Foreign Persons Investing in U.S. Real Estate: Partnership and Other Structures, Opportunities and Traps

NYU Summer Institute in Taxation: Advanced International Tax

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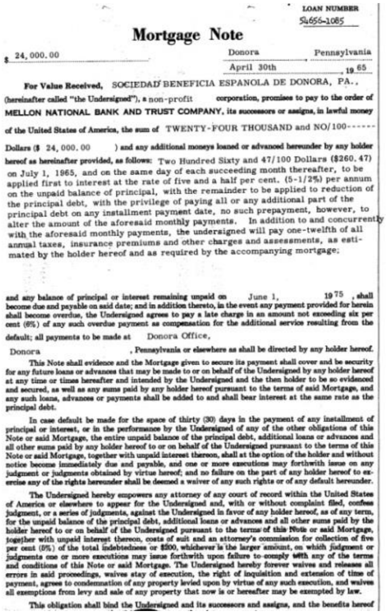
Principal Topics

- **Building Blocks**
- **Planning**
- **Tax Planning with Debt**
- **Real Estate Investment Trusts**
- **Questions**



LOAN NUMBER 54656-1085

Mortgage Note

$ 24,000.00

Donora, Pennsylvania

April 30th, 19 65

For Value Received, SOCIEDAD BENEFICIA ESPANOLA DE DONORA, PA., (hereinafter called "the Undersigned"), a non-profit corporation, promises to pay to the order of MELLON NATIONAL BANK AND TRUST COMPANY, its successors or assigns, in lawful money of the United States of America, the sum of TWENTY-FOUR THOUSAND and NO/100------ Dollars ($ 24,000.00) and any additional moneys loaned or advanced hereunder by any holder hereof as hereinafter provided, as follows: Two Hundred Sixty and 47/100 Dollars ($260.47) on July 1, 1965, and on the same day of each succeeding month thereafter, to be applied first to interest at the rate of five and a half per cent. (5-1/2%) per annum on the unpaid balance of principal, with the remainder to be applied to reduction of the principal debt, with the privilege of paying all or any additional part of the principal debt on any installment payment date, no such prepayment, however, to alter the amount of the aforesaid monthly payments. In addition to and concurrently with the aforesaid monthly payments, the undersigned will pay one-twelfth of all annual taxes, insurance premiums and other charges and assessments, as estimated by the holder hereof and as required by the accompanying mortgage;

and any balance of principal or interest remaining unpaid on June 1, 19 75, shall become due and payable on said date; and in addition thereto, in the event any payment provided for herein shall become overdue, the Undersigned agrees to pay a late charge in an amount not exceeding six per cent (6%) of any such overdue payment as compensation for the additional service resulting from the default; all payments to be made at Donora Office, Donora, Pennsylvania or elsewhere as shall be directed by any holder hereof.

This Note shall evidence and the Mortgage given to secure its payment shall cover and be security for any future loans or advances that may be made to or on behalf of the Undersigned by any holder hereof at any time or times hereafter and intended by the Undersigned and the then holder to be so evidenced and secured, as well as any sums paid by any holder hereof pursuant to the terms of said Mortgage, and any such loans, advances or payments shall be added to and shall bear interest at the same rate as the principal debt.

In case default be made for the space of thirty (30) days in the payment of any installment of principal or interest, or in the performance by the Undersigned of any of the other obligations of this Note or said Mortgage, the entire unpaid balance of the principal debt, additional loans or advances and all other sums paid by any holder hereof to or on behalf of the Undersigned pursuant to the terms of this Note or said Mortgage, together with unpaid interest thereon, shall at the option of the holder and without notice become immediately due and payable, and one or more executions may forthwith issue on any judgment or judgments obtained by virtue hereof; and no failure on the part of any holder hereof to exercise any of the rights hereunder shall be deemed a waiver of any such rights or of any default hereunder.

The Undersigned hereby empowers any attorney of any court of record within the United States of America or elsewhere to appear for the Undersigned and, with or without complaint filed, confess judgment, or a series of judgments, against the Undersigned in favor of any holder hereof, as of any term, for the unpaid balance of the principal debt, additional loans or advances and all other sums paid by the holder hereof to or on behalf of the Undersigned pursuant to the terms of this Note or said Mortgage, together with unpaid interest thereon, costs of suit and an attorney's commission for collection of five per cent (5%) of the total indebtedness or $200, whichever is the larger amount, on which judgment or judgments one or more executions may issue forthwith upon failure to comply with any of the terms and conditions of this Note or said Mortgage. The Undersigned hereby forever waives and releases all errors in said proceedings, waives stay of execution, the right of inquisition and extension of time of payment, agrees to condemnation of any property levied upon by virtue of any such execution, and waives all exemptions from levy and sale of any property that now is or hereafter may be exempted by law.

This obligation shall bind the Undersigned and its successors and assigns, and the benefits hereof

BUILDING BLOCKS: OWNERSHIP OF REAL ESTATE, STOCK & NOTE

Two U.S. Tax Regimes May Apply

- **Passive Income**: FDAP Income from U.S. Sources
  - 30% tax on “gross income”
    - U.S. payor withholds tax
    - Subject to reduction or elimination by (i) Tax Treaty or (ii) Code exemption (e.g., portfolio interest)

- **Active Income**: ECI Income
  - If engaged in U.S. trade or business (ETB) then income effectively connected (ECI) with that business is subject to U.S. income tax
    - Must file U.S. tax return

      Tax imposed at graduated rates (NRA is eligible for long-term capital gains rates)

      Tax imposed on “net income” so get deductions to lower tax liability
    - Branch profits tax may apply to non-US corporations

Rental Income

- Rental income: **FDAP** income subject to 30% withholding tax
- Tax can be very harsh
  - Example:
    - Lessee pays $100 rent to owner and lessee pays expenses to 3rd parties related to the property of $100 (e.g., real property taxes, insurance)
    - Gross rental income = $200
    - Withholding tax = $60
    - Net cash owner gets = $40 ($100 - $60)
    - Effective tax rate of 60%

Rental Income (cont'd)

- If leasing or other activity in relation to property makes foreign owner **ETB,** then rental income becomes **ECI**
- <u>Tax *only* on "net income</u>" from property, which is usually produces lower tax for owner
  - Example:
    - Lessee pays $100 rent to owner and lessee pays expenses related to the property of $100
    - Gross rental income = $200
    - Net rental income (before depreciation & interest deductions) = $100
    - Maximum Tax (assuming no depreciation or interest) = $35
    - Effective tax rate = 35% and lower if get depreciation, interest & other deductions
  - Owner must file tax return

Rental Income (cont'd)

- When does leasing make foreign owner **ETB**?
  - General Rules:
    - Rental of one property to one tenant under a "net" lease is not ETB

      See Rev. Rul. 73-522; *Neill*
    - Rental to many tenants is ETB

      See *Pinchot* (11 real estate properties)
  - Election to be ETB: §871(d), 882(d)
    - Often recommended since lower tax burden (due to deductions)
- If rental income is ECI, give Form W-8ECI to lessee to eliminate withholding tax

Sale of Real Estate

- Gain is Taxable: Foreign Investment in Real Property Tax Act of 1980 (**FIRPTA**) – §897
  - Gain from sale of "United States real property interest" ("USRPI") taxed as if:
    - Foreign seller is engaged in a trade or business in the U.S. & the gain is effectively connected with that trade or business
  - Foreign sellers are taxed on gains at the same rates applicable to U.S. sellers
    - Gain can qualify for long-term capital gains treatment
    - Like kind exchange treatment does not apply *unless* the seller receives U.S. property in the exchange – §1031(h)

Sale of Real Estate (cont'd)

- Definition of USRPI (Treas. Reg. § 1.897-1)
  - Interest in real property:
    - Real property includes land, buildings, and other improvements

      Includes growing crops and timber, and mines, wells and other natural deposits – but once extracted or severed, crops, timber, ores, minerals, etc. are no longer USRPIs

      Includes "associated personal property"

      Includes direct or indirect right to share in appreciation in value, gross or net proceeds or profits from real property
    - Does not include mortgage loan at fixed rate of interest (or variable rate such as prime, LIBOR, etc.)
  - Interest in domestic corporation that was a U.S. real property holding corporation (USRPHC – see later slide) at any time during the 5-year period preceding sale

Sale of Real Estate (cont’d)

- Withholding Requirement: §1445
  - Buyer must withhold 10% of “Amount Realized” on Sale
- Problem: Overwithholding
  - Example:
    - Sell real estate with a tax basis of $900 for $1,000
    - Buyer must withhold $100 tax (10% of $1,000) even though gain is only $100 & tax will be less than that
  - Solution: Get Exemption or reduced rate certificate by filing Form 8288-B before the sale
- Rev. Proc. 2000-35 explains this
- Recommended in example above to lower the withholding tax

Sale of Real Estate (cont'd)

- Other Exemptions to Withholding:
  - Non-recognition rules can apply
    - Domestication of a foreign corporation that owns US real estate under §897(e)
    - Contribution of US real estate to a newly formed US company under §897(e)
    - §1031 Like kind exchange of US real estate for other US real estate under §897(e)
    - §355 spin-offs may work under §897(d)

Dividend from U.S. Corporation

- **Dividend income**:
  - FDAP income subject to 30% withholding tax
    - Subject to reduction or elimination: Tax Treaties
- **Non-dividend distributions:**
  - If corporation is a USRPHC, as discussed below, withhold 10% of the distribution - §1445(e)(3)
    - Subject to reduction if go to IRS to obtain exemption or reduced rate certificate
- **REIT Dividends:**
  - Special rules discussed later

Sale of Stock of U.S. Corporation

- Normal rule: Gain from sale is not U.S. source FDAP income and does not make investor ETB
- FIRPTA: Taxable if sell stock of a U.S. Real Property Holding Corporations (USRPHC)
  - Treats the gain as ECI income
  - Corporate sellers also have branch profits tax

Sale of Stock (cont'd)

- USRPHC definition (§897(c)(2)):
  - FMV of USRPIs held on any "applicable determination date" equals or exceeds
    - 50% of sum of FMVs of (i) USRPIs; (ii) non-U.S. real property interests; and (iii) other trade or business assets
  - Look-through rule for assets held through entities
    - For corporations, only look-through if own more than 50%
- Exemption:
  - Regularly traded class of stock if taxpayer owns 5% or less
  - Does not include stock in a corporation that has sold all of its USRPIs in taxable transactions

Interest Income from U.S. Mortgage

- Interest income is **FDAP** income subject to 30% withholding tax
- Elimination under:
  - Portfolio Interest Exemption- §§ 871(h), 881(c) applies to all interest if debt is in registered form except:
    - Loan by foreign bank in the ordinary course of business
    - Loan from 10% or greater shareholder or partner
    - Contingent interest
    - HIRE Act of 2010 eliminated exception for post-3/18/2010 instruments in bearer form
  - Tax Treaties
    - Almost all treaties provide for exemption or reduced rate

Interest Income (cont'd)

- <u>Issue</u>: Can a foreign lender be ETB?
  - **"Buy" outstanding mortgages:** No
  - **"Originate" or make new loans:** Yes, if lender makes many loans in the U.S. and are therefore conducting a lending business in the U.S. (looks like a bank)
- If ownership of mortgages makes lender ETB, then portfolio interest exemption will <u>not</u> apply
  - Must file U.S. tax return and pay tax on net income from lending business
- <u>Issue</u>: How is interest from foreign seller financing of real estate sale taxed?
  - Not taxable under FIRPTA
  - Either FDAP income or (less commonly) ECI, whether or not sale that generated the note is taxed under FIRPTA

