

International Tax Consequences of Distressed Real Estate
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Agenda

- COD Income – In general
- Withholding Tax Consequences of U.S.-Source COD Income
- Exceptions to COD Income
- New Deferral of COD Income Provision

COD Income and Section 108

COD Income – In General

- Section 61(a)(12) provides that a taxpayer must include in gross income "[i]ncome from discharge of indebtedness." ("COD Income")
- There are several ways in which a taxpayer may have COD Income
 - a debtor or a person related to the debtor purchases its obligations at a discount
 - a defaulting debtor transfers property in satisfaction of a debt obligation or when a creditor forgives all or a portion of a debt
 - Nonrecourse debt--property deemed sold at face amount of debt, therefore no COD Income, but gain or loss equal to difference between face amount of debt and adjusted basis
 - Recourse debt--property deemed sold at FMV, therefore gain or loss equal to difference between FMV and adjusted basis and COD Income equal to difference between face amount of debt and FMV

COD Income and Section 108 – In General

- Section 108(a)(1) provides that gross income does not include any amount which would be includable in gross income "by reason of the discharge (in whole or in part) of indebtedness" of the taxpayer if
 - (1) the discharge occurs in a title 11 bankruptcy case,
 - (2) the discharge occurs when the taxpayer is "insolvent,"
 - (3) the debt discharged is "qualified farm indebtedness," or
 - (4) for taxpayers other than a C corporation, the debt discharged is "qualified real property business indebtedness."

COD Income and Section 108 – In General (cont.)

- If one of these conditions is satisfied, the COD income will be excluded from the taxpayer's gross income but under Section 108(b) the taxpayer will be required to reduce the following tax attributes, if applicable:
 - (1) NOLs.
 - (2) General business credits.
 - (3) Minimum tax credits.
 - (4) Capital loss carryovers.
 - (5) The basis of its property.
 - (6) Passive activity losses and credit carryovers.
 - (7) Foreign tax credit carryovers.

Qualified Real Property Business Indebtedness

- Qualified Real Property Business Indebtedness (“QRPBI”) means debt secured by real property and, if incurred after December 31, 1992, was incurred to acquire, construct or substantially improve the real property.
- The amount of QRPBI excluded from COD Income is limited to
 - the difference between the principal amount of the QRPBI and the FMV of the property;
 - the aggregate adjusted basis of all depreciable real property held by the taxpayer.
- The amount of QRPBI excluded from COD Income must be applied to reduce the basis of depreciable real property of the taxpayer.

Source of COD Income

Source of COD Income – Why is it Relevant?

- Foreign debtors engaged in a U.S. trade or business – if U.S. source, then will be effectively connected income and taxed at graduated U.S. tax rates.
- Foreign debtors not engaged in U.S. trade or business – if U.S. source, may be subject to 30 percent withholding tax as FDAP income (unless reduced or eliminated by treaty).
- U.S. debtors engaged in business both within and without the United States – impacts their foreign tax credit calculations.

Source of COD Income – Various Theories

- Most recent position of the IRS is that the source of COD income is “unclear”. *See* 1999 FSA LEXIS 401.
- There are at least four theories under which COD income could be sourced:
 - Place of discharge
 - Residence of the debtor
 - Interest expense sourcing rules
 - Tracing approach

Source of COD Income – Place of Discharge

- The first theory is that COD Income should be sourced according to the location where the purchase of the debt occurs.
- This theory is derived from an old (and now obsolete) ruling in which the IRS looked solely to the place of purchase to determine the source of COD Income.
- In IT 3119, 1937-2 CB 227 IT 3119, 1937-2 CB 227, the taxpayer was a foreign corporation that conducted a business outside the U.S. but maintained an office in the U.S.
 - Board of Tax Appeals followed this result in *Corporacion de Ventas de Salitre Y Yoda de Chile v. Commissioner*, 44 BTA 393 (1941) *rev'd on other grounds*, 130 F2d 141 (CA-2, 1942).
- The IRS ruled that the taxpayer realized COD Income at the time that it repurchased its bonds. Addressing the issue of source, the IRS simply stated that the COD Income was U.S. source because "the purchase was made in the United States."
- While this approach is simple, it allows debtors, in effect, to choose how to source their COD Income.

Source of COD Income – Residence of the Debtor

- A second theory is that COD Income should be sourced in the same manner as the interest payments on the debt would have been sourced (i.e., generally by the residence of the debtor under Section 861(a)(1)).
- This approach seems to have some support.
 - *See Bank of America v. United States*, 680 F2d 142, (Ct. Cl., 1982) (acceptance commissions sourced by analogy to the source of interest income rules).
- Its simplicity may be undermined by the fact that it would allow indebtedness of foreign persons to escape the U.S. tax system, even in an extreme case where a debt was issued in the U.S., repurchased in the U.S., and denominated in the U.S. dollar.

