AMERICAN BAR ASSOCIATION

Tax Section

2023 MAY TAX MEETING

MARRIOTT MARQUIS WASHINGTON, DC

Inbound Investment Funds Formation, ETB and Other Tax Implications

US Activities of Foreigners and Tax Treaties Committee

May 5, 2023

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Fund Formation and Investor Considerations

Fund Formation and Investor Considerations

- Investors may have differing concerns when investing in a fund (*e.g.*, type of investments, type of income received, ownership percentage, withholding tax, availability of treaty benefits, disposition of investment, liquidity)
- Structure of the fund will be largely dependent on the type of investors
- What may be good for one investor might be toxic for another

Fund Formation and Investor Considerations

- Foreign Corporations:
  - Foreign corporations engaged in a U.S. trade or business ("**ETB**") must file a tax return and pay corporate income tax (21%) on U.S. source income / potential 30% branch profits tax
  - Subject to WHT (30% or lower treaty rate)
  - Return not required when tax is fully paid at source
- Qualified Foreign Pension Funds ("**QFPF**"):
  - A QFPF is any trust, corporation, or other organization or arrangement that meets certain statutory requirements
  - Subject to U.S. tax but exempt from Foreign Investment in Real Property Tax Act ("**FIRPTA**")
  - Prefer not to invest directly in U.S. real estate

Fund Formation and Investor Considerations

- Sovereign Wealth Funds:
  - Funded and controlled by foreign governments, including the “integral parts” of government departments or agencies but also includes separate legal entities that are “controlled” by the foreign government
  - Income received from investments in the U.S. is not included in gross income and exempt from taxation under Section 892
  - Cannot be for commercial purposes and may not take a controlling stake in an investment

- Charitable Organizations:
  - Tax exempts that may want to avoid unrelated business taxable income

Fund Formation and Investor Considerations

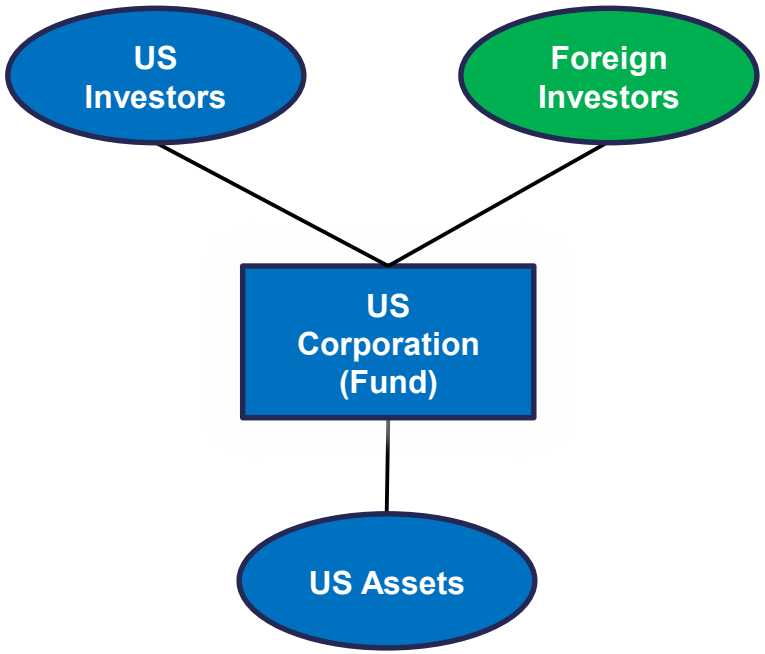
- Corporation:
  - Subject to 21% corporate income tax (i.e., tax leakage)
  - Serves to “block” the character of the income

- Partnerships:
  - “Flow through” entity
  - Partners pay tax, not the partnership

