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Contents

FEATURE

BEST PRACTICES IN CODE SEC. 1031 ART EXCHANGES

Introduction

Code Sec. 1031 has been used, albeit inconsistently, for years by savvy owners of fine art to preserve capital by deferring the gain on the sale of appreciated artworks. Motivation to use Code Sec. 1031 has recently intensified due to:

- a very active market that is driving prices higher by way of increased competition;
- higher tax rates on gain, with the new 3.8% tax on Net Investment Income[1] in effect and ever-hungrier local taxing authorities seeking to collect sales and use taxes; and
- low interest rates for investors using leverage to buy or refinance after the fact.

Art held for investment is not excluded from Code Sec. 1031 treatment, but in contrast to real estate for which the availability of Code

Sec. 1031 is more widely understood, there are many important aspects of exchanging artworks that remain murky. A resulting lack of clarity creates risk and uncertainty that often inhibits strategic and safe application of Code Sec. 1031 to these assets. Unlike real estate, the art world has a transactional culture that has little regulatory oversight of participants and where transactions are frequently completed on the basis of reputation and trust. When this culture fails, the results can be devastating. Further, the development of coherent answers to important questions regarding exchanges of artworks seems uninteresting to many of the usual participants in these transactions and remains largely neglected.

This article addresses several of these questions, and addresses two aspects of artwork exchanges: technical Code Sec. 1031 requirements and practical aspects of implementing artwork exchanges under existing rules. There are two major issues in each category:

1. Code Sec. 1031 Qualification Requirements:
    - Qualified Use: Investor or collector?
    - Like-Kind Issues: What can be exchanged for what?
2. Implementation:
    - Forward or Reverse: Which is the optimal form of Code Sec. 1031 artwork exchange?
    - Choosing a QI or EAT: What criteria should be used?

Overview of Code Sec. 1031 Principles

Code Sec. 1031 allows for non-recognition of gain on the sale of assets held for trade or business or investment purposes. Since artwork will almost never be income producing on a current basis,[2] the "held for investment" criteria will generally serve as a basis for application of the section to a disposition/acquisition transaction. Because exchanges where two parties simultaneously swap assets are not common, most exchanges are undertaken as deferred exchanges under the umbrella of Code Sec. 1031(a)(3), utilizing a "qualified intermediary" or "QI," to receive, hold and spend relinquished art sale proceeds pursuant to the Treasury Regulations' constructive receipt safe harbor.[3] The standard deferred or "forward" exchange occurs when relinquished property is sold prior to the acquisition of replacement property. Most of the mechanical rules for implementing deferred exchanges are well established.

A "reverse" exchange is used when the replacement property will or must be acquired prior to the sale of relinquished property. The IRS has provided guidance for several forms of "safe harbor" reverse exchanges in IRS Rev. Proc. 2000-37 (as amended),[4] utilizing ownership accommodation arrangements that are available through a subset of the QI community, including the use of an "Exchange Accommodation Titleholder" (or "EAT" in the context of reverse exchanges).

Qualified Use – Collector, Dealer or Investor?

Meeting the "qualified use" requirement for Code Sec. 1031 exchanges of artworks means that an artwork owner must treat artworks as assets being held for investment or income, rather than merely as additions to a personal collection where the intent is limited to deriving pleasure through possession and display or as assets held as inventory or otherwise for sale. This is widely referred to as the "qualified use" requirement and applies to property transferred and received in a Code Sec. 1031 exchange. For sellers of collected art, the question will normally be whether relinquished and replacement art is considered held primarily for investment rather than for personal purposes. If the seller is considered a dealer, holding art for sale to customers in the ordinary course of business, Code Sec. 1031 will not be available for works leaving or entering inventory but may still be available for long-term hold pieces.

It has been said that artworks which are displayed in the owner's personal residence have questionable status as investments. An example of a judicial conclusion to this effect is found in *Blodgett v. Commissioner*, where a claimed loss on the transfer of art was disallowed.[5] The case makes clear, however, that this is not always the result. The relevant questions are whether the art owner acted like an investor with respect to a specific piece, exhibiting behavior such as gaining education in the investment characteristics of art, maintaining records of investment value on an ongoing basis and having a history of art investing. It is permissible to derive personal *pleasure* from ownership of an investment asset, but that must be a *secondary* intent of the acquisition and ownership.

In the real estate context, this question most often arises with vacation use properties. In this category, the most important factor determining Code Sec. 1031 qualification seems to be the degree of effort (and success) spent in renting a property compared to the amount of personal use.[6] As with real estate, there are various strategic and operational measures that indicate investment intent relating to artworks. Since artworks generally are not depreciable, do not generate rental income and are not used in the various other ways that businesses use real estate, an owner must be able to demonstrate that the primary intent of acquiring and holding artworks is to sell them later for a price that is higher than the original purchase price plus the cost of ownership. While the storage strategy for collectables is clearly an indicator of intent, there can be many other indicators, and it is the overall strategy that can become compelling, no matter how much time the artworks spend in the owner's personal residence. Although the IRS will base its determination of primary investment intent on all the facts and circumstances affecting a particular owner, if some or all of the following strategies are implemented, the owner should be in a strong position to satisfy the qualified use requirement:

Investment Strategies

- Develop a business plan that describes a fine art investment strategy and then conduct affairs related to the investments in a business-like manner to actualize the investment intent;
- Focus acquisitions on specific themes – e.g., artist groups, mediums, time periods;
- Develop expertise in one or more themes, consult with other experts, publish articles discussing some aspect of the investments; and
- Display art periodically in venues that promote the theme, thereby increasing the demand for works that are part of the theme.

Asset Value Protection Strategies

- Obtain independent valuation, confirmation of authenticity and title insurance for new acquisitions to establish their value and increase the ability to sell later at a profit;
- Own assets in a special purpose entity to show separation of assets and isolation of risk; and
- Obtain damage and theft insurance policies that are separate from the owner's residential policy and provide protection no matter where the assets are stored or displayed.

Financial and operational strategies

- Be able to show strategic transaction flow, profits and losses, the total cost of ownership and operations to show the results/returns from the investments;
- Keep fastidious records of transactions, appraisals and comparable transactions involving similar works by other owners to understand the present equity in the investment;
- Use credit facilities to make investment acquisitions that are separate from credit facilities used for other, non-investment purposes;
- Take (initial) delivery in a location other than the owner's primary personal residence; and
- When a sale is planned, display or store art at a location other than the owner's personal residence and ship to the buyer from that location.

While no single strategy is foolproof, the courts have concluded in the past that artwork maintained in a residence can still qualify as held for business purposes and that home display is not a dispositive negative factor where investment intent can be otherwise demonstrated.[7]

Like-Kind Determinations

There is no definitive guidance on how the "like-kind" standard of Code Sec. 1031 applies to artworks. Unlike depreciable personal property, there is no safe-harbor asset class or like-class system. Virtually the only published authority related to the subject was issued by the IRS in 1981 when it was asked to rule whether a collection of lithographs destroyed in a fire could be replaced under Code Sec. 1033(a)'s "similar or related in service or use" rule by paintings, sculptures and seriagraphs and other works of art. In Letter Ruling 8127089, the IRS reached the conclusion that proposed replacement properties did not meet the "similar or related in service or use" test but provided no rationale or reasoning to support the conclusion. There is no way of knowing whether the IRS would reach the same conclusion today and, of course, thirty year old letter rulings must be taken with a grain of salt. However, in light of this published position, the most conservative approach is to utilize a very narrow like-kind standard for artworks in terms of medium, which suggests that only oil paintings can be exchanged for oil paintings, sculpture for other sculpture, lithographs for other lithographs, and so on. One might even go so far as to restrict the standard to works in the same medium by the same artist. However, if applied to define application of Code Sec. 1031's like-kind standard to art, such a medium-based, approach provides a framework that may unreasonably limit the number of exchanges that can be successfully accomplished. This approach may also be inconsistent with the fundamental principle applicable to the like-kind standard: that property be of the same "nature and character" and that differences in "grade or quality" do not matter. Fine art of various media shares intuitively obvious and profound similarities that clearly are indicative of "nature and character" and have little to do with the medium employed.

