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Recent Internal IRS Guidance Regarding Economic Substance Doctrine

In July 2011, the Large Business and International Division of the IRS issued an internal directive (the “Directive”) setting forth the process examiners should follow when determining whether to apply the economic substance doctrine to challenge a transaction.¹ In setting forth the process to be followed, the Directive also provided some insight into when the economic substance doctrine, as codified, may be applicable.

In 2010, Congress codified the economic substance doctrine. Section 7701(o) applies to any transaction where the economic substance doctrine is relevant and provides that a transaction lacks economic substance if either (i) the transaction does not meaningfully change the taxpayer’s economic position (apart from federal income tax effects) or (ii) the taxpayer does not have a substantial purpose (apart from federal income tax effects) for entering into the transaction. Whether the economic substance doctrine is

relevant is determined as if section 7701(o) was not enacted. The taxpayer is subject to a strict liability penalty equal to 40% of any underpayment attributable to a transaction that either lacks economic substance or fails under any similar rule of law.² The penalty is reduced to 20% of the underpayment if the taxpayer disclosed the transaction.³

Pursuant to the Directive, an examiner must first determine whether the economic substance doctrine applies to a transaction. Second, the examiner must determine whether the economic substance doctrine is the best method to challenge the transaction. Finally, the examiner must seek the approval of the appropriate director of field operations in order to apply the economic substance doctrine.

What is a “transaction”?

The Directive provides limited guidance on what constitutes a “transaction.” According to the Directive, generally the transaction includes all related steps taken together, but it may be appropriate to apply the economic substance doctrine separately to an individual step if the individual step is a tax-motivated step bearing only an incidental relationship to the single common business transaction. Thus, the fact the transaction, as a whole, has economic substance may not provide cover for individual steps inserted into the transaction for tax reasons.

Is the Economic Substance Doctrine Appropriate?

The examiner should determine whether the economic substance doctrine is appropriate by examining the facts and circumstances surrounding the transaction. In making this determination, relevant facts include whether the transaction: (1) is promoted or developed by the tax department or outside advisors; (2) includes unnecessary steps; (3) has significant risk of loss; (4) is pre-packaged; (5) accelerates a loss or duplicates a deduction; or (6) separates income from a related deduction. Furthermore, the Directive provides that the economic substance doctrine is likely inappropriate if the transaction involves the decision to finance operations using debt instead of equity, to invest abroad using a foreign entity instead of a domestic entity, or to utilize a related party.

Is the Economic Substance Doctrine the Best Method to Challenge the Transaction?

If, after examining these relevant facts, the examiner believes the economic substance doctrine is appropriate, then the examiner should determine whether the economic substance doctrine is the best method to challenge the transaction. The Directive asks the examiner to answer seven questions:

- 1) Is the transaction a statutory or regulatory election?
- 2) Is the transaction subject to a detailed statutory or regulatory scheme?
- 3) Has either a judicial decision or IRS guidance upheld a substantially similar transaction (regardless of whether the precedent discusses the economic substance doctrine)?
- 4) Does the transaction involve tax credits?

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- 5) Is a different judicial doctrine, such as the step transaction doctrine, a more appropriate method to challenge the transaction?
 - 6) Does recharacterizing the transaction provide a more appropriate method to challenge the transaction?
 - 7) Is the economic substance doctrine not one of the stronger arguments available to challenge the transaction?

If the answer to any of the questions is “yes,” then the Directive provides that the economic substance doctrine should generally not be asserted. If the answer to all of the questions is “no,” then the examiner should submit a written request to the appropriate director of field operations seeking approval to assert the economic substance doctrine. At this point, the taxpayer should be provided with an opportunity to explain why the economic substance doctrine should not be applied.

What the Directive Adds

The Directive provides some insight into when the IRS will seek to apply the economic substance doctrine to challenge a transaction. The directive strongly suggests that the economic substance doctrine should not be used as a general anti-abuse provision. For example, if the transaction is subject to a statutory or regulatory scheme, these rules should be used to challenge the transaction and not the economic substance doctrine. Similarly, if recharacterizing a portion of the transaction or a different judicial doctrine is a more appropriate method to challenge the transaction, then the transaction should be recharacterized and the economic substance doctrine should not be asserted.

Furthermore, the Directive provides that the IRS will only impose the strict liability penalty for transactions that lack economic substance. The statute provides that the strict liability penalty may be applied to transactions that lack economic substance or that fail to meet the requirements of other similar rules of law. However, according to the Directive, the IRS will not impose the strict liability penalty until after the IRS issues additional guidance concerning what other doctrines may be subject to the penalty.

¹ LB&I Control No.: LB&I-4-0711-015.

² I.R.C. § 6664.

³ *Id.*

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REITs and Carbon Emission Units

The IRS recently provided guidance regarding certain federal income tax consequences that arise when a timber real estate investment trust participates in an emissions trading program where carbon emission units (“CE Units”) are received and/or exchanged in connection with the decision to hold, harvest, plant or replant trees. Specifically, in PLR 201123003 (the “Ruling”), for purposes of the REIT provisions of the Code, the IRS ruled on (i) whether such CE Units qualify as “real estate assets,” (ii) whether any inclusion in gross income¹ upon receipt of such CE Units is considered as “qualifying income,” and (iii) whether the income from the sale of CE Units is considered gain from the sale of real property.²

Background

In the Ruling, T-REIT, a U.S. Corporation that files its U.S. tax returns as a real estate investment trust, is an international forest products company primarily engaged in timberland operation and management. Through various pass-through entities, T-REIT owns a number of acres of timberland and real estate located in a foreign country (“Winterfell”). T-REIT participates in Winterfell’s Emissions Trading Program (the “Program”), a regulatory program designed to create incentives to reduce greenhouse gas (“GHG”) emissions. The Program is premised on the fact that carbon dioxide, one of the GHGs that the Program seeks to reduce, can be temporarily removed from the atmosphere by forests and other woody vegetation. As trees and other vegetation grow, they digest carbon dioxide through photosynthesis; however, once trees are harvested, the carbon dioxide they have stored is returned to the atmosphere. The Program is designed to create incentives for forest owners that harvest trees to plant replacements. Under the Program, the government of Winterfell allocates CE Units, each of which represents one ton of carbon dioxide removed from the atmosphere, to certain forest owners to account for the carbon dioxide their forests have captured. In short, the Program imposes the economic equivalent of a land use restriction on the forest owner by requiring the forest owner to surrender CE Units if it harvests its trees and does not plant sufficient replacement trees. The CE Units serve as an offset for the loss in the value of the forest owner’s land as a result of the restrictions imposed by the Program. Forest owners that are allocated CE Units may (a) hold them for use in future compliance periods or (b) sell them in the local or international markets.