Sale of U.S. Mortgage

- General rule: Gain from sale is not U.S. source FDAP & not ECI
- Exception:
  - If in U.S. lending business then gain from sale would be ECI and therefore taxable
  - If mortgage loan has contingent interest then the loan is a USRPI and gain from its sale will be taxable under FIRPTA
- Example: Loan has 5% fixed interest and contingent interest = 25% of cash flow from the property

FATCA & REAL ESTATE

FATCA: Application to Real Estate

- FFI: 30% withholding on withholdable payments under §1471 will be imposed unless FFI:
  - Signs agreement with IRS (“PFFI Agreement”);
  - Is resident of country that has signed a FATCA IGA;
  - Is exempt from FATCA under existing IRS guidance
- NFFE: 30% withholding on withholdable payments under §1472 will be imposed unless NFFE:
  - Certifies that it has no substantial U.S. owner”; or
  - Provides the name, address, and TIN of each substantial U.S. owner; and
  - In either case, withholding agent (a) neither knows nor has reason to know certification is incorrect and (b) provides the substantial U.S. owner to IRS

FATCA: Application to Real Estate (cont'd)

Withholdable payments – real estate-related income:

- FDAP:
  - U.S.-source interest (e.g., interest from mortgage loan),
  - Dividends (e.g., dividend from USRPHC),
  - Rents and other types of payments from the U.S. (e.g., rent on U.S. real estate)
- U.S. Securities:
  - Gross proceeds from the sale of any property that could produce U.S.—source dividends or interest
  - This includes USRPHC stock and loan principal repayments from a U.S. borrower

ESTATE AND GIFT TAXES

Gift Tax

- Nonresident aliens are taxed on gifts of tangible (but not intangible) property located in the United States
  - Gift of U.S. real property is subject to gift tax
  - Gift of stock (whether domestic or foreign corporation) is *not* subject to tax
  - Gift of partnership interest probably *not* subject to tax
  - Points to note:
    - No step-up in basis on *inter vivos* gift
    - No unified credit
    - Substance over form risk. For example:

      Donee or trust is funded with cash and purchases real property from grantor – e.g., *Davies v. Commissioner*, 40 T.C. 525 (1963)

      Foreign owner contributes property to partnership and then makes gift of partnership interest

Estate Tax

- Estate of nonresident alien is subject to estate tax on property located in the United States. Includes:
  - U.S. real property and tangible property located on it
  - Stock in U.S. corporation (publicly traded or not)
  - But not stock in foreign corporation
  - Top rate (2013) 40%; unified credit equivalent to $60,000 exemption (unchanged for decades)
- Uncertain treatment of partnership interests
  - IRS position: Interest is located in the U.S. if partnership is engaged in U.S. trade or business. What if:
    - Partnership not ETB but decedent elected under §871(d)?
    - Partnership owns only residence for NRA's personal use?
  - Other theories: Place of organization or partner domicile

PLANNING

Before Planning Begins

- Understand investor characteristics - type, location
- Ascertain investment characteristics and objectives:
  - Use – personal use, business, investment
  - Types of income generated from real estate: Rent, interest, dividends, capital gains, services and others
  - Capital – equity, debt (many different flavors and sources)
  - Exit – anticipated timing, method
- Consider choice of entity – wholly-owned, joint ventures, passive investment vehicles (e.g., REITs)
- Withholding and compliance
- Estate and gift taxes

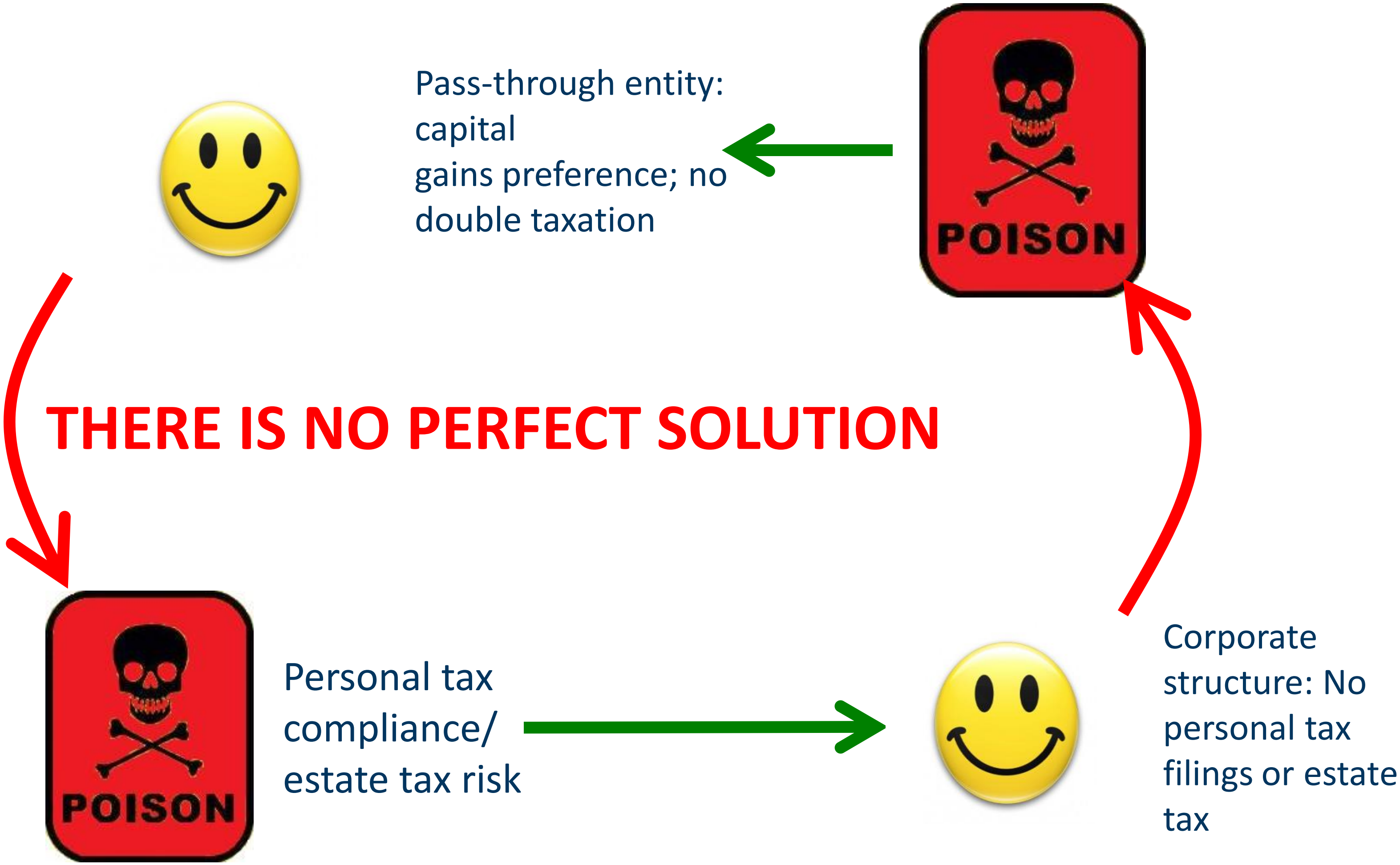
Home Country Taxation

- No planning should be undertaken before considering whether home country taxation is relevant
- U.S. taxation of foreign investors may be modified by treaty
  - No exception from U.S. taxation of gain from real estate but treaties can reduce or eliminate tax on interest and dividends
  - Almost all treaties contain "limitation on benefits" provisions to counteract abusive use of treaties

Objectives Drive Structure

- Tax objectives:
  - Avoid cross-border double taxation (U.S./foreign)
  - Mitigate taxation of operating income
  - Avoid double taxation of corporate earnings
  - Obtain long-term capital gains treatment on sale
  - Avoid gift and estate taxes
  - Limit overwithholding
  - Limit contact with U.S. tax system
- Nontax objectives
  - Preserve confidentiality
  - Facilitate inter-family transfers
  - Limited liability

Structuring May Mean Picking Your Poison



Options - 1

Foreign
Individual

$\downarrow$

real estate

- 20% tax or 39.6% tax
- Privacy Concerns
- Estate Tax at 40%
- but - only one level of tax!

Options - 2

Foreign Individual

↓

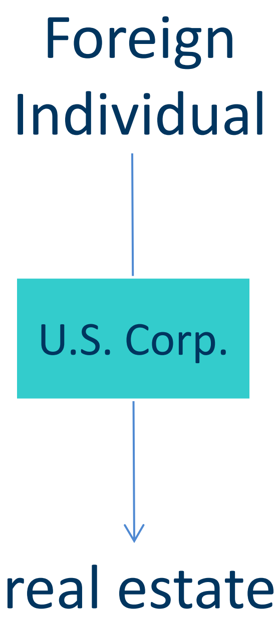
Foreign Corp.

↓

real estate

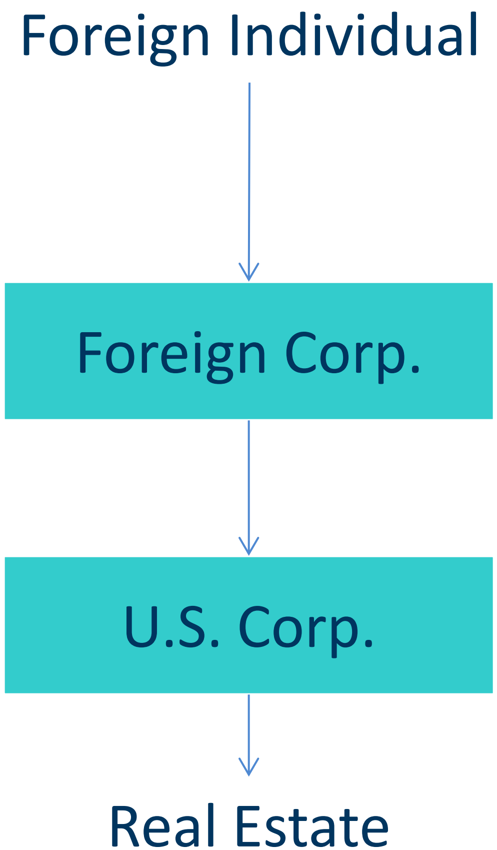
- No Estate Tax
- Branch Profits Tax
- Privacy Concerns
- Sale of Stock - Tax Free BUT!
- Tax-Free Refinancing Distributions