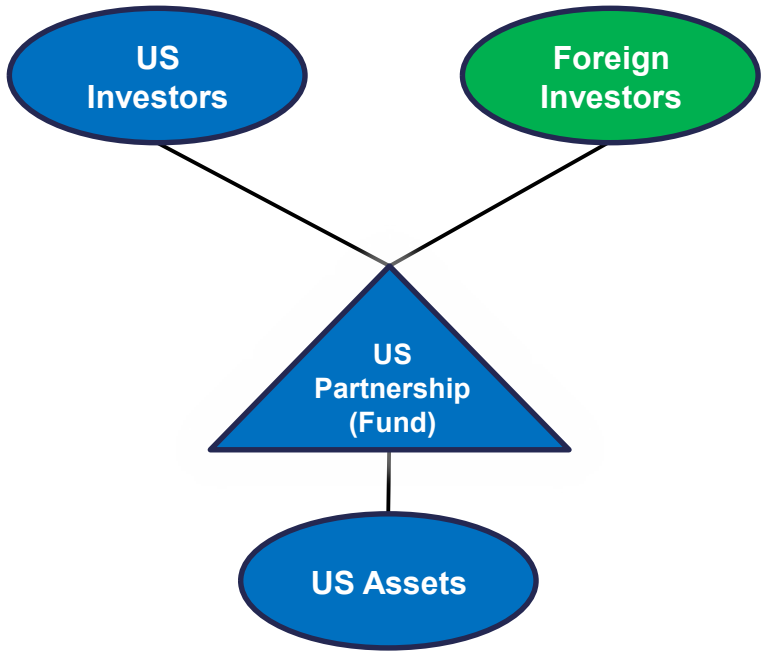
- Disregarded entities – not a taxpayer for U.S. federal income tax purposes

Fund Formation and Investor Considerations

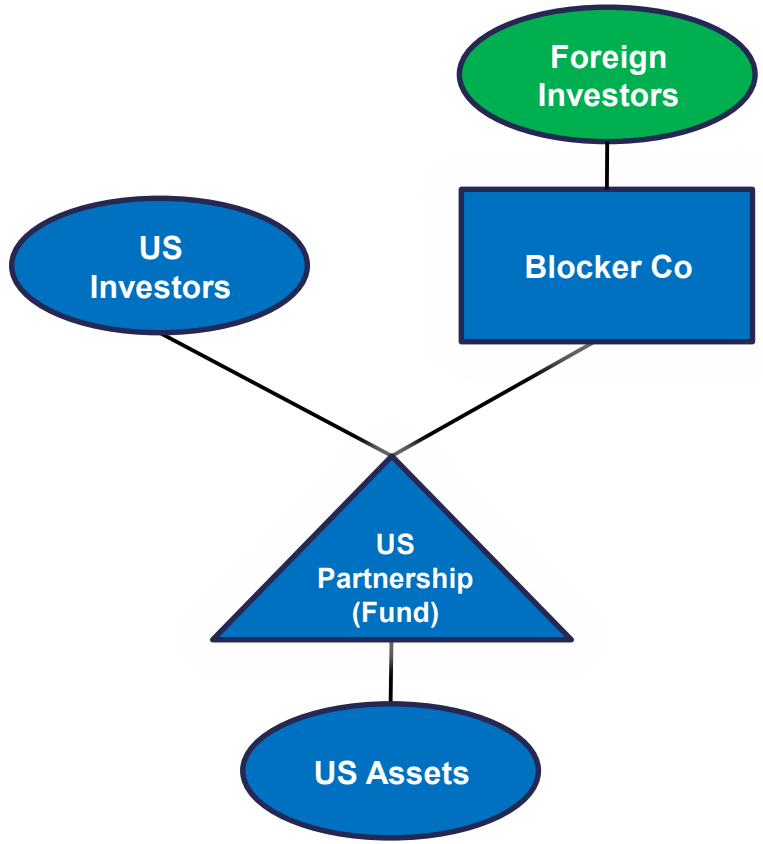
Investment through a US Corporation



Investment through a US Partnership



Investment through a Blocker Co



Effectively Connected Trade or Business

General ECI Considerations

- A foreign investor that is (directly or indirectly) ETB is subject to tax on income that is effectively connected with a U.S. trade or business:
  - Requires a partner to file a U.S. income tax return and pay tax at the same rates applicable to U.S. taxpayers
  - If a partnership is ETB, then the partner is considered so engaged. Section 875
  - May also have 30% branch profits tax if the investor is a foreign corporation

Trade or Business in the U.S.