Overview of Relevant REIT Rules

Under the REIT qualification rules, at least 75 percent of the value of the total assets of a REIT must be represented by real estate assets, cash and cash items (including receivables) and Government securities at the close of each quarter of its tax year.³ For this purpose, the term “real estate assets” includes real property and interests in real property.⁴ Further, the term “interests in real property” includes fee ownership, co-ownership and leaseholds of land or

improvements thereon (or options to acquire such).⁵ Moreover, the Regulations provide that “real property” includes land or improvements thereon, such as buildings or other inherently permanent structures and structural components.⁶

In addition, the REIT provisions of the Code contain two tests which require that 95 percent and 75 percent of the gross income of a REIT, respectively, must be derived from various sources of approved passive income.⁷ Such tests include gain from the sale or other disposition of real property (including interests in real property) that is not property described in Code Sec. 1221(a)(1).⁸

Qualification of CE Units as Real Estate Assets

It is a well-established principle of law that growing timber is considered a portion of the real property on which it grows, and the owner of that timber has an interest in so much of the soil as is necessary to sustain it.⁹ Consequently, standing timber is treated as real property for federal income tax purposes. For example, the IRS has held that timber growing on the land is part of the land and that an exchange of timberlands of different qualities nevertheless constitutes a like-kind exchange because both are land held for investment.¹⁰ Accordingly, timberlands and the standing timber thereon constitute real property and, therefore, real estate assets under the REIT provisions.

Although the definitions and examples of “real property” and “interests in real property” provided in the Regulations are not exclusive, the plain language leads to the conclusion that any asset other than the physical real estate itself must be *inextricably tied or connected to the real estate* to fall within either of those definitions. In the Ruling, the CE Units allocated to T-REIT by the Winterfell government were considered intangible assets inextricably linked to the specific stands of growing trees that absorb carbon dioxide. Accordingly, the CE Units were treated as real estate assets for purposes of the REIT provisions.

Allocation of CE Units as Qualifying Income

The Code generally defines gross income as “income from whatever source derived,” except as otherwise provided by law.¹¹ Gross income includes income realized in any form, whether in money, property, or services.¹² This definition encompasses all “accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.”¹³ Generally speaking, the granting of a transferable right by a government does not cause the realization of income.¹⁴ While the Ruling itself does not indicate whether or not allocation of CE Units should be included in gross income, it does provide guidance on the proper classification of the receipt of CE Units “to the extent any amounts are otherwise includible in gross income by reason of the allocation of [CE Units to the taxpayer].”

Code Sec. 856(c)(5)(J) provides that, to the extent necessary to carry out the purposes behind the REIT rules, the Secretary of the Treasury is authorized to determine whether any item of income or gain that *does not qualify* under Code Secs. 856(c)(2) or 856(c)(3) to satisfy the 95 percent and 75 percent REIT gross income tests *nevertheless may be considered as gross income that qualifies* under such tests. The staff of the Joint Committee on Taxation elaborated on such authorization as follows: “[t]he provision authorizes the Treasury Department to issue guidance that would allow other items of income to be excluded for purposes of the computation of qualifying gross income under either the 75 percent or the 95 percent test, respectively, or to be included as qualifying income for either of such tests, respectively, in appropriate cases consistent with the purposes of the REIT provisions.”¹⁵

The legislative history underlying the REIT provisions indicates that the central concern behind the gross income restrictions is that the gross income of a REIT should be largely composed of passive income. For example, H.R. Rep. No. 2020¹⁶ states that “[o]ne of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business.” In describing the 75 percent test, the report states that “[u]nder this test at least 75 percent of the income [of the REIT] must, in one manner or another, be derived from real property.”¹⁷

The Ruling held that this was an appropriate case to invoke the authority granted in Code Sec. 856(c)(5)(J), allowing T-REIT to classify the CE Unit income as qualifying income based upon the relationship of the income to the qualifying assets of the REIT. The income derived from the CE Units was viewed as being inextricably linked to the underlying timberland and standing timber, which are qualifying REIT assets. Moreover, the Ruling held that the income derived from the allocation of CE Units was not based, in whole or part, on the profits or losses of any person or entity and is derived from a source that is inherently passive in nature.

Sale of CE Units as Sale or Other Disposition of Real Property

Based upon the reasoning set forth above, the CE Units were viewed as real estate assets, and income therefrom was classified as qualifying income under the 95 and 75 percent tests. Consequently, the gain from the sale of the CE Units was treated as gain from the sale or other disposition of real property for purposes of Code Secs. 856(c)(2) and 856(c)(3).

Conclusion

As indicated in the Ruling, an asset other than physical real estate itself must be “inextricably tied or connected” to the physical real estate to be viewed as producing qualified REIT income. Absent this heightened connection, the asset at issue is unlikely to qualify as “real property” under the REIT rules. As technology, environmental policy and society at large continue to evolve, this connectivity test will need to evolve. The Ruling is positive evidence that the IRS

will continue to be flexible in its interpretation of “real property” under the REIT rules where appropriate.

¹ Note that the Ruling does not opine on whether or not receipt of such CE Units constitutes gross income but, rather, to the extent such receipt does create gross income, whether such income is properly classified as “qualifying income” under the Treasury’s discretionary authority.

² See, I.R.C. § 856 *et seq.* All section references are to the United States Internal Revenue Code of 1986, as amended (“Code”), and the Treasury Regulations promulgated thereunder (“Regulations”).

³ I.R.C. § 856(c)(4)(A).

⁴ I.R.C. § 856(c)(5)(B).

⁵ I.R.C. § 856(c)(5)(C).

