

## Fund Structures for Offshore Investors in U.S. Distressed Assets



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# Preliminaries: Defining Terms

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- Distressed assets: residential mortgage loans and real estate
- Distressed investing:
  - Acquiring sub- or non-performing loans for which workouts are contemplated, or acquiring distressed real estate (REO)
  - Acquiring performing loans at distressed prices
- U.S. trade or business?
  - Acquiring loans with a view to working them out – likely a trade or business
  - Acquiring distressed real estate – trade or business
  - Acquire performing loans – no trade or business, even if later renegotiate loans

# “With a View to Work Out”: Trade or Business?

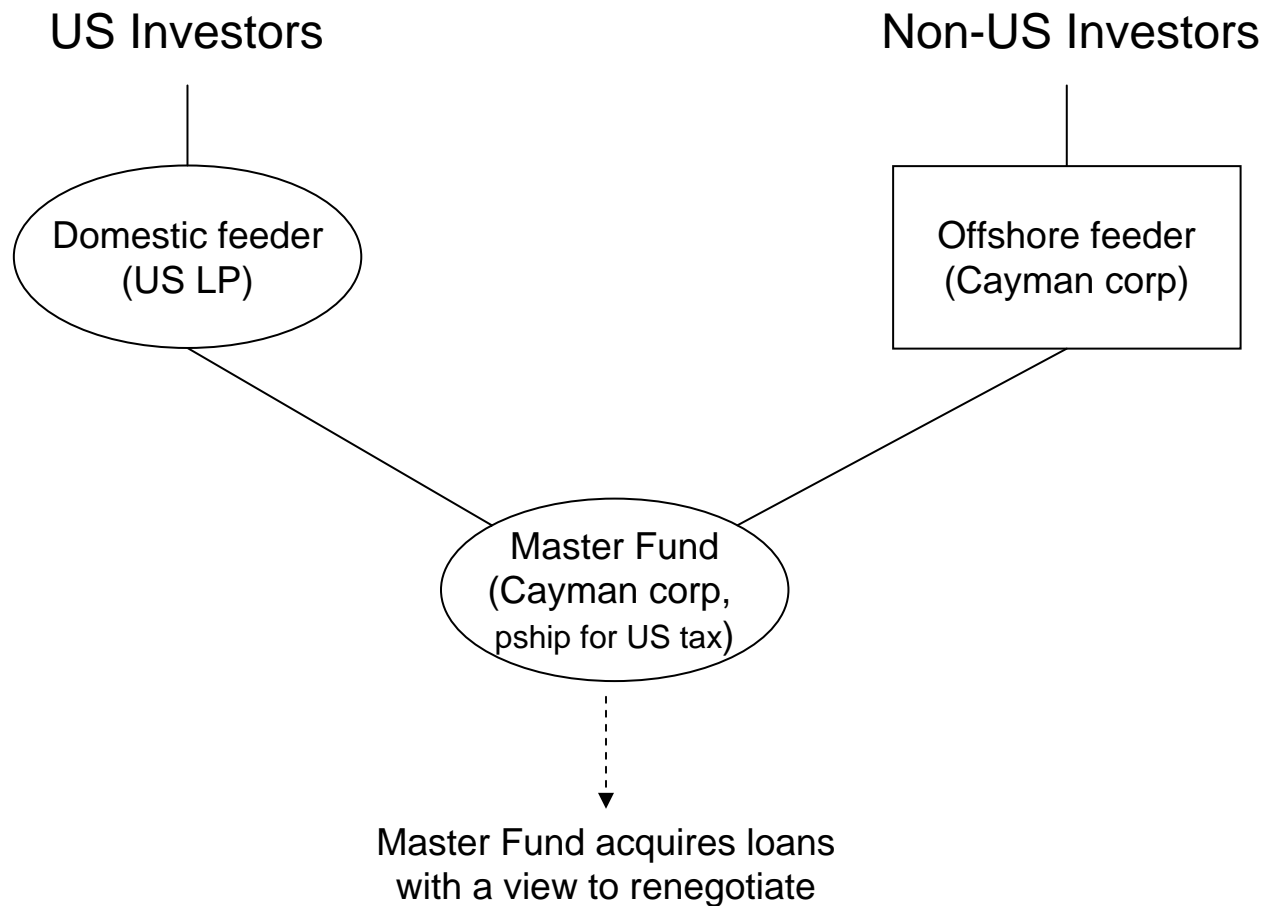
- Securities Trading Safe Harbor: Section 864(b)(2)(A)(ii)
  - Trading in securities for one’s own account is not a U.S. trade or business
  - Loans are securities
  - Renegotiating is “for your own account”
  - What’s the problem?
- Safe harbor has limits, the boundaries of which are unclear
  - MFA letter to Treasury and IRS, April 2008
  - Comments to PPIP Legacy Loan Program
- Many practitioners believe, or are concerned, that buying loans with a view to working them out results in a trade or business

