

# A Loan Trader's Guide to FIRPTA Withholding and Mixed-Asset Recoveries

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**The purpose of this article is to assist loan market participants in identifying Foreign Investment in Real Property Tax Act issues that may arise in connection with loan restructurings and other purchases of loans and related proceeds of such loans, and to briefly discuss possible solutions to the Act's valuation issues in mixed-asset recoveries.**

Under The Foreign Investment in Real Property Tax Act of 1980<sup>1</sup> ("FIRPTA"), any disposition of a "United States real property interest"<sup>2</sup> by a foreign person is subject to income tax withholding, and the buyer of any such interest must deduct and withhold 15 percent from the purchase price, subject to any available exemptions.<sup>3</sup> The purpose of this article is to assist loan market participants in identifying FIRPTA issues that may arise in connection with loan restructurings and other purchases of loans and related proceeds of such loans, and to briefly discuss possible solutions to FIRPTA valuation issues in mixed-asset recoveries.

## **"United States Real Property Interest" Defined**

A "United States real property interest" (a "USRPI") is generally defined as an interest in real property located in the United States.<sup>4</sup> In situations involving the sale of a traditional

real property interest, such as a parcel of land, the applicability of FIRPTA to such a transaction is generally a straightforward analysis. However, and more importantly for the purpose of this article, a USRPI may also include an interest (other than solely as a creditor) in a domestic corporation if such corporation is a "United States real property holding corporation" (a "USRPHC").<sup>5