⁶ Treas. Reg. § 1.856-3(d). Under this regulation, “real property” includes, for example, the wiring, plumbing system, HVAC system, elevators or escalators, or other structural components of a building. The term does not include assets ancillary to the operation of a business, such as machinery, non-structural transportation equipment, office equipment, furnishings, etc., even though such items may be termed fixtures under local law. Local law definitions are not controlling for purposes of determining the meaning of “real property” under Code Sec. 856 and the Regulations thereunder.

⁷ I.R.C. § 856(c)(3) & (c)(2) (95 percent and 75 percent tests, respectively).

⁸ *Id.* Code Sec. 1221(a)(1) provides that, for federal income tax purposes, the term “capital asset” means property held by the taxpayer (whether or not connected with the taxpayer’s trade or business), but does not include stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the tax year, or property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer’s trade or business.

⁹ See *Hutchins v. King*, 68 U.S. 53, 59 (1863); *Laird v. United States*, 115 F. Supp. 931, 933 (W.D. Wis. 1953).

¹⁰ Rev. Rul. 72-515, 1972-2 C.B. 466.

¹¹ I.R.C. § 61.

¹² Reg. § 1.61-1(a).

¹³ *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

¹⁴ Rev. Rul. 92-16, 1992-1 C.B. 15 (allocation of air emission rights by the U.S. Environmental Protection Agency does not cause a utility to realize gross income); Rev. Rul. 67-135, 1967-1 C.B. 20 (fair market value of an oil and gas lease obtained from the federal government through a lottery is not includible in income).

¹⁵ Joint Committee on Taxation Staff, General Explanation of the Tax Legislation Enacted in the 110th Congress, 110th Cong., 2d Sess. (2009), 239.

¹⁶ 86th Cong., 2d Sess. 4 (1960) at 6, 1960-2 C.B. 819, at 822-23.

¹⁷ *Id.* at 822.

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Tax Court Disregards Express Allocation of Payments in Fully-Executed, Arm's-Length Settlement Agreement

As a general rule, where damages are received pursuant to a settlement agreement containing an express damages allocation, that allocation will be upheld in determining the tax consequences of an agreement negotiated at arm's length and in good faith.

A recent Tax Court decision, however, serves as a reminder that the settling parties' designation of the settlement proceeds may be disregarded where it fails to reflect the "economic realities" of the underlying claims. See *Healthpoint, Ltd. v. Comm'r*, T.C. Memo 2011-241 (Oct. 3, 2011).

Background/Case Discussion

In *Healthpoint*, the taxpayer, Healthpoint, Ltd. ("Healthpoint"), was a pharmaceutical partnership that manufactured and marketed a successful prescription ointment, Accuzyme. A generic form of Accuzyme was subsequently developed by a competitor, Ethex Corporation ("Ethex"). The generic form marketed by Ethex, however, contained an additional, potentially harmful chemical. Ethex's marketing strategy caused patients and doctors to believe that its drug, Ethezyme, was a generic equivalent of Accuzyme and could be used as a substitute. As a result, after patients began experiencing the negative effects of Ethezyme, doctors did not order Accuzyme in place of Ethezyme because it was marketed as a generic version of Accuzyme, Healthpoint's product.

Healthpoint filed two lawsuits against Ethex. In the first action, Healthpoint brought claims under federal law for false advertising, unfair competition and trademark dilution. It also alleged various theories of liability under state law. While this action was ongoing, Healthpoint brought a second action against Ethex, this time claiming that Ethex was unlawfully marketing a new formulation of Ethezyme as a generic equivalent to Accuzyme. The second lawsuit contained similar claims.

The first lawsuit was eventually tried to jury, which returned a verdict of approximately \$16 million in favor of Healthpoint, allocated as follows:

| <u>Damage</u> | <u>Amount</u> |
|---|---------------|
| Actual damages | \$5,000,000 |
| Disgorgement of profits from false advertising & unfair competition | \$1,640,000 |
| Punitive damages | \$3,174,515 |
| Lanham Act enhanced damages | \$6,349,030 |

Shortly before the second lawsuit was tried, the parties agreed to a global settlement of both actions for approximately \$16.3 million, with the following damages allocation:

| <u>Damage</u> | <u>Amount</u> |
|--------------------------------------|---------------|
| Ethex 1: | |
| Damage to goodwill and reputation | \$10,450,000 |
| Lost profits/disgorgement of profits | \$ 1,350,000 |
| Ethex 2: | |
| Damage to goodwill and reputation | \$4,050,000 |
| Lost profits/disgorgement of profits | \$ 450,000 |

The settlement agreement also contained a provision clarifying that no proceeds would be attributable to willful misconduct or punitive damages.

Healthpoint filed its federal income tax return using an allocation consistent with the settlement agreement. The IRS challenged Healthpoint's characterization, claiming that the items should have been allocated to mirror the allocations made by the jury in the first lawsuit. Healthpoint argued that the allocations made in the settlement agreement should be respected as the product of an arm's-length agreement made in good faith by adverse parties. It then brought suit in Tax Court challenging the IRS' position.

Although the Tax Court ultimately agreed with the IRS, it confirmed that an express allocation in a settlement agreement will be respected for federal tax purposes where the agreement is the product of adverse parties negotiating at arm's length and in good faith. This general rule, the Tax Court explained, will not necessarily apply, however, where the allocation of settlement proceeds fails to reflect the "economic realities" of the underlying claims.

The Tax Court explained: "However, general adversity between the parties to a lawsuit is to be expected. The requirement that parties involved in settlement negotiations be adverse is a factor in determining whether the final agreement reflected the true intentions of the parties

involved. If the parties were generally adverse but ultimately allocated the funds in a way that did not represent the claims they actually intended to settle, then we need not respect the allocations made in the settlement agreement.”

In *Healthpoint*, Ethex was indifferent as to how the proceeds were allocated, so long as there was no provision implying intentional wrongdoing. Moreover, it would be to Healthpoint’s advantage to allocate proceeds to items taxed at more preferential rates, such as goodwill. Healthpoint, however, failed to maintain any documentation relating to goodwill or make any calculations during the settlement negotiations to justify the allocations in the agreement. Nor did it involve tax counsel in negotiating and drafting the agreement, which the Tax Court noted.