# Trade or Business: Unfavorable Consequences

- Effectively connected income (ECI) subject to tax at 35%
- Foreign corporation's ECI also subject to branch profits tax of 30%
- ECI can be subject to tax at a maximum blended rate of 54.5%

# Master-Feeder Fund Structure

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# Effect of ECI on Master-Feeder Fund Structure

- Master Fund is engaged in a trade or business
- Partnership's trade or business is imputed to its partners – Sec. 875
- Offshore Feeder is a corporation, so ECI and branch profits tax
- Withholding on Fund's ECI allocable to non-US partners – Sec. 1446
- Foreign Feeder - US tax return filing obligations
- Result: U.S. Tax at 54.5%

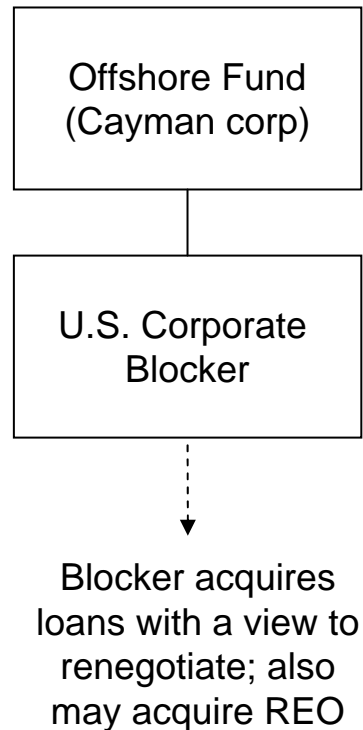
# Structures to Minimize ECI Risk

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- U.S. Corporate Blocker
- REMIC
- REIT

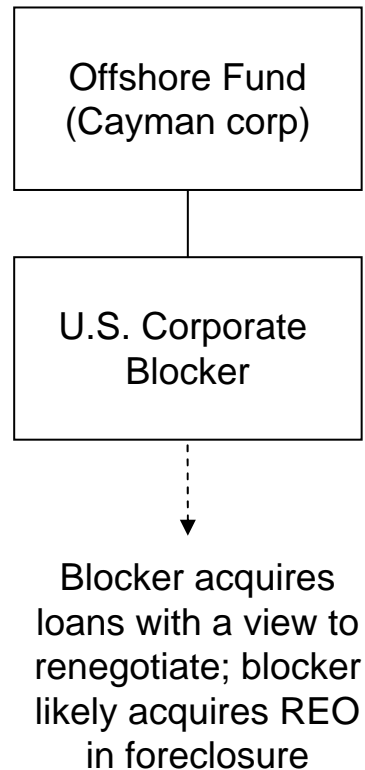
# U.S. Corporate Blocker - Basic Structure

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- U.S. Corporate Blocker
  - U.S. corporation shields Offshore fund and non-US investors from ECI
  - U.S. corporation pays tax at 35%
  - No branch profits tax
- Result: better than 54.5%
- Issues:
  - How to get cash up to Offshore Fund?
  - Exit strategy?

