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Reverse Hybrid Entities in U.S. Real Estate Investment Fund Structure

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Structuring cross-border deals with tax concerns in mind involves multiple tax sources and principles. Planning must take into account U.S. taxation, withholding, international tax treaties, foreign taxes and choice of entity considerations that do not always line up with foreign expectations. It gets even trickier when the investments involve U.S. real estate.

FIRPTA

In 1980, Congress enacted the Foreign Investment in Real Property Tax Act ("FIRPTA"), adding Internal Revenue Code Section ("Code Sec.") 897 to the Internal Revenue Code ("the Code"). FIRPTA brought a new nomenclature to the tax law and requires additional planning when structuring a transaction involving a U.S. real property interest ("USRPI"). A USRPI includes real estate as well as interests in partnerships and domestic corporations that own primarily U.S. real estate.

FIRPTA classifies gain or loss from the disposition of a USRPI as effectively connected with a U.S. trade or business. The result is that even passive real estate holdings that produce gain will be taxable to a foreign investor. And since enforcing that tax to a non-U.S. investor can be challenging, FIRPTA added a 10-percent gross withholding obligation on the purchaser or transferee of a USRPI. It is not just property that FIRPTA taints. Interests in domestic corporations or partnerships that own USRPIs can be considered USRPIs themselves.

Prior to FIRPTA, a foreign seller of U.S. real estate was often not subject to U.S. income tax on any gain from the sale of a USRPI unless the foreign seller's activities were substantial enough to be considered engaged in a trade or business in the United States. A foreign seller could also be subject to U.S. income tax if they made a "net basis" election under Code Sec. 871(d) or 882(d); or, in the case of an individual, if the foreign seller was physically present in the United States for 183 days or more in the year of the sale.

ALSO IN THIS ISSUE

FIRPTA constituted a sea change in the taxation of foreign investment in U.S. real property. More than 30 years later, it still poses a planning challenge. Some argue that it has hurt the U.S. real property market by discouraging foreign investment and therefore should be repealed. But like all tax problems, careful planning may help to reduce FIRPTA's bite.

This article discusses the structure of a real estate investment fund that has a mix of investors, including U.S. individuals, foreign individuals and foreign corporations. Structuring such a fund raises a number of issues that are relevant to FIRPTA planning and to international M & A in general. These issues include the use of reverse-hybrid entities and financing with a mixture of debt and equity to reduce overall tax burdens.

U.S. Investor Baseline

U.S. investors are subject to U.S. taxes and so they generally worry little about fund mechanics. However, it is worth describing a U.S. investor to contrast with his foreign counterpart. A U.S. investor will often invest directly in a U.S. limited partnership (*i.e.*, the fund). The partnership may own LLCs, which are often set up for separate properties/projects and which in turn manage and own U.S. real property interests.

The fund, as a partnership, should cause the U.S. investor to realize income equal to the investor's distributive share of items of income, gain, losses and deductions, regardless of whether the partner actually receives any distributions. The character of income should remain the same as it flows up to the investors. Likewise, for ordinary income or loss (rental income, for example), the income would flow to the U.S. investors as ordinary income or loss.

For capital gains or losses, the income would flow up as capital gains or losses. The character of gain or loss from the disposition of real property depends on whether the real property qualifies as a capital asset. To qualify as a capital asset, U.S. real property generally must not be: (i) an inventory item; (ii) held primarily for sale to customers in the ordinary course of the taxpayer's trade or business; or (iii) property used in the taxpayer's trade or business. [Code Sec. 1221(a)(1).]

Courts look at several factors to determine whether a taxpayer intended to hold an asset for investment rather than "in the ordinary course of the taxpayer's trade or business." These factors include:

- the nature and purpose of the acquisition and duration of ownership;
- the extent and nature of the taxpayer's efforts to sell the property;
- the number, extent, continuity and substantiality of the sales;
- the extent of subdividing, developing and advertising to increase sales;
- use of a business office for sale of the property; and
- the character and degree of supervision or control exercised by the taxpayer over the agent selling the property. [*See, e.g., Winthrop*, CA-5, 69-2 USTC ¶9686, 417 F2d 905.]

Such multifactor tests may help, but sometimes they can just be downright confusing. What really matters is the intent to sell to customers.

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For a U.S. individual investor, there may be substantial tax advantages if the real estate investment is considered a capital asset, thus allowing gain from its disposition to be taxed at long-term capital gains rates. Individual and corporate taxpayers have limitations on the use of capital losses, however, which must also be considered. Structuring the transaction so that each real property interest is owned by a separate vehicle may help in timing and netting of gains and losses.