Options - 3



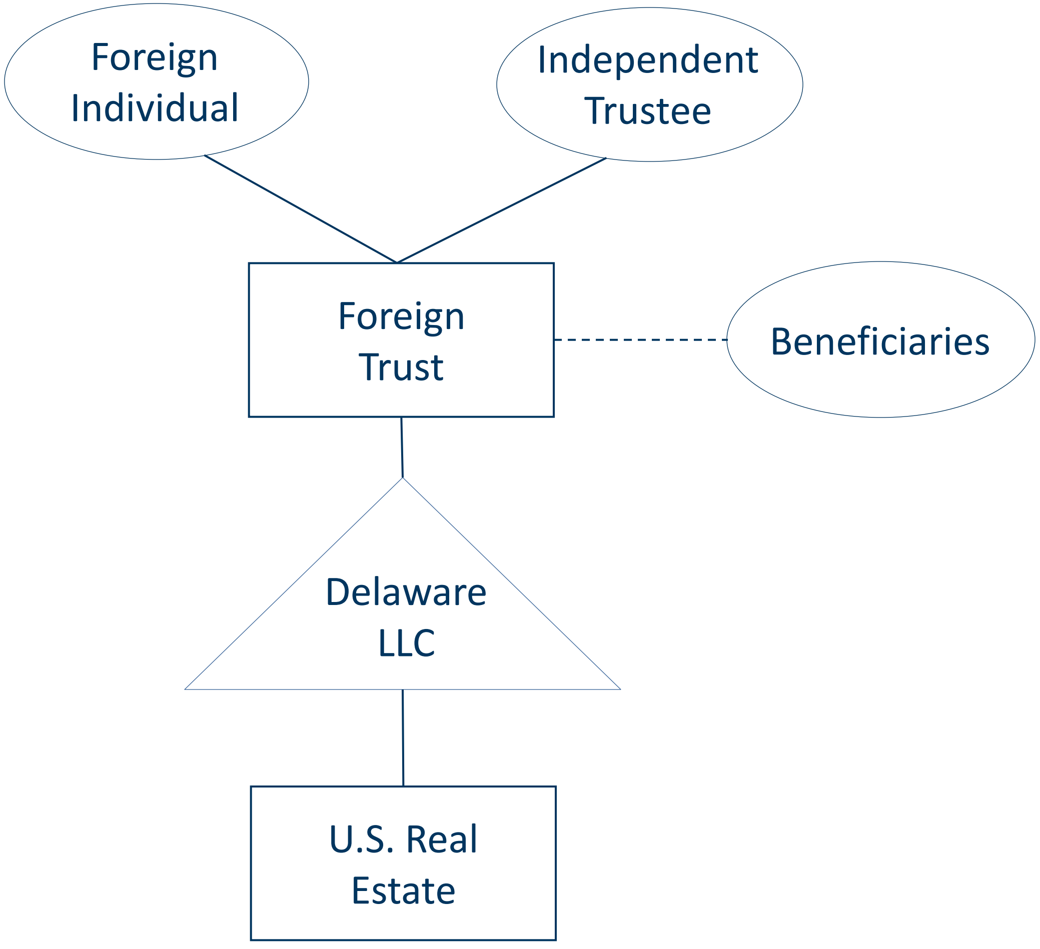
- No Branch Profits Tax
- Dividend Withholding Tax
- Estate Tax
- Privacy Concerns
- Sale of Stock – Taxable
- Taxable Refinancing Distributions

Options - 4



- No Branch Profits Tax
- No Estate Tax
- No Disclosure
- Sale of Stock
- Taxable Refinancing Distributions

Options - 5



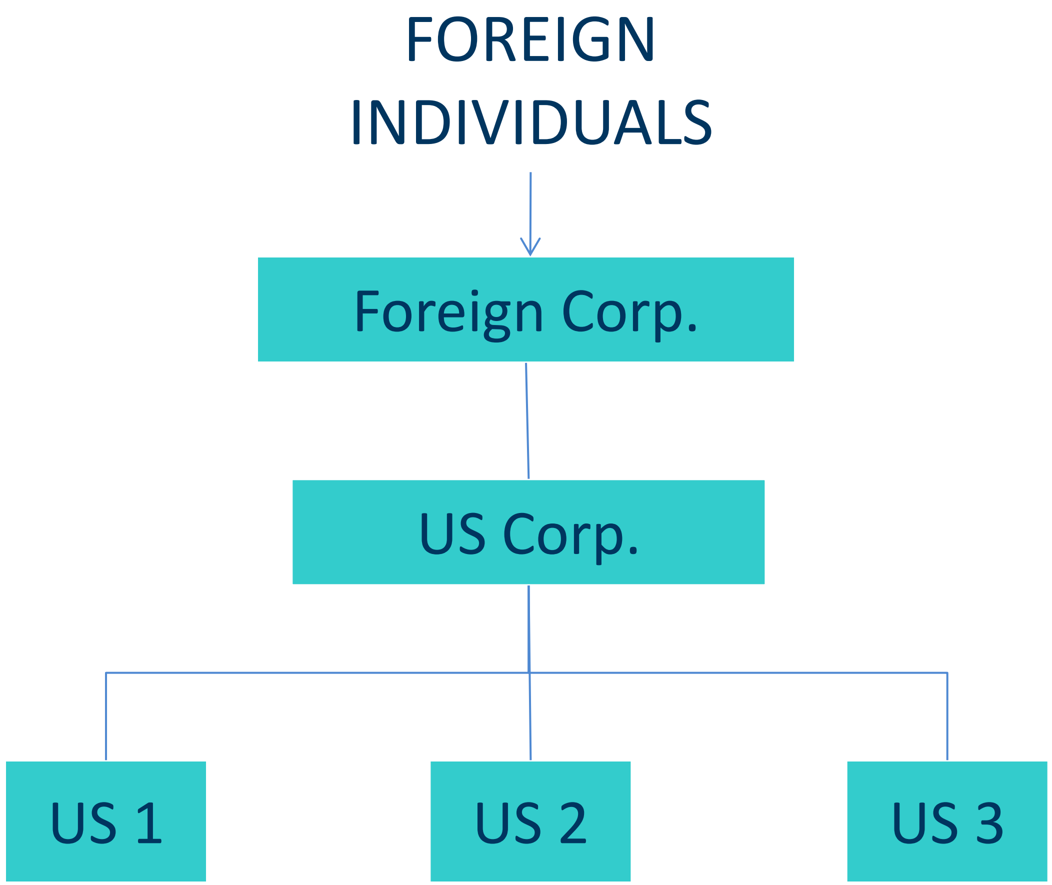
Foreign Individual
Independent Trustee
Foreign Trust
Beneficiaries
Delaware LLC
U.S. Real Estate

Non-Grantor Foreign Trust

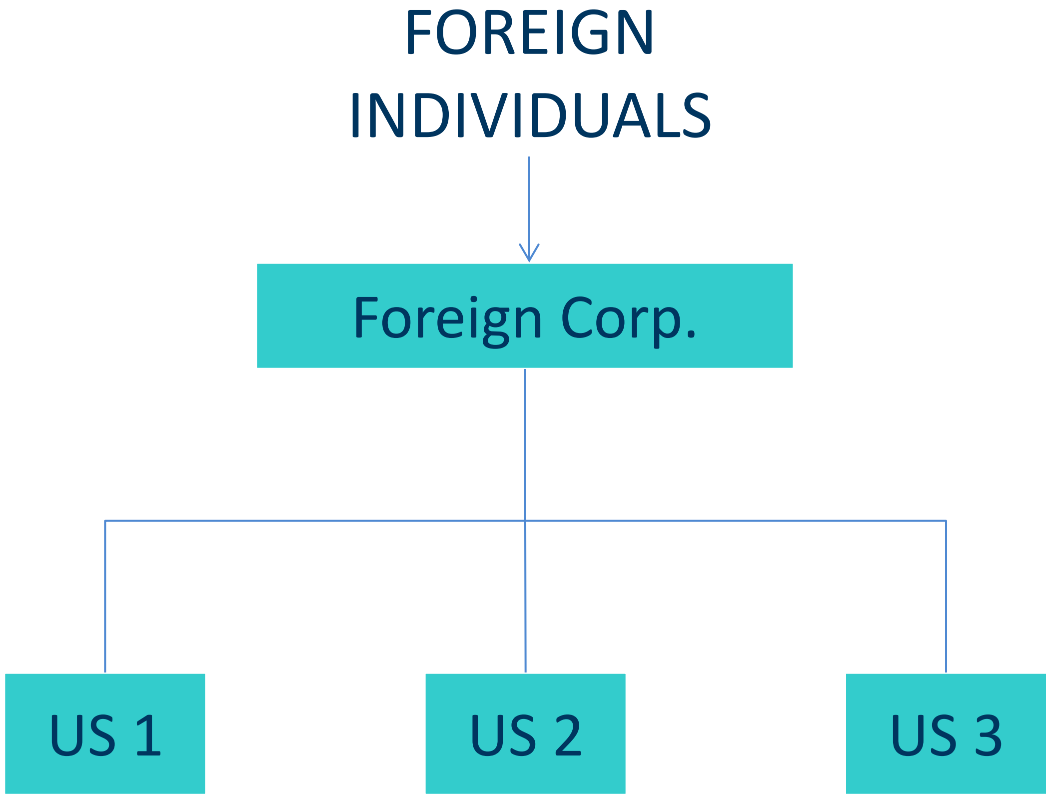
The tax consequences that may be anticipated under the foregoing structure are as follows:

- The transfer of cash to the Trust is not subject to U.S. gift tax.
- Under U.S. tax law, the Trust will be treated as if it were an individual. It will be entitled to the benefits of the 20% tax applicable to capital gains, the 25% tax applicable to depreciation recapture, and 39.6% tax on operating profits.
- There will be no further tax as funds are distributed to the beneficiaries.
- The assets in the Trust should not be subject to U.S. estate tax at the time of the individual's demise provided that (i) the individual does not retain the right to the income of the Trust during his lifetime -- although he may receive discretionary distributions along with other beneficiaries, (ii) the Trust is not revocable or amendable by the individual, and (iii) the individual does not retain any dominion or control over the Trust or its assets.
- Query whether IRS will treat foreign trust as a foreign corporation if the asset is non-personal use real estate.

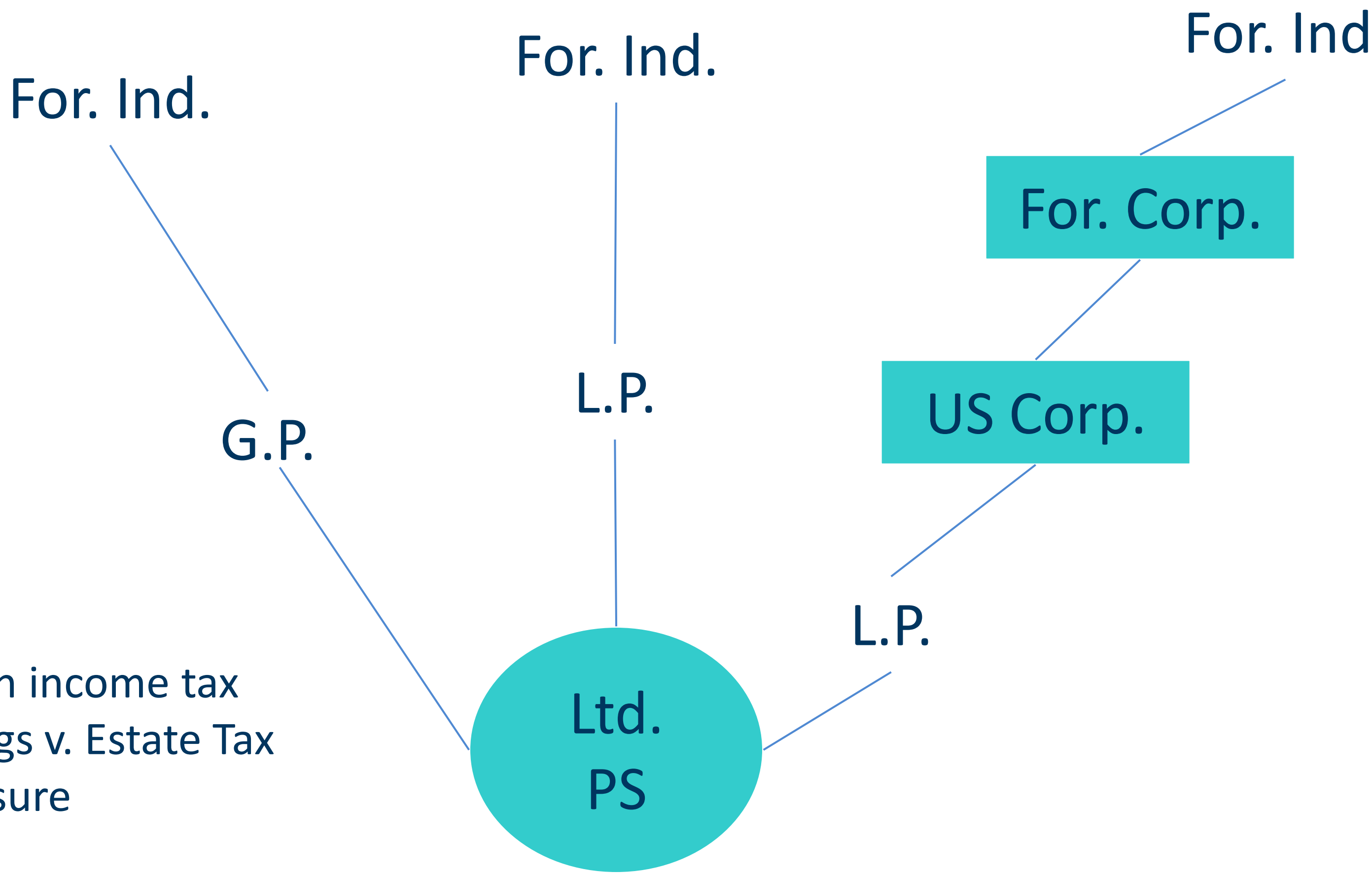
Multiple Properties



Multiple Properties (cont'd)



