an interest holder in the DRH shall have the character of such item of income under U.S. law. Accordingly, no interest deduction would be available for the recharacterized payment.

As noted above, U.S. Parent Corporation is a DRH under the Section 894 regulations.[3] Also as noted above, U.S. Parent took the position that substance-over-form principles should apply to treat the secured financing arrangement as a deemed dividend payment from U.S. Subsidiary to U.S. Parent, followed by deemed interest payments from U.S. Parent to Country A Corporation. It appears the taxpayer may have also taken the position that for purposes of Section 894, however, the form of the transaction should be respected, with the result that Section 894 would not apply. The IRS disagreed, noting that the same substance-over-form principles should apply for purposes of applying the Section 894 rules on payments by DRH. The Service therefore concluded that the special rules of Treas. Reg. Section 1.894-1(d)(2) should be applied notwithstanding that the

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Dividend Distributions *(from page 5)*

transactions resulted in deemed rather than actual payments. In so concluding, the Service found that the characterization of an item of income paid under U.S. law, as required by Treas. Reg. Section 1.8941(d)(2)(ii)(A), should be applied whether the payments actually occurred or were deemed to occur. Moreover, the Service noted that the secured financing arrangement was in substance precisely the type of DRH structure that was targeted by the Section 894(c) regulations; the overall effect of the transactions if respected would have resulted in (1) a deduction under U.S. law for U.S. Parent's outbound interest payment to Country A Corporation, (2) the elimination of U.S. withholding tax on the interest payment under the Treaty, and (3) the imposition of little or no tax by Country A on the item of income characterized for Country A tax purposes as a dividend, as a result of the Country A foreign tax credit. The Service observed that this result was "inconsistent with the intent of the Treaty to reduce or eliminate double taxation of income" and actually led to "double non-taxation of income."

In a very mechanical and systematic application of the regulations under Section 894, the Service found that Treas. Reg. Section 1.894-1(d)(2)(ii)(B) applied to recharacterize the deemed interest payments by U.S. Parent to Country A Corporation as Section 301(a) dividend distributions. First, Treas. Reg. Section 1.894-1(d)(2)(ii)(B)(1)(i) was satisfied because U.S. Subsidiary, a domestic entity, was deemed to make a dividend distribution to U.S. Parent, a DRH, under U.S. law.[4] Moreover, while under country A law, Country A Sub 1 and Sub 2 were not treated as deriving their proportionate share of the deemed interest payment, the IRS concluded that under Treas. Reg. Section 1.894-1(d)(2)(ii)(B)(2), the dividend received by Country A Corporation nonetheless would be treated as derived by Country A Sub 1 and Country A Sub 2. Thus the requirement under Treas. Reg. Section 1.894-1(d)(2)(ii)(B)(1)(i) that the related foreign interest holder in the DRH be treated as deriving its proportionate share of the dividend was also met.

Second, Treas. Reg. Section 1.8941(d)(2)(ii)(B)(1)(ii)[5] was satisfied because U.S. Parent, a DRH, was deemed to make a deductible interest payment to Country A Corporation, a person the income and losses of which were available under the group relief provisions of Country A to offset the income and losses of related foreign-interest holders in U.S. Parent. In so finding, the Service rejected arguments by the taxpayer that this regulation provision was intended to cover situations where there was an interest expense deduction in

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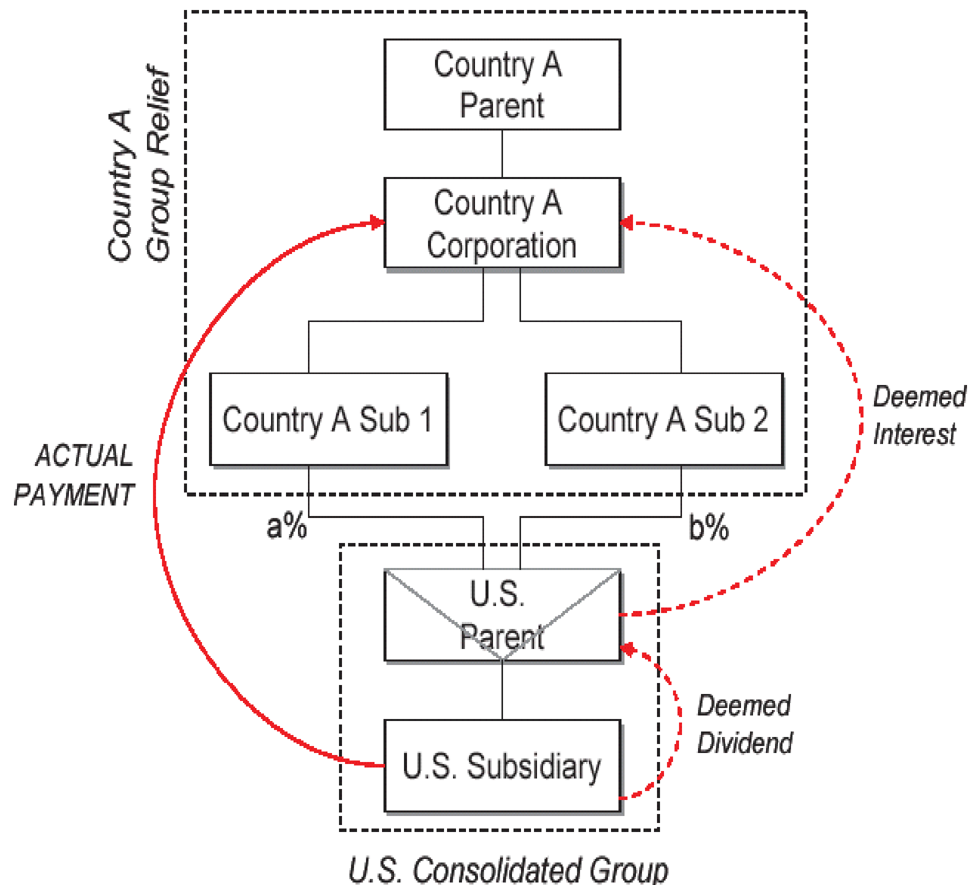
the U.S. and under the law of the foreign jurisdiction. Further, under the present facts the applicable Treaty permitted a reduction in U.S. withholding tax if the interests were beneficially owned by a resident of Country A entitled to the benefits of the Treaty.