# U.S. Corporate Blocker – How to Get Cash Out?



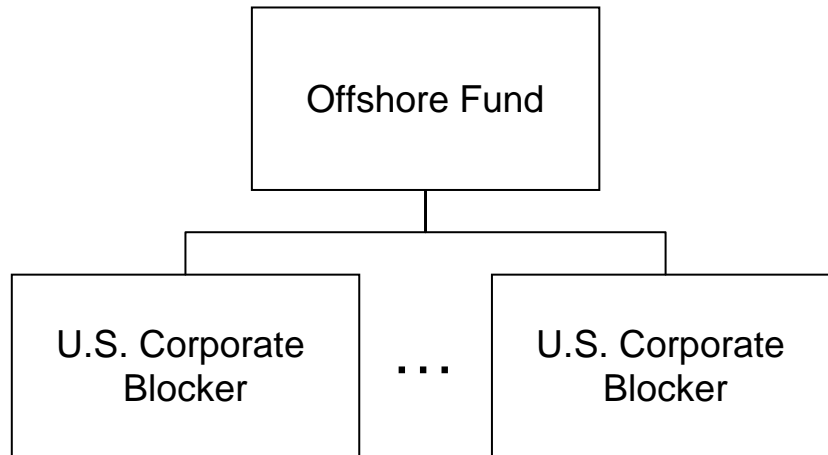
- How to repatriate cash?
  - Dividends attract U.S. withholding tax
  - Answer: Don't pay dividends
  - Instead: sell stock of blocker
  - Gain on sale is capital gain
  - Offshore Fund pays no US tax on capital gain (Sec. 865(a)(2), 864(c)(4))
  - Caveats:
    - Keep capital invested?
    - What if no buyer at intended time of sale?
    - Also: If corporate blocker has acquired REO, beware FIRPTA

# Foreign Investment in Real Property Tax Act

- Foreign Investment in Real Property Tax Act of 1980
- Gain (or loss) realized by a non-US person from the sale of a US real property interest (USRPI) is taxed as ECI
- USRPI:
  - Real property
  - Partnership interest
  - Stock of a USRPHC, but not stock of a corporation that has sold all of its USRPIs in taxable transactions and owns no USRPIs at the time of sale
- USRPHC – US real property holding corporation:
  - USRPIs comprise at least 50% of certain of the corporation's assets
  - 50% test: lookback for five years preceding a stock sale

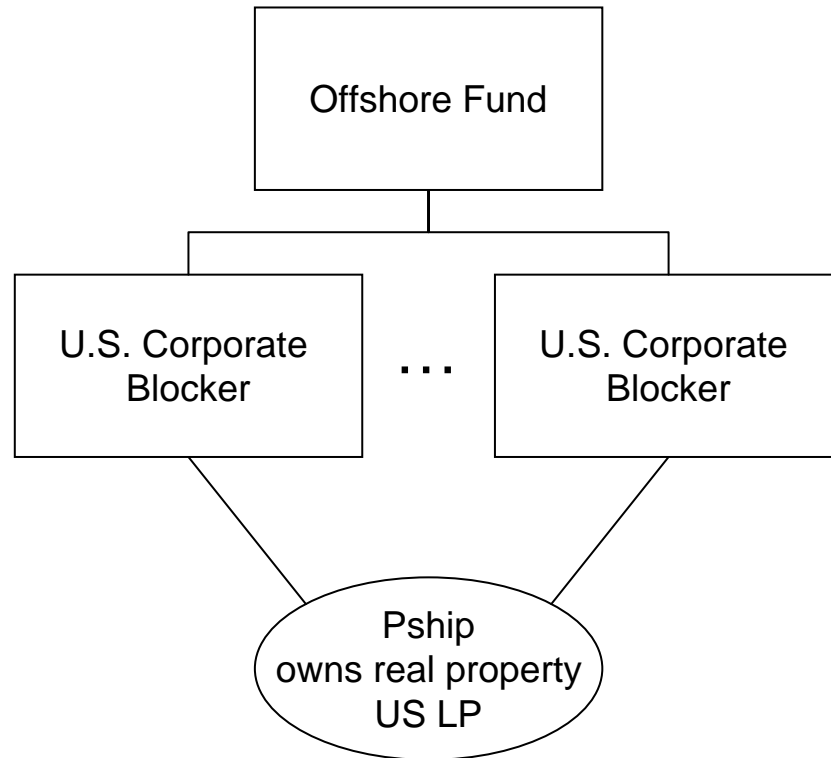
# U.S. Corporate Blocker – FIRPTA

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- Interim and Exit Strategy/FIRPTA: Use Multiple Blockers and Liquidate
  - Use multiple blockers for interim cash distributions
  - Blocker sells REO in taxable transactions
  - Blocker is then liquidated
  - Liquidation is capital gain for Offshore Fund (Sec. 331(a)), so no U.S. tax
  - Because of “cleansing,” FIRPTA will not apply to liquidation (Sec. 897(c)(1)(B))
  - Result: non-US investors still subject to only one level of US tax