In the absence of other guidance, it is *incumbent upon the taxpayer* to implement a strategy based on some guideline or heuristic for determining whether one artwork is like-kind to another as part of the larger process of implementing systematic and well-managed investment activities. The following is a possible definitional framework that emphasizes that artworks are in a category of their own, one that is separate from other "collectables," based on their ontology – that is, the reason that they are created: like-kind 'artwork' is a *tangible* expression or application of human creative skill and imagination intended to be visually apprehended and created specifically for the transmission of the creative intent of the artist without secondary use or application to some practical purpose. It is important to note, however, that no published authority has adopted this approach.

Forward or Reverse – What is the Optimal Form?

Once an owner of art determines that a specific piece qualifies for Code Sec. 1031 deferral on sale and that the intended reinvestment will qualify as like-kind, a logical next step is to create a tax-effective optimization strategy for acquisition and disposition. Some of the primary criteria for optimization are 1) transaction control and strategic success, 2) maximizing tax efficiencies of all kinds and 3) reducing risk related to the assets. The primary difference between the two forms of exchange – forward and reverse – is the *timing* of the acquisition of the new artwork relative to the disposition of the artworks to be sold.

In some cases, the timing of transactions will be dictated by specific factors. For example, a particularly strategic or desirable piece may become available at auction and must either be acquired immediately or lost to a competing bidder. In order to satisfy the strategic goal, a reverse exchange would likely be required. However, if the cash proceeds from sale of the artwork to be sold are absolutely necessary to allow purchase of any replacement artworks, then a forward exchange would be the only option. But, when the various buy and sell factors can be controlled, the potential art seller should certainly analyze the available options to determine which form is best based on an evaluation of the optimization criteria.

Some pros and cons of forward and reverse exchanges as they relate to artworks include:

- Forward exchanges are well understood and avoid some transactional costs that may apply to reverse exchanges. In addition, funds resulting from the sale of the old artworks are available for the purchase of the new artworks. Further, the owner does not have to trust a third party's ownership of the replacement art once acquired from a seller or of the owner's art prior to transfer to a buyer.
- Forward exchanges require meeting the Code Sec. 1031(a)(3) 45-day and 180-day deadlines for identification and acquisition of replacement artworks. These deadlines may put pressure on the owner to make purchases that are not ideal and can reduce the spontaneity that many art owners enjoy and rely on for the quality of their portfolios. In some cases, the options for effectively managing the purchase to reduce or avoid sales and use tax may be reduced. In addition, in a forward exchange, the cash proceeds of the sale of the old artworks must be held by a QI until the new artworks are acquired.
- If new artworks are acquired in a reverse exchange, the remaining task is to sell old artworks within limited time periods. This gives owners the opportunity to make acquisitions that support their strategy for making changes to their art portfolio, rather than having to identify and acquire new artworks while under the artificial pressure of the Code Sec. 1031 deadlines or risk failing to achieve Code Sec. 1031 deferral due to unforeseen delays in closing acquisitions. In addition, the reverse exchange allows the owner to buy at auction or through a gallery or broker precisely when desirable new pieces become available, knowing that they can be included in a Code Sec. 1031

exchange. It may be possible to lower sales and use taxes on the purchase of new artworks where the owner lives in a low tax jurisdiction or one without applicable use taxes. This sometimes can be done by having the entity (usually a LLC) involved in the reverse exchange take title to the purchase in a non-tax or reduced tax location or by taking advantage of "trade-in credits" available in some jurisdictions. In either case, the LLC must have certain resale licensing. In addition, since cash received on sale of relinquished art will generally be applied immediately to reimburse the owner's advance of cash to purchase replacement art, there is no significant period when the cash is not deployed and there need be no period when cash is held by a third party.

- There are also some disadvantages to reverse exchanges, with the most significant being that funds required for the acquisition of the new artworks must be supplied prior to the sale of the old artworks. In addition, due to the need to set up a qualified exchange accommodation arrangement using an EAT to hold sufficient "qualified indicia of ownership" unnecessary in forward exchanges, reverse exchange may be more complex and costly, and not all Code Sec. 1031 exchange companies handle reverse exchanges or handle them well.

All things considered, the reverse exchange may be the informed investor's "secret weapon," as it allows acquisitions to be made that are both strategic and spontaneous while providing maximum potential for additional deferral of gain, accretive tax efficiencies, asset utilization and security. Art ownership and transfer does not involve the same degree of formality as real estate, making "qualified indicia of ownership" of art easier to achieve for an EAT in an art exchange than for real estate or some other asset classes. The portability of most art allows the owner to rather easily take physical possession of artworks during the period of time that an EAT holds legal title. The key is to work with an experienced and reputable exchange accommodation firm that will assist in implementation of the owner's desired objectives consistent with both good business practices and tax rules.

Selecting a Code Sec. 1031 Accommodator

The Code Sec. 1031 QI/EAT "industry" consists of over 200 firms. There is wide variety in expertise, geographic focus, commitment to asset security and flexibility or problem-solving capabilities.

Some firms are subsidiaries of banks. Bank-owned QIs are excellent choices for deferred exchanges, because they generally have the needed expertise to structure moderately-complex deferred exchange transactions and they clearly provide the necessary asset security provisions for the cash proceeds of the initial sale. However, bank-owned QIs rarely provide reverse exchange services due to 1) the internally perceived risks of holding title to assets other than cash and 2) the frequent need to sometimes deviate from standard transaction formats and quickly develop customized reverse exchange structures that satisfy the requirements of a client.

Some firms are subsidiaries of real estate title insurance providers. These firms specialize in real estate exchanges and are able to offer both delayed and reverse exchanges. Their expertise with asset categories other than real estate varies, as might be expected. Further, their ability to structure complex exchanges involving unusual purchase or sale arrangements, entity bifurcation for sale tax efficiency or other attractive elements of a strategy for artworks also varies and may sometimes be limited. These firms are generally considered to have excellent asset security provisions.

Many other QI/EAT firms are small and sometimes regionally focused independent firms that deal almost exclusively with real estate exchanges. While they may have considerable expertise with real estate, a firm's expertise in other asset categories should be explored thoroughly before engaging the firm for artwork exchanges. Further, asset security issues need to be considered any time these firms are utilized – both for forward and reverse exchanges – to make sure that the owner is protected against accommodation firm failure.

Independent firms vary in their scope of coverage, sophistication, exposure to exchanges involving personal property and degree to which they have developed structures responding to both funds security and transactional complexities of personal property exchanges. Artwork exchanges call for assistance from a QI/EAT that has the depth of experience and expertise to recognize issues and assist the owner and his/her/its advisors in solving them. A key to this is the ability to be very responsive and offer both process flexibility and expertise dedicated to problem-solving.