- Not defined in either the Code or Regulations
  - Based on a facts and circumstances determination. Treas. Reg. § 1.864-2(e)

- Trading Safe Harbor, Section 864(b)(2)
  - A foreign investor is not treated as being ETB if the activities are limited to:
    1. Trading stocks, securities or commodities through a resident broker, commission agent, custodian or other independent agent; or
       - This only applies if the taxpayer does not have an office or fixed place of business in the U.S. at any time during the taxable year through which the transactions in stocks, securities, or commodities are effected
    2. Trading in stock, securities or commodities for the taxpayer's own account

Lending as a Trade or Business?
Case Law

- Foreign individual not ETB; only made 1 loan to a U.S. corporation
  - *Pasquel v. Comm'r*, 12 TCM 1431 (1953)

- Foreign corporation ETB based on review of factors in Treas. Reg. § 1.864-4(c)(5)
  - Receiving deposits from the public
  - Making personal, mortgage, industrial or other loans to the public
  - Purchasing, selling, discounting or negotiating notes, drafts, checks, etc. for the public on a regular basis
  - Issuing letters of credit to the public and negotiating drafts drawn thereunder;
  - Providing trust services for the public; or
  - Financing foreign exchange transactions for the public
  - *InverWorld v. Comm'r*, 71 TCM 3231 (1996)

Lending as a Trade or Business?
Case Law

- Interest income received by a foreign corporation from loans originated to U.S. borrowers is ECI where the loans were solicited and negotiated through the U.S. office of an independent agent and approved and signed outside of the U.S. by the foreign corporation's employees
  - The ECI rules only require income be attributable to the U.S. office through which the business is carried on
    - Does not require the U.S. office belong to or be attributable to the taxpayer
  - Legal Advice Memorandum 2009-010

- Fund was ETB where, on a considerable, continuous and regular basis, originated loans and acted as an underwriter in various stock offerings on behalf of the fund
  - Fund manager directly negotiated with borrowers, conducted extensive due diligence, originated "numerous" loans, solicited business with borrowers and issuers and received fees
  - CCA 201501013, *YA Global* pending in Tax Court

Lending as a Trade or Business?
Treaty Strategy

- The investment manager originates loans in the U.S. on behalf of foreign investors or a foreign investment vehicle that qualifies for the benefits of an income tax treaty with the U.S.

- Most income tax treaties exempt business profits from source-country taxation so long as the items are not attributable to a permanent establishment ("**PE**") in the source country

- The PE of an agent (e.g., the investment manager) is typically attributed to the principal (e.g., the fund), unless the agent is an independent agent

- Generally, a treaty requires an independent agent to have legal and economic independence:
  - **Legal Independence**: The agent must be responsible to the principal for the results of its work, but not subject to significant control in how that work is carried out
  - **Economic Independence**: The agent needs to have entrepreneurial risk

Lending as a Trade or Business?
Proposed Safe Harbors

- **Season and Sell:** Foreign person is not ETB if:
  1. The foreign person was not committed to purchase the loan until after the lender was contractually committed to the financing
  2. The foreign person has no understanding or arrangement with the borrower at any time prior to purchasing the loan
  3. The loan is not purchased from or made by an affiliate of the foreign person or someone who makes investment decisions for the foreign person
  4. The investment manager for the foreign person is not affiliated with the person that makes lending decisions for the lender
  5. The loan was made by the lender in the ordinary course of its business, not as an accommodation to the foreign person; and
  6. The loan is purchased by the foreign person at least 24 hours after the closing or modification of the loan

Lending as a Trade or Business? Proposed Safe Harbors

- **Limit Number of Loans:** Foreign person is not ETB if:
  1. The foreign person does not hold themselves out as a lender or dealer in securities
  2. The originated loans are not disposed of before 2 years or maturity; and
  3. The foreign person does not originate more than 4 loans in the current taxable year and each of the past two years
- **Loan Incidental to Equity Investment**: Disregard a loan made to a U.S. borrower if:
  1. The foreign person acquires stock or rights to acquire stock in the borrower in connection with the loan
  2. The foreign person holds the loan and related stock or stock rights for more than 12 months; and
  3. At the time of making the investment, the foreign person reasonably expects to earn more than 50% of its return from appreciation in the equity component of the investment unit
- **Lending to Protect a Pre-Existing Investment**: Foreign person not ETB if the loan is made primarily for the purpose of protecting or enhancing a pre-existing investment
- *Report Offering Proposed Guidance Regarding U.S. Federal Income Tax Treatment of Certain Lending Activities Conducted within the United States*, New York City Bar, May 3, 2007