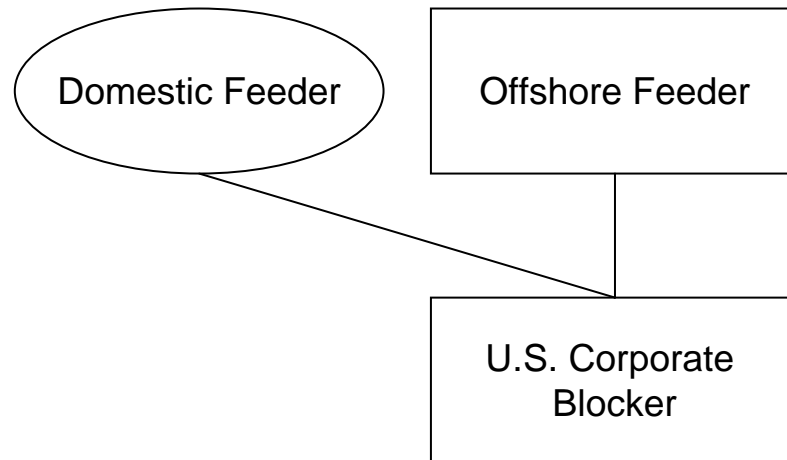
# U.S. Corporate Blocker - FIRPTA alternative



- Another FIRPTA structure:

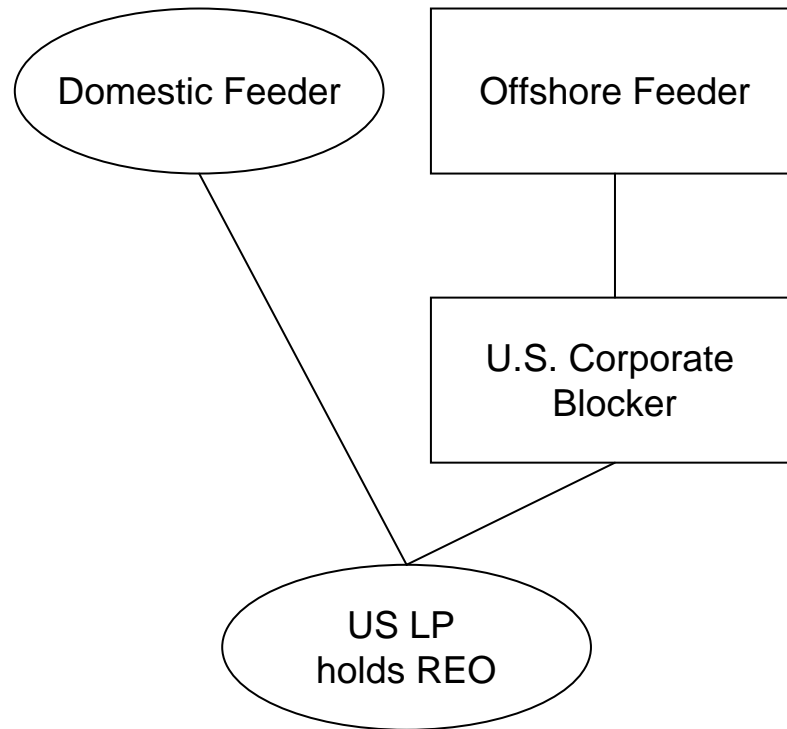
- Partnership beneath blockers owns REO
- Each blocker owns a partnership interest
- Prior to liquidating a blocker, partnership redeems the corresponding partnership interest
- Non-tax benefits - simplicity
- Tax: slightly more aggressive

# U.S. Corporate Blocker - One More Twist



- Liquidating U.S. corporate blocker:
  - Tax-free for Offshore Feeder and non-US investors
  - Taxable for US investors

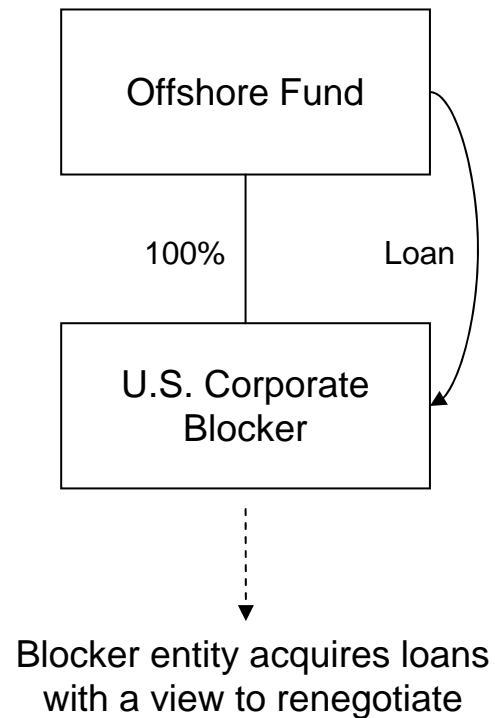
# U.S. Corporate Blocker - One More Twist