Foreign Investors

With foreign investors, investment fund structures and compliance issues become exponentially more complicated. Of course, some issues are the same for both foreign and individual investors, such as the allocation of gains and losses from a real estate partnership, as well as the character of those items. Nonetheless, a foreign investor faces a number of distinct tax issues.

Foreign investors are subject to U.S. income tax on income that either is effectively connected with a U.S. trade or business (effectively connected income or "ECI") or sourced in the United States. As such, foreign investors must ask themselves whether they will be engaged in a trade or business in the United States by virtue of investment in a real estate partnership.

Treaties add extra complexity to the determination of whether income is taxable in the United States by adding a test as to whether there is a permanent establishment ("PE"). Typically, U.S. source income that is not linked to a trade or business is considered fixed, determinable, annual and periodical ("FDAP") income, which is subject to taxation on a gross basis at a 30-percent rate, unless reduced by treaty.

Rental income and gains from the sale of real estate located in the United States are U.S. source FDAP income. Generally, dividends and interest paid by a U.S. corporation are U.S. source FDAP income. In some cases, interest paid by a foreign corporation or a foreign or domestic partnership is also U.S. source FDAP income.

To File or Not to File

One initial question foreign investors face is whether they want to file a U.S. tax return. If they do not, they may want to invest in a real estate fund through a "blocker" corporation.

Of course, there may be disadvantages to the use of a blocker corporation. One positive feature of FIRPTA is that it does not change the character of gains or losses. If the disposition of the underlying USRPI results in capital gains, FIRPTA will not convert them to ordinary income for a foreign investor.

A foreign individual investor, therefore, may not want to invest through a blocker corporation if doing so might forfeit an opportunity for long-term capital gains rates. Nevertheless, some foreign investors may be so loath to file a U.S. tax return that they may be willing to pay more tax to avoid the headache and perceived exposure that filing a U.S. tax return can bring. They may ask, "How much can the tax rate be?"

30-Percent Tax on Gross Is High

A 30-percent tax is generally imposed by the Code on the gross amount of most types of FDAP income. One exception is income from the sale of U.S. source property. The rate of this "gross basis" tax can sometimes be reduced or eliminated by a tax treaty or by a specific statutory exemption.

For example, the portfolio interest exemption allows most interest paid to foreign persons (other than banks or related parties) to leave the United States tax-free with no withholding. [Code Secs. 871(h), 882(c).] But if none of these exceptions applies, or if a treaty does not reduce the rate, the prospect of this 30-percent tax is often enough to dissuade investment.

Tax Me, Please

Under FIRPTA, gains from the sale of a USRPI are taxed on a net basis as ECI regardless of whether the taxpayer is actually engaged in a U.S. trade or business. A foreign investor in a real estate partnership may actually want to elect to be treated as engaged in a U.S. trade or business. This sounds counter-intuitive. Usually, foreign investors do *not* want to be considered engaged in a U.S. trade or business. The general perception is that it will bring tax disadvantages rather than tax advantages.

Code Secs. 871(d) and 882(d) allow a foreign corporation or international investor that earns income from real property, but that is not engaged in a U.S. trade or business (for example, raw land or leased property), to elect to be taxed on a net basis at graduated rates *as if* the income were ECI. This "net basis election" can often help with real estate investments because the production of rental income typically involves significant expense.

After making the election, the investor can avoid the 30-percent tax on gross rents and is allowed to deduct expenses associated with the real estate, such as depreciation and interest. If these expenses exceed income, it is possible that no U.S. tax will be due.

One More Acronym

In addition to FIRPTA, ECI and FDAP, there is yet another acronym to learn: "BPT" or Branch Profits Tax. If a foreign corporation invests in a U.S. real estate partnership, an additional 30-percent tax may apply to the "dividend equivalent amount" from the corporation's trade or business (*i.e.*, the branch) if it is not reinvested in the U.S. branch. For an individual, this is another reason to bite the bullet and file a return instead of using a blocker corporation.

The BPT applies to earnings and profits of a foreign corporation that are derived from ECI, and the 30-percent rate applies unless a treaty specifies a lower rate or eliminates the tax. Because the BPT is imposed on top of the net basis U.S. corporate tax, a foreign corporation subject to BPT may pay an effective tax rate of more than 50-percent.

This punitive 50-percent rate makes even the 30-percent gross rate on FDAP income seem reasonable. But with all of these high rates, what can be done to make a foreign investor's participation in the real estate fund more economical from a tax perspective?