IRS Lending Audit Campaign

- On June 10, 2021, the IRS added the acquisition of loans by non-US persons to its list of audit campaigns:
  - This campaign addresses whether foreign investors were subject to U.S. tax on effectively connected income from lending transactions engaged in through a U.S. trade or business. In general, foreign investors who only trade stocks and securities for their own account are not engaged in a U.S. trade or business under the safe harbor rule set forth in 26 USC 864(b)(2). The safe harbor rule, however, is not available to dealers in stocks or securities, or to entities engaged in a lending business, or to foreign investors in partnerships engaged in such activities. The treatment stream for this campaign is issue-based examinations.

FIRPTA / REIT Considerations

FIRPTA / REIT Considerations

- What is a Real Estate Investment Trust ("**REIT**")?
  - Investment vehicle that is commonly used for real estate investments, similar to a mutual fund for real estate
  - Allows investors to pool capital to participate in real estate ownership or mortgage financing
  - Provides investors with the benefits of many tax advantages available to larger and more sophisticated investors and businesses
  - Professional management of a diversified portfolio of real estate assets
  - Preferred vehicle for foreign investors due to tax efficient nature

FIRPTA / REIT Considerations

- A REIT must meet various organizational, operational, income and asset tests, and elect to be taxed as a REIT for U.S. federal income tax purposes
- Taxation as a REIT entitles the entity to a “dividends paid deduction” such that the REIT may not have to pay corporate income tax
- Shareholders of the REIT must pay tax on the dividend income (subject to certain exceptions)
- Results in a single level of tax payable by shareholders
- REITs are heavily regulated – Maintaining REIT compliance and the associated administrative burden may be costly

FIRPTA / REIT Considerations

- Gain from the sale of stock by a foreign corporation generally is treated as foreign source income
- However, gain derived from dispositions of stock of certain "U.S. real property holding corporations" ("**USRPHC**") is income effectively connected with a U.S. trade or business and therefore, subject to U.S. federal income tax
- Generally, the sale of shares of a U.S. corporation by its foreign shareholders should **not** result in taxable gain in the U.S. unless it is a USRPHC.
- The disposition of a U.S. real property interest ("**USRPI**") by a foreign person is subject to income tax withholding in the US.

FIRPTA / REIT Considerations

- A USRPI is presumed to include any interest in a U.S. corporation unless the taxpayer establishes that the corporation was, at no time, a USRPHC during the 5-year period ending on the date of the disposition
- A corporation meets the definition of a USRPHC if the fair market value of its USRPIs equals at least 50% of the fair market value of the company's USRPIs, its interest in real property located outside the U.S., and any other of its assets used in the U.S. trade or business
- To the extent that a U.S. corporation is a USRPHC, a sale of stock of such U.S. corporation would be treated as a sale of a USRPI and subject to FIRPTA. Treaties generally do not provide an exemption to FIRPTA
- Upon disposition of a USRPI, the FIRPTA rules require that the **buyer** is required to withhold 15% of the amount realized on the disposition of the USRPI and remit this amount to the IRS