- Liquidating U.S. corporate blocker:
  - Tax-free for non-US investors
  - Taxable for US investors
- Solution:
  - Partnership below corporate blocker holds REO
  - One partnership per blocker
  - Partnership disposes of all REO
  - Partnership and blocker are then liquidated

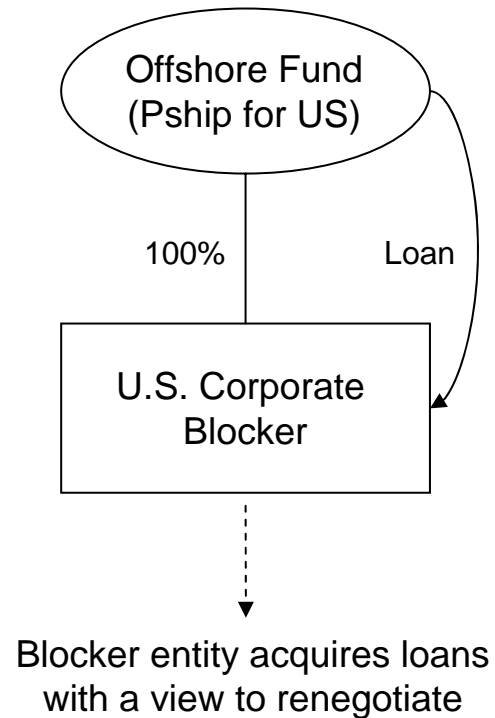
# U.S. Corporate Blocker - Capitalization

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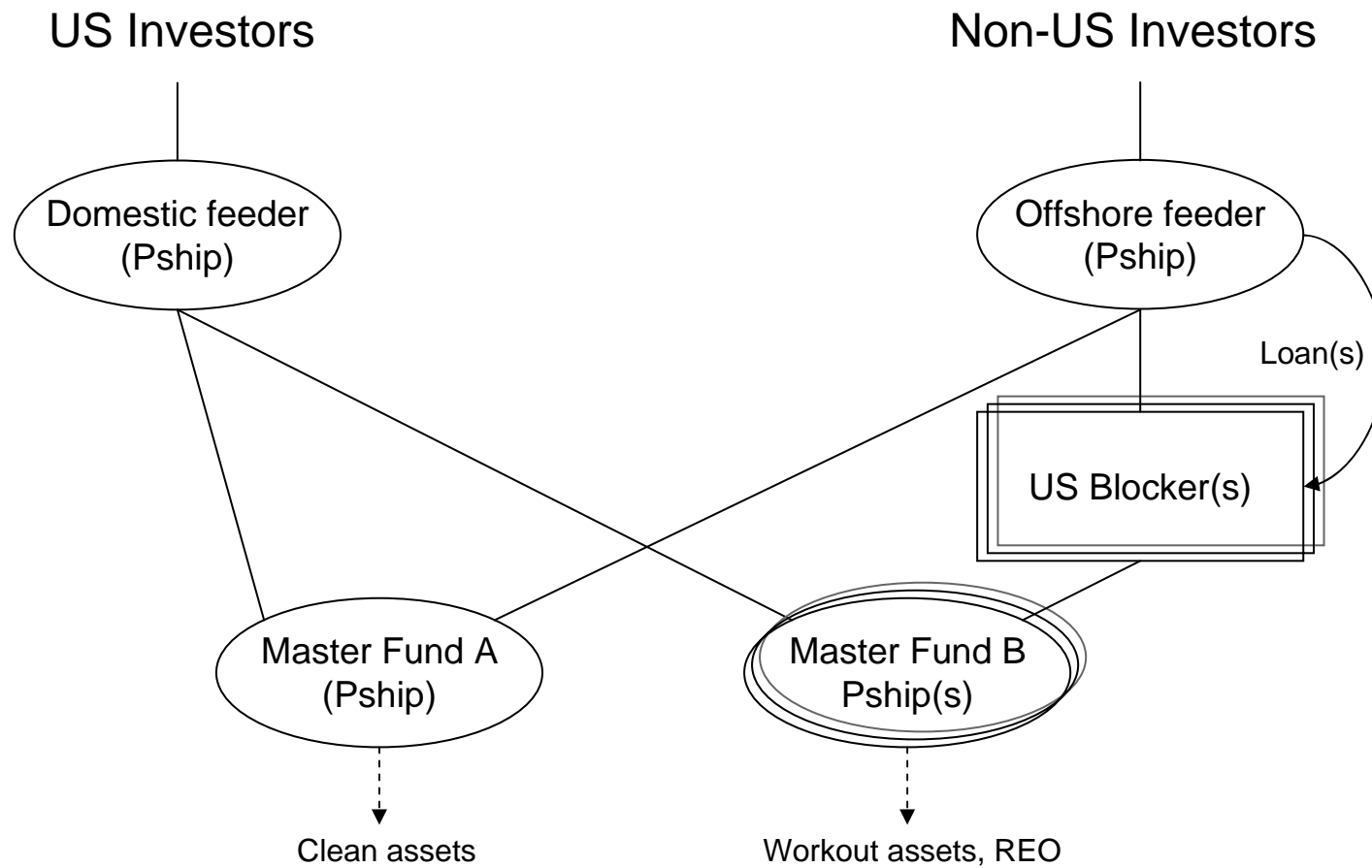
- Capitalize blocker with debt and equity
  - Debt/equity issues
  - Portfolio interest exemption eliminates US withholding tax
  - But: interest paid to Offshore Fund is not portfolio interest - a 10% shareholder