Finally, as a result of the findings under Treas. Reg. Sections 1.8941(d)(2)(ii)(B)(1)(i) and (ii), Treas. Reg. Section 1.894-1(d)(2)(ii)(B)(1)(iii) applied to treat the deemed interest payments from U.S. Parent to Country A Corporation as dividend distributions within the meaning of Section 301(a). As a result, U.S. Parent's interest expense deduction was disallowed. In addition, the Service ruled that because the applicable Treaty imposed a withholding tax on dividends paid by a U.S. corporation, the deemed dividend payments by U.S. Parent to Country A Corporation were subject to U.S. withholding tax.

Implications

The IRS found that the secured financing arrangement at issue in ILM 200645018 fits within Treas. Reg. Section 1.8941(d)(2)(ii)(B), resulting in a recharacterization of the deemed interest payments as dividend payments. It appears that this is the first time that the IRS has applied Treas. Reg. Section 1.894-1(d)(2) in published guidance. More important, the IRS in this ILM has taken the position that Section 894 may be applied to a transaction as recast pursuant to the substance-over-form doctrine. Moreover, this memorandum confirms that for purposes of applying the provisions of Treas. Reg. Section 1.894-1(d)(2)(ii)(B), the secured financing arrangement should be characterized under the principles of U.S. law rather than the law of the foreign jurisdiction where the entity receiving the payment (whether deemed or actual) is located.



[1]The Service assumes that the transactions at issue were appropriately treated as a secured financing.

[2]The parties subsequently undertook a reorganization whereby a U.S. holding company was inserted into the organization and treated as owning the Preferred Share instead of U.S. Parent. Thus, following the reorganization, the direct payments from U.S. Subsidiary to Country A Corporation with respect to the Preferred Share would be treated as deemed dividend payments from U.S. Subsidiary to U.S. HoldCo, rather than the DRH, followed by deemed interest payments from U.S. HoldCo to Country A Corporation. Therefore, following the reorganization, there were no longer actual or deemed payments to or from a DRH. As a result, the discussion in the memorandum is not applicable to those payments made pursuant to the secured financing arrangement after the reorganization.

[3]Treas. Reg. Section 1.894-1(d)(2)(i) defines a domestic reverse hybrid entity as "a domestic entity that is treated as not fiscally transparent for U.S. tax purposes and as fiscally transparent under the laws of the interest holder's jurisdiction, with respect to the item of income received by the domestic entity."

[4]Treas. Reg. Section 1.8941(d)(2)(ii)(B)(1)(i) provides that in general, if "a domestic entity makes a payment to a related domestic reverse hybrid entity that is treated as a dividend under either the laws of the United States or the laws of the jurisdiction of a related foreign interest holder in the domestic reverse hybrid entity, and under the laws of the jurisdiction of the related foreign interest holder in the domestic reverse hybrid entity, the related foreign interest holder is treated as deriving its proportionate share of the payment under the principles of paragraph (d)(1) of this section; and . . ."

[5]Treas. Reg. Section 1.8941(d)(2)(ii)(B)(1)(ii) provides that "[t]he domestic reverse hybrid entity makes a payment of a type that is deductible for U.S. tax purposes to the related foreign interest holder or to a person, wherever organized, the income and losses of which are available, under the laws of the jurisdiction of the related foreign interest holder, to offset the income and losses of the related foreign interest holder, and for which a reduction in U.S. withholding tax would be allowed under an applicable income tax treaty; then . . ." ❑

DCL *(from page 3)*

the current regulations) that contain the caption, Election under § 1.1503-2(g)(1) to Use Dual Consolidated Loss of a UK Permanent Establishment under U.S./UK Competent Authority Agreement" and provide some information and representations in addition to those required under the current DCL regulations. Such representations include a representation that the DCL of the taxpayer's UK permanent establishment is eligible for relief under the G-1 Agreement and that the taxpayer agrees to notify both the U.S. and UK competent authorities in the event that a triggering event occurs. In addition to providing a modified (g)(2)(i) agreement with the taxpayer's timely filed U.S. federal income tax return for the year in which the loss is incurred, an electing taxpayer must provide a copy of the modified (g)(2)(i) agreement to both the US and UK competent authorities by the deadline for the taxpayer's US federal income tax return for that year.