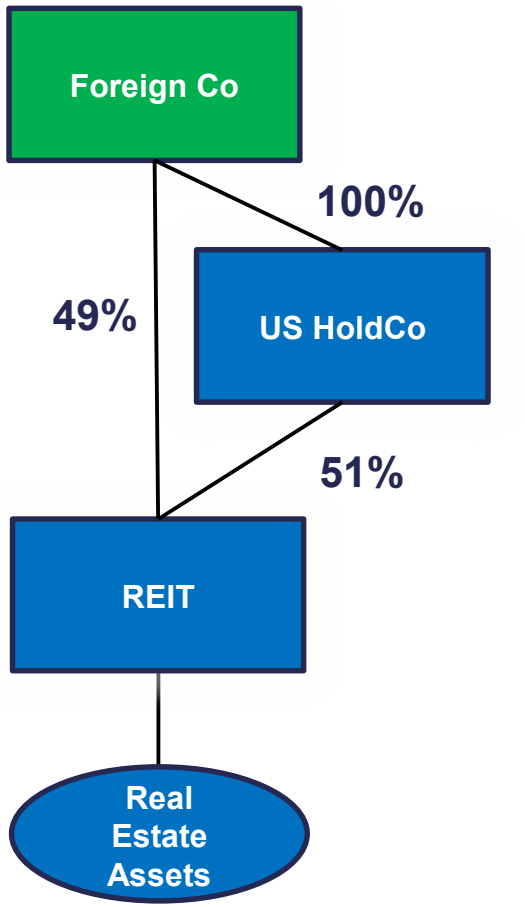
FIRPTA / REIT Considerations

Investor in REIT:	Foreign Corporation	QFPF	Sovereign Wealth Fund
Tax Considerations	• Subject to withholding tax on REIT distributions, which may be reduced or eliminated via application of tax treaty. • Capital gain distributions still subject to FIRPTA.	• Section 897(l) provides that a QFPF is not subject to FIRPTA taxation or FIRPTA withholding. • A QFPF continues to be taxable under the provisions of the Code generally applicable to non-U.S. investors, such as U.S. ECI and ordinary dividend income from REITs and other corporations.	• Certain sovereign wealth fund (SWF) investors that hold a minority interest (i.e., less than 50%) in a REIT and dispose of shares in such REIT should not be subject to a FIRPTA tax (regardless of whether the REIT is domestically controlled). • But such SWF investors remain taxable on REIT capital gains distributions.

FIRPTA / REIT Considerations

- Shares in a domestically controlled REIT do not constitute USRPIs. As a result, any gain on the disposition of a domestically controlled REIT should not be subject to FIRPTA.
  - A REIT is treated as domestically controlled if, at all times during the past five years, less than 50 percent in value of the stock was held directly or indirectly by foreign persons
  - Capital gain distributions from domestically controlled REITs are not exempt from FIRPTA
- Treasury issued proposed regulations on December 29, 2022, that address the determination of whether a qualified investment entity ("**QIE**") is domestically controlled, and therefore eligible for an exemption from tax under FIRPTA
- The Proposed Regulations provide that the certain non-publicly traded entities should be "looked through" to their underlying owners, including domestic corporations that are owned 25% or more directly or indirectly by foreign persons

FIRPTA / REIT Considerations



- Prop. Treas. Reg. § 1.897-1(c)(3)(iii)(B) provides for the look-through rule for a foreign-owned domestic corporation
- Certain presumptions in the proposed regulations
- ABA Section of Taxation submitted comments (February 27, 2023) on proposed regulations recommending withdrawal of look through

Withholding Considerations

Withholding Mechanics – FDAP

- FDAP = Interest, dividends, rents, royalties, etc.
- U.S. source FDAP is generally subject to gross-basis withholding at 30%
  - Source of FDAP income passes through the fund to its partners
- Withholding on certain types of income may be reduced by statute or treaty
  - *E.g.*, portfolio interest, interest on bank deposits, and OID on certain short-term indebtedness are exempt
  - Non-US partner must certify its non-U.S. status and entitlement to treaty benefits (if applicable)
- Certain types of payees may be exempt from withholding
  - *E.g.*, foreign governments and certain of their controlled entities under Section 892

Withholding Mechanics – FDAP

- Who is the withholding agent for a non-US partner's share of FDAP?
  - If a U.S. fund, the U.S. fund is the withholding agent
  - If a non-U.S. fund:
    - The payor is generally the withholding agent
    - A non-U.S. fund that is a "withholding foreign partnership" is the withholding agent
- When is withholding required?
  - Upon distribution or, if not distributed, on the earlier of providing the K-1 or the due date for providing the K-1 to the non-U.S. partner
- If over withholding occurs, non-U.S. partner may apply for a refund

Withholding Mechanics – ECI

- ECI is generally taxed on a net basis at the rates applicable to U.S. persons
  - Additional 30% branch profits tax may apply to non-U.S. corporations
- If the fund is ETB, non-US partners are similarly treated as ETB
  - If the fund is ETB and maintains an office in the U.S., or if the GP conducts activities on the fund's behalf from a U.S. office, non-US partners will generally be treated as conducting trade or business through a permanent establishment in the U.S.