Traditional Partnership



Weigh income tax savings v. Estate Tax Exposure

Tax Planning with Debt

Debt:Equity

- Any use of a mixture of equity capital and loans provided by the equity investors requires the usual attention to detail to avoid reclassification by IRS
- In particular:
  - Loans must be documented
  - Overall terms should be at arm's length
  - Payment terms must be achievable; use OID/deferral options if there will be predictable delays in payment (e.g. development loan)
  - Internal and overall ratios must be reasonable
  - Terms should be observed and lender must take steps an unrelated lender would take to monitor and enforce loan

Earnings Stripping, AHYDO, 267(a)

- Earnings stripping (§ 163(j))
  - Applies if debt-equity ratio exceeds 1.5
  - Limits deduction for net interest expense to 50% of "adjusted taxable income" (analogous to EBITDA)
  - Excess interest is carried forward to future years
  - Excess limitation carried over against excess interest for 5 years
- Applicable High Yield Debt Obligation (§ 163(e)(5) & (i))
  - Applies if borrower is a corporation, term exceeds 5 years and OID at rate greater than AFR + 5%
  - Excess non-deductible (but interest in hands of lender)
  - If lender related, non-excess not deducted until paid
- If lender related, §§ 267(a)(3) (interest) and 163(e)(3) (OID) defer deduction until interest paid

Possible Planning to Avoid Earning Stripping, Section 267(a), and Section 163(e)(3)

- Prop. Reg. Section 1.163-4(j), Section 163(e)(3)(B), and Section 267(a)(3)(B) all indicate that payments or accruals to related CFCs are exempt from these provisions, so long as the income is included in the hands of a U.S. shareholder as subpart F income.
- A U.S. partnership is treated as U.S. shareholder for subpart F purposes under Sections 951(b), 957(c), and 7701(a)(4).
- This should be the case regardless of whether all partners of U.S. partnership are foreign persons.
  - See 1995 FSA Lexis 496 (March 17, 1995) and 1995 FSA Lexis 131
- Thus, could insert U.S. partnership in between foreign shareholders and foreign lending corp. and potentially avoid these rules.

REAL ESTATE INVESTMENT TRUSTS (REITS)

REITs – Dividends

- **Ordinary Dividend** - §§1441 & 1442
  - FDAP income subject to 30% withholding tax or lower treaty rate
- **Capital Gains Dividend** – §897(h)(1):
  - **General Rule** if relates to sale of real estate
    - Taxable under FIRPTA
    - REIT withholds 35% tax and shareholder must file tax return
  - **Publicly traded REIT Rule**: If foreign person owns 5% or less of stock for at least one year then
    - Treated like ordinary dividend subject to 30% withholding tax or lower treaty rate
    - Benefit: Less tax than general rule, no requirement to file tax return and no branch profits tax on foreign corporate shareholder

REITs – Dividends (cont'd)

- Section 857(b)(3)(F) provides that shareholder who gets "ordinary income" benefits of §897(h)(1) with respect to capital gain dividend:
  - Dividend not taxed under §897(b)(3)(B) or (D)
  - Dividend is treated as ordinary REIT dividend
- Recharacterized capital gain distribution is taxed as ordinary dividend, i.e., withholding at 30%, subject to reduced rate or exemption under treaty or §892
- Foreign investor using these rules:
  - Does not have to file a U.S. tax return because of the capital gain distribution
  - Branch profits tax is no longer applicable to such distribution to a non-U.S. corporate investor

REITs – Sale of REIT Stock

- General Rule
  - Gain is taxable under FIRPTA
  - Exceptions:
    - Publicly Traded REIT: No tax on shareholder owning 5% or less since not USRPHC – §897(c)(3)
- Domestically controlled REIT
  - Domestically controlled if 50% or more of the REIT is owned by U.S. persons during last 5 years or if less, time REIT has been in existence
- No tax since not USRPI – §897(h)(2)

REITs – Tax Treaties

The 2006 U.S. Model Treaty provides:

- 5% dividend rate does not apply to REIT dividends,
- 15% rate on REIT ordinary dividends (0% if paid to a pension fund) if:
  - Beneficial owner is an individual or pension fund, in either case holding not more than 10% interest in REIT;
  - Dividends is paid with respect to publicly traded class of stock and beneficial owner holds an interest of not more than 5% of any class of the REIT's stock; or
  - Beneficial owner holds an interest of not more than 10% in the REIT and the REIT is diversified.

REITs – Tax Treaties

- Under the 2006 Model Treaty, a REIT shall be "diversified" if the value of no single interest in real property exceeds 10% of its total interests in real property. For the purposes of this rule, foreclosure property is not considered an interest in real property
- The 2006 U.S. Model Technical Explanation states that distributions of gains “attributable to the alienation of a U.S. real property interest” from a REIT will not be a dividend, but rather will be taxable as gain from real property

REITs – Tax Treaties

- Recent treaties are identical, e.g., Japan and Belgium, or substantially similar, e.g., U.K. and new Canadian protocol.
- No ownership limit for dividend exemption for pension funds in Canadian and Swiss treaties. Note an 80% of class of shares limit in Dutch treaty MOU.
- Explicit statement in protocol to Dutch treaty that pension fund dividend exemption inapplicable to REIT dividends of gains from dispositions of USRPIs.
- Special rule allowing Australia listed property trusts to get 15% rate except to the extent 5% holders would not qualify for 15% rate if they received the REIT dividend directly.
- Older treaties do not distinguish between REIT and C corporation dividends, allowing some foreign investors to get dividend withholding rates below that of 2006 Model Treaty (e.g., Hungary and Poland treaties provide for withholding rates as low as 5% in some circumstances for REIT dividends)

REITs – Withholding

- FIRPTA Withholding – Treas. Reg. § 1.1445-8
  - 35% withholding with respect to capital gain dividends or, if larger, largest amount that could have been designated as capital gain dividends.
  - Catch-up withholding for designations of prior distributions as capital gain dividends.
- IRC § 1445(e)(3) – 10% withholding tax on non-dividend distributions by USRPHCs.
- As noted previously, to the extent a distribution from a REIT is from gain on the disposition of a USRPI under §897(h)(1), the distributing entity must generally withhold 35% under §1445(e)(6).

Agenda

- I. Planning with Portfolio Interest
  - Option attribution exception through partnership
  - Contingent interest
- II. Repatriation Strategies
  - No Treaty - Boot within gain limitation
  - Planning with Derivative Benefits Article of Treaties
  - Planning with Treaties without LOB provisions
- III. FIRPTA
  - Shared appreciation mortgages
  - Swaps

PLANNING WITH PORTFOLIO INTEREST EXCEPTION

Planning with Portfolio Interest Exception

- Foreign persons generally are subject to U.S. taxation on two categories of income:
  - (1) Certain passive types of U.S. source income, e.g., interest, dividends, rents, annuities, and other types of "fixed or determinable annual or periodical income" (FDAP).
  - (2) Income that is effectively connected to a U.S. trade or business (ECI).
- FDAP income is subject to a 30% withholding tax that is imposed on a foreign person's gross income (subject to reduction or elimination by an applicable income tax treaty).
- ECI is subject to tax on a net basis at the graduated tax rates generally applicable to U.S. persons.

Planning with Portfolio Interest Exception

- Subject to certain exceptions, U.S. source interest paid to a foreign person that is not ECI is subject to 30 percent withholding tax.

- However, Sections 871(h) and 881(c) provide that interest that qualifies as "portfolio interest" is exempt from U.S. taxation.

Planning with Portfolio Interest Exception

- Exception to portfolio interest: Does not apply if lender is 10-percent voting shareholder of issuing corporation or 10-percent owner of capital or profits interest in issuing partnership.

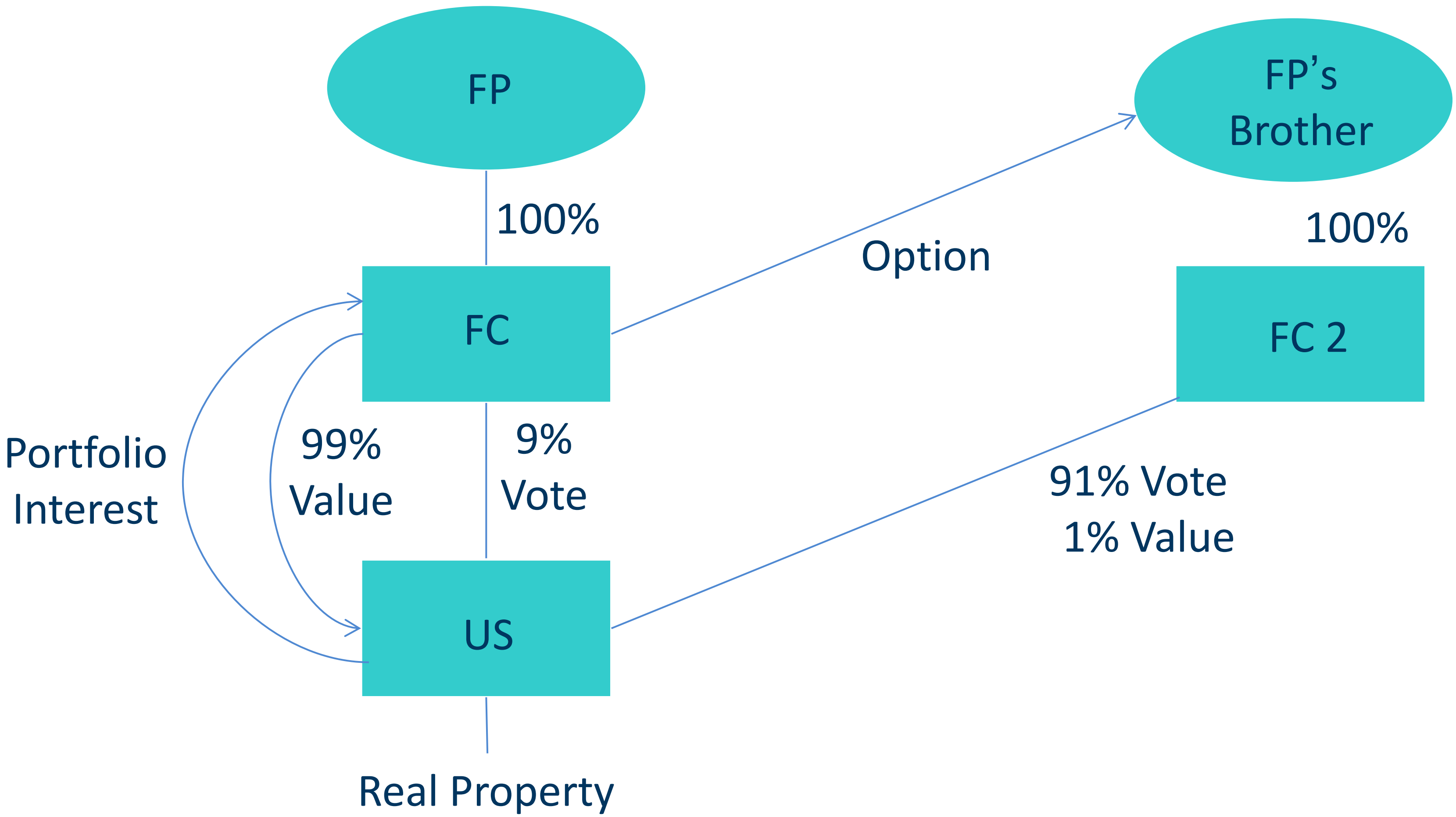
- For this purpose, Section 318 attribution rules apply to determine ownership, including Section 318(a)(4) option attribution rule.