In short, allocating settlement proceeds solely with a view toward obtaining beneficial tax consequences, without more, may result in those allocations being challenged by the IRS and disregarded in court. Given the similarity of the lawsuits, the Tax Court ultimately reallocated the damages proceeds to reflect the allocations made by the jury in the first lawsuit. It also awarded an accuracy-related penalty.

Conclusion

Settling parties should remain aware that the nature of the claims – not the settling parties’ characterization – determines the ultimate tax consequences of a settlement agreement, even when the agreement is negotiated by adverse parties in good faith. If the settling parties’ damages allocation does not reflect the economic realities of the underlying claims, as in *Healthpoint*, the parties run the risk that their allocation may be disregarded. As a result, tax counsel should be involved in the negotiation and drafting of the settlement agreement to help ensure that the agreement will be respected for tax purposes.

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New 990 Regulations

Organizations exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code (“Code”) fall into two broad categories: public charities and private foundations. Public charities are generally those 501(c)(3) organizations that are “publicly supported”¹ as evidenced by their satisfaction of either the one-third of support test² or the facts and circumstances test³ (each a “Support Test”). Public Charities are the preferred classification because: (1) private foundations are subject to various stringent operational rules that do not apply to public charities;⁴ (2) private foundations file a more-involved Form 990-PF than the types of Form 990 filed by public charities;⁵ (3) private foundations are subject to a tax on net investment income;⁶ (4) private foundations may not use certain fundraising techniques;⁷ (5) donors may receive a lower deduction for donations of certain property to private foundations;⁸ and (6) private foundations must provide notice to the IRS and sometimes pay a fee if they want to terminate.⁹

Until recently, when an organization sought public charity status on its Form 1023 and received a favorable determination letter from the Internal Revenue Service (“IRS”) recognizing it as exempt under section 501(c)(3) of the Code, its public charity status (if granted) would be for a five-year “advance ruling period.” After this advance ruling period, the organization would make a separate filing to the IRS to establish public charity status based on satisfaction of one of the Support Tests.

On September 9, 2008, proposed regulations were issued to, among other things, eliminate the advance ruling period process for public charities. On September 7, 2011, final regulations (“Final Regulations”) were issued that largely mirror the proposed regulations. The Final Regulations do not materially alter the Support Tests, but they have changed the timing and process of determining public charity status.

Under the Final Regulations, in general, public support for the current year—based on such current year and the four preceding years—is examined for such current year in Schedule A of an organization’s Form 990. If an organization satisfies a Support Test for any given year, it is a public charity for that year and the subsequent year. If it fails to satisfy both Support Tests for any given year, there are no consequences for that year (because it is covered by the satisfaction during the prior year). But if it fails to satisfy both Support Tests in the succeeding year, then it will be treated as a private foundation for that year, but only for purposes of the private foundation termination rules, reporting requirements and tax on net investment income.¹⁰ The next succeeding year and beyond, it will be treated as a private foundation for all purposes.

More specifically, in the context of new organizations, because there is no longer an advance ruling period, an organization applying for recognition of exemption under section 501(c)(3) of the Code will now be deemed a public charity for its first five years if it shows that it can reasonably be expected to meet either Support Test.¹¹ After it has completed its first five years, it will continue to be classified as a public charity for its sixth year if either (i) it satisfied either Support Test for its fifth year (based on all five years) or (ii) it satisfies either Support Test for its sixth year (based on years two through six).¹² Otherwise, it will be treated as a private foundation for the sixth year, but only for purposes of the private foundation termination rules, reporting requirements and tax on net investment income.¹³ For the following (seventh) year and beyond, it will be treated as a private foundation for all purposes.¹⁴

The IRS has not yet modified the Form 1023 to eliminate the question regarding the advance ruling period (Part X Question 6a), but it has issued updated instructions that such should not be filled out.

¹ Such organizations are exempt under § 170(b)(1)(A)(vi) as a sub-classification of § 501(c)(3) exemption; but other 501(c)(3) organizations, such as schools (§ 170(b)(1)(A)(ii)) and churches (§ 170(b)(1)(A)(i)), are public charities regardless of their public support.

² Treas. Reg. § 1.170A-9(f)(2).

³ Treas. Reg. § 1.170A-9(f)(3).

⁴ See I.R.C. §§ 4940-4946.

⁵ Treas. Reg. § 1.6033-2(a)(2)(i).

⁶ I.R.C. §§ 4940(a), (e).

⁷ See Treas. Reg. § 1.170A-9(i)(2) regarding pooled common funds.

⁸ For example, under § 170(b)(1)(A), individual donors may generally deduct up to 50% of their adjusted gross income to public charities, but only up to a 30% limit for certain private foundations. And under §§ 170(b)(1)(C)(i) and 170(e)(1)(B)(ii), donors of long-term capital gain property generally receive a deduction equal to fair market value if they donate to a public charity, but only a deduction equal to their basis if they donate to certain private foundations.

⁹ I.R.C. § 507.

¹⁰ Treas. Reg. § 1.170A-9(f)(4)(vii)(B).

¹¹ Treas. Reg. § 1.70A-9(4)(v).

¹² The public support calculation is set forth in Schedule A of the Form 990.

¹³ Treas. Reg. § 1.170A-9(f)(4)(vii)(A).

¹⁴ *Id.*

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Step Transaction Doctrine Not Applicable for §351 Purposes Where Stock Received Is Transferred in a Prearranged §721 Contribution

In Private Letter Ruling 201133006, the Service, for the first time, treated an exchange of stock for property as a non-recognition event under section 351, even though the stock received was immediately transferred to a partnership in a section 721 contribution. While this ruling is not binding precedent on taxpayers, it is significant in that it both expands the type of post-transfer transactions a taxpayer can potentially utilize to receive non-recognition under section 351, as well as limits the transactions a taxpayer can potentially use to “bust” an exchange that would otherwise qualify under section 351.