Perhaps uniquely in the world of fine art, owners are sometimes encouraged to use an art gallery or dealer as an accommodator.[8] While this approach can work, it seems to be a clear example of the somewhat unique transactional culture in the world of fine art. It also raises the issue of how the disqualified person rules of Treas. Reg. Sec. 1.1031(k)-1(k) apply. There are several questions specific to Code Sec. 1031 exchanges that arise:

- Does the phrase "agent" apply when the dealer has represented the owner in any capacity in the two years leading up to the exchange? If so, the dealer would be disqualified from acting as the owner's QI or EAT since no exception applies.
- Does the dealer have any meaningful expertise or experience regarding the execution of Code Sec. 1031 exchanges? If not, are the owner's other advisors sufficiently familiar with the requirements to assure successful completion of the transaction?
- What security devices are in place to protect against loss of cash exchange proceeds through misappropriation by the dealer or its employees and if such devices are established, will they be consistent with applicable requirements, such as Code Sec. 468B?

Making an informed choice from among these various types of professional QI/EAT firms can be challenging. Some potential QI/EAT criteria include the following:

- A combination of expertise, references, responsiveness, flexibility and a problem-solving mentality that suits the business objectives and personal preferences of the Investor.
- Assurance that the firm is not (even arguably) a "disqualified person."
    - The QI/EAT should be demonstrably compliant with all applicable federal and state statues affecting this line of business, including Patriot Act and OFAC screening.
- Availability of state-of-the-art asset security for both deferred and reverse exchanges.
    - Use of segregated, dedicated funds management protocols, including qualified escrow or qualified trust accounts, with ability to authenticate each movement of cash.
    - Availability of corporate guarantees from rated issuers or fidelity bond protection ensuring against theft of the funds.
    - Use of entity forms for QI and EATs that are designed to be resistant to consolidation should their parent entities become subject to bankruptcy court jurisdiction.
- Familiarity and ability to work with artwork purchase and sale arrangements that are less formal and/or more complex than those found in other asset categories. Specifically, one should ensure that:
    - If the purchase and sale agreements between the owner and a buyer are informal, the QI/EAT must be able to accept an assignment of the owner's right as found in such arrangements that will satisfy the Code Sec. 1031 requirements; and
    - The role of galleries, auction firms and consignment arrangements are well-understood and taken into account as it relates to transfer of title and the receipt and disbursement of cash.

Conclusion

Commentators are optimistic about art owners' ability to defer income taxation by engaging in like-kind exchanges of artworks that have appreciated in value. The keys to successfully achieving this objective are:

- Treat the artworks to be exchanged consistently with other investment assets and document this treatment.

- Until more complete guidance is available, the most conservative approach is to limit exchanges to art of the same medium. However, with appropriate advice and explanation of the state of the law, many owners may consider choosing to utilize a more expansive and defensible definition of the like-kind standard for art that is both intellectual supportable and consistent with the underlying Congressional intent behind Code Sec. 1031.
- Employ professional advisors and experienced Code Sec. 1031 accommodation assistance. Make informed decisions about which form of exchange to utilize.

With soaring potential financial benefits of Code Sec. 1031 exchanges of artworks and increasing clarity regarding some previously unclear aspects of such exchanges, it seems like the time is right to explore these options.

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1 I.R.C. § 1411.

2 This article does not discuss the potential for generating income by charging admission to view art, since this is not typical. Obviously private museums and exhibition businesses (e.g., Madame Tussaud's, etc.) may be subject to different analyses.

3 Treas. Reg. § 1.1031(k)-1(g)(4).

4 2000-2 C.B. 308.

5 TC Memo 2003-12, *aff'd*, 394 F.3d 1030 (CA 8 2005).

6 *See*, *e.g.*, Rev. Proc. 2008-16, 2008-1 C.B. 547, which "codifies" the results of PLR 8103117; *Reesink vs. Commr*, TC Memo 2012-118, *Moore vs. Commr*, TC Memo 2007-134.

7 *See*, *e.g.*, analysis of majority and dissent in *Wrightsman vs. U.S.*, 192 Ct. Cl. 722 (428 F.2d 1316)(1970).

8 *See*, *e.g.*, Wierbicki, "Like-Kind Exchanges," Trusts & Estates, May 2013, at p. 41.

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REAL ESTATE CAPITAL MARKETS

IRS REIT WORKING GROUP

In its Form 8-K filed with the Securities and Exchange Commission on June 6, 2013, Iron Mountain Incorporated ("Iron Mountain") disclosed that the IRS had informed Iron Mountain that it had formed a new internal working group (the "Working Group") to "study the current legal standards the IRS uses to define 'real estate' for purposes of the REIT provisions of the [Internal Revenue Code] and what changes or refinements, if any, should be made to those current legal standards."[1] Further, Iron Mountain indicated that it believed the formation of the Working Group and the study to be conducted thereby would impact the timing of pending private letter ruling ("PLR") requests submitted to the IRS by Iron Mountain and other companies.[2] What followed was a flurry of industry speculation and editorial commentary of a largely negative nature. Indeed, a survey of the coverage of the announcement of the Working Group reveals a sense that the IRS is potentially changing the game (or, perhaps, even the definition of real estate itself). The market also reacted, as shares of companies in the process of converting to a REIT or publicly considering such conversion posted significant declines in the days following the announcement. On November 14, 2013, the IRS contacted various companies to inform them that the Working Group had completed its task and that the IRS would continue to issue PLRs regarding the definition of real estate for purposes of the REIT rules.[3] As of this writing, the IRS has yet to issue a formal announcement regarding the Working Group or its findings. While it has yet to be seen whether or not the Working Group will ultimately have the limiting effect on the REIT industry as some feared, the reality is perhaps less drastic as initially interpreted and may indeed be consistent with prior IRS practice and procedure in the area.

Background

When Congress originally created REITs in 1960, the vehicle was envisioned as a means for average retail investors to make passive investments in commercial properties. The principal advantage of an investment in real property through a REIT is the avoidance of the corporate level of taxation due to the deduction for dividends paid.[4] When Congress enacted REIT legislation, it drew a distinction between operating businesses and the rental of commercial real estate, however, it failed to distinguish between rental real estate classes.[5] Over the last five decades, the REIT has evolved into a powerful vehicle covering a broad spectrum of rental real estate classes, such as office, industrial and multifamily residential properties.[6] Recently, an increasing number of taxpayer favorable PLRs covering an increasingly diverse universe of asset types, coupled with media coverage of noteworthy conversion announcements in the wake of such PLRs, has furthered the perception that the IRS is expanding or liberalizing its application of the longstanding REIT rules and, further, has led to an increased interest in the REIT as an investment vehicle and as an option for an increasingly diverse array of companies (or affiliates created for the purpose of holding "real estate assets") to convert.[7]

With the announcement of the Working Group, and the resulting largely negative reaction in the media and stock markets, there is a sense that the momentum the recent PLRs provided to the industry may have been setback, and the optimism and expectations in connection with the potential IRS blessing of new asset types (e.g., solar panels[8]) appears somewhat tempered. Before delving into the specifics of the market reaction, it is necessary to provide background regarding the Working Group, as well as an overview of some of the recent noteworthy pending and completed REIT conversions as of this writing. This article does each in turn.