Annex A to the G-1 Agreement also provides special rules for taxpayers who wish to elect relief under the G-1 Agreement for DCLs that were incurred in open tax years for which the deadline (including extensions) for the taxpayer's U.S. federal income tax return for such year is on or before January 4, 2007. These rules allow taxpayers to make elections under the G-1 Agreement by amending their tax returns for the relevant year, provided such amendments are filed on or before the due date of the taxpayers' U.S. federal income tax return due for the first tax year ending after January 4, 2007. The G-1 Agreement also affords potential relief under section 9100 and Notice 2006-13, 2006-8 I.R.B. 496, under certain circumstances to taxpayers intending to elect relief under the G-1 Agreement, but whose filings under the G-1 Agreement were not timely.

Annex B to the G-1 Agreement provides similar rules and conditions to taxpayers electing relief under the agreement to reduce the taxable income of UK affiliates.

The G-1 Agreement provides that any reference to the law of a Contracting State includes any successor provisions to such law provided that such provisions are not "materially inconsistent" with the G-1 Agreement. The G-1 Agreement expressly provides that the May 2006 proposed DCL regulations, when finalized, will be treated as successor provisions that are not materially inconsistent with the G-1 Agreement.

The G-1 Agreement may be terminated only by joint agreement of the competent authorities prior to January 1, 2012. After 2011, either competent authority may unilaterally terminate the agreement by providing written notice to the other competent authority three months in advance of the actual termination date.

This article and the comments contained therein do not constitute legal advice or formal opinion, and should not be regarded as a substitute for detailed advice in individual cases. ❑

JAPAN

The Battle Over Treatment of Intercompany Services by Japan and U.S. Tax Authorities

by Steven D. Harris, Makoto Nomoto and Barbara J. Mantegani (KPMG)

Some taxpayers liken tax authorities to the larger-than-life creatures from the days of black and white movies: imposing, capable of causing accidental destruction and woefully out of touch with the way the world actually operates. But in the world of multinational transfer pricing, both the Japanese and the U.S. governments have become thoroughly modern in recent years. Their focus has shifted from tangible goods transactions to intercompany services—the engine driving the global economy—which present the most challenges and opportunities for taxpayers and tax authorities alike.

July's new regulations issued by the Internal Revenue Service (IRS) governing cross-border services transactions generated numerous articles and observations seeking to understand their implications and provide compliance advice. This article takes a somewhat different tack by looking at how the tax authorities of two of the world's largest economies—Japan and the United States—have approached the subject. Let's begin with the Japanese perspective.

Japan's View on Intercompany Services

Japanese multinationals' business operations have rapidly expanded into new parts of the world in the last several years. Particularly, due to the pressure to cut costs, many Japanese companies relocated manufacturing facilities to other Asian countries such as China, Thailand, or Vietnam. As the manufacturing sites shift offshore, the Japanese companies engage in more "out-out" transactions, which mean that goods manufactured outside of Japan are sold directly to markets outside of Japan, bypassing the Japanese headquarters (e.g., a Chinese manufacturing subsidiary selling goods directly to a U.S. distribution subsidiary). Consequently, the Japanese government has become very concerned about the resulting loss of tax revenue and responded to the situation in a number of ways.

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First, the National Tax Agency (NTA) of Japan revised the Transfer Pricing Administrative Operation Guidelines (TPAOG) in June 2002 to add a new section regarding treatment of intercompany services, which requires Japanese companies to collect more service fees from overseas subsidiaries. While the new section in the TPAOG only provided general principles and left actual application to the field's discretion, it listed specific examples of headquarter functions for which Japanese companies should seek compensation from their overseas subsidiaries. Examples cited in the TPAOG included:

The IRS has the right to impute contractual terms in the absence of a written agreement between the parties.

- corporate planning and coordination
- budgeting and control
- accounting, tax, legal, management and collection of debts
- operation, maintenance and administration of IT system
- cash flow management and liquidity control
- funding and fund management
- foreign exchange and interest rate risk management
- manufacturing and purchasing logistics and marketing support
- hiring and training of employees

Although not specifically mentioned in the NTA guidelines, it is our understanding that, from an enforcement perspective, the NTA is not only requiring that these costs be charged out, but that they be charged out with a markup. The concept of a "cost safe harbor," which allows intercompany services costs to be charged out with no markup, does not appear to exist. This presents challenges for U.S. taxpayers, where cost-based charge-outs have been accepted for many years, and where in the case of cross-charges the IRS might be skeptical about outbound payments that always include a markup, when the taxpayer has elected to use the SCM for inbound payments.

Second, in 2003, the Japanese government enacted a new law permitting application of the Transactional Net Margin Method (TNMM). Like the Comparable Profits Method (CPM) used in the U.S., TNMM is a transfer pricing method that examines adequacy of profit level of the entity engaged in related party transactions by reference to profitability of companies with similar functions. This move by the Japanese government surprised some because the Japanese government historically had taken a very strong position against application of CPM by the U.S. However, reportedly, the Japanese government decided to adopt TNMM in order to disallow excess profits of Japanese companies' overseas subsidiaries by testing their profitability against that of local comparable companies. Thus, for example, if a Japanese company's manufacturing subsidiary in Thailand is making higher profits than comparable Thai manufacturers, the NTA may deem service fees and royalties paid by the subsidiary to the Japanese parent to be insufficient.