Planning with Portfolio Interest Exception

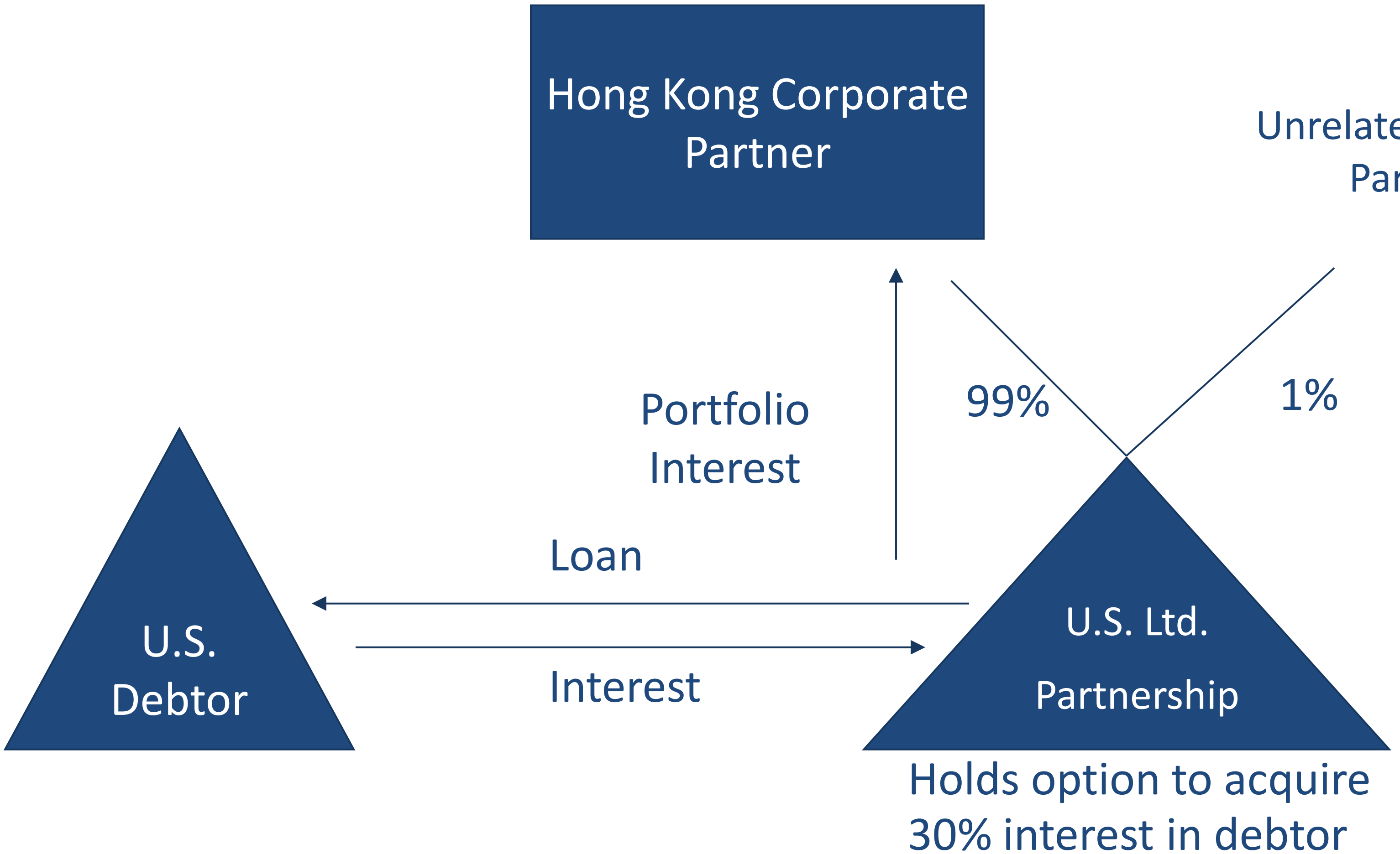
- However, Section 318(a)(4) option attribution rule is limited by Section 871(h)(3)(C)(iii), so that the ownership of stock represented by option is attributed only to partnership that holds the option, not the partners.

- Therefore, it may be possible for non-U.S. investor to indirectly own more than 10-percent of debtor and still obtain portfolio interest treatment if invest through a partnership that holds an option to acquire more than 10-percent of stock of debtor.

Portfolio Interest Friendly Structure



Planning with Portfolio Interest Exception



Planning with Portfolio Interest Exception

- In example, even though Section 318(a)(4) treats U.S. limited partnership as owning 30-percent of debtor, Section 871(h)(3)(C)(iii) prevents the equity interest from being attributed to the foreign corporate partner.
- Therefore, no U.S. withholding tax on distributive share of interest payments even though, economically, foreign corporate partner owns more than 10 percent of debtor through option.
- Result confirmed in 1994 FSA LEXIS 430 (Feb. 2, 1994).

Planning with Portfolio Interest Exception

- In general, portfolio interest also does not include certain contingent interest. Sections 871(h)(4) and 881(c)(4).

- For this purpose, contingent interest is defined as
  - (i) any interest if the amount of such interest is determined by reference to
    - (I) any receipts, sales or other cash flow of the debtor or a related person,
    - (II) any income or profits of the debtor or a related person,
    - (III) any change in value of any property of the debtor or a related person, or
    - (IV) any dividend, partnership distributions, or similar payments made by the debtor or a related person, or
  - (ii) any other type of contingent interest that is identified by the Secretary by regulation, where a denial of the portfolio interest exemption is necessary or appropriate to prevent avoidance of Federal income tax

Planning with Portfolio Interest Exception

- However, there is an exception to the contingent interest rule for:
  - Any amount of interest determined by reference to
    - (I) changes in the value of property (including stock) that is "actively traded" (within the meaning of section 1092(d)) other than property described in section 897(c)(1) or (g)) (i.e., USRPIs and interests in partnerships, trusts, or estates that are considered USRPIs),
    - (II) the yield on property described in subclause (I), or
    - (III) changes in any index of the value of property described in subclause (I) or of the yield on property described in subclause (II).
  - Therefore, interest paid to a foreign person that is contingent on one of the above factors will be exempt from the 30 percent U.S. withholding tax (regardless of the existence of a treaty).

Planning with Portfolio Interest Exception

- PLR 200933002:
  - A U.S. corporation issues equity-linked and credit-linked notes to foreign persons.
  - The notes paid contingent interest, which was based on the performance of an unrelated investment fund during the term of the note.
  - Corporation hedged its exposure to the contingent interest payment by holding shares of the fund while the notes were outstanding.
  - The fund was registered in the E.U. under a regime comparable to registration in the U.S. under the Investment Company Act of 1940.
  - The fund's daily net asset value was available on a quotation system.
  - The IRS ruled that the contingent interest payments were exempt from U.S. withholding tax under the portfolio interest exception holding that interests in the fund were traded in an "interdealer market" where information on the fund's daily net asset value was available to subscribers to a quotation system.

Planning with Portfolio Interest Exception

- What is considered "actively traded" property (within the meaning of Section 1092(d)) for purposes of this rule?
- The legislative history to Section 1092 merely provides that "[i]n order to be treated as actively traded, property need not be traded on an exchange or in a recognized market."
- In the preamble to the Regulations under Section 1.446-3 (dealing with notional principal contracts), the IRS stated that it "believes that the term 'actively traded' under Section 1092 was intended to cover financial instruments that are liquid or easily offset, even when those instruments are not traded in an exchange or in a recognized secondary market."

Repatriation Strategies

Repatriation Strategies - Brazil

CFC-Type rules

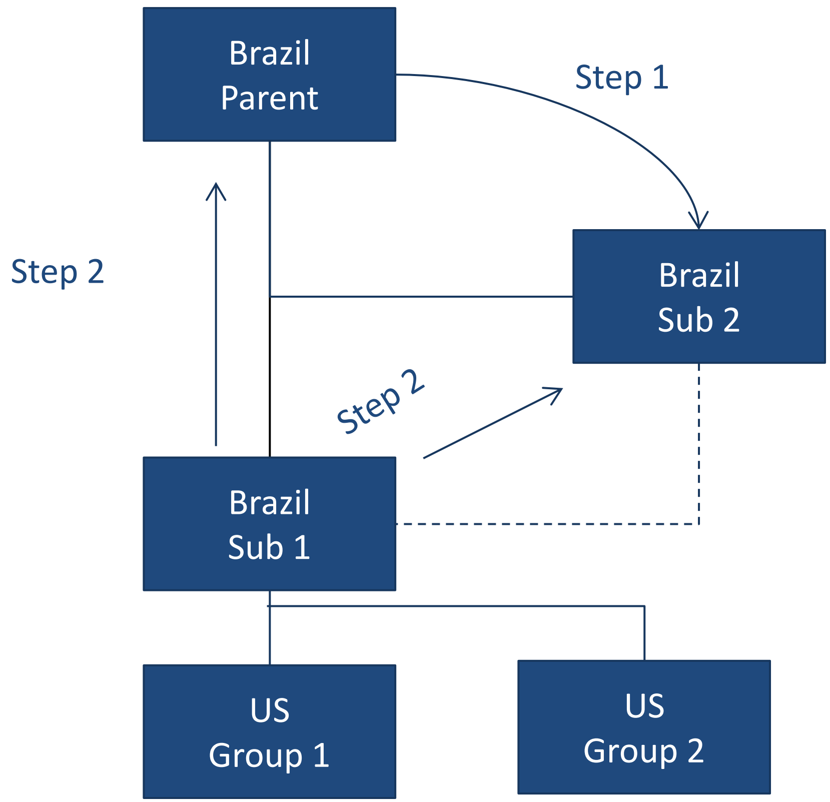
- Regardless of actual distribution, profits of foreign subsidiaries are subject to taxation on an annual basis (34%).
- 35% US Corporate Income Tax + US State Income Tax should be creditable to Brazil Holding, thereby avoiding double taxation
  - ✓ There should be no taxation in Brazil
  - ✓ Attention to the effective tax rate in the US

Main Concern

- Absence of Brazil-US Double Tax Treaty
  - ✓ 30% WHT on dividends and interest payments
- Interposition of a Hold Co (in a jurisdiction with which US has a tax treaty) between Brazil and US may not be beneficial due to LOB provisions
  - ✓ Parent Holding Co’s subsidiary with substantial business could strengthen the structure

Boot Within Gain Exception

Transaction Steps

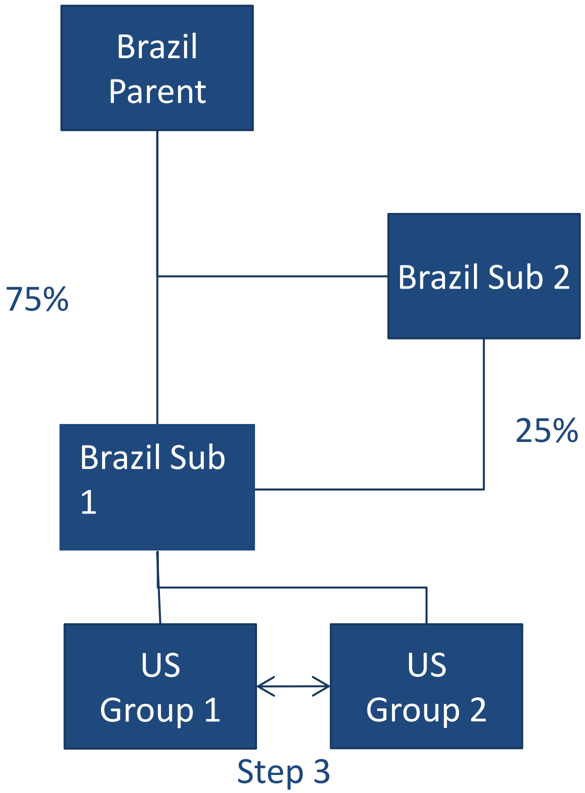


Transaction Steps

- Step 1: Brazil Parent transfers 25% of the shares of Brazil Sub 1 to Brazil Sub 2.
- Step 2: Brazil Sub 1 makes a tax election to liquidate for U.S. Federal tax purposes, distributing its assets to its shareholders.