IRS Review of REIT Conversion Guidelines

The Working Group was formed with the purpose of studying the current legal standards the IRS uses to define "real estate" for purposes of the REIT rules.[9] The Working Group was to consider what changes or refinements, if any, should be made to those current legal standards. The definition of real estate assets is critical to whether or not a taxpayer will qualify as a REIT due to its central role in both the "income tests"[10] and "asset tests"[11] found in the REIT provisions. The viability of some of the newly proposed REITs hinges entirely on whether or not some specific type of asset constitutes real estate for purposes of the REIT rules. While the recent history of PLRs has shown a favorable trend towards approval of a wide range of assets as qualifying real estate under the REIT rules, the statutory basis and law underlying such rulings has actually remained relatively consistent over the history of REITs. In this regard, it appears that the IRS, via the Working Group, was pausing to evaluate the current application of the well-settled statutory rules to the ever-diversifying PLR requests to ensure that the recent trend of so-called expansive PLRs is consistent with the intended scope and definition of real estate for purposes of the REIT rules. The IRS itself has similarly indicated in previous statements that it has used the same standard to identify qualifying assets for many years, and that the approval of new assets is the result of newly developed assets meeting those existing standards, and "should not be confused with a relaxation of the standards themselves."[12] With respect to this most recent Working Group, there is some indication that the group was actually an internal group that meets periodically to discuss the PLRs that the IRS is working on in the REIT arena – in other words, the Working Group was not necessarily a formal group or even newly-established.[13]

Noteworthy Pending and Recent REIT Conversions

The number and diversity of the recent completed, pending and contemplated REIT conversions illustrates the increasing interest in the structure and the market perception of expanding IRS lenience. This section is intended to provide just a high-level sampling of some recent noteworthy contemplated, pending or completed REIT conversions covering a wide range of underlying asset types. The depth of the following list illustrates the far-reaching impact of the IRS' recent trend of taxpayer favorable PLRs.

Document Storage

As noted in the introduction to this article, the announcement of the Working Group actually arose in connection with public disclosure of the formation of the Working Group by the document storage company Iron Mountain. Iron Mountain had sought a ruling from the IRS that certain racking structures utilized in its document storage warehouses constitute real estate for purposes of the REIT rules.

Data Center Operator

Data centers are buildings that house computers, servers and internet exchanges and the infrastructure needed to run the same. Equinix, Inc. ("Equinix"), a data center operator, is currently planning to convert to a REIT, and is facing scrutiny similar to that encountered by Iron Mountain. Equinix would not necessarily be alone, as Digital Realty Trust, Inc. and DuPont Fabros Technology, Inc. are already operating as REITs.

Outdoor Advertising

Outdoor billboard advertising company Lamar Advertising Co. ("Lamar") has disclosed that it plans to become a REIT and that the IRS is reviewing its election to become a REIT. Earlier this year CBS Corp. submitted a PLR request to the IRS in connection with its own similar plans to convert its outdoor advertising business to a REIT.

Casino

Last year, casino operator Penn National Gaming, Inc. ("Penn") announced its plans to separate its real estate and operating assets by way of a tax-free spin-off transaction that would create the first-of-its-kind gaming focused REIT. Penn's announcement of the transaction was made at the same time as its announcement that it had received a favorable PLR from the IRS.

Solar Power Generation

The media and industry watchers have given significant attention to Renewable Energy Trust Capital, Inc.'s requested ruling from the IRS that ground-mounted solar projects are real estate for REIT purposes. While observers continue to wait for this much-anticipated PLR, a recent PLR believed to have been issued to Hannon Armstrong Sustainable Infrastructure Capital, Inc., and which holds that certain described structural improvements were real estate for purposes of the REIT rules and that interest income from financing such assets qualified as interest on obligations secured by mortgages on real property or interests in real property for purposes of the REIT income tests, failed to live up to the industry's hope that the IRS would provide a sweeping and conclusive blessing of solar assets.[14]

Others

The list can go on, and indeed does. Other similar recent contemplated, pending and completed REIT conversions include prison operators, cell towers, timberland and accommodations businesses.

Market Reaction / Impact

The reaction of the media and various industry watchers was overwhelmingly negative and nervous immediately following the announcement of the Working Group. The announcement generated a significant amount of editorial commentary, much of which was speculative given the relative lack of details provided regarding the specifics of the Working Group. Because the timeline to completion of the Working Group's study was unknown, there was much discussion of the potential delay, or even moratorium, in connection with the IRS' review of existing PLR requests and approval of new applications for REIT status.[15] Some commentators even raised concerns over the possibility that the IRS could strip some companies of their favorable tax status.[16] In the days following the announcement, the stock market followed suit and the stock prices of Iron Mountain, Equinix and Lamar posted losses in spite of a broad market rally.[17] While the media's reaction to the news of the Working Group may have been speculative, it was not necessarily completely unfounded. If the premise is true that the IRS' recent run of largely taxpayer favorable PLRs was an expansion of the REIT rules as much of the editorial commentary suggests, then it may very well be true that the IRS has decided to hit the brakes and take a change of course in order to rein in the application of the REIT rules in order to maintain consistency with the original Congressional intent. Any scaling back by the IRS could have the very real result of hampering the growth of, or even downsizing, the industry.

In the alternative, many tax practitioners believe that it is entirely possible that the Working Group was simply a periodic and necessary evaluation by the IRS to ensure that it is properly and consistently applying longstanding statutory REIT rules. Those of this opinion argue that, while the Working Group was charged with reviewing the legal standards and any changes that may be necessary thereto, there was not and is not necessarily any indication that the IRS intends to change anything. The IRS may simply have been slowing down and taking its time in light of the flood of interest in REITs (and the corresponding influx of PLR requests regarding an increasingly diverse pool of asset types). If this is the case, the results of the Working Group may ultimately be a low impact event in the grand scheme of things. As the time since the announcement of the Working Group continued to grow, there was a noticeable softening of the editorial commentary, and an increasing number of commentators began to posit that perhaps the initial negative reaction in the media was an overreaction to what will ultimately amount to the continuation of the IRS' current approach to applying the same REIT rules to new types of assets.

Conclusion

As of this writing, the IRS has not made any formal announcement regarding the Working Group or its findings. It remains to be seen whether or not the nervousness associated with the announcement of the Working Group was justified. If the IRS was indeed seeking a change of course with respect to the way it applies the REIT rules, then the formation of and review by the Working Group may indeed prove to be a watershed moment for the REIT industry. However, it is possible, and many tax practitioners believe more likely given the consistency of the statutory provisions and the application thereof, that the IRS was not seeking to change anything and that, instead, it was simply taking the opportunity to make a periodic review of the application of said rules to ensure the continued consistent application thereof.

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[1] Iron Mountain Incorporated, Current Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (Form 8-K), at 2 (June 6, 2013).

[2] *Id.* Iron Mountain indicated that the IRS had informed the company that the IRS is "tentatively adverse" on Iron Mountain's PLR request that racking structures constitute "real estate" for REIT purposes.

[3] *See*, Iron Mountain Incorporated, Current Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (Form 8-K), at 2 (November 14, 2013); Lamar Advertising Company, Current Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (Form 8-K), at 2 (November 14, 2013); Equinix, Inc., Current Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (Form 8-K), at 2 (November 14, 2013).

[4] Michael E. Shaff, *The Service's Trend of Friendly REIT Rulings Continues*, 4 Colum. J. Tax L. Tax Matters 17 (2013).

[5] Daniel F. Cullen, *Solar REITs and the IRS Working Group*, J. of Passthrough Entities, September-October 2013.

[6] *Id.*

[7] Indeed, Vol. 4, No. 1 of the Columbia Journal of Tax Law Tax Matters (*available at* http://www.columbiataxjournal.org/tax-matters-vol-4-no-1/) was dedicated to this very issue. As the introduction paragraph notes:

> "In several recent private letter rulings, the IRS appears to apply an expansive interpretation of the definition of "real property" and "rents from real property" in relation to real estate investment trusts (REITs). As REITs purchase properties that include renewable assets, such as solar panels and wind turbines, the continuing development of such assets puts further pressure on the definition of real property and rents from real property. Although private letter rulings do not have precedential effect, some practitioners may look to them for guidance regarding specific issues, especially if a transaction comes squarely within, or close to, the four corners of a ruling. If a private letter ruling describes property such as electricity transmission lines, natural gas pipelines, cell towers, billboards, or renewable assets with sufficient specificity, perhaps tax advisors could become comfortable concluding that similar assets would qualify for the treatment granted in the private letter rulings."