The transaction in question involved a limited partnership and a trust (collectively, the “Partners”) which held interests in a limited liability company (“Old LLC”), a partnership for federal tax purposes. The Partners transferred their membership interests in Old LLC to a real estate investment trust (“New REIT”) in exchange solely for membership interests in New REIT. At the same time, unrelated investors contributed cash to New REIT in exchange for a separate class of non-voting preferred interests. Thereafter, the Partners contributed their New REIT membership interests to a newly formed limited liability company (“New LLC”), a partnership for federal tax purposes, in exchange for membership interests in New LLC. At issue was whether the Partners’ contribution to New LLC would cause the original transfer of Old LLC interests to New REIT to “bust” and be disqualified under section 351.

Under section 351, non-recognition of gain or loss is permitted on a transfer of property by one or more persons to a corporation in exchange solely for stock of such corporation if “immediately after the exchange” such person or persons “control” the transferee corporation. For purposes of section 351, control is defined under section 368(c) as ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of each class of non-voting stock.¹ The definition of “immediately after the exchange” is somewhat less clear. The regulations state that “immediately after the exchange” extends beyond simultaneous exchanges to include transfers where the rights of the transferring party or parties have been previously defined and the execution of the agreement between such parties proceeds in an expeditious and orderly manner.² No additional clarification is provided.

The question of when a transaction will be treated as separate from the whole is a frequently litigated issue, especially in connection with a section 351 transaction that is followed by multiple transactions. The step transaction doctrine permits a series of formally separate steps to be amalgamated and treated as a single transaction where they are in substance integrated,

interdependent and focused toward a particular end result.³ Generally, if a transferor has a binding commitment to transfer property following a section 351 transaction, the two transactions may be stepped together so that “control immediately after the exchange” may not be met. Such treatment may be denied because to allow it could violate section 351’s basic premise of granting non-recognition only where the transfer is a mere change in the transferor’s form of ownership.⁴ However, the Service will not apply the step transaction doctrine where, pursuant to a plan, a taxpayer transfers property to a corporation in a section 351 exchange which is followed by a transfer of the same property to one or more tiers of corporations.⁵

In Revenue Ruling 2003-51, notwithstanding the general rule, the Service determined that a pre-existing agreement did not trigger the step transaction doctrine. This ruling involved two unrelated, domestic corporations, Corporation W and Corporation X, that wanted to consolidate their business A operations. Corporation W engaged in business A directly with two other businesses, whereas Corporation X engaged in business A through its subsidiary, Sub Y. Pursuant to a prearranged binding agreement, the corporations undertook the following transactions:

1. Corporation W formed a new domestic corporation, Corporation Z, and transferred all of its business A assets in exchange for Corporation Z stock;
2. Immediately following step 1, Corporation W contributed all of its Corporation Z stock to Sub Y in exchange for Sub Y stock;
3. Simultaneously with step 2, Corporation X contributed additional capital to Sub Y, to meet the capital needs of business A, in exchange for additional Sub Y stock; and
4. After steps 2 and 3, Sub Y transferred the cash received from Corporation X and its business A assets to Corporation Z.

The Service determined that the first and second transaction did not need to be combined simply because there was a pre-existing binding agreement. The Service stated that, unlike a sale of a transferor’s shares to a third party which terminates the transferor’s interest, a nontaxable transaction does not necessarily have the same effect and, therefore, does not violate the intent of section 351. Additionally, the Service emphasized the fact that the transactions could have been recast in alternative tax free forms because each individual step would qualify for non-recognition under section 351.

The Service’s determination in PLR 201133006, citing Rev. Rul. 2003-51, is unique in that this scenario did not involve multiple transactions which individually qualified for non-recognition under section 351. Nonetheless, both transactions qualified for non-recognition treatment and provided a continuity of interest to the Partners: the first transaction between the Partners and New REIT was a potential section 351 exchange, and the second transaction was a section 721 contribution from the Partners to New LLC. Therefore, the Service allowed non-recognition treatment under section 351, as opposed to applying the step transaction doctrine to collapse the two transfers, because this treatment coincided with the basic purpose of section 351.

The recent Private Letter Ruling may be advantageous to a taxpayer looking to avail itself of the benefits of non-recognition under section 351. It suggests a willingness by the Service to allow more flexibility in the types of transactions a taxpayer can utilize following the receipt of stock for property and, thus, expands the principals of Rev. Rul. 2003-51. Conversely, taxpayers who, like the one in *Intermountain Lumber*, wish to receive a step-up in basis as opposed to non-recognition should exercise caution in utilizing a similar transaction to “bust” a section 351 contribution.

¹ Treas. Reg. § 1.351-1(a)(1).

² *Id.*

³ *Penrod v. Comm’r*, 88 T.C. 1415, 1428 (1987).

⁴ *Intermountain Lumber Co. v Comm’r*, 65 T.C 1025 (1976); *but see* Rev. Rul. 79-194, 1979-1 C.B. 145 Situation 1 (sale of New Co. shares from one investor in New Co. to other investors in New Co. did not prevent non-recognition treatment as “persons transferring property to Newco” owned 100% immediately after the sale).

⁵ See Rev. Rul. 77-449, 1977-2 C.B. 110; Rev. Rul. 83-34, 1983-1 C.B. 79; Rev. Rul. 83-40, 1983-1 C.B. 273.

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Discussion Draft on Interpretation and Application of Article 5 of the OECD Model Tax Convention

On 12 October 2011, the OECD Committee on Fiscal Affairs issued a public discussion draft on proposals for additions and changes to the Commentary on Article 5 (Permanent Establishment) (“Article 5”) of the OECD Model Tax Convention (the “Discussion Draft”). These changes relate to specific areas of the guidance in the Commentary, and are not intended to change the text of Article 5.

Article 5 sets out the circumstances in which a permanent establishment (“PE”) can arise. This is a key concept in international taxation and is used to allocate taxing rights between treaty partner countries when an enterprise of one state derives business profits from another state. The Commentary to the Model Tax Convention explains in greater detail what a PE means in practice.

The proposals for additions and changes to the Commentary on Article 5 have been suggested by a working group which keeps the Model Tax Convention and its commentary under review. Due to the practical importance of the proposed changes, comments have been requested from all interested parties. The Discussion Draft is lengthy and addresses a large number of issues of interpretation – this article will focus on some of the most important issues.