# U.S. Corporate Blocker - Capitalization



- Organize offshore fund as a partnership
- This helps with portfolio interest exemption
- 10% shareholder status tested at the partner, not partnership, level (Sec. 1.871-14(g)(3))
- Estate tax?

# Putting It Together



# REMICs: Opportunities and Pitfalls

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- REMIC: Real Estate Mortgage Investment Conduit
  - REMIC: a creature of the US tax law
  - The preferred vehicle for RMBS and CMBS securitizations
  - A REMIC may hold mortgage loans, modify and/or foreclose on defaulted loans, and hold REO acquired in foreclosure to provide for orderly disposition
  - A REMIC issues regular interests, treated as debt, and one class of residual interests, treated as equity of the REMIC
  - Funds should acquire regular interests, not residual interests

# REMICs: Opportunities

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- REMIC tax benefits
  - Avoids ECI and FIRPTA issues
  - Can foreclose inside the REMIC
  - Certainty of tax result granted by statute
    - Regular interests are characterized as debt, including subordinate classes
    - No entity level tax

## ... and Pitfalls

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- Two issues with using REMICs for distressed assets:
  - “Workout factory” – acquiring loans with a view to work out
  - Foreclosure property

# “Workout Factory”

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“Diana Imholtz, an attorney in the IRS Office of Associate Chief Counsel (Financial Institutions and Products), and James A. Gouwar of McKee Nelson LLP, told the Financial Transactions Committee that the **[REMIC] guidance does not cover formation of a "workout factory"** -- a new REMIC full of dodgy loans that are awaiting modification.

The IRS has not made a technical statement about whether forming a workout factory would qualify for REMIC status, Imholtz and Gouwar emphasized. Not too many people are forming subprime REMICs, they noted. So more guidance would only come if this became a problem. A REMIC is supposed to be a static pool of mortgages, while a workout factory might look more like a business, Imholtz said.” (emphasis added)

Tax Notes Today, September 18, 2008  
(Reporting on September 12, 2008, ABA Meeting)