[8] The possibility of solar REITs has received considerable attention in the media over the past year. The recently issued PLR 201323016 has been met with a somewhat lukewarm reception, and industry watchers continue to await the much-anticipated PLR to be issued in connection with the Renewable Energy Trust Capital, Inc.'s PLR request.

[9] *See*, I.R.C. §§ 856 to 859.

[10] I.R.C. §§ 856(c)(2) & (3).

[11] I.R.C. §§ 856(c)(4)(A) & (B).

[12] Vipal Monga, *Firms Restructure As REITs*, Wall Street Journal, *available at* online.wsj.com/article/SB10000872396390443517104577573150214714834.html (Aug. 7, 2012).

[13] *See*, Kelly Kogan, *REIT "Working Group" Business as Usual for IRS*, Project Finance News, *available at* http://www.pfnewswire.com/2013/08/reit-working-group-business-as-usual.html (Aug. 15, 2013).

[14] *See*, Priv. Ltr. Rul. 201323016. Practitioners have connected this PLR to the Hannon Armstrong SEC S-11 filing. The PLR does not actually refer to renewable energy assets, let alone solar assets specifically.

[15] With the announcement of the completion of the Working Group, various companies' public filings have disclosed that the IRS has indicated that it will resume issuing PLRs regarding the definition of real estate for the purposes of the REIT rules. *See, supra* note 3.

[16] A.D. Pruitt and Amol Sharma, *IRS Puts Brakes on Corporate Push to Capture Real Estate Tax Break*, Wall Street Journal, *available at* online.wsj.com/article/SB10001424127887324299104578531101364286158.html (June 7, 2013).

[17] *Id.*

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TAX CONTROVERSY

COURT OF FEDERAL CLAIMS WEIGHS IN ON REQUISITE "INTENT TO EVADE TAX" IN APPLYING STATUTES OF LIMITATION FOR ASSESSMENT

In *BASR Partnership v. United States*,[1] the United States Court of Federal Claims recently held that, in analyzing the statute of limitations applicable to a federal income tax return, the meaning of "intent to evade tax," as such text is used in Code Sec. 6501(c), is limited to instances in which the taxpayer harbored the requisite intent to commit fraud and does not include instances in which the taxpayer's return preparer alone harbored such intent. The *BASR Partnership* court declined to adopt the "factual inquiry" approach taken by the Second Circuit in *City Wide Transit, Inc. v. Commissioner*.[3]

Background

In *BASR Partnership*, William F. Pettinati, Sr., and Mr. Pettinati's accountant ("Malone") received advice from an attorney ("Mayer") as to the tax consequences of the sale of Page Printing Co. ("Page"), a business owned by Mr. Pettinati, his wife, and two gift trusts established for the benefit of the Pettinatis' two sons. The transaction involved a series of steps designed to enable the Pettinatis to trigger a Code Sec. 754 basis step-up with respect to their stock in Page. Such steps included the creation of a family general partnership ("BASR") to which the Page stock was contributed. BASR sold its Page stock to a third party buyer in August 1999.

Malone prepared BASR's tax returns for 1999 in accordance with Mayer's advice. Mr. Pettinati, as BASR's tax matters partner, subsequently filed such tax returns and the IRS stamped such tax returns as received on October 12, 2000. The IRS initiated an audit of such tax returns on August 8, 2006, and issued a Final Partnership Administrative Adjustment ("FPAA") on January 20, 2010. On April 26, 2010, BASR filed a complaint in the United States Court of Federal Claims seeking a refund of federal taxes paid and alleging that the January 20, 2010, FPAA was untimely pursuant to Code Sec. 6229 and Code Sec. 6501.

The court emphasized that there was "no question that BASR's partnership return included false or fraudulent items." However, the Government did not contend that the Pettinatis themselves possessed an "intent to evade tax" within the meaning of Code Sec. 6501(c)(1). Rather, the Government contended that BASR's returns were "false or fraudulent" due to the tax shelter transactions fraudulently structured by Mayer with the intent to evade tax.

Statutes of Limitation for Assessment

Code Sec. 6501(a) provides the general rule that the amount of any taxes imposed under the Code must be assessed within three years after the return was filed.[4] An exception is provided in Code Sec. 6501(c)(1) which states that "[i]n the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time."

Code Sec. 6229(a) provides the general rule that the period for assessing income taxes with respect to any person which is attributable to any partnership item (or affected item) for a partnership taxable year shall not expire before the date which is three years after the later of the date on which such partnership return was filed or the due date of such return (without regard to extensions). Code Sec. 6229(c) provides a special rule in the event any partner has, with the intent to evade tax, signed or participated directly or indirectly in the preparation of a partnership return which includes a false or fraudulent item. In such case, with respect to the partners so signing or participating in the preparation of such return, any income taxes imposed which are attributable to any partnership item (or affected item) for the partnership taxable year to which the return relates may be assessed at any time.[5] With respect to all other partners, the general rule provided in Code Sec. 6229(a) applies to such return substituting "6 years" for "3 years."[6]

Analyzing the Requisite Fraudulent Intent

As a threshold issue, the *BASR Partnership* court cited *Prati v. United States*[7] for the proposition that "[s]ections 6501 and 6229 do not operate independently to allow a taxpayer to assert one in isolation and thereby render an otherwise timely assessment untimely."[8] Thus, when a tax assessment involves a partnership item or an affected item, Code Sec. 6229 can extend (but not shorten) the statute of limitations that is otherwise applicable under Code Sec. 6501.

The Government argued that the fraudulent intent required to extend the statute of limitations under Code Sec. 6501(c)(1) is not limited to the taxpayer. In support of its argument, the Government pointed to *City Wide Transit, Inc. v. Commissioner*,[9] in which the Second Circuit recently held that a tax preparer's fraudulent intent triggered the statute of limitations extension in Code Sec. 6501(c)(1) despite the fact that the tax preparer primarily intended to benefit himself rather than the taxpayers. In *City Wide*, an accountant filed fraudulent tax returns on behalf of the taxpayer in order to embezzle money otherwise due to the IRS. The Tax Court held that the tax evasion was only an "incidental consequence or secondary effect of [the accountant's] embezzlement scheme."[10] The Second Circuit reversed, explaining that "[t]he statute is agnostic as to the attendant motivations for submitting a fraudulent return and only requires that the Commissioner prove a fraudulent return was filed with an intent to evade, that is avoid, paying a tax otherwise due." The Second Circuit was not persuaded that tax evasion

was "a subordinate element to a more grandiose scheme." Rather, the court held that the accountant's scheme was tax evasion.

In *BASR Partnership*, the Government also cited *Allen v. Commissioner*,[11] in which the Tax Court held that "[n]othing in the plain meaning of the statute suggests the limitations period is extended only in the case of the taxpayer's fraud. The statute keys the extension to the fraudulent nature of the return, not to the identity of the perpetrator of the fraud."[12] The *Allen* court explained that "statutes of limitation are strictly construed in favor of the Government."[13]

The *BASR Partnership* court explained that Code Sec. 6501(a) defines "return" as "the return to be filed by the *taxpayer* (and does not include a return of any person from whom the taxpayer received an item of income, gain, loss, deduction, or credit)."[14] The court rationalized that because the language of Code Sec. 6501(a) is expressly limited to a return filed by the "taxpayer," the fraudulent intent referenced in Code Sec. 6501(c) is by implication limited to fraud by the taxpayer.[15] Thus, the court determined that the IRS is bound by the standard three year statute of limitations period in Code Sec. 6501(a) unless the taxpayer possesses fraudulent intent or Code Sec. 6229(c) applies. The Government had conceded that the taxpayers (i.e., the Pettinatis) did not have the requisite intent to commit fraud.