Boot Within Gain Exception (cont.)

Transaction Steps (Cont'd)

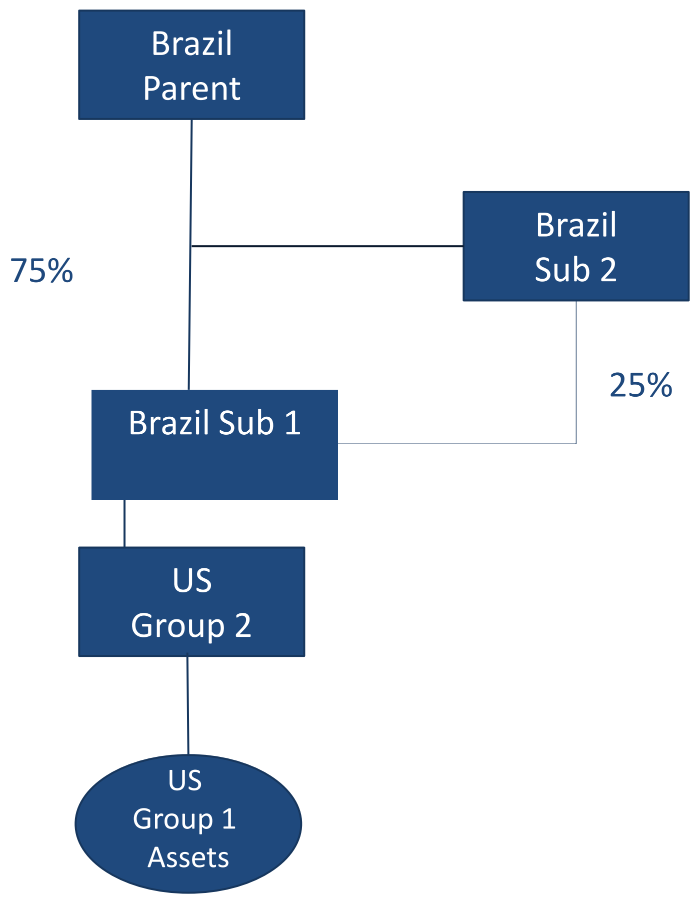


Transaction Steps (Cont'd)

- Step 3: US Group 1 merges with US Group 2 with Brazil Sub 1 receiving cash in the merger.
  - The direction of the merger could be reversed depending on various considerations.
  - A merger into a disregarded entity of the US acquiring company may also be possible.

Boot Within Gain Exception (cont.)

Final Structure



<u>U.S. Federal Income Tax Considerations</u>

- If the transaction is respected, step 1 and 2 will step up the basis in the stock of US Group 2. See Granite Trust and Sections 331 and 336.
- Step 3 is intended to be a D reorganization subject to the boot within gain limitation of Section 356.

<u>Brazil Tax Considerations</u>

- Step 1 – Tax neutral, provided it is implemented at book value
- Step 3 – From a Brazilian tax perspective, deemed as a share deal
  - Risk of capital gain taxation in case implemented at fair market value
  - Interposition of a Hold Co (e.g. in Austria or Spain) could be an alternative
  - If paid through Spanish holding company (ETVE), dividends can be received tax-free in Brazil under Spain-Brazil income tax treaty.

Planning with Treaties with Derivative Benefit Provisions

Derivative Benefits Provisions – In General

- Many treaties concluded with the United States that have LOB provisions contain a “derivative benefits” clause in such provision.
- Under such provision, a company that qualifies as a “resident” for treaty purposes, but fails to qualify under the LOB provision because of ownership by third country residents, may still qualify for treaty benefits if the third country owners are “equivalent beneficiaries.”

Derivative Benefits – In General

- To qualify as an equivalent beneficiary, the following factors typically must be satisfied:
  - (i) there is a tax treaty between the equivalent beneficiary's country of residence and the United States,
  - (ii) the equivalent beneficiary would be entitled to benefits under that treaty if it invested directly in the United States, instead of through the treaty company, and
  - (iii) in the case of interest, dividends, and royalties, the treaty between the United States and the equivalent beneficiary's country of residence must provide a withholding rate that is "as least as low" as the rate available under the treaty claimed.

Derivative Benefits – In General

- In addition, the equivalent beneficiary typically must be resident in:
  - A European Union (EU) jurisdiction,
  - A European Economic Area (EEA) jurisdiction,
  - A jurisdiction that is a party to the North American Free Trade Agreement (NAFTA),
  - Switzerland.
  - Australia (in the case of Malta treaty)

Derivative Benefits – In General

- Example: Assume FCo, a French company, wholly owns a U.K. company (UKCo), which in turn wholly owns a U.S. company (USCo). With respect to dividends, the U.S.-U.K. treaty has (i) no withholding for 80-percent-or greater corporate owners, (ii) 5 percent withholding for 10-percent-or-greater corporate owners, and (iii) 15 percent in all other cases. Under the U.S.-French treaty, the lowest withholding rate on dividends is 5 percent. Despite the fact that U.S. has treaty with France (a member of the EU), and FCo would be entitled to treaty benefits under the U.S.-France treaty, FCo is not equivalent beneficiary because the withholding rate on dividends under U.S.-France treaty (5 percent) is not as low as lowest withholding rate under U.S-U.K. treaty. Thus, dividends paid from USCo to UKCo not eligible for 0 percent rate. *Query* whether rate is 30 percent or 5 percent?

Current List of Treaties that have Derivative Benefits Provisions

- Belgium – applies to EU, EEA, NAFTA, and Switzerland
- Canada – applies to any jurisdiction that has treaty with the U.S.
- Denmark - applies to EU and EEA, and parties to NAFTA
- Finland - applies to EU and EEA, and parties to NAFTA
- Germany - applies to EU and EEA, and parties to NAFTA
- Iceland - applies to UE and EEA, and parties to NAFTA
- Ireland - applies to EU and EEA, and parties to NAFTA
- Jamaica – applies to any jurisdiction that has treaty with the U.S.
- Luxembourg – applies to members of EU and parties to NAFTA
- Malta - applies to EU and EEU, parties to NAFTA and Australia
- Mexico – applies to parties to NAFTA
- Netherlands - applies to EU and EEA, and parties to NAFTA
- Sweden - applies to EU, EEA, parties to NAFTA, and Switzerland
- Switzerland - applies to EU and EEA, and parties to NAFTA
- United Kingdom - applies to EU and EEA, and parties to NAFTA

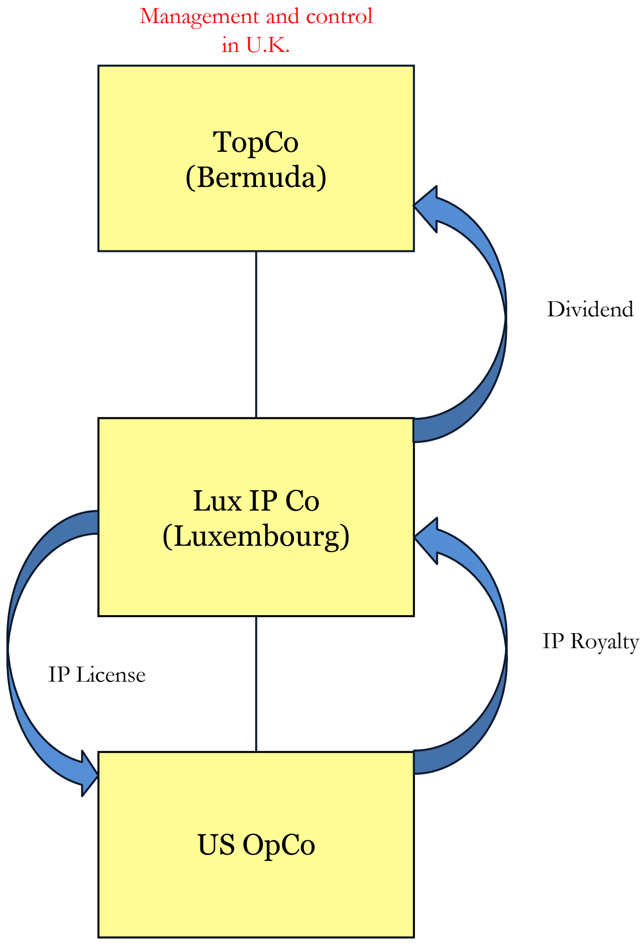
Planning Opportunities – Local Law Shopping

- One foreign jurisdiction may have more favorable local tax benefits than other jurisdiction, including:
  - Lower corporate income tax rate
  - Participation exemption on dividends and capital gains
  - No withholding on interest, dividends, or royalties
  - No thin capitalization rules
  - No stamp or capital duties
  - Better treaty network
  - No transfer pricing rules
  - Tax consolidation or group relief

Planning Opportunities – Local Law Shopping

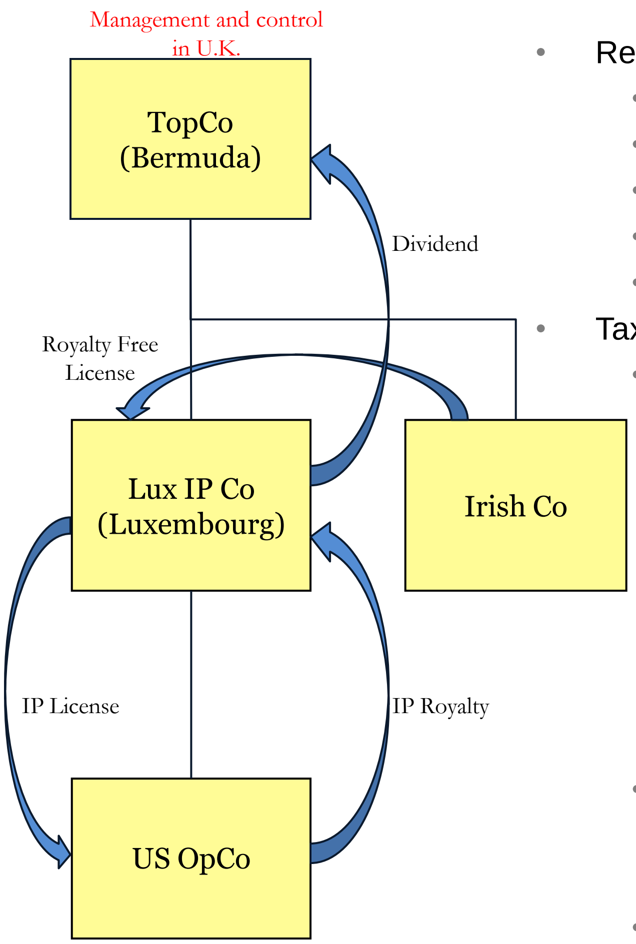
- Example: Residents of France wish to lend money to the United States to finance the acquisition of U.S. real property that will be owned by related parties. Instead of investing through French corporation, which has a 33.3 percent corporate income tax rate, French taxpayers invest through Swiss corporation, which has an 8.5 percent effective corporate income tax rate, no withholding taxes on interest and royalties, and very favorable participation exemption for dividends and capital gains. Both U.S.-France and U.S.-Swiss treaties provide for 0 percent withholding on interest paid from U.S. sources. French residents would qualify as "equivalent beneficiaries" under U.S.-Swiss treaty, and therefore, have the ability to shop for more favorable local tax benefits.