Notably, while the main targets under the new TNMM regime appear to be Japanese companies' transactions with their manufacturing subsidiaries in Asian countries, their transactions with subsidiaries in the U.S. may also be subject to potential adjustments if the U.S. subsidiaries are earning relatively high profits. U.S. subsidiaries of Japanese companies should be very cautious about the results of the U.S. contemporaneous documentation study showing profits above the inter-quartile range, as the NTA agents are aware of the U.S. contemporaneous documentation requirement and often ask for the study prepared for U.S. purposes.

Finally, during 2006, the Japanese government again revised the TPAOG to clarify and expand its policy regarding intangibles. According to the revised guidelines, the scope of the NTA examinations on intangibles now includes not only technology-based intangibles such as patents or trade secrets but also human resources-based intangibles such as workforce with certain know-how or ability and organization-based intangibles such as business processes or business network. Also, in evaluating allocation of profits generated by intangibles, the revised guidelines direct the NTA agents to consider not only the legal ownership but also the level of contributions made by each related party in creating, maintaining, and improving the intangibles by inquiring who made the decisions, who performed the services, who bore the costs, and who managed the risks. The revised guidelines specifically note that "mere bearing of costs alone may be viewed as a low-level contribution where high profits are expected." Further, the revised guidelines provide that, where there is no formal agreement regarding the use of intangibles, intercompany pricing would be tested based on an imputed agreement—an approach similar to the one adopted by the new U.S. temporary regulations as discussed later.

From an enforcement perspective, the NTA apparently is intensifying transfer pricing examinations. Between the fiscal year ended June 30, 2004 and the fiscal year ended June 30, 2005, while the total amount of all transfer pricing adjustments jumped from 75,800 million yen (approximately $700 million) to 216,800 million yen (approximately $1,961 million), the amount of transfer pricing adjustment per case also more than doubled from 1,220 million yen (approximately $11.3 million) to 2,640 million yen (approximately $23.9 million). A major portion of the large increase, as reported in the press, appears to be attributable to the cases involving intercompany services and intangibles.

Given the fact that the Japanese government is as much concerned about inter-company services and intangibles as the U.S. government, Japanese companies operating in the U.S. face unique challenges. For example, while the Japanese parent may try to collect more service fees and royalties from the U.S. subsidiary to comply with the NTA requirements, the subsidiary must carefully consider whether such payments would be justifiable under the new U.S. rules. Accordingly, Japanese multinationals operating in the U.S. must analyze the new U.S. temporary regulations and the NTA policies and try to develop an approach that is

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acceptable under both regimes, which in some cases may be a daunting task.

U.S. Regulations on Services Transactions

A quick summary of the new U.S. regulations is necessary to be able to identify the potential issues that may arise from a U.S.-Japan compliance standpoint.

On July 31, 2006, the IRS issued a set of rules governing intercompany services and intangibles, which replaced rules that had been in effect since 1968. The new rules go into effect on January 1, 2007, and will require taxpayers to closely scrutinize all of their intercompany services transactions, as well as their intercompany transactions involving intangibles. These rules follow on the Japanese NTA's guidelines regarding services transactions issued in 2002 and discussed previously in this article, and could lead to some very practical difficulties for companies attempting to comply with both sets of rules. The following discussion highlights a few of these difficulties from the U.S. perspective.

Services Cost Method—Basic Rules

To put the following discussion into context, a few of the basic rules set forth in the new regulations should be noted here, the most significant of which is the establishment of a new specified method, the Services Cost Method (SCM), which allows covered services (as defined in the regulations) to be charged out at cost without a mark-up.

To be a "covered service" the service must meet several criteria:

- First, the service must either be specifically identified in an annual Revenue Procedure issued by the IRS, or must be a service for which the median comparable markup on total services costs is less than or equal to seven percent. Among the services identified in the initial revenue procedure (released by the IRS through an announcement issued shortly after the regulations themselves) are those typically referred to as "back office" or "headquarters" services, e.g., accounting services, data entry, human resources, public relations and computer network support.
- Second, the service must not be an "excluded transaction" as defined in the regulations. Among those transactions are manufacturing, distribution, and research and development.
- Finally, for services to be covered services, the taxpayer must reasonably conclude, in its business judgment, that the services do not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in either the renderer or the recipient's business ("core services").

Cross-border Challenge

On the one hand, allowing services that might attract a mark-up to be charged out at cost could be seen as favorable to service recipients outside of the U.S., and it is unlikely that the NTA would challenge payments made by a Japanese affiliate for services received from a U.S. affiliate.

On the other hand, although not specifically mentioned in the NTA guidelines, it is our understanding that the NTA is requiring that costs incurred in Japan be charged out with a markup. The concept of a "cost safe harbor" found in the U.S. regulations, which allows low margin or back office types of intercompany services costs to be charged out with no markup, does not appear to exist in Japan.