Reverse Hybrid

There are many possible solutions. One possibility is to have the foreign investors come into the real estate partnership through a reverse hybrid entity which functions as a blocker corporation. This may sound complicated but is actually fairly simple.

A reverse hybrid entity makes a U.S. tax election to be treated as a corporation for U.S. tax purposes but is fiscally transparent (similar to a U.S. partnership) in the foreign jurisdiction.

The foreign investor might choose to invest in the reverse hybrid through a mixture of debt and equity. An advantage of this structure is that if the foreign investor only has a stock and debt interest in a U.S. corporation, it may not be viewed as carrying on a trade or business through a permanent establishment in the United States. In addition to facilitating the use of leverage, the reverse hybrid may preserve treaty benefits, and an investor may still be allowed to file a U.S. individual return and thereby take advantage of long-term capital gains rates on gains from the sale of underlying properties.

At the end of the day, the reverse hybrid may only be subject to tax on U.S. source FDAP income which may include certain interest payments. Capital gain may not be subject to U.S. tax if it is non-U.S. sourced. However, IRS regulations may limit the effectiveness of this planning technique, and careful consideration is required.

By funding the investment with a mixture of debt and equity, the reverse hybrid borrower may be able to deduct interest payments made to the non-U.S. investor, for U.S. tax purposes. This could reduce the overall tax liability. Nevertheless, this requires that the debt must be respected as debt. It also involves careful planning in light of a number of Tax Code sections that might limit the deductibility of interest.

Preserving Deductibility of Interest

A corporation is generally allowed to deduct interest paid or accrued within a tax year on its debt. Still, there are provisions in the Tax Code that limit such deductions under certain circumstances. For example, there are limitations concerning "investment interest" indebtedness. [Code Sec. 163(d).] Also, there are rules limiting deductions with respect to excess interest paid to related foreign persons (the so-called "earnings stripping" rules). [Code Sec. 163(j).]

In general, the earnings stripping rules defer a corporate debtor's deductions for interest paid to "related" persons exempt from U.S. tax. They also defer such deductions with respect to interest paid on debt guaranteed by "related" persons exempt from U.S. federal income tax or subject to reduced rates of U.S. federal income tax in certain years.

The rules apply to years where: (i) the debt to equity ratio of the corporation exceeds 1.5:1; and (ii) the corporation's net interest expense exceeds 50 percent of the corporation's "adjusted taxable income" (usually the corporation's earnings before interest, taxes, depreciation and amortization). [Code Sec.

163(j)(2)(A), (B).] Disallowed interest may be carried forward indefinitely, and "excess" interest may be carried forward three years. [Code Sec. 163(j)(1)(B), (2)(B)(ii).]

Code Sec. 267 must also be considered regarding the timing of the interest deduction. If interest is paid to a foreign person, the payor can only claim a deduction if the payor actually makes the payment of interest. The deduction cannot be claimed on an accrual of interest.

Liquidating the Reverse Hybrid

Another feature of the reverse hybrid is that it can be liquidated by "checking the box" to be treated as a partnership. This is an important feature, and it has some potential tax advantages as well. When this "tax" liquidation is done, the reverse hybrid is no longer reverse or hybrid. Finally, branch profits tax may be avoided as well through the use of a reverse hybrid.

In fact, it then becomes transparent for both U.S. and foreign tax purposes. The liquidation is treated as a sale disposition of the corporation's assets. An advantage of liquidating the reverse hybrid is that if all the underlying real property assets have been sold, the corporation may merely be holding cash at that point.

Consequently, it is possible that no gain would be recognized as a result of the liquidation, at least at the corporate level. Depending on the type of foreign investor in the (former) reverse hybrid, upon complete liquidation, there may not be any withholding either. Capital gains may apply at the corporate level, but withholding taxes may be avoided if the foreign investor is not otherwise subject to U.S. taxation. For example, if the foreign investor was an individual who was present in the United States for 200 days during the year of liquidation, the tax advantages of the liquidation may not apply.

Conclusion

The use of a reverse hybrid can bring potential tax benefits to a foreign investor that seeks to invest in a U.S. real estate partnership. It can also bring benefits to international M & A transactions in other contexts. Of course, everything depends on the details.

In international tax planning, U.S. tax rules must be carefully considered. So must tax rules in foreign jurisdictions, as well as any applicable tax treaties. With careful planning, the pain of FIRPTA, FDAP, ECI and the BPT might be reduced.