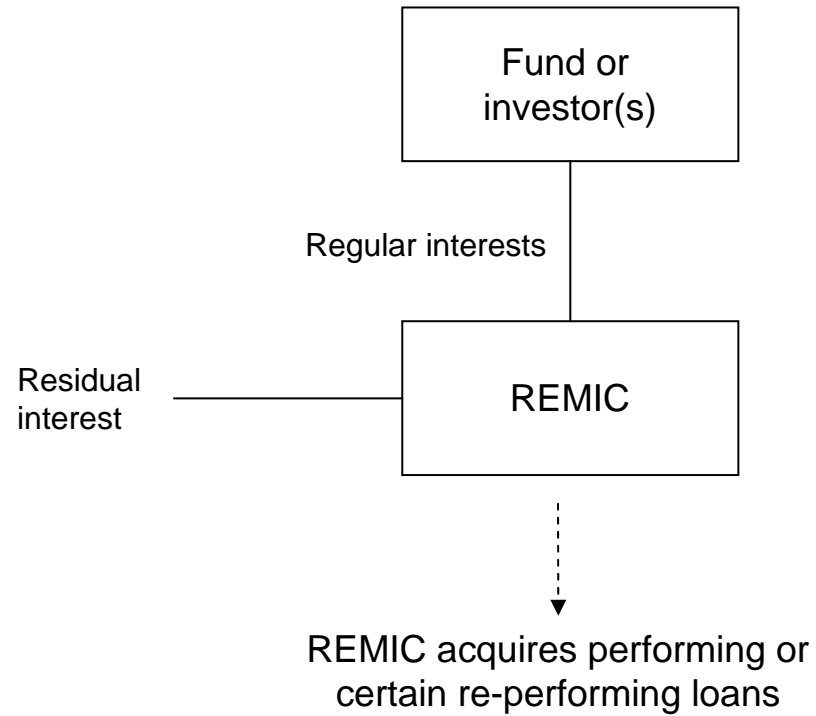
# Foreclosure Property

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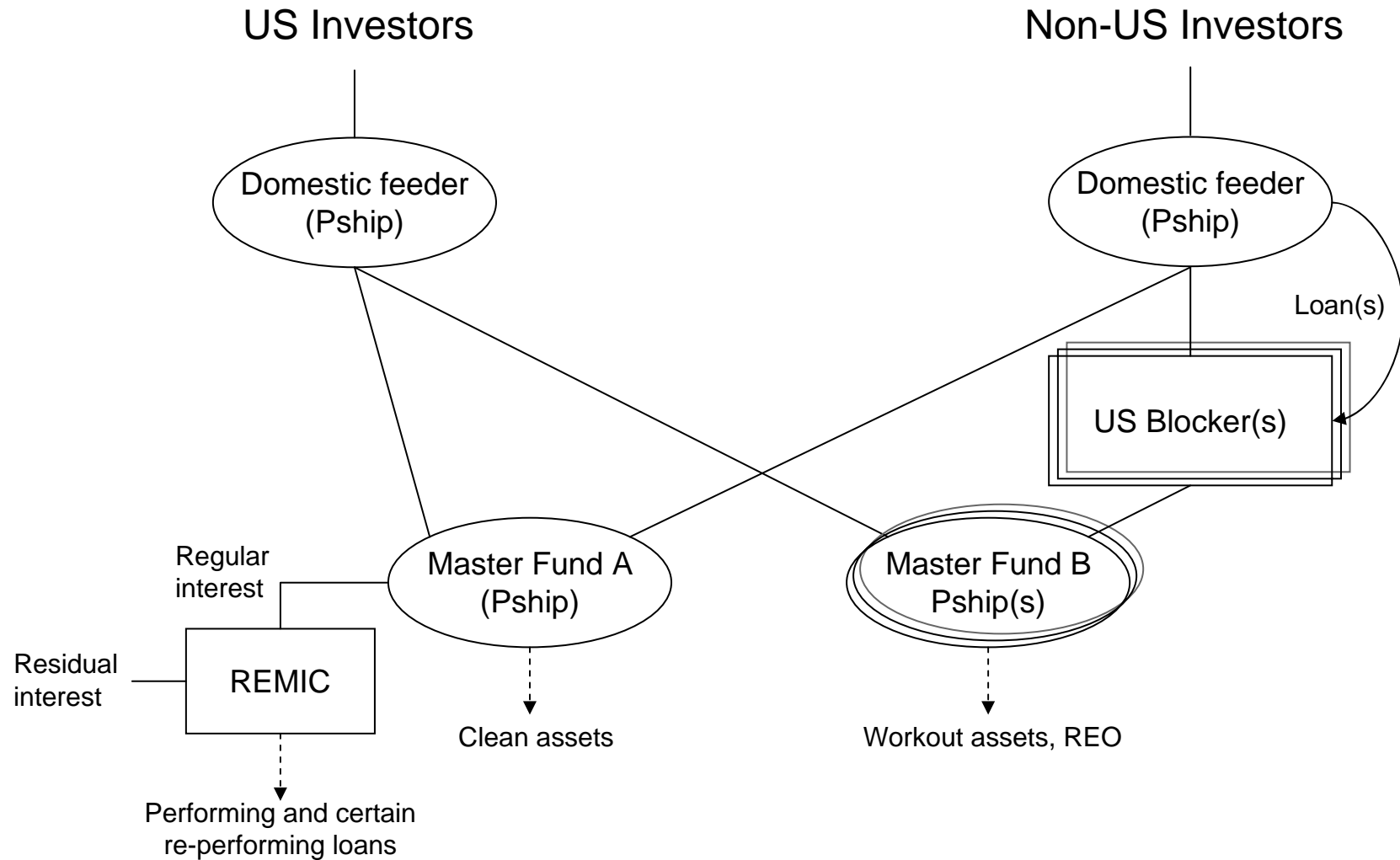
- Substantially all of a REMIC's assets must be qualified mortgages, cash flow investments, qualified reserve assets, and "foreclosure property." Sections 860D(a)(4) and 860G(a)(5)
  - REO will not be considered foreclosure property if a REMIC had "improper knowledge" that the loan would default. Cf. Section 1.856-6(b)(3).
    - For example: loans more than 59 days past due
  - If a REMIC acquires property which does not qualify as "foreclosure property," REMIC status could be jeopardized
  - Accordingly, REMICs manage this issue by limiting the amount of non-"foreclosure property" that may be in the REMIC at any time
  - If more loans default, the REMIC sells those loans rather than foreclosing