From a U.S. perspective, if a U.S. affiliate elects to use the SCM for the covered services it charges out to affiliates, and yet is charged a mark-up on similar services provided by the Japanese affiliate, there is a risk that the IRS would refuse to allow the U.S. taxpayer to elect the SCM and would require the covered services to bear an arm's length markup. Although it is still unclear how these issues might ultimately be resolved, taxpayers are well-advised to apply a consistent approach for both inbound and outbound services charges.

Taxpayers may use SSAs only for covered services, i.e., low-margin services or services that are not core services.

Stewardship Expenses

Under both the current and the new U.S. regulations, a service renderer is only required to charge for intercompany services if it provides a benefit to a group of controlled entities or to a specific member of a controlled group. Looking specifically to shareholder-related or "stewardship" activities, the new regulations conclude that the benefit test is not met where the sole effect of the activity is either to protect the renderer's capital investment or to facilitate compliance with legal requirements, or both. This definition of shareholder activities is much narrower than the definition in the current rules, which refer simply to expenses "associated with" the issuance of stock and maintenance of shareholder relations.

Cross-border Challenge

This part of the new regulations is particularly important because it relates to the amount of a cost pool (cost base) that must be charged-out, not just the markup that might be applied. Adjustments to the cost base are often multiples of any adjustment to a markup. Consider the following example. Company P is a U.S. multinational with $100 million of U.S. headquarters expenses. Company P's consolidated revenue is 50 percent from U.S. operations and 50 percent from foreign operations. Historically, Company P has charged out $20 million of its U.S. headquarters' costs to its foreign subsidiaries, based on an analysis that identified $50 million of the headquarters expense as related to U.S. operations and $30 million as stewardship.

The IRS may look at Company P's headquarters charge-out policy and question whether the amount to be charged out should be closer to 40 percent of the $100 million total costs, given that 50 percent of the consolidated revenue is

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foreign and the narrower stewardship definition in the new regulations suggests that only $10 million of the headquarters expense is stewardship. An adjustment of $20 million would certainly be important as compared with imposing a cost-plus markup to the current cost base of $20 million. The NTA, on the other hand, could reject the increased costs and deny the Japanese affiliate the deduction for the increased expense.

Taxpayers that have historically managed their intercompany transactions without formal agreements may want to memorialize their relationships with affiliates in writing.

Further, where the headquarters expenses are incurred by a Japanese parent and charged out to the U.S. subsidiary, the IRS might seek to disallow some portion of the inbound charges as stewardship. Either case could lead to potential double taxation that would require Competent Authority assistance to resolve.

Contractual Terms

While a contractual relationship between controlled parties will be respected if it is consistent with economic substance, the IRS has the right to impute contractual terms, consistent with economic substance and based on all the facts and circumstances, in the absence of a written agreement between the parties. Similarly, the NTA strongly encourages the creation of an explicit written agreement, and will impute contractual terms and test intercompany transactions against an imputed agreement where the parties have no written document that describes their relationship.

Cross-border Challenge

If a U.S. subsidiary provides contract research and development (R&D) services to a Japanese recipient (which will own the resulting intangibles), but the markup on those services is below an arm's length range, the IRS may make an adjustment to bring the results into the arm's length range, but may not recharacterize the transaction as something other than contract R&D and impute ownership of the intangibles to the service provider as long as the parties have a clear contractual agreement and the economic substance of the transaction is consistent with that agreement. However, if there is no agreement between the parties, either the IRS or the NTA could attempt to recharacterize the transaction in inconsistent ways. The IRS might argue that the under-compensation of the service provider means that the resulting intangibles are actually owned by the service provider and not the recipient, and the Japanese affiliate should be charged a royalty. The NTA might argue that while the mark-up might need to be increased, the economic substance of the relationship is that the resulting intangibles are, in fact, owned in Japan because the Japanese affiliate made key decisions, borne risks, directed the R&D, paid for all the costs, and is the legal owner of the resulting intangible.

Shared Services Arrangements

The new U.S. regulations include a welcome provision that gives taxpayers the opportunity to enter into Shared Services Arrangements (SSAs) regarding covered services eligible for the SCM. In general, a SSA must:

- include one or more participants;
- include all the controlled taxpayers that reasonably anticipate a benefit from one or more specified covered services; and
- be structured such that each covered service (or reasonable aggregation) confers a benefit on at least one participant in the SSA.

The SSA rules also include some documentation requirements. To establish a SSA the taxpayer must maintain:

- a statement that the taxpayer intends to apply the SCM to evaluate the arm's length charge for the covered services;
- a list of participants and the renderer or renderers of the covered services;
- a description of the allocation key, which must be consistent with each participant's expected share of reasonably anticipated benefits; and
- a description of an aggregation of covered services for purposes of the SSA.

Taxpayers may use SSAs only for covered services, i.e., low-margin services or services identified in the annual IRS revenue procedure, which are not core services. The aggregation rules in particular could relieve taxpayers of some of the administrative burdens associated with charging out multiple types of services using different allocation keys.

Cross-border Challenge

The potential taxpayer benefit to the SSA in the U.S. must be tempered with the potential that this mechanism might not be accepted by another tax authority. Lack of acceptance by the NTA could be driven by the fact that, if the services are provided by Japan, they may not be marked up in a SSA environment. If the aggregated services are provided for the benefit of Japan, the NTA could disallow deductions for payments made under a SSA because:

- they lack an acceptable level of precision;
- they are based on allocation keys with which the NTA does not agree; or
- the charge includes costs associated with services for which the Japanese affiliate did not receive a specific benefit.