Implications

Although the *BASR Partnership* court adopted a taxpayer-friendly position with respect to the statutes of limitation for assessment, taxpayers should be cautious in relying upon this holding. As discussed above, several other courts have held that Code Sec. 6501(c) applies in the case of return preparer fraud regardless of the taxpayer's innocence. Even the *BASR Partnership* court acknowledged the compelling policy reasons why the extended limitations period of Code Sec. 6501(c) should apply despite the fact that only the return preparer harbored the requisite fraudulent intent noting the "practical impediments to the discovery of tax fraud." As the IRS has frequently explained, the Government faces the same difficulties in investigating fraud cases whether the fraudulence of a return is due to the taxpayer's intent or another involved in the return's preparation.[16]

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1 112 AFTR 2d 2013-XXXX (Fed. Cl. Sept. 30, 2013).

3 709 F.3d 102 (2d Cir. 2013).

4 For these purposes, the term "return" means the return to be filed by the taxpayer (and does not include a return of any person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit). I.R.C. § 6501(a). If a return is filed early, such return is deemed to be filed as of the due date of such return. I.R.C. § 6501(b)(1).

5 I.R.C. § 6229(c)(1)(A).

6 I.R.C. § 6229(c)(1)(B).

7 603 F.3d 1301 (Fed. Cir. 2010).

[8] *Id.* at 1307.
[9] 709 F.3d 102 (2d Cir. 2013).
[10] *City Wide Transit, Inc. v. Comm'r*, 102 T.C.M. (CCH) 542, 2011 WL 5884981, at 5 (2011).
[11] 128 T.C. 37 (2007).
[12] *Id.* at 40.
[13] *Id.* (citing *Badaracco v. Comm'r*, 464 U.S. 386, 391 (1984)).
[14] I.R.C. § 6501(a) (emphasis added).
[15] In addition, the *BASR Partnership* court reviewed the legislative history of section 6501(c)(1) and found support for the view that it is the taxpayer who must have the intent to evade tax, citing section 250(b) of the Revenue Act of 1918.
[16] *See, e.g.*, *Badaracco*, 464 U.S. at 398; *Lucia v. United States*, 474 F.2d 565, 570 (5th Cir. 1973).

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TAX EXEMPT ORGANIZATIONS

INTERACTIVE FORM 1023

Background

Almost all organizations that desire to receive tax-deductible contributions as an organization described under Code Sec. 501(c)(3) must file IRS Form 1023.[1] The basic Form 1023 is 12 pages long and there are an additional 14 schedule pages that may need to be filled out depending on the nature and structure of the applicant organization. In addition, many of the questions require elaboration on separately attached sheets (including a narrative description of activities). Furthermore organizations are required to attach their organizational documents (for example, charter and bylaws for a corporation) and may be required to file additional attachments depending on the type of organization, its governance and activities.[2]

Questions on Form 1023 fall into several categories, including organizational structure, compensation, specific activities and financial data. Many of the questions contain terms of art that are not generally known to the public; for example, Part X Question 7 asks whether the applicant received any "unusual grants." In order to understand such terms of art, an inexperienced applicant would need to refer to the IRS Instructions to Form 1023.

Inexperienced applicants often fill out the Form 1023 incorrectly. They either do not read or do not understand the instructions and fail to provide answers or answer incorrectly. Incomplete applications may lead to delays in IRS processing, and this is significant because the processing time can already be lengthy. In fact, applications that the IRS deems to "require development" before they can be approved must be assigned to an exempt organizations division agent; and as of October 31, 2013, the IRS is assigning for review Forms 1023 received in May 2012.[3] The current Form 1023 was most recently updated in June 2006, though by notice in October 2012, the IRS changed some of the required responses on the Form 1023.

Interactive Form 1023

In September 2013, the IRS released an interactive version of Form 1023 for review. This form may not currently be used, but the IRS intends to make it available for use at the end of the year.[4] It seems that the interactive Form 1023 has four advantages over the current Form 1023. First, the interactive Form 1023 is only accessible through www.stayexempt.irs.gov and this website requires potential applicants to answer certain questions before they can access the interactive Form 1023, such as "Do you have an Employer Identification Number (EIN)," "Do you have an organizing document" and "Does your organizing document contain the required Section 501(c)(3) purpose and dissolution clauses?" The website includes an explanation of each question and in the last case, an example of appropriate clauses. Because these

questions must be answered affirmatively in order to qualify for recognition under Code Sec. 501(c)(3), asking them up-front should lessen some incorrectly filled out Forms 1023.

Second, for questions that require elaboration, the interactive Form 1023 automatically provides appropriately labeled attachments for applicants to use. Third, once an applicant has filled out the interactive Form 1023 and all such attachments, such applicant can print all of the same at once. Fourth and perhaps most importantly, the interactive Form 1023 includes pop-up information boxes for most items. For example, the question regarding "unusual grants" described above has a pop-up box that describes what constitutes an unusual grant. These pop-up boxes should significantly reduce the number of incorrectly answered questions.

It seems that there is only one disadvantage to the interactive Form 1023 when compared with the current Form 1023: because the attachments to the interactive Form 1023 are in pdf format, it will not be as easy to review and revise them as it would be if they were in Microsoft Word or another word processing format.

In addition, there are two areas that the IRS should have addressed in the interactive Form 1023 (and perhaps still will address with the final version). First, the interactive Form 1023 may not be filed electronically—applicants still need to print out and mail all the documents. Second, the interactive Form 1023 does not update the current Form 1023. For example, Part IX of Form 1023 asks for financial data for a certain number of years depending on how long the applicant organization has been in existence. But the October 2012 notice changed the number of years of financial information required in Part IX. Part IX of the interactive Form 1023, rather than incorporating the October 2012 change in the form itself, still sets forth the old requirement in the form itself and has the updated requirement only in a pop-up box.

Conclusion

The interactive Form 1023 likely will not have an impact on lawyers, accountants and others that regularly file Forms 1023 with the IRS. The pop-up buttons, initial questions, automatic attachments and easy printing do not really benefit such persons who are already familiar with the attachments, questions and terms of art. Nonetheless, the changes should make it much easier for inexperienced applicants to correctly and efficiently file the Form 1023. This should reduce the time IRS agents need to spend identifying incomplete applications and improve processing times for all applicants. In other words, the interactive Form 1023, though not perfect, should provide benefits for inexperienced applicants.

[1] Exceptions include churches, their integrated auxiliaries, conventions or associations of churches and public charities, the gross receipts of which in each taxable year are normally not more than $5,000. I.R.C. § 508(c).

[2] The Form 1023 Checklist, attached at the end of the Form 1023 at http://www.irs.gov/pub/irs-pdf/f1023.pdf, sets forth all the possible attachments.

[3] http://www.irs.gov/Charities-&-Non-Profits/Where-Is-My-Exemption-Application.

[4] EO Update: e-news for Charities and Nonprofits (September 6, 2013).

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EUROPE

EXPATRIATES IN GERMANY – TAX CONSEQUENCES FOR EMPLOYERS AND EMPLOYEES

German Income Tax Consequences for Employee

Employees having their domicile or their habitual abode in Germany are generally subject to German Income Tax on their worldwide income, including the income paid as consideration for their employment activities.