Source of COD Income – Interest Expense Sourcing Rules

- A third theory is that COD Income should be sourced by reference to the source of the gross income to which a debtor's interest deductions would have been allocated and apportioned under Temp. Treas. Reg. Section 1.861-9T.
- Support for this position is found in Rev. Rul. 92-92, 1992-2 C.B. 103, in which the IRS stated that to determine whether COD Income was income from a passive activity, it is appropriate to allocate the COD Income in the same manner as the Temp. Treas. Reg. Section 1.163-8T interest allocation rules allocate the debt at the time of the discharge.
 - Thus, because 60% of the debt was allocated to passive activity expenditures and 40% was allocated to other expenditures, the IRS allocated 60% of the COD Income to income from a passive activity and 40% to income from a non-passive activity.

Source of COD Income – Tracing Approach

- The fourth approach would source COD Income by tracing the loan proceeds to particular assets or activities of the debtor.
- This approach was taken by the Tax Court in *Big Hong Ng*, TC Memo 1997-248, where a foreign corporation whose sole business activity was the rental of an interest in U.S. real estate. It owed money to two related corporations, one of which was U.S. The taxpayer distributed its interest in the U.S. real estate to its shareholder without retiring the debt. The corporation ceased doing business on the distribution of the real estate and its debts were discharged at that time.
- After the IRS asserted that the taxpayer was liable for tax on the COD Income arising from the debts that were discharged, the taxpayer argued that the COD Income was neither U.S. source nor ECI. The Tax Court disagreed and stated that the taxpayer's rental activity constituted a U.S. trade or business and the debts were related to that activity.
 - The Tax Court did not state that the COD Income was U.S. source, but it was implicit because COD Income is not one of the limited items of foreign source income that constitutes ECI.

Source of COD Income – NY Bar Suggestion for a Foreign Debtor

- The fifth approach can be extrapolated from a NYSBA Tax Section report dated November 5, 2004, relating to the sourcing of COD Income of a foreign debtor.
- “Alternative #2: Treasury might require the foreign debtor to source COD Income in the following order and priority: first, to the extent attributable to previously deducted but unpaid interest, according to the source of the foreign debtor’s gross income that those deductions offset; second, to the extent that the discharged debt was “booked” in the United States, to the United States; otherwise to the residence of the foreign debtor.”

U.S. Withholding Tax Consequences

Is COD Income Considered FDAP Income?

- It is not entirely clear whether COD Income is considered FDAP income.
- It is not really “fixed” or “determinable” (unless it is clear that the debtor is insolvent), and it is not really “annual” or “periodic” like most other forms of FDAP, such as dividends, interest, rents, or royalties.
- Treas. Reg. Section 1.1441-2(b)(1) defines FDAP to include all amounts "included in gross income under Section 61 (including original issue discount)" other than certain gains derived from the sale of property and any other category of income that the IRS determines is not FDAP by published guidance.
 - Regulation Section 1.1441-2(d)(2) creates a deemed payment of income to the borrower at the time the event of forgiveness occurs.
- Thus, it appears that COD Income constitutes FDAP income and the IRS seems to agree. *See* 1999 FSA LEXIS 401.

Withholding Tax Consequences

- Assuming COD Income is found to be from U.S. sources and it is FDAP income, a determination needs to be made whether such income is subject to withholding tax in the U.S.
- Under Sections 1441 and 1442, withholding is required on payments of U.S. source FDAP income to foreign individuals, partnerships, and corporations.
- The withholding rate generally is 30 percent, although most income tax treaties concluded with the U.S. reduce this rate for various specified types of income.

Withholding Tax Consequences (cont.)

- As noted earlier, Regulation Section 1.1441-2(d)(2) seems to indicate that COD Income constitutes FDAP income that may trigger a withholding tax obligation.
- As a result, unless an exception applies (e.g., the COD Income is effectively connected income or a treaty applies), withholding would appear to be required on U.S.-source COD Income. *See* 1999 FSA LEXIS 401.
 - The “other income” provision contained in many U.S. income tax treaties would seem to exempt COD Income from U.S. withholding tax.
- How could withholding tax apply when debtor receives no funds from which amount may be withheld?
- Regulation Section 1.1441-2(d)(2) creates a deemed payment of income to the borrower at the time the event of forgiveness occurs.
 - A payment is considered made when the amount would be includible in the income of the beneficial owner under the U.S. tax principles governing the cash basis method of accounting.