Conclusion

In light of the extensive changes in the U.S. regulations and the fact that the regulations have a delayed effective date of January 1, 2007, taxpayers with U.S.-Japan intercompany services have an opportunity to examine their own facts and circumstances to determine how best to achieve compliance in both countries. Taxpayers that have historically managed

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their intercompany transactions without formal agreements in place may want to consider memorializing their relationships with affiliates in writing, and avoid the risk that the IRS and/or the NTA will step in and impute provisions that are undesirable.

Further, while uncertainties remain with respect to how particular transactions will be viewed by both governments, it is important that taxpayers carefully survey all U.S.-Japan intercompany transactions. A systematic approach to manage cross-border intercompany services between the two systems would start with these steps:

- survey all cross-border intercompany services transactions where a benefit is conveyed on one or more parties;
- determine which transactions are material, i.e., that present the highest risk of potentially significant adjustments;
- determine which transactions consist of shareholder or stewardship type services, which cannot be charged out;
- determine which material transactions are already subject to written intercompany agreements. If no written agreement exists, one should be prepared. If a written agreement exists, it should be reviewed to determine its current relevance.

The information contained herein is general in nature and based on authorities that are subject to change. Applicability to specific situations is to be determined through consultation with your tax adviser. The views and opinions are those of the authors and do not necessarily represent the views and opinions of KPMG LLP. ❑

NETHERLANDS

Proposals Designed to Make Dutch Corporate Income Tax Regime More Competitive

by Eric van der Stoel, Hans Drijer and Jos Hellebrekers (Otterspeer, Haasnoot & Partners)

Introduction

On October 3, 2006, the Lower House of Dutch Parliament passed the 2007 Corporate Income Tax Reform Bill (2007 Bill). The Upper House of Dutch Parliament is currently reviewing the 2007 Bill and it is expected that it will pass the 2007 Bill prior to year end. The Upper House cannot amend the 2007 Bill, but Upper House discussions may lead to more detailed explanations. The intended effective date is January 1, 2007.

The object is to make the Dutch corporate income tax (CIT) system more competitive and to make its legislation more "EU proof." Rates are reduced but the tax base is broadened.

The Proposals

Corporate Income Tax

CIT rates will be reduced, introducing the following scale (current top rate: 29.6 percent).

Taxable amount	Percentage
< € 25,000	20.0 percent
€ 25,000 - € 60,000	23.5 percent
> € 60,000	25.5 percent

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Dividend Withholding Tax

The dividend withholding tax rate will be reduced to 15 percent (current rate: 25 percent).

For qualifying EU parent companies, a 5 percent threshold in a qualifying Dutch subsidiary company will be sufficient to benefit from a full exemption of the dividend withholding tax (instead of the current 20 percent threshold).

The changes are designed to make the Dutch tax system more competitive.

Tax exempt EU funds, which are comparable to Dutch exempt funds (e.g., Dutch pension funds), will also be entitled to a refund of Dutch dividend withholding tax.

Group Interest Income

In order to make the Netherlands more attractive for group financing activities, the so-called Group Interest Income Box is introduced. At request of the company, an effective 5 percent CIT rate will apply to the net group interest income of a company (broadly, the difference between interest income and interest costs for loans granted to or taken up from group companies). Positive net group interest income is taken into account only insofar as it does not exceed a certain percentage (at present: 4.25 percent) of the average equities of the company at the beginning and the end of the book year. The relevant net group interest income includes

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proceeds of short term investments held for the intended acquisition of subsidiaries, as well as costs (except for currency results) regarding intercompany loans. In order to avoid abuse, all Dutch companies belonging to the group must file a request for this tax regime, and the minimum period for which the regime applies is three years.

As this measure (and also the Patent Box discussed below) is generally applicable, it should not be a form of state aid prohibited by the EC Treaty. Nevertheless discussions with the Commission of the EU are taking place, as a result of which it is expected that the effective date will

The tax on interest income from intercompany loans has been reduced to 5 percent.

be January 1, 2008 instead of January 1, 2007 for both the Group Interest Income Box and the Patent Box.

Reduced Tax on Income from Patents

In order to stimulate innovation, a so-called Patent Box is introduced to stimulate development of intangible assets.

If opted for the Patent Box, an effective 10 percent CIT rate will apply to the net income—proceeds less amortization and other related costs—for such patents. If not opted for the Patent Box, companies are no longer required to capitalize their development costs as part of the cost price of such intangibles, but instead can fully deduct the development costs.

If opted at a later stage, the Patent Box will apply only from the moment when earlier deducted development costs have been compensated by the income arising from the Patent.

In order to avoid abuse and to some extent lengthy discussions, qualifying net income subject to the low tax rate, is limited to four times the development costs and costs for further improvement.

Participation Exemption

The number of requirements under which a Dutch parent company can claim the participation exemption (i.e., a full exemption of dividends and capital gains realized with a qualifying shareholding) is reduced to two:

- the participation should have a capital divided in shares;
- the shareholding must be at least 5 percent or more of the nominal paid up share capital of the subsidiary.