Licensing of IP into U.S. through Luxembourg



- Restructuring
  - Management and control of TopCo is moved to the U.K. so that TopCo can qualify as a U.K. resident for purposes of U.S.-Luxembourg and U.S.-U.K. income tax treaties.
  - US OpCo pays royalties to Lux IP Co
  - Lux IP Co pays dividends to TopCo
- Tax treatment
  - Royalties paid by US OpCo to Lux IP Co:
    - Exempt from U.S. withholding tax under U.S.-Luxembourg Treaty
    - Subject to an effective tax rate of 5.84% in Luxembourg
  - Dividends paid by Lux IP Co to TopCo:
    - Not subject to withholding tax in Luxembourg
    - Exempt from tax in Bermuda and the U.K.
  - **Overall effective tax rate = 5.84%**

License of IP and Royalty Free License from Ireland



- Restructuring
  - Management and control of TopCo moved to the U.K.
  - Lux IP Co is formed to hold US OpCo
  - Irish Co licenses IP to Lux IP Co on a royalty-free basis
  - Lux IP Co licenses the IP to US OpCo in exchange for royalty payment
  - Lux IP Co pays dividends to TopCo
- Tax treatment
  - Royalty payments
    - No transfer pricing rules on passive income in Ireland so no taxable income because no actual royalty payment
    - Royalty payment from US OpCo to Lux IP Co exempt from U.S. withholding tax under U.S.-Luxembourg Treaty
    - Minimal tax in Luxembourg due to deemed royalty deduction
      - Leaving a spread of approximately 5% of income
      - Spread taxed at regular corporate income tax rate of 28.8% in Luxembourg
  - Dividends paid by Lux IP Co to TopCo
    - Not subject to withholding tax in Luxembourg
    - Exempt from tax in Bermuda and the U.K.
  - **Overall effective tax rate = less than 1%**

Tax Planning with Treaties Without LOB Provisions

- Current list of treaties without LOB provisions:
  - Greece
  - Romania
  - Pakistan
  - The Philippines
  - Egypt
  - Morocco
  - Trinidad and Tobago
  - Korea
  - Poland - New treaty signed but not effective yet
  - Hungary – New treaty signed but not effective yet.
  - Norway – Treaty has been re-negotiated but not signed or released yet.

Planning with Treaties Without LOB Provisions

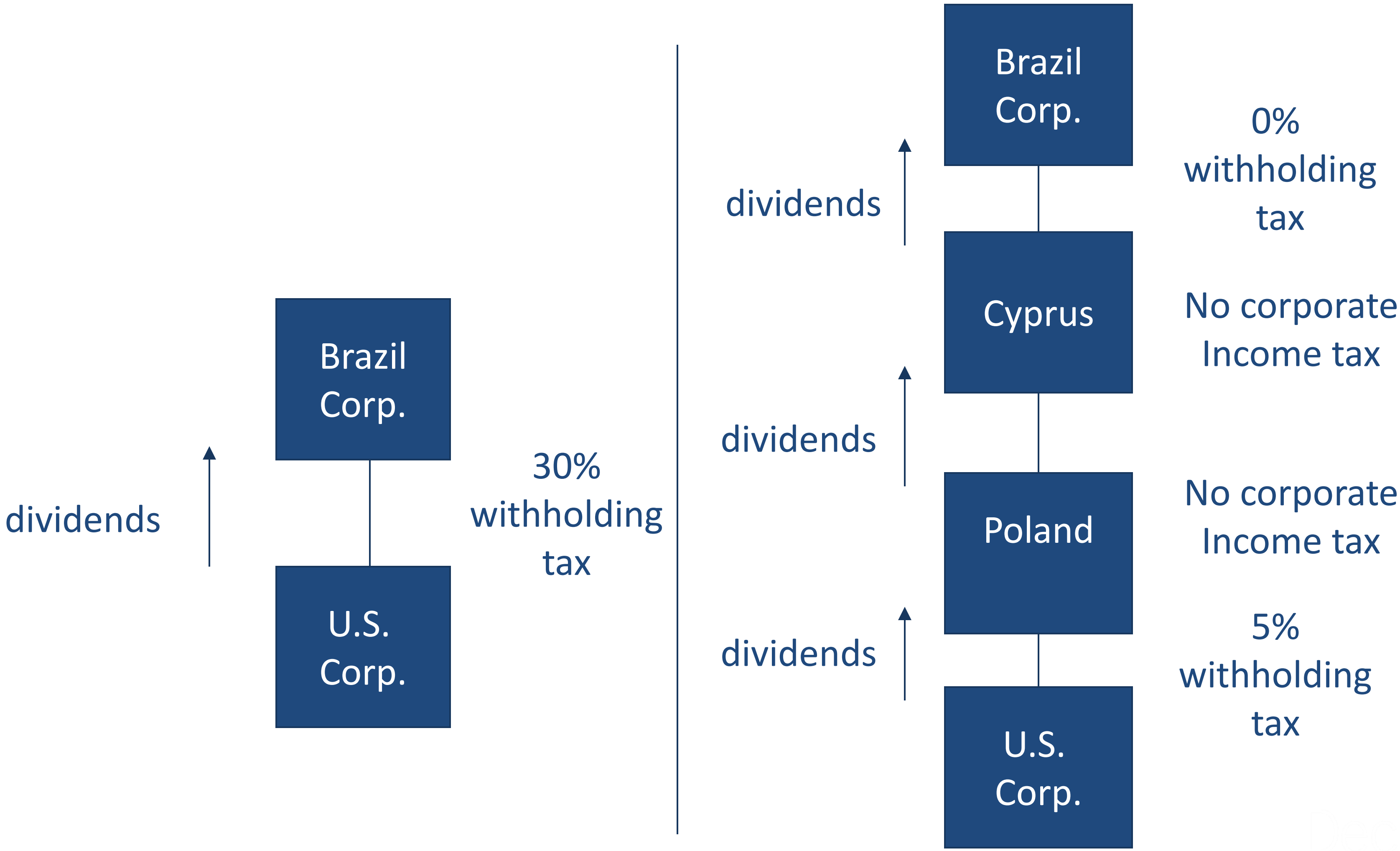
- Repatriation of Profits from the U.S. to Non-Treaty Jurisdictions

  - Dividends paid by U.S. corporations to foreign non-treaty shareholders subject to 30 percent withholding tax in the United States.
  - Possible to reduce dividend withholding tax from 30 percent to 5 percent by insertion of treaty company that (i) has no LOB provision and (ii) exempts U.S.-source dividend from corporate income tax, either as a result of participation exemption or foreign tax credit.

Tax Planning with Treaties Without LOB Provisions

- An example of a treaty jurisdiction:
  - Poland
    - U.S-Poland treaty has no LOB provision and has 5 percent withholding tax on dividends paid by U.S. corporations that are owned by Polish corporations that own at least 10 percent of the voting stock of the U.S. corporation.
    - Poland has foreign tax credit that allows U.S. corporate taxes to be credited against Polish corporate taxes (currently 19% tax rate in Poland), so long as Polish company owns 75% of U.S. company,
    - Poland does not impose withholding taxes on dividends paid to EU jurisdictions

Tax Planning with Treaties Without LOB Provisions



FIRPTA Planning

FIRPTA Planning

- Section 897(a) imposes U.S. tax on “gain from the disposition of a US real property interest” recognized by non-US persons.

- US real property interests include stock (& participating debt) in a U.S. corporation if the FMV of its US real property is equal to or greater than 50% its assets.

- Section 1445(a) requires the transferee of a US real property interest to withhold 10% of the proceeds in respect of the tax due under Section 897.

FIRPTA Planning

- Therefore, if non-U.S. taxpayers invests directly in U.S. real estate or through entity, gain from the disposition of the real property or the interest in the entity would be subject to U.S. federal income tax at graduated rates.
- In addition, if non-U.S. taxpayer invests through foreign corporation also likely subject to branch profits tax.
- One possible option to avoid FIRPTA is for foreign investor to use shared appreciation mortgage to invest synthetically in U.S. real estate.
  - Shared appreciation mortgage is loan that provides for interest that is contingent on the gain from the sale of the property.