Having a domicile in Germany means holding an apartment that the individual will keep and use. This means that the individual is entitled to dispose of the premises and does not use it for only temporary purposes. The term "apartment" means any premises which are suitable to reside in, not necessarily requiring kitchen or washrooms. It does not matter if an employee who is a non-German citizen but has his domicile in Germany has another residence abroad.

Whether or not an employee's residence qualifies as a domicile for income tax purposes depends on the circumstances of each case. If the requirement of a domicile is not met, the employee will nevertheless be subject to German Income Tax if his habitual abode is in Germany. This is the case where the individual has spent a coherent period of six months in Germany, irrespective of short-term interruptions during such period. Homeward journeys for visiting the employee's family, vacations or business travels do not interrupt the six-month period. In contrast to a domicile, an individual cannot have more than one habitual abode.

If an employee does not have his domicile or habitual abode in Germany, his income, nevertheless, may – at least partially - be subject to German Income Tax, provided the income relates to the employee's activities which are utilized in Germany in order to generate German source income. This may, for example, be the case where a U.S. tax resident is acting as a *Geschäftsführer* (managing director) for a German company which has its place of management in Germany. It does neither matter whether the salary is paid by a domestic or foreign employer, nor whether the employee has German citizenship.

Impact of Double Tax Treaties

Once the employee becomes subject to German Income Tax, he may still be subject to income tax in the state where he was posted from, be it because he is still keeping his residence in the sending state, or be it because he holds the citizenship of the sending state and the taxability is tied to the citizenship.

A U.S. tax resident who maintains his residence in the United States, but who also establishes a residence or a habitual abode in Germany, may qualify as a resident of both states. In this case, the so-called "tie-breaker rule" of the double tax treaty between the United States and Germany (the "DTT") applies. According to this rule, the employee shall be deemed to be a resident only of the country in which he has a permanent home available to him. If he has a permanent home available to him in both states, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (the so-called "center of vital interests"). For married employees, this is usually the state where the residence of the family is located. If this state cannot be determined, or if a permanent home is not available to him in either state, he shall be deemed to be a resident only of the state in which he has an habitual abode. If he has a habitual abode in both states or in neither of them, he shall be deemed to be a resident only of the state of which he is a national.

The determination of the residence is crucial as the DTT links the tax consequences to the residence. In case the expatriate has shifted his "center of vital interests" to Germany, his employment income is subject to German Income Tax. However, if the employee's family stays behind, and if the employee is permanently returning to the United States but still maintaining an apartment in Germany, the employee's residence and the state where his employment is exercised deviate. In such a case, additional considerations must be taken into account. The employee's income would be subject to income tax in the United States, if (a) the employee is present in Germany for a period or periods not exceeding 183 days in the respective calendar year, (b) the remuneration is paid by, or on behalf of, an employer who is not a German resident, and (c) the remuneration is not borne by a permanent establishment which the employer has in Germany. If the foregoing requirements are not met, the employee is subject to German Income Tax. It must be observed that his taxability in Germany only relates to the income from his activities in Germany. If necessary, the income must be split up on a day-per-day basis.

The application of the DTT has the effect that the German Income Tax can be credited against the employee's aggregate income tax assessed in the United States.

The taxable income will be subject to tax at the individual employee's tax rate, which depends upon the employee's taxable income. The higher the taxable income the higher the tax rate. Currently, income tax rates range from 15% to 45%. Taxable income exceeding EUR 250,000 (unmarried employees) and EUR 500,000 (married couples filing their tax returns jointly) is subject to an income tax rate of 45%. An additional tax, the so-called solidarity surcharge (*Solidaritätszuschlag*), amounts to 5.5% of the income tax liability.

Employer's Obligations Arising From German Income Tax Liability of Employee

In principle, salary paid by an employer to a German tax resident employee is subject to wage tax, i.e. the employer has to deduct and withhold a portion of the employee's gross salary and to

forward the withheld amount to the tax authorities. Such withheld wage tax is deemed a prepayment for the employee's overall tax liability in relation to his salary. In addition, the employer is obliged to deduct solidarity surcharge, church tax (if applicable) and social security contributions.

Solidarity surcharge amounts to 5.5.% of the calculated wage tax.

Whether or not church tax is deducted depends upon the employee's membership in a church (e.g. catholic or protestant). The German federal states have different church tax rates, either 8% or 9% of the calculated wage tax.

The social security contributions comprise contributions for:

- health insurance;
- compulsory long-term care insurance (also called nursing care insurance);
- statutory pension insurance (also called old age pension insurance); and
- unemployment insurance.

The costs for the social security contributions are in principle shared between employer and employee at 1:1; however, the employer is obliged to withhold also the employee's portion and to forward it to the social security institutions. With regard to the specific social security contributions certain particularities exist.

It must be distinguished whether the employee is member of the statutory health insurance or of a private health insurance. Regarding the statutory health insurance (in 2013) the employer has to pay 7.3.% of the gross salary into the insurance scheme, while the employee has to cover 8.2% of the gross salary. The income limit for the assessment of the contribution is EUR 3,937 per month (in 2013) and EUR 4,050 (per 2014), for gross salaries exceeding this limit no further health insurance contributions arise. The contributions are deducted at source and paid to the health insurance scheme. In case the employee is a member of a private health insurance, the employer usually is paying its compulsory contribution out to the employee in addition to the net salary. The private health insurance scheme is collecting the contributions from the employee himself. The amount of the contributions may vary, depending upon the insurance company. Usually, the contributions are lower than those paid to the statutory health insurance scheme.

The compulsory long-term care insurance amounts to a rate of 2.05% (as of 2013) of the gross salary, shared by employer and employee. The income limit for the assessment of the contribution is also EUR 3,937 per month (in 2013) and EUR 4,050 (per 2014). For taxpayers without children an additional contribution at 0.25% arises which must be borne by the employee fully.

Regarding the statutory pension insurance, the contribution rate is 18.9% of the gross salary. The income limit for the assessment of the contribution is EUR 5,800 per month (in 2013) and EUR 5,950 (in 2014). The contribution must be borne by employer and employee at 1:1.

The contribution rate for the unemployment insurance is 3% of the gross salary altogether. The income limit for the assessment of the contribution is also EUR 5,800 per month (in 2013) and EUR 5,950 (in 2014) and must also be borne by employer and employee at 1:1.

Non-compliance with the wage tax and social security contribution withholding constitutes the employer's liability with regard to the amounts wrongfully paid out to the employee. In case the employee fails to pay the assessed income tax, the tax authorities may assert the income tax and the other surcharges and contributions directly against the employer. In addition, in case of a willful behavior the employer and the managing directors, respectively, would also be exposed to criminal liability.

However, to be subject to the employer's obligation, the employer must (a) have its place of management, its business seat, a permanent establishment or a permanent representative in Germany (so-called "domestic employer"), or (b) professionally and commercially assign employees to third parties in Germany without having a German tax presence itself (so-called "foreign assignor").

It is quite common for U.S. companies to employ German tax residents in order to establish and promote the business of the U.S. headquarter in Germany. In such cases the German tax resident employee often undertakes his activities from his home office, leading to the question if through the home office the employee creates a permanent establishment of the U.S. company in Germany. Such permanent establishment could trigger a tax liability for all taxable income of the US company which can be attributed to the employee's activities. Per the definition of a permanent establishment under German domestic tax law, a home office currently should not qualify as a permanent establishment. However, this subject may become more critical in the future, as the Commentary to the Model Treaty Convention may be altered in this regard. It remains to be seen how the German tax administration would adopt this point of view.