There are normally two tests that need to be considered in order to establish the existence of a PE. The first test is whether there is a “fixed place of business through which the business of an enterprise is wholly or partly carried on.”¹ Even if it is concluded that an enterprise has no fixed place of business, it is still possible for a PE to be in existence where a “dependent agent” acts on behalf of the foreign enterprise, and that agent has, and habitually exercises, an authority to conclude contracts in the name of the foreign enterprise.²

For each of the issues discussed, the Discussion Draft includes a description of the issue that led to the recommendation, the relevant recommendation itself, and the proposed changes to the Commentary on Article 5.

Meaning of “at the disposal of”

The concept of “at the disposal of” is not included in the definition of PE but is a test included in the commentary. A place of business may constitute a PE if that place is *at the disposal of the enterprise*.³ The Discussion Draft suggests that whether or not a location (place of business)

may be considered to be at the disposal of the enterprise depends on the presence of the enterprise at the location and the activities it performs at the location.

If the changes to the Commentary are made as suggested, a location will be considered to be at the disposal of the enterprise where: (i) the enterprise has an exclusive legal right to use that location and it is used for carrying on that enterprise's own business activities; or (ii) where that enterprise performs business activities on a continuous and regular basis at a location that belongs to another enterprise or that is used by a number of enterprises.⁴ This will not be so where the enterprise's presence is intermittent or incidental.

It is considered that where an enterprise does not have a right to be present at a location and does not use that location itself, such location cannot be said to be "at the disposal" of the enterprise. The commentary explains, by way of example, that a location which is owned and used exclusively by a contract manufacturer cannot be considered to be at the disposal of the enterprise that owns the parts that are assembled by the contract manufacturer merely because those parts will be used in the business of that enterprise.

Home office as a PE

Two new paragraphs are proposed to deal with the situation where a home office is used by an employee to carry on the business of a foreign enterprise. Whilst the home office is clearly at the disposal of the employee and is a place where the business activities of the employer are partly carried on, the crucial issue to be determined is whether this home office is at the disposal of the enterprise (i.e., the employer). This is difficult to establish and will need to be based on the facts and circumstances of each case. The Discussion Draft suggests that where a home office is used on a regular and continuous basis for the activities of the enterprise and the enterprise has required the employee to work from home, the home office may be considered to be at the disposal of the enterprise. It was noted, however, that activities carried on at a home office will often only be of an auxiliary and preparatory nature and will not, therefore, create a PE.

Time requirement for the existence of a PE

The Discussion Draft notes the concerns raised in respect of the uncertainty surrounding the period required in order for a location to be considered a PE. The previous commentary included criteria to be used to ascertain whether a PE existed. In order for there to be a PE, the commentary provides that a duration of six months is required; the element of recurrence and the nature of the business will also be considered. The Discussion Draft suggests the inclusion of a few new examples where the six-month timeframe is not relevant and where regular short-term activity may lead to the existence of a PE.

Secondment of enterprise's employees

The proposed commentary in the Discussion Draft provides some useful guidance as to the criteria to be used in determining whether an employee seconded to a group company in another state may create a PE. A distinction is drawn between (i) those employees of an enterprise who are seconded overseas and who remain employed by that enterprise, yet whilst overseas actually perform the business activities of the overseas enterprise, and (ii) those employees who perform the activities of the enterprise by which they are employed whilst overseas.

Subcontracting all or part of a contract

The Discussion Draft suggests changes to clarify whether a PE will arise where a contractor subcontracts all aspects of a project to a subcontractor in another state. It has been noted that where an enterprise carries on its business through sub-contractors, a PE may be found to exist if the conditions under Article 5 are met.

Activities of a preparatory and auxiliary nature

Article 5(4) of the OECD Model Tax Convention contains various exceptions to the definition of PE. One of the exceptions applies to activities of a preparatory or auxiliary nature. The Discussion Draft confirms that the various activities listed in Article 5(4) (a)-(d) (including the use of facilities for the storage of goods, the maintenance of a fixed place of business to collect information for the enterprise, etc.) are automatic exceptions from the PE rule. Other unspecified activities referred to in 5(4)(e) must meet the preparatory or auxiliary test.

The Discussion Draft confirms that, whilst such unspecified activities may contribute to the productivity of the enterprise, the PE test would not be met as the activities involved are too remote from the actual realization of profits by the enterprise. The intention of this change is to remove any suggestion that there could be a link between the attribution of profits and the existence of a PE.

Meaning of the phrase “to conclude contracts in the name of the enterprise”

This point has been largely directed at commissionaire arrangements given that two recent cases concerning such arrangements in the French and Norwegian courts have produced conflicting conclusions as to whether or not a commissionaire under civil law, who cannot legally bind its (undisclosed) principal, may, nevertheless, constitute a dependent agent PE for that principal.⁵ This phrase does have much wider ramifications, especially as it is the key element of the dependent agent PE test in Article 5(5).

Article 5(5) requires the conclusion of the contract “in the name of the enterprise” for an agency PE to arise. Commissionaire arrangements would not initially seem to lead to the existence of a PE. However, the current commentary states that the contracts do not actually have to be in the name of the principal to be binding on the principal and to give rise to a PE.

A new sentence to the Commentary has been suggested by the Discussion Draft providing for circumstances in which a foreign principal would be bound by a contract concluded with a third party by a person acting on behalf of that enterprise, even if the agent did not disclose that he was acting for the enterprise and the name of the enterprise was not referred to in the contract. It should be noted that the conflicting decisions in respect of commissionaire arrangements, and the uncertainties arising in this area as a result, have not been resolved in the Discussion Draft.

Joint Ventures and Partnerships

The Discussion Draft recommends that the definition of “enterprise of a contracting state” as used in Article 5 refers to any form of enterprise carried on by a resident of a contracting state, including a company, partnership, sole proprietorship or other legal form. When different enterprises collaborate on the same project, whether this collaboration constitutes separate enterprises depends on the facts in question and the relevant domestic law.

In many cases, different enterprises will agree to carry on a separate part of the business rather than setting up a separate company to carry on the enterprise. Often the enterprises will not jointly carry on the business activities or share the profits resulting from such activities, even though they may share the overall output from the project. The Discussion Draft concludes that it would be difficult to consider that a separate enterprise has been set up in such circumstances.