At present a shareholding of less than 5 percent may also qualify for the participation exemption. Under the proposals, shareholdings of less than 5 percent will no longer qualify. However, if a shareholding of 5 percent or more, which is held for at least one year, drops below the 5 percent, the participation exemption remains applicable for a maximum of three years.

Furthermore, the current subject to tax test and the non-passive portfolio investment are abolished and replaced by a new requirement. The participation exemption will not apply to a shareholding in a "low taxed passive portfolio subsidiary." This is a company that *(i)* is a passive portfolio subsidiary and *(ii)* is subject to an effective CIT rate of less than 10 percent. In such cases, double tax relief is not given by way of the participation exemption but instead by way of a tax credit system. A passive portfolio subsidiary is a company the assets (including attributed assets of direct and indirect participations) of which consist of more than 50 percent of passive portfolio investments. Unless an exception applies, group financing is generally deemed to be passive as well as other forms of making assets available within a group of companies. However, a shareholding in a qualifying real estate subsidiary is deemed not to be a shareholding in a low taxed passive portfolio subsidiary (i.e., may qualify for the participation exemption even if passive and low taxed).

The possibility of recognizing losses realized upon the finalization of the liquidation (winding up) of a subsidiary remains, notwithstanding the fact that the shareholding qualified for the participation exemption.

Interest on Related-Party Loans

As a result of the introduction of general thin capitalization rules in 2004, the existing specific anti-abuse rules regarding interest deduction became superfluous or unnecessarily complicated. Accordingly, in the proposal, specific rules on hybrid loans are abolished and the rules for loans (artificially) created within a group are streamlined. However, interest on a related-party loan to finance a third party acquisition can be non-deductible under the proposal. Non-deductibility of interest on related-party loans can be avoided if *(i)* the interest is effectively subject to at least a 10 percent CIT at the level of the recipient, or *(ii)* there is a sound business reason for the transaction and the loan conditions are at arm's length.

Broadening the Tax Base

Reduction of the CIT rates is largely compensated by the following measures to broaden the tax base:

- annual depreciation period of fixed assets may not be more than 20 percent;
- annual amortization of goodwill may not be more than 10 percent;
- depreciation of real estate used in an enterprise of the company or a related company stops where the book value would drop below 50 percent of the (fair market) value determined for real estate tax purposes;
- depreciation of real estate used as passive portfolio investment stops where the book value drops below 100 percent of the (fair market) value determined for real estate tax purposes;
- compensation of tax losses will be limited to one year carry back and nine years carry forward;
- companies which have granted stock options to employees are not able to deduct employment costs when these options "vest." ❑

UK REITs—The Wait is Almost Over

by Adrian Levy and David Saleh (Clifford Chance)

Introduction

It is often said that "good things come to those who wait." This certainly seems to be true for the UK real estate industry. For years it has been lobbying the government for a liquid UK tax transparent vehicle and finally its patience has paid off. After extensive consultation legislation has been passed, in the form of the Finance Act 2006, that will see Real Estate Investment Trusts (REITs) enter the UK property scene as soon as January next year. These REITs will be exempt from UK corporation tax on rental income and capital gains, provided an entry charge is paid and certain conditions satisfied.

The UK is not exactly trail-blazing. The U.S. and Australia have a well-established REIT market. The first U.S. REITs came to market in the 1960s with the market really taking off in the 1990s. The U.S. listed market now comprises approximately 195 REITs with a market value of circa $380 billion, while the Australian market comprises 53 REITs (known as listed property trusts) with a market value of circa A$104bn. Other jurisdictions also have REITs (or equivalent offerings) including Japan, France, Spain, Italy, Belgium, the Netherlands, Luxembourg, Turkey and some of the countries in Asia and the Pacific.

Many are speculating that REITs will change the face of the UK listed real estate sector, which in recent years has seen scores of companies taken private as share prices failed to reflect net asset value. Some anticipate that the advent of REITs will result in this sector doubling to over £100 billion in the next five years, with new listed companies coming to market and existing companies converting.

REIT Conditions

So what are the conditions that would allow a company to become a UK REIT? Broadly speaking the entity will need to be:

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- a company that is closed-ended (i.e., not an OEIC) with only one class of ordinary shares in issue (although non-voting fixed rate preference shares will also be permitted);
- tax resident in the UK and not dual tax resident in the UK and another jurisdiction; and
- listed on a recognized stock exchange, which in the context of the UK means the Official List (and not the Alternative Investment Market), but could also be certain overseas exchanges such as NASDAQ, the Luxembourg Stock Exchange, the Irish Stock Exchange and others.

Property development companies will not be eligible for REIT status.

The entity must not be:

- a "close company" (which is basically defined for tax purposes as a company that is controlled by five or fewer participants); or
- a party to a loan that carries profit linked, asset linked or excessive interest or that provides for repayment of an excessive amount.

The REIT will also need to satisfy certain conditions in relation to its business activities. It will need to:

- hold at least three properties, with no single property exceeding 40 percent of the fair value of the properties. For these purposes a property is treated as a single property if it is going to be rented out as a single unit, so, by way of example, a shopping center would not be treated as one property—it would be treated as multiple properties. Any property occupied by the REIT will not count;
- derive at least 75 percent of its income from property rental. As a result of this condition property development companies will not be eligible for REIT status;
- hold 75 percent (in value) of its assets for property rental business. This is another reason why property development companies will not be eligible for REIT status; and
- distribute 90 percent of income profits (computed under tax not accounting rules) to shareholders annually. This is to be distributed by way of dividend (subject to any corporate law prohibitions).