If the non-German employer does not qualify as "domestic employer" or as "foreign assignor," the employee himself is obliged to make the necessary registrations with the tax authorities and the social security institutions. In particular, the employee will be obliged to make monthly Income Tax prepayments made on the basis of his annual salary.

Particularities with Regard to Stock Options

The employer's obligation to withhold wage tax and social security contributions also occurs if salary-like benefits in kind are granted. While neither the grant nor the vesting of stock options

trigger German Income Tax implications, the employee's exercise of the stock options is subject to German Income Tax.

The tax base is the difference between (i) the market value of the shares at the date of transfer and (ii) the sum of the agreed exercise price. If the agreed exercise price is equal to the market value of the shares at the date of transfer, the exercise of the options does not trigger income tax. In case the exercise price is zero, the market value of the shares is the relevant tax base.

If the employee is employed by a German subsidiary, while the shares are issued by a U.S. company, this has no effect on the wage tax withholding obligation of the German employer, provided that the employer could have known that such benefit is granted. According to German Income Tax law, such knowledge is assumed, if the employer and the issuer qualify as affiliated companies.

If the entire gross salary of the employee should not be sufficient, the employee would be obliged to provide his employer with the necessary amounts which the employer would have to use in order to cover its wage tax withholding obligation. If the employee fails to do so, the employer would be obliged to inform the tax authorities in order release itself from its wage tax obligation.

Particularities may arise if an expatriate has already been granted stock options when working outside of Germany, while the stock options were exercised when being a German tax resident. In such a case it must be examined when the options were actually vested. It must be taken into account that stock options are deemed as consideration for an employee's efforts during the period between the grant of the option right and the first point of time when the employee is entitled to exercise the option right. Therefore, the issue is where the income which was generated by the option holder between the grant of the options and the vesting will be subject to taxation. In a case, where (a) the option holder has not been a German tax resident, and (b) the option holder has conducted his entire work between the grant of the options and the vesting of the options solely outside of Germany, Germany would not have the taxation right in relation to the accrued benefits, so that no obligation to withhold tax and social security contributions in Germany for the employer would exist. However, according to a German treaty-override provision this exemption from wage tax withholding obligations would require evidence to be provided by the employee that this other country has either waived its taxation right or that the tax in relation to the accrued benefits was assessed and paid in such other country.

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ASIA

CHINA EXPORTED SERVICES: ZERO-RATED VAT OR EXEMPTION

The current Business Tax ("BT")[1] to Value Added Tax ("VAT")[2] Transformation Pilot Program[3] in The People's Republic of China ("PRC") provides zero-rated treatment[4] or exemption from VAT to certain cross-border services. Zero-rated VAT treatment provides greater potential refund benefits than a VAT exemption because when a service is zero-rated, no output VAT[5] is payable, but input VAT incurred on costs is fully recoverable. As a result, there is no VAT cost. By contrast, when a service is VAT-exempt, no output VAT is payable, but the input VAT incurred on costs is not recoverable and, therefore, becomes a cost to the business.

Zero-rate VAT

China's State Administration of Taxation ("SAT") released a bulletin on August 28, 2013[6] ("Bulletin 47"), which provides nationwide implementation guidance for the application of zero-rated VAT treatment on qualifying taxable services. Bulletin 47 applies retroactively from August 1, 2013 and supersedes guidance issued in 2012 on the procedures for claiming zero-rated treatment for taxable services under the VAT pilot program[7] ("Bulletin 13"). The following services are subject to the zero-rate VAT:

- International transport services (including cross-border and overseas transport of passengers and cargo);
- Research and development services provided for overseas entities; and
- Design services provided for overseas entities (except design services provided for domestic immovable property).

Bulletin 13 clarified how the calculation of the "exempt, credit and refund" method[8] is to be used. Bulletin 47 makes the following changes/clarifications:

- Where international transport is provided using vehicles obtained under a voyage charter, time charter or wet lease, the lessee, rather than the lessor, can apply for zero-rated VAT treatment.
- The "exempt and refund" method applies to trading companies that provide services eligible for zero-rated VAT treatment. The VAT refund mechanism under this method is generally less complicated than that under the "exempt, credit and refund" method.

VAT exemption

On September 13, 2013, the SAT issued Bulletin [2013] No. 52 ("Bulletin 52"), which provides for the implementation of VAT exemptions for exported services. The exemptions apply broadly to many cross-border service arrangements.

Bulletin 52 provides that the following services qualify for exemption from VAT:

- Leasing of tangible movable property where the asset is being used outside of the PRC;
- Unlicensed international transportation;
- Engineering, as well as exploration services, with the related project or mineral resources located outside the PRC;
- Technology transfer, technology consulting, energy management services (except where the object of the energy management contract is located in the PRC) provided to overseas entities;
- Software services, circuit design and testing services, business process management services provided to overseas entities;
- Convention and exhibition services located outside the PRC;
- Trademark and copyright transfer services, intellectual property services provided to overseas entities;
- Advertising services where the related advertisement is released outside the PRC;
- Warehousing services where the location of the warehouse is outside the PRC;
- Logistics and ancillary services provided to overseas entities (except warehousing services);
- Certification, verification and consulting services provided to overseas entities (except for services in relation to goods or immovable property located in the PRC);
- Broadcast and distribution of radio, films and television programs outside the PRC; and
- Production of radio, films and television programs for overseas entities.

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[1] BT is a turnover tax imposed upon activities involving intangible goods and services, which are not subject to VAT.

[2] VAT is a turnover tax levied on all units and individuals engaged in the sale of goods, the provision of processing, repair or replacement services, or the importation of goods, within the territory of the People's Republic of China.

[3] The VAT Reform Pilot began on 1 January 2012 in Shanghai and applies to the transportation and certain modern service industries. The pilot aims to resolve the double or multiple taxation issues that arise under China's current indirect tax system, which includes both a VAT levied on the supply of goods, the provision of repair, processing and replacement services, and on imports, and a BT levied on the provision of other services and the transfer of intangibles and real property. Different rates are imposed under the VAT and BT regimes, and unlike VAT, an input tax credit is not available under the BT regime. The reform will gradually replace the dual tax system with a single system applying to the supply of both goods and services.

[4] Generally, export goods attract a zero rate of VAT. Taxpayers exporting goods at the zero tax rate will not incur any tax upon exporting. In addition, they can apply for a tax refund in relation to the purchase or manufacture of the exported goods on which VAT has previously been paid. This is known as tax refund on export.

[5] Output tax (also referred to as "sales VAT") is computed based on the value of the taxpayer's sales. For taxpayers selling goods or supplying taxable labour services, output tax is calculated by applying the stipulated tax rate to the sales value. Under the tax credit system, the output VAT is offset by the input VAT payable by the taxpayer on the purchase of goods or on the receipt of taxable services. The VAT paid by the general taxpayer is the input tax. The input tax is used as a credit against the output tax levied on selling the goods. As a result, only the net amount under the offset mechanism is the tax to be borne by the general taxpayer.

[6] SAT Bulletin [2013] No. 47.

[7] SAT Bulletin [2012] No. 13.

[8] Exemption – goods and services are exempt from output VAT. Deduction – applies to production enterprises (or service provided enterprises) whose self-manufactured goods are both exported (either directly or through export agents) and sold domestically. The input VAT credit on materials purchased for the production of export goods can offset against the output VAT on domestic sales. Refund – applies if there is excess input VAT above that amount retained for credit (to be carried forward).

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