# REMIC Structure

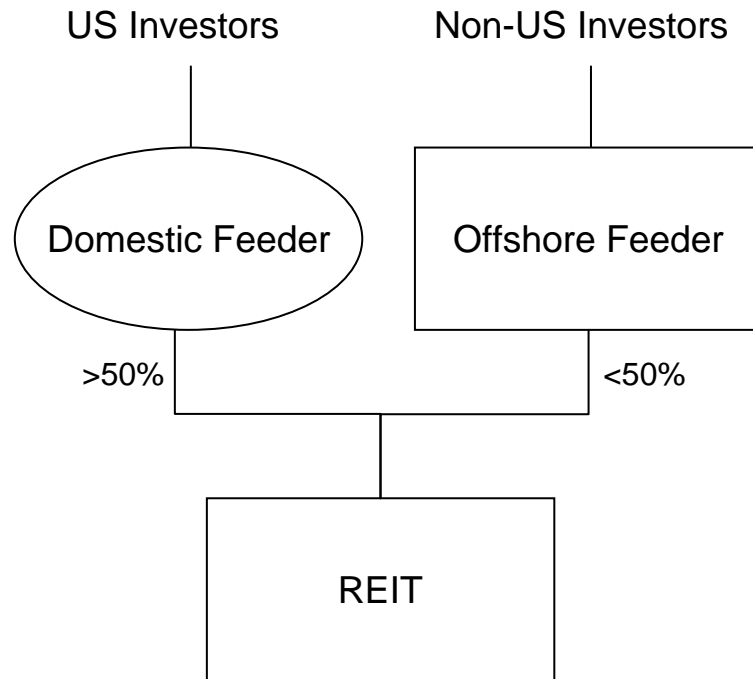
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# Putting it Together - With a REMIC



# REIT Structure



- Domestically-controlled REIT: US investors > 50%
- Benefits:
  - REIT is not a USRPHC
  - REIT shares are not USRPIs
- Challenges:
  - REIT tests: income, assets, distributions
  - Non-US investors taxable on distributions of real estate gains
- At least one PPIP REIT filed preliminary S-11 in May 2009

# Other Tax Issues

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- Obama Administration Revenue Proposals
- NY Personal Income Tax
  - Amendment for 2009 eliminates itemized deductions (except charitable contributions) for taxpayers earning more than \$1 million
  - No deduction for investment interest
  - Example: NY taxpayer is an investor in a leveraged fund
    - Taxpayer earns 20% gross return but only receives 10% net return after interest expense
    - For NY tax purposes, the taxpayer cannot deduct the interest, and will pay tax on the 20% gross amount
  - This may influence some NY-based fund investors / managers to invest through an offshore feeder

# Contact Information

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