Withholding Mechanics – ECI

- Withholding for non-US partners' shares of ECI
  - The fund is required to withhold on a non-U.S. partner's share of ECI
  - Withholding is generally applied at the highest rate applicable to the non-U.S. partner
    - Withholding is creditable against the non-U.S. partner's tax liability
- Withholding does not alleviate non-U.S. partner's obligation to file to a U.S. income tax return with respect to share of ECI
- Failure to file a U.S. tax return will generally preclude the ability to:
  - Offset effectively connected losses and deductions against effectively connected income and gains
  - Claim credits against the tax liability for ECI

Withholding Mechanics – Section 1446(f)

- Gain derived by a non-U.S. partner from the sale of a partnership interest that is ETB constitutes ECI to the extent that the gain is attributable to partnership assets which if sold, would have given rise to ECI – Section 864(c)(8)
- Transferee of a partnership interest is required to withhold 10% of the amount realized
- Exceptions to withholding
  - Transferee receives a certificate of non-foreign status from the transferor
  - Transferee receives a certificate from the transferor that the transfer would not result in any realized gain (including ordinary income arising under Section 751)

Withholding Mechanics – Section 1446(f)

- Exceptions to withholding (cont'd)
  - Transferee receives a certification from the partnership stating that there would be de minimis effectively connected gain
    - If the partnership sold all of its assets at FMV:
      - Partnership would have no effectively connected gain or the amount of effectively connected net gain would be less than 10 percent of the total net gain
      - Transferor would not have a distributive share of effectively connected net gain or transferor's distributive share of effectively connected net gain would be less than 10 percent of transferor's distributive share of total net gain
    - The partnership was not ETB at any time during the taxable year through the date of the transfer

Withholding Mechanics – Section 1446(f)

- Exceptions to withholding (cont'd)
  - Transferee receives a certification from the transferor stating:
    - Transferor was a partner in the partnership during each of the three preceding taxable years (the "look-back period")
    - Transferor's distributive share of gross ECI was less than $1 million and less than 10 percent of the transferor's total distributive share of gross income from the partnership for each taxable year during the look-back period
    - Return filing and tax payment requirements have been satisfied during the look-back period
  - Transferee receives a certification from the transferor that a nonrecognition provision applies to the transferor
  - Transferee receives a certification from the transferor that the transferor is not subject to tax on the transfer pursuant to an income tax treaty

Withholding Mechanics – Section 1446(f)

- If transferee fails to withhold, the partnership is obligated to withhold from distributions to the transferee the under-withheld amount, plus interest
  - Applicable to transfers occurring on or after January 1, 2023 (Notice 2021-51)
  - Exceptions to withholding:
    - Partnership already possesses a certification of non-foreign status for the transferor
    - Partnership receives a withholding certification from the transferee within 10 days after the transfer that states an exemption to withholding applies or that the transferee withheld the full amount

Partnership Audits

Partnership Audits

- The Bipartisan Budget Act (the "**BBA**") enacted in 2015
  - Replaces the TEFRA and the electing large partnership rules
  - Established a new centralized audit regime for partnerships
  - Goes beyond establishing procedural rules to also address administrative issues
- Partnership and its partners are bound by actions taken in and results of the partnership-level proceeding
- Generally effective beginning January 1, 2018

TEFRA and BBA: High Level Comparison

Partnership Procedures	TEFRA	BBA
Partnership point of contact for examination	Tax Matters Partner	Partnership Representative
Partner participation rights during examination	Partners have the ability to participate in the examination and challenge partnership adjustments	Partners have no participation right to challenge partnership adjustment
Partner consistency of reporting	Partners must report items consistently with the partnership	Partners must report items consistently with the partnership
Notice requirements	Notice requirements (NBAP, FPAA)	Notice requirements (NAP, NOPPA, FPA)
Items adjusted during examination	Partnership item/Affected item	Partnership related item (PRI)
Where adjustments/assessments occur	Adjustments at the partnership level/tax assessment at the partner level	Adjustment and assessment at the partnership level (imputed underpayment)

Source: https://www.irs.gov/businesses/partnerships/bba-centralized-partnership-audit-regime