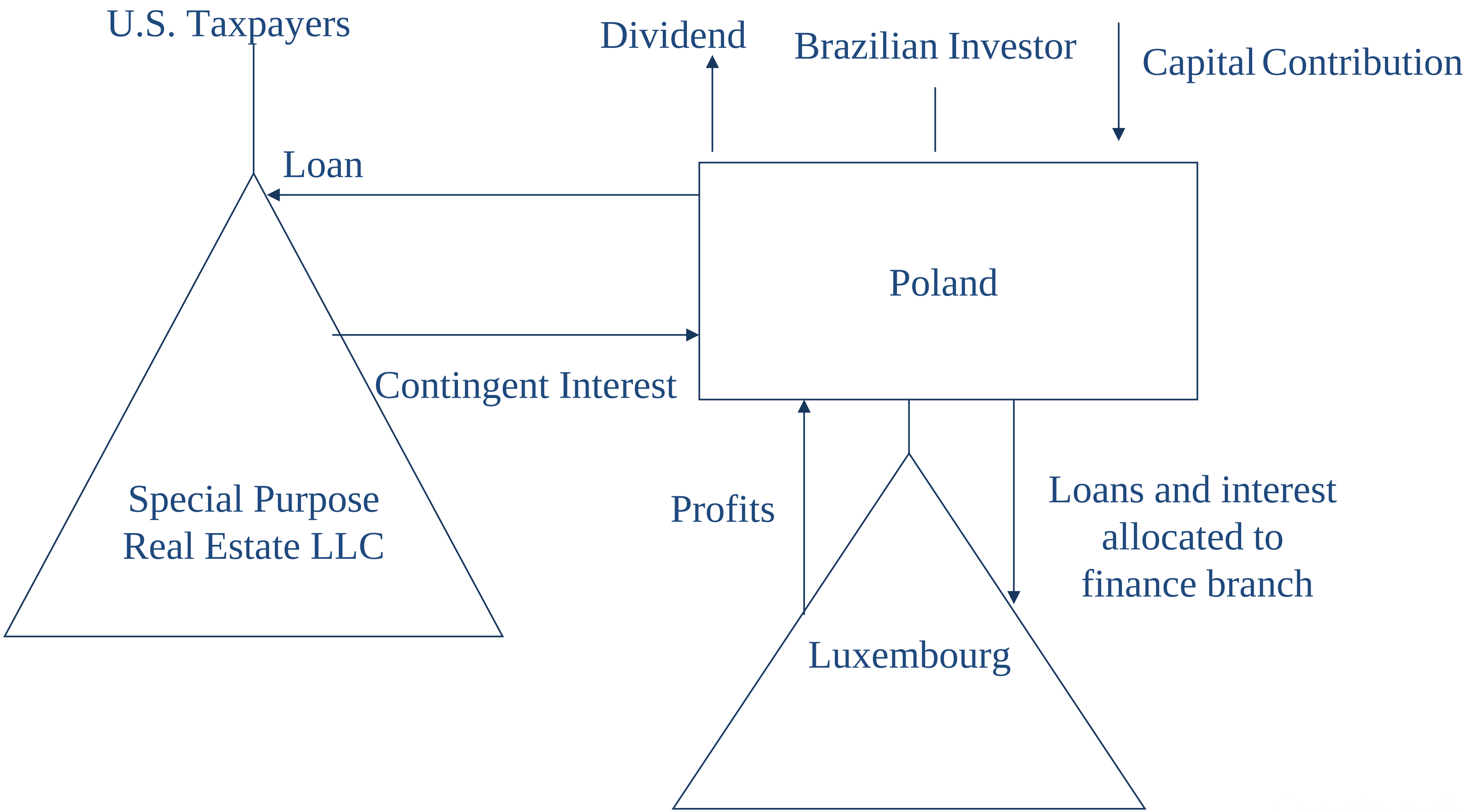
FIRPTA Planning

- Regulation Section 1.897-1(h), Example 2
  - Foreign corporation makes $1 million loan to domestic individual which is secured by mortgage on real property purchased with loan proceeds.
  - Loan agreement entitles lender to fixed monthly payments, constituting repayment of principal plus fixed interest rate.
  - Lender also entitled to receive certain percentage of the appreciation in value of real property at the time that the loan is retired.
  - Shared appreciation loan treated as U.S. real property interest (USRPI), but receipt of final payments do not constitute “disposition” of USRPI for purposes of Section 897.

FIRPTA Planning

- Example 2 concludes that Section 897 is not triggered on receipt of final loan payment because payment constitutes principal and interest, not gain for tax purposes.
- Thus, appreciation payment is treated as interest for tax purposes.
- Cannot qualify for exemption from withholding under portfolio interest rules because payment is "contingent interest." Section 871(h)(4).
- However, taxpayer could rely on treaty with zero percent withholding on contingent interest.

Potential Structure



FIRPTA Planning

- Possible IRS Arguments:
  - Regulation Section 1.881-3 (“conduit financing” rules) should not apply because loans allocated to branch.
  - Section 894(c) should not apply because payment not made directly to hybrid entity.
  - Aiken Industries should not apply because no second payment for tax purposes.
  - No LOB provision in U.S.-Poland income tax treaty.
  - No anti-triangular provisions in U.S.-Poland treaty.
    - Many U.S. treaties (e.g., France, Luxembourg, Switzerland) deny treaty benefits if U.S.-source income that is paid to foreign corporation is attributable to permanent establishment, and combined tax rates in both foreign jurisdictions do not exceed a certain percentage.

FIRPTA Planning

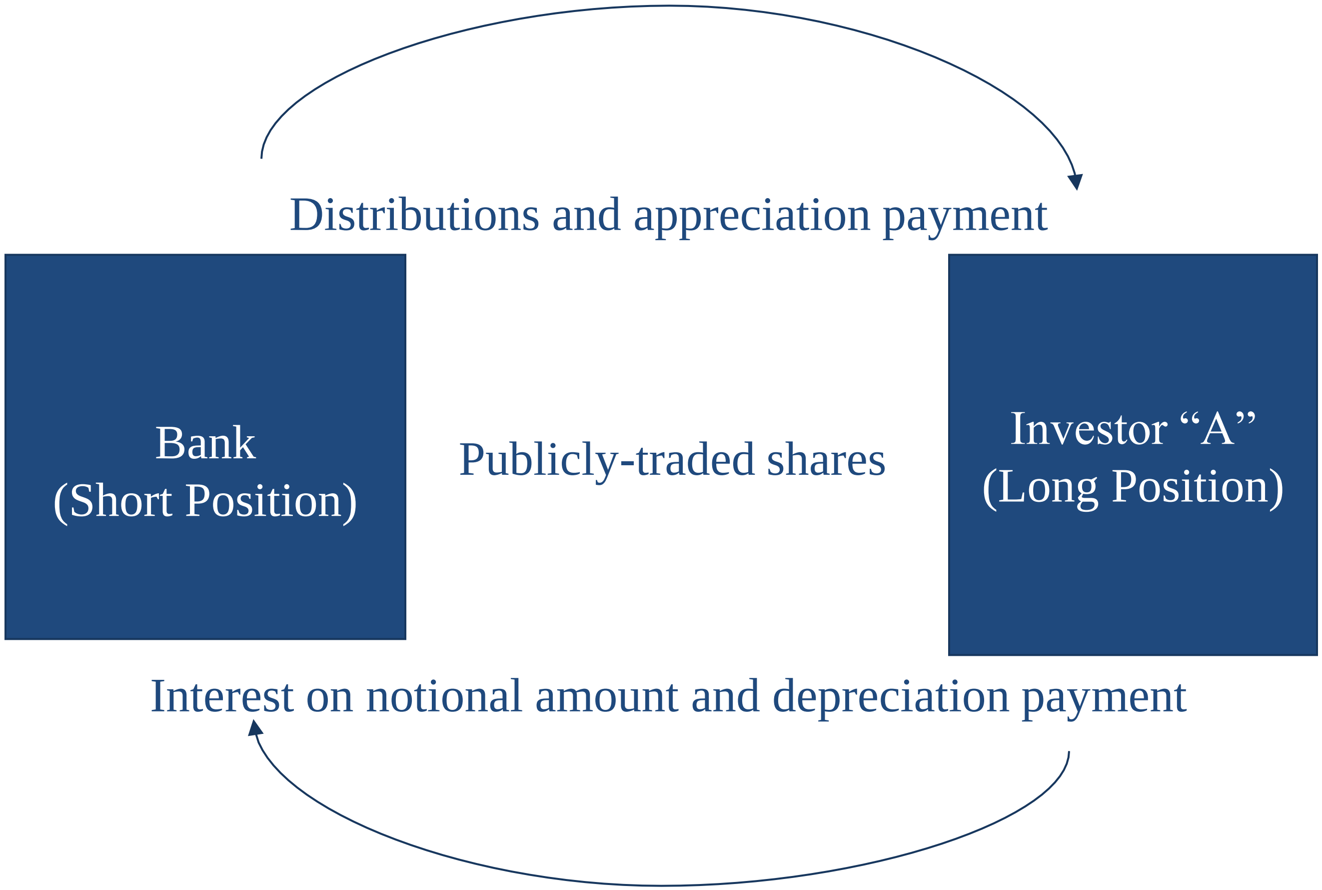
- Swaps and FIRPTA
- Section 861(a)(5) treats FIRPTA gain as U.S.-source income.
- Regulation Section 1.863-7(b) sources income from swap payments based on resident of recipient.
- Query whether long party to a swap, the payments of which are tied to U.S. real property will be subject to Section 897?

FIRPTA Planning

- What is an equity swap?

  - Cash-settled bilateral contract, in which each party agrees to make certain payments to the other depending on the price and dividend performance of the underlying equity.
  - Used to either (i) simulate an investment in an underlying equity interest without making an actual investment or (ii) to divest oneself of economic exposure with respect to the underlying equity.
  - Payments are based on notional amount, which may be number of shares or value of certain number of shares.

FIRPTA Planning



FIRPTA Planning

- U.S. withholding tax consequences of equity swaps
  - Foreign investors generally subject to 30% withholding tax on U.S.-source dividends.
  - Income from equity swaps (i.e., NPCs) sourced according to residence of recipient. 1.863-7(b).
    - But see new proposed regulations for certain exceptions
  - Thus, payments received by a foreign investor under an equity swap will be foreign-source income and not subject to withholding tax. Reg. Section 1.1441-4(a)(3)(i).

FIRPTA Planning

- Swaps and FIRPTA
  - Preamble to NPC regulations issued in 1993 indicates that "[T]he IRS is considering whether notional principal contracts involving…[certain] specified indices (e.g., United States real property) are subject to Section 897."
    - No guidance had been issued for 15 years.
  - Treas. Reg. Section 1.897-1(d)(3)(i)(D) (FIRPTA interest includes direct or indirect to share in the appreciation in the value, or in the gross or net proceeds or profits generated by, the real property.)

FIRPTA Planning

- Swaps and FIRPTA
  - Rev Rul. 2008-31 (released June 12, 2008)
    - Issue was whether an interest in an NPC, the return on which is calculated by reference to an index referencing data from a geographically and numerically broad range of United States real estate, is a USRPI under section 897(c)(1) of the Code?

FIRPTA Planning

- Swaps and FIRPTA – Facts of Rev. Rel. 2008-31
  - X maintains and widely publishes an index (the "Index") that seeks to measure the appreciation and depreciation of residential or commercial real estate values within a metropolitan statistical area ("MSA"), a combined statistical area ("CSA") (both as defined by the United States Office of Management and Budget), or a similarly large geographic area within the United States.
  - The MSA, CSA or similarly large geographic area has a population exceeding one million people. The Index is calculated by reference to (1) sales prices (obtained from various public records), (2) appraisals and reported income, or (3) similar objective financial information, each with respect to a broad range of real property holdings of unrelated owners within the relevant geographic area during a relevant testing period. Using proprietary methods, this information is weighted, aggregated, and mathematically translated into the Index.
  - Because of the broad-based nature of the Index, an investor cannot, as a practical matter, directly or indirectly, own or lease a material percentage of the real estate, the values of which are reflected by the Index.

FIRPTA Planning

- Swaps and FIRPTA – Facts of Rev. Rul. 2008-31 (cont.)
  - On January 1, Year 1, FC, a foreign corporation, enters into a NPC, with unrelated counterparty DC, a domestic corporation. Neither FC nor DC is related to X.
  - Pursuant to the NPC, FC profits if the Index appreciates (that is, to the extent the underlying United States real property in the particular geographic region appreciates in value) over certain levels. Conversely, FC suffers a loss if the Index depreciates (or fails to appreciate more than at a specified rate).
  - During the term of the NPC, DC does not, directly or indirectly, own or lease a material percentage of the real property, the values of which are reflected by the Index.

FIRPTA Planning

- Swaps and FIRPTA – Holding of Rev. Rul. 2008-31
  - Because of the broad-based nature of the Index, the NPC does not represent a "direct or indirect right to share in the appreciation in the value . . . [of] the real property" within the meaning of Treas. Reg. Section 1.897-1(d)(2).
  - Accordingly, FC's interest in the NPC calculated by reference to the Index is not a USRPI under section 897(c)(1).

FIRPTA Planning

- Swaps and FIRPTA (cont.)
  - Questions not answered by ruling:
    - How broadly based does the index need to be?
    - Is the maturity of a swap a “disposition” for purposes of Section 897(a)?
      - TAM 9730007 and PLR 9824026 would seem to indicate not.
  - See also Treas. Reg. Section 1.897-1(h), example 2 (shared appreciation mortgage is USRPI but final payments (i.e., maturity of contract) is not a “disposition” for purposes of Section 897(a)).
    - Rationale of example is that final loan payments do not constitute “gain” for tax purposes.
  - Query whether same rationale should apply to final payments received pursuant to swap.