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Furthermore, once a company has become a REIT there are two key limitations which, if breached, will result in it paying a "tax charge." First, if the REIT's gearing results in it exceeding the ratio of income profits of the tax-exempt business (before financing costs and capital allowances) to interest of 1.25, then there will be a tax charge on the amount of profit that causes the ratio to be exceeded. Second, if a person is beneficially entitled to 10 percent or more of the share capital, voting power or dividend entitlement of a REIT, and a dividend is paid to such shareholder, then a tax charge can be levied on the REIT.

There has been some concern in relation to the 10 percent shareholder rule which, although it covers all shareholders, is only intended to prevent significant overseas shareholders claiming double tax treaty relief and thereby reducing the Treasury's take. In response to these concerns, the Treasury has clarified that a REIT may avoid the penalty if it takes "reasonable steps" to prevent paying a dividend to a substantial shareholder. Guidance Notes are expected on what will constitute these reasonable steps. The practical effect of the 10 percent shareholder rule is that significant shareholders will have to dividend strip and sell down their dividend entitlement. This will be inconvenient and add an additional cost to substantial shareholders. The 10 percent shareholder rule will also increase the compliance burden on property investment companies.

Elective Process

A company does not automatically become a REIT. The company must serve a written notice on the UK Tax Authority (HMRC) before the beginning of the accounting period from which it wants to be treated as a REIT. REIT status generally continues (provided the "conditions relating to the company" are met) until the company serves a further written notice on HMRC terminating REIT status.

HMRC will however have the power to issue a notice disapplying REIT status from the end of a previous accounting period where the REIT has made repeated or serious breaches of the "conditions relating to the business" or has embarked on repeated or serious attempts at tax avoidance.

Entry Charge

Throughout the consultation process the Treasury has made it clear that it expects a fair level of taxation to continue to be paid by the real estate sector. So to achieve REIT status a company will need to pay an

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entry charge that will be collected in the same way as UK corporation tax. The entry charge will be 2 percent of the gross market value of the rental properties held by the REIT. The entry charge will be payable when a company elects to become a REIT although, at an increased overall cost, payment of the charge could be spread over four years (at the rate of 0.50 percent, 0.53 percent, 0.56 percent and 0.60 percent). If a REIT acquires a company that owns a property, a further entry charge will be payable based on the value of the property indirectly acquired.

Exit Charge

As well as an entry charge there can be financial implications on leaving the REIT regime which could be characterized as an "exit charge." When a company elects to leave the REIT regime within 10 years of joining, and disposes of any property which was involved in its tax exempt business within two years of leaving, financial consequences may follow. Broadly, any uplift in the base cost of the property which occurred under the regime will be disregarded, which could potentially result in a higher capital gain or lower allowable loss than would otherwise be the case. In addition there will be no rebate of the entry charge in such cases.

Also, if a company leaves the REIT regime involuntarily within 10 years, HMRC have wide powers to direct how they are to be taxed, including in relation to the period during which they qualified as a REIT. HMRC's intention is to prevent companies from attaining a tax advantage by deliberately breaching a condition (for example by crystallizing a tax loss in a non tax-exempt environment).

Market Reaction

The UK real estate sector has reacted positively to the proposed REIT regime. Many of the concerns that existed a year ago have been put to rest and there is overwhelming relief that the entry charge was not pitched at a higher level or based on a percentage of contingent capital gains. On the day the draft legislation was announced, the share price for the listed real estate sector rose by approximately 10 percent. Since then a number of listed companies have stated that subject to reviewing the regulations and understanding the detailed risks, they will convert to a REIT. Such companies include some of the largest UK listed property companies, such as British Land plc, Land Securities plc and Hammerson plc.

The regime has also provided land rich companies with food for thought. Some of the largest retailers, hoteliers and leisure companies have been looking at the structure and considering whether to spin off their property assets into REITs as an alternative to sale and leaseback arrangements that have been so popular over recent years. Whether this route will prove useful will depend, in part, on a company's willingness to relinquish control of its property, and finding ways around the restriction that a REIT may not be owner-occupied (as defined by accounting standards) or occupied by a company whose shares are "stapled" to a REIT.

The new REIT regime is also being considered by the private equity market as an additional structure for realizing the real estate value of an investee company. Currently, private equity players in the UK make good use of the PropCo-OpCo structure, where the property ownership and operational activities of a company are separated into two entities with the property owning company (the PropCo) ultimately being securitized or joint ventured. REITs could add a new dimension to this structure with a REIT taking the place of the PropCo.

Conclusion

Not withstanding the enthusiasm with which REITs have been greeted in the UK, they are not without certain drawbacks. REITs will need to be listed on a recognized stock exchange and so will need to be broadly held and suffer the associated cost and regulatory burden. There are technical difficulties with dividends from overseas subsidiaries not being tax exempt REIT income and the 10 percent shareholder rule is, at best, inconvenient. However, listed REITs will be an on-shore vehicle that is a welcome addition to some of the other existing tax transparent property owning structures. ❑

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