The BBA Basics

- Scope – Section 6221
  - "Any adjustment to a partnership-related item shall be determined, and any tax attributable thereto shall be assessed and collected, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to any such item shall be determined, at the partnership level, except to the extent otherwise provided in this subchapter"
    - Partnership-related item
      - Any item or amount with respect to a partnership which is relevant in determining the tax liability of any person under Chapter 1 of the Code
      - Any partner's distributive share of any such amount; or
      - Any imputed underpayment

The BBA Basics

- Scope – Section 6221 (cont'd)
  - Election out for certain partnerships
    - Partnerships with 100 or fewer eligible partners
      - Eligible partners: Individuals, "C" corporations, foreign entities that would be a "C" corporation if a domestic entity, "S" corporations (regardless of whether one or more shareholders of the "S" corporation are not an eligible partner), estates of deceased partners
      - Ineligible partners: Partnerships, trusts, disregarded entities, foreign entities that would not be a "C" corporation if a domestic entity, estates of individuals other than a deceased partner, nominees
    - Election out is made for each taxable year with a timely filed return
    - Partnership must notify each partner of the election out within 30 days
    - If election is made, the IRS must audit and collect tax from each partner individually

The BBA Basics

- Partnership Representative – Section 6223
  - Partnership representative has the sole authority to act on behalf of the partnership
    - Binds current and former partners
    - Includes authority to extend the statute of limitations, enter into settlements, agree to partnership adjustments, and make push-out elections
    - Partnership representative's failure to follow state law, partnership agreement, or other agreement has no effect on the partnership representative's authority
  - Partnership designates the partnership representative on its tax return for the relevant year

The BBA Basics

- Partnership Representative – Section 6223 (cont'd)
  - Who can serve as the partnership representative?
    - Person must have a "substantial presence in the United States"
      - Person makes themselves available to meet in person with the IRS in the U.S. at a reasonable time and place as determined by the IRS
      - Person has a TIN, a street address in the U.S. and a telephone number with a U.S. area code
    - "Person" can be an entity
      - If an entity, partnership must appoint a "designated individual" that can act on the entity's behalf
      - Designated individual must satisfy the substantial presence requirement

The BBA Basics

- Partnership-Level Tax – Section 6225
  - If adjustments for the reviewed year result in an imputed underpayment, the partnership pays the imputed underpayment in the adjustment year
    - Partnership is directly liable for the tax
  - If adjustments for the reviewed year do not result in an imputed underpayment, the partnership takes the adjustments into account in the adjustment year
    - No refund of tax to the partnership

The BBA Basics

- Partnership-Level Tax – Section 6225 (cont'd)
  - Imputed underpayment is subject to modification
    - Partner attributes
      - Foreign partner entitled to exemption or treaty benefit
      - Tax-exempt partners that would not be subject to tax on the adjusted income
      - C corporations
      - Individuals eligible for reduced rates on qualified dividends and capital gains
    - Amended returns by the partners
      - Adjustments are taken into account by the partners, not the partnership