The Discussion Draft also provides suggested commentary in respect of enterprises that take the form of a fiscally transparent partnership. Those enterprises will be carried on by each partner and each partner’s share of the profits attributable to the PE will be deemed to be derived by an enterprise of the state in which each partner is resident.

Conclusion

The commentary to the OECD Model Tax Convention is not generally considered to be binding on taxpayers in the OECD member states (currently 34 countries); however, it can be an extremely useful tool in understanding tax treaties that follow the OECD model.

Public comments have been invited on the proposed changes and should be submitted to the OECD before 10 February 2012. If adopted, the proposed changes will be included in the next update of the Model Tax Convention, currently scheduled for 2014. If the changes to the

Commentary are adopted, they could be significant for the interpretation of existing tax treaties, and companies would be well advised to monitor developments.

¹ See Article 5(1) OECD Model Tax Convention on Income and Capital.

² See Article 5(5) OECD Model Tax Convention on Income and Capital.

³ See *further* paragraphs 4 to 4.2 of the Commentary on Article 5 concerning the definition of Permanent Establishment, which sets out that a Permanent Establishment may exist if a business has a certain amount of space at its disposal.

⁴ The Discussion Draft suggests changes to paragraph 4.2 of the Commentary.

⁵ See CE 31 March 2010, Zimmer Ltd, No. 304715 and 380525 conclusions Julie Burguburu, BDCF No.6/2010; Borgarting Lagmannsrett, dated 2 March 2011, Dell Products v. Skatt Ost, ref 10-032855ASD-BORG/03.

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Overview of Important Changes in PRC Tax Law During 2011

1. Trial real estate tax policies implemented in Chongqing and Shanghai. On 27 January 2011, the municipal governments in both Chongqing and Shanghai released interim measures relating to the real estate tax on residential property owned by individuals, which means that the long-awaited trial reform of the real estate tax has finally been launched. The interim measures are effective as of 28 January 2011. The taxation of residential property is expected to eventually expand nationwide.

| | Shanghai | Chongqing |
|----------------|--|---|
| Scope of trial | Shanghai municipal administrative area | Nine central districts of Chongqing City |
| Taxable target | <ul style="list-style-type: none"> •Newly-purchased second and subsequent residential property by a Shanghai resident family •Newly-purchased residential property by a non-Shanghai resident family | <ul style="list-style-type: none"> •Villas owned by individuals •Newly-purchased high-end residential property by individuals where the price per gross floor area (“GFA”) is two times or above the average GFA price in the previous two years of all newly-constructed commercial property in the nine central districts •Second and subsequent ordinary residential property that is newly-purchased by non-Chongqing resident individuals who do not work or operate a company in Chongqing |
| Taxpayer | Owner of the residential property | Owner of the residential property |
| Tax base | 70% of the transaction price of the residential property (provisionally adopted) | Transaction price of the property. However, once a villa or high-end residential property qualifies as a taxable target, the tax base remains, regardless of any subsequent change in ownership (provided no new rules stipulate otherwise). |
| Tax rate | 0.4%, 0.6% | 0.5%, 1%, 1.2% |

2. SAT clarifies VAT and BT treatment of asset restructuring transactions. The State Administration of Taxation (“SAT”) issued a bulletin (Bulletin of the SAT [2011] No. 13, “Bulletin 13”) on 18 February 2011 to clarify the Value Added Tax (“VAT”) treatment of asset restructuring transactions. Effective as of 1 March 2011, Bulletin 13 provides that the transfer of all or part of the tangible assets of an enterprise, along with associated receivables, debts and workforce, through a merger, division, sale or swap in an asset restructuring transaction, does not fall within the scope of VAT.

SAT issued guidance on 26 September 2011 (Bulletin [2011] No. 51, “Bulletin 51”) that clarifies the Business Tax (“BT”) treatment of asset restructuring transactions. According to Bulletin 51, the transfer of all or part of the tangible assets of an enterprise, along with associated receivables, debt and workforce to other units and/or individuals in an asset restructuring transaction via a merger, division, sale or asset exchange, does not fall within the scope of the BT. The transfer of immovable property and land use rights in the course of such transactions also fall outside the scope of the BT.

3. New asset loss rules simplify tax deduction procedures. On 31 March 2011, SAT issued the Measures for Corporate Income Tax (“CIT”) Deduction on Asset Losses of Enterprises (“New Measures”) by way of Announcement No. 25. The New Measures replace the Measures for Tax Deduction on Asset Losses of Enterprises issued in 2009 (“Old Measures”). The New Measures have broadened the scope of asset losses, removed the requirement of prior approval for asset losses and, in some cases, simplified documentary evidence requirements. Under the New Measures, SAT will give more power to enterprises to manage their compliance with the asset loss deduction rules, while reserving its right to conduct audits on their compliance. With the resultant redeployment of resources, tax authorities will be able to focus on conducting tax audits on high-risk targets or areas.

The New Measures are effective as of 1 January 2011. Changes in the new measures include:

- Scope of assets expanded to include intangible assets.
- Distinction made between actual asset losses and statutory asset losses, both deductible.
- Accounting recognition of loss required.
- Prior approval no longer required, and replaced by mere itemized reporting.
- Re-opening of the prior year tax position and making of belated loss claims possible up to five years.

- Third party technical opinions and professional reports given great reliance as evidence.

4. New Double Taxation Agreement signed with the U.K. On 27 June 2011, the governments of the People’s Republic of China and the U.K. signed a new comprehensive agreement for the avoidance of double taxation (“New DTA”). The key features of the New DTA include:

- A reduced 5% withholding tax (“WHT”) rate on dividends (down from 10%).
- A reduction in the effective WHT rate from 7% to 6% in respect of royalties for the use of, or the right to use, industrial, commercial or scientific equipment.
- Measures to limit the double taxation of capital gains and “other income.”
- Changes to the taxation of technical fees paid between the two countries.
- An updated definition of permanent establishment (“PE”), which now includes a “service PE.”
- A “miscellaneous rule” that specifically enables the Chinese tax authorities to apply the domestic general anti-avoidance rules, notwithstanding the provisions of the treaty.
- Additional anti-treaty shopping measures.

