

By Micah Bloomfield

Turmoil Creates *Buying Opportunities* for **Foreign Investors**

Investments by foreign investors benefit the U.S. economy by providing much-needed liquidity but can come with some with unexpected tax issues.

Recent troubles in the credit markets, combined with the decline in the value of the dollar and rising oil prices, have opened up opportunities for foreign investors to purchase mortgage- and asset-backed securities, as well as whole loans, at low and potentially favorable prices. Such foreign investments, typically through hedge funds managed either in the U.S. or offshore, will likely benefit the U.S. economy by providing much-needed liquidity.

The opportunities come in three flavors: purchasing an existing debt at a discount with the intention of making a profit when the current flight to quality reverses; making new loans to borrowers who, in the current economic environment, have trouble finding other lenders; and purchasing existing debt at a steep discount with the expectation that the borrower will need to modify the debt to avoid a foreclosure, or other form of attempting collect from the borrower using judicial procedures.

The catch is that without careful structuring, a foreign investor making new loans or purchasing, and subsequently modifying, existing debt may be treated, for U.S. tax purposes, as engaging in business in the U.S. — with substantial additional taxes for that investor.

There is no major tax problem with the first category of investment. A foreign investor who buys debt at a discount with the intention of profiting by sales when the debt increases in price generally is not treated as engaged in a trade or business in the U.S. under the so-called trading safe harbor of section 864(b)(2) of the Internal Revenue Code of 1986, as amended, and consequently is not subject to U.S. federal net income taxes.

Furthermore, with relatively simple structuring the interest on the debt generally will qualify for the portfolio interest exemption under Code sections 871(h) and 881(c), and therefore will not be subject to the 30% withholding tax on interest payments



Welcome to the land of the free...unless you're buying distressed mortgages Getty

from U.S. sources. One way of achieving this, for example, is by setting up a grantor trust issuing registered certificates to hold the debt if it is not already in registered form — See Treas. Reg. § 1.871-14(d)(1).

Unintended tax consequences

However, for the latter two categories there is a significant risk that lending money or restructuring existing debt in a material manner will be treated as a U.S. trade or business if the investor or its hedge fund conducts significant activities relating to the lending or the restructuring in the U.S. The 2007-2008 Priority Guidance Plan of the Office of Tax Policy of the Treasury Department and the Internal Revenue Service (Aug. 13, 2007) under the International Issues category, 2007 WL 2350239, suggests that guidance on the lending activities of foreign investors may be forthcoming (“Guidance on financing activities, including lending activities under section 864.”)

See also the First Periodic Update of the 2007-2008 Priority Guidance Plan (April 22, 2008), BNA TaxCore No. 78 which cites some guidance relating to financing but not to Section 864. The tax cost can be substantial. A foreign corporation that is engaged in business in the U.S., either directly or through a hedge fund, can end up with a federal tax liability of close to 55%, consisting of a regular tax of 35% and a branch profits tax of up to an additional 19.5%.

One way to lessen the tax burden with newly originated loans is to fund the corporation that originates the loans with debt. Interest paid on the debt will reduce the taxable income of the corporation, but the interest may be able to qualify for the portfolio interest exemption, and thus not be subject to the 30% withholding tax. It should be noted that there are certain restrictions on the amount of interest that may be deducted, both because having too much debt may cause all or some of the debt to be treated as equity giving rise to non-deductible dividends, and because of a special earnings stripping rule in Code section 163(j).

Although the portfolio interest exemption will not apply to debt paid to a person who owns at least 10% of the voting stock of the corporation, the Treasury Department adopted regulations in 2007 that apply the 10% test at the partner level, rather than at the partnership level. (See Treas. Reg. § 1.871-14(g).) The effective tax rate can be further reduced by liquidating the corporation after the profits have been realized, rather than paying dividends, since the liquidating distribution generally is not taxable to foreign stockholders.

Various other innovative approaches may be considered to reduce the tax liability of the corporation, such as electing to be treated as a REIT if the debt is mostly mortgage debt, or the use of credit default swaps. There is more information concerning the consequences to foreign stockholders when a REIT liquidates in Chief Counsel Attorney Memorandum AM 2008-

003 (Feb. 15, 2008), 2008 WL 459787. But it is worth noting that when the REIT holds mortgages rather than real estate, the results generally are more favorable than described in the memorandum.

An innovative approach

A significant modification of an existing loan generally is treated as the creation of a new loan. (See Treas. Reg. § 1.1001-3.) For recent developments concerning loan modifications, see Rev. Proc. 2007-72, permitting the modification of certain subprime loans without causing a REMIC or grantor trust to lose its status as such, and Proposed Regulations at 72 Fed. Reg. 63523 (November 9, 2007), which would add to the flexibility of REMICs to make certain modifications to commercial loans.

Thus, an investor buying debt and modifying it may be treated as engaged in a lending business. The investor can reduce its tax liability in a manner similar to that used by a foreign investor that is originating new loans.

Other alternatives are available or may emerge in the future. Several groups have lobbied the Treasury Department to conclude that modifying distressed debt is not a U.S. trade or business. The Managed Funds Association drafted a letter outlining this position to the Treasury Department and the Internal Revenue Service on April 9th, 2008. Allowing foreign hedge funds to buy and modify distressed debt could give the economy the shot in the arm, and the psychological boost, it needs to recover from the credit freeze. In a private communication with the author, one commentator suggested legislation allowing hedge funds to lend more broadly in the U.S.

In the case of mortgage debt, a particularly innovative approach has involved using a REMIC to buy distressed debt. A REMIC itself is generally not taxable and it can pay interest on the regular interests it issues to foreign investors without subjecting them to U.S. taxes. However, proper structuring is required to sidestep certain traps for the unwary such as the prohibited transaction taxes, taxes on a residual interest's excess inclusion income, and alternative minimum taxes.

Upheaval in the credit markets has caused significant pain both in the U.S. and in the broader world economy. The turmoil presents foreign investors with opportunities to buy U.S. debt, and these purchases have the potential to provide a significant boost to the U.S. economy by injecting much-needed liquidity into the credit markets. With proper tax structuring, foreign investors can make these investments without incurring significant tax liabilities. The stresses in the market may accelerate guidance from the Treasury Department concerning lending activities by foreign investors in the U.S. ▼

With proper tax structuring, foreign investors can make these investments without incurring significant tax liabilities.

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