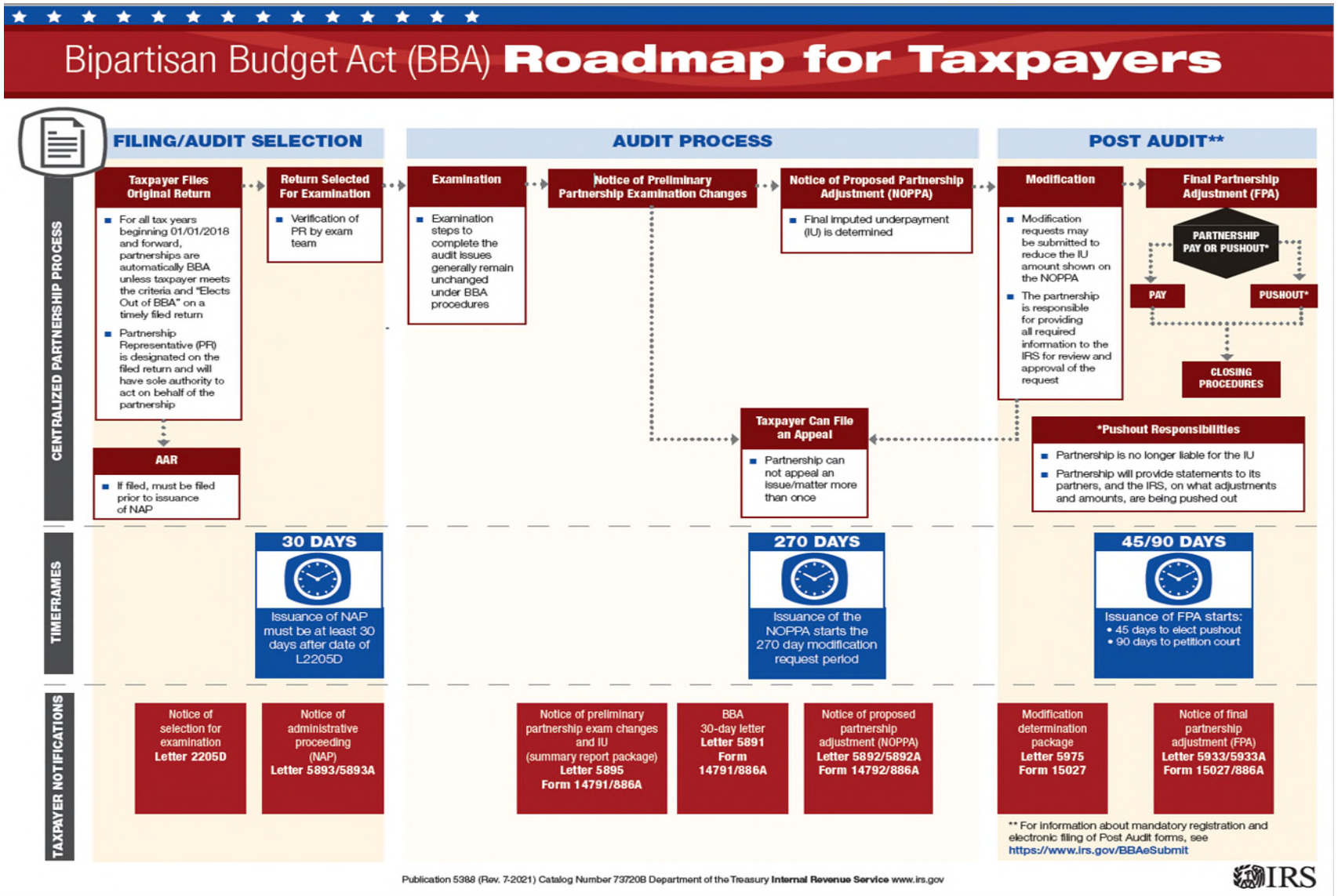
The BBA Basics

- Push-Out Election – Section 6226
  - Partnership may elect to "push out" adjustments to partners in the reviewed year
    - Tax burden is borne by the reviewed-year partners, not the partnership
  - Reviewed-year partner reports the tax from taking into account its share of any adjustments, including any applicable interest or penalties, in the tax year it receives a statement of adjustment
  - Election must be filed within 45 days of the date the Notice of Final Partnership Adjustments is mailed by the IRS

The BBA Basics

- Coordination with Withholding Rules – Treas. Reg. § 301.6241-6
  - Withholding is generally outside the scope of the BBA
  - The BBA rules coordinate with the withholding rules to avoid double taxation
    - If the partnership pays an imputed underpayment under Section 6225, the payment should satisfy the partnership's withholding obligation associated with the adjustment
    - If the partnership makes a push-out election under Section 6226, the partnership must withhold to the extent an adjustment relates to an amount subject to withholding and the withholding tax has not already been collected
    - Consideration to be given to application of penalties and interest

The BBA Audit Roadmap



Practical Considerations

- Whether to require that the fund elect out of the BBA audit procedures if eligible
- Whether to require that the fund elect to push out any adjustments to its partners
- Who will serve as the “partnership representative”
- Whether an investor is required to indemnify the fund for fund-level tax liabilities imposed under the BBA audit procedures
  - Whether the indemnification obligation survives the investor’s departure from the fund
  - Whether the expenses of the partnership representative should be borne by the fund
- Whether investors are entitled to notification and approval rights regarding any tax proceeding

Questions?