Withholding Tax Consequences – Exemptions from Withholding

- Withholding is not required in two situations:
 - (i) The withholding agent is not related (within the meaning of Section 482) to the beneficial owner, and does not have custody of, or control over, property of the borrower at any time between the time that the loan is forgiven and the due date (including extensions) of the Form 1042 for the year in which the payment is deemed to occur.
 - For this purpose, a partial payment by the borrower is not treated as a payment over which the lender has custody or control.
 - (ii) The withholding agent does not have knowledge of the events that give rise to the deemed payment.
- Neither of these relief provisions will apply to deemed payments that are part of a prearranged plan to avoid withholding.

Withholding Tax Consequences – Exemptions from Withholding (cont.)

- The exemption from withholding on COD Income applies regardless of whether documentation is furnished to the withholding agent.
 - Documentation may have to be furnished, however, for purposes of the information reporting provisions and backup withholding under section 3406.
- Moreover, the exemption from withholding is not a determination that the amounts are not FDAP income, nor does it constitute an exemption from reporting the amount under Regulation Sections 1.1461-1(b) and (c) (i.e., Forms 1042 and 1042-S).

Section 108 Insolvency Calculation

Section 108 Insolvency Calculation – Which Assets are Counted?

- A taxpayer can exclude COD Income if taxpayer is "insolvent."
- Generally, a taxpayer is insolvent when the amount of the taxpayer's liabilities exceeds the FMV of the taxpayer's assets.
- The amount of the exclusion will be limited to the amount of the taxpayer's insolvency.
- Assuming a foreign person is taxed on U.S.-source COD Income (either as ECI or FDAP income), how does the foreign person measure insolvency?

Section 108 Insolvency Calculation – Which Assets are Counted? (cont.)

- There is no clear rule governing which assets of a foreign person will be counted in the determination of insolvency under Section 108.
- One possibility is that only U.S.-situs assets should be included in this calculation.
 - This position is based on *United States v. Van Der Horst*, 270 F Supp 365, (DC Del., 1967), which held that foreign-situs assets should *not* be considered in determining whether a foreign person was insolvent for purposes of the Uniform Fraudulent Conveyance Act.
- On the other hand, *Carlson v. Commissioner*, 116 T.C. 87 (2001), arguably supports the view that all assets of a foreign person should be included in the insolvency calculation.
 - In *Carlson*, the court concluded that an Alaskan fishing permit—an exempt asset under Alaska law—should be included in Section 108’s insolvency calculation.

Application of Section 108(i) to Foreign Debtors

Section 108(i) – How Does Provision Apply When Debtor is Foreign?

- The American Reinvestment and Recovery Act permits the deferral of the recognition of COD Income in certain situations.
- New Section 108(i) allows a taxpayer to elect to defer COD Income arising from a "reacquisition" of "an applicable debt instrument" after December 31, 2008 and before January 1, 2011.
- Deferral of OID deductions
 - If a new instrument issued in a debt-for-debt exchange has OID, the issuer's OID deductions will be deferred until the inclusion period of the COD Income begins.
- Deferred COD Income must be ratably included in the taxpayer's gross income over the years 2014 through 2018 (the "inclusion period").

Section 108(i) – How Does Provision Apply When Debtor is Foreign? (cont.)

- Applies to an applicable debt instrument.
- The term “applicable debt instrument” means any debt instrument which was issued by—
 - (i) a C corporation, or
 - (ii) any other person in connection with the conduct of a trade or business by such person.

Section 108(i) – How Does Provision Apply When Debtor is Foreign? (cont.)

- All deferred amounts (COD Income and OID deductions) will be taken into account in the taxable year (or in the case of a title 11 case, the day before the petition is filed) in which the following events occur:
 - In the case of the death of the taxpayer,
 - the liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case),
 - the cessation of business by the taxpayer, or
 - similar circumstances.

Section 108(i) – How Does Provision Apply When Debtor is Foreign? (cont.)

- What if foreign person that has U.S.-source COD Income that is treated as ECI elects to defer the income inclusion under Section 108(i), but when inclusion period begins five years later, the foreign person is no longer engaged in a U.S. trade or business?
 - Will the cessation of the foreign person’s U.S. trade or business be treated as “the cessation of business of the taxpayer” for acceleration purposes?
 - Will the cessation of the foreign person’s U.S. trade or business fall under the “similar circumstances” catch all for acceleration purposes?
 - Will Section 864(c)(6) or (c)(7) apply to treat COD income as arising in year when foreign person was engaged in U.S. trade or business?

Section 108(i) – How Does Provision Apply When Debtor is Foreign? (cont.)

- What if foreign person with U.S.-source COD Income treated as FDAP income subject to withholding elects to defer the income inclusion under Section 108(i), but when inclusion period begins five years later, the withholding agent no longer has custody of, or control over, property of the borrower?
- Or what happens if, when the inclusion period begins, foreign person now resident in jurisdiction whose income tax treaty with the U.S. excludes the COD income under the “other income” provision of the treaty?
- Would either of these situations fall under the “similar circumstances” catch all of the acceleration provision?

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