5. Amended Individual Income Tax Law taking effect. The National People’s Congress (“NPC”) finally approved the amended Individual Income Tax Law (“IIT Law”) on 30 June 2011 (with changes made to the draft amended IIT Law in response to the public comments), which will take effect on 1 September 2011.

The standard monthly deduction (i.e., taxable income threshold) for employment income is now increased from RMB2000 to RMB3500. In addition, the tax rate for the first bracket for employment income is now reduced from 5% to 3%. A comparison of the existing and new tax rate tables is below.

| Old tax rates and brackets | | | Amended tax rates and brackets | | |
|--|------------------------------|--------------|--|------------------------------|--------------|
| Grade | Monthly taxable income (RMB) | Tax rates(%) | Grade | Monthly taxable income (RMB) | Tax rates(%) |
| 1 | 500 or less | 5 | 1 | 1500 or less | 3 |
| 2 | The part >500 and ≤2000 | 10 | 2 | The part >1500 and ≤4500 | 10 |
| 3 | The part >2000 and ≤5000 | 15 | 3 | The part >4500 and ≤9000 | 20 |
| 4 | The part >5000 and ≤20000 | 20 | 4 | The part >9000 and ≤35000 | 25 |
| 5 | The part >20000 and ≤40000 | 25 | 5 | The part >35000 and ≤55000 | 30 |
| 6 | The part >40000 and ≤60000 | 30 | 6 | The part >55000 and ≤80000 | 35 |
| 7 | The part >60000 and ≤80000 | 35 | 7 | The part >80000 | 45 |
| 8 | The part >80000 and ≤100000 | 40 | | | |
| 9 | The part >100000 | 45 | | | |
| The monthly taxable income from wages and salaries shall be the balance after the standard deduction (local Chinese RMB2000/Expatriate RMB4800) from the monthly income. | | | The monthly taxable income from wages and salaries shall be the balance after the standard deduction (local Chinese RMB3500/Expatriate RMB4800) from the monthly income. | | |

6. Innovative tax and customs policies introduced to Hengqin Island. The State Council in July 2011 approved a series of innovative tax, customs, finance and land policies to be offered to Hengqin Island within the Zhuhai Special Economic Zone, a coastal city in Southeast China. The State Council has granted Hengqin Island preferential policies that are more innovative than those given to any of the other special economic zones so far. The www.bryancave.com *A Broader Perspective*

policies are designed to attract investors, experts, experienced executives and even skilled labor from the following industries: tourism, commercial services, financial services, cultural innovation, Chinese medicine and health care, scientific research and hi-tech industries. These policies clearly indicate the central government's commitment to encourage cooperation between Hong Kong/Macao and the Guangdong Province to take the respective advantages and to get mutual benefits. The preferential tax and customs policies may include:

| | |
|---|--|
| <p>Customs duty</p> | <ul style="list-style-type: none"> •Production-related commodities (including equipment for production purpose) shipped from overseas to Hengqin Island shall be kept under bonded status until they are moved to other areas of the Mainland China. •When products manufactured in Hengqin Island are sold and moved to other areas of the Mainland China, the importer may select to report customs duty based on either the duty rate applicable to the imported raw materials or the duty rate applicable to the finished goods. |
| <p>Corporate income tax ("CIT")</p> | <p>Qualified enterprises shall be eligible for a reduced CIT rate of 15% on their taxable profits.</p> |
| <p>Value-added tax ("VAT") and Consumption tax ("CT")</p> | <p>Trading of commodities among enterprises in Hengqin Island shall be exempted from VAT and CT.</p> <p>Production-related commodities sold and transported from the Mainland China to Hengqin Island shall be treated as exports and eligible for export tax refund.</p> |
| <p>Individual income tax ("IIT")</p> | <p>Hong Kong and Macao residents working in Hengqin Island will receive a IIT rebate from the Guangdong provincial government so that their effective income tax burdens will be equalized to what they should pay if they work in Hong Kong/Macao.</p> |

7. New Round of Fiscal Incentives for China's Western Region. On July 27 2011, the Ministry of Finance, General Administration of Customs ("GAC") and State Administration of Taxation ("SAT") jointly issued circular Caishui [2011] No. 58 ("Circular 58") providing fiscal incentives to further support the country's "go-west" strategy.

Circular 58 in general extends the following incentives for the Western Region for the period from 1 January 2011 to 31 December 2020:

- CIT – qualified enterprises in encouraged industries are eligible for a reduced CIT rate of 15%;
- Customs duty – equipment imported within the total investment of qualified projects for self-use are exempt from customs duty.

8. Pilot Program of the indirect tax reform. The Chinese State Council announced on 26 October 2011 that it will launch the much-anticipated pilot VAT reform program (“Pilot Program”) on 1 January 2012. The pilot program will initially apply to transportation and modern service industries in Shanghai and will be rolled out nationwide when conditions permit. Key features include:

- Scope of application: Pilot Program will start with the Transportation industry and certain “modern service industries” (collectively called “Pilot Industries”) in Shanghai, which may possibly be extended countrywide for selected industries, when the circumstances warrant it.
- Pilot Industries and rates: Further to the prevailing 17% and 13% VAT rates, two additional VAT rates, 11% and 6%, will be added.

| | |
|---|-----|
| Leasing of tangible movable property | 17% |
| Transportation services | 11% |
| Research and development (R&D) and technical services | 6% |
| Information technology (IT) services | 6% |
| Cultural and creative services | 6% |
| Logistics and ancillary services | 6% |
| Certification and consulting services | 6% |

- Continuity of existing preferential BT treatment for Pilot Industries: BT incentives for the Pilot Industries may continue, but will be adjusted according to VAT.

-
- Credit mechanism: VAT paid by taxpayers in the Pilot Industries can be taken as input credit.

2011 will soon be over, and 2012 is coming. For foreign investors, China's taxes are full of opportunities and challenges. Approvals from the competent tax authority are generally required to enjoy the tax benefits, while the VAT reform pilot is full of large variables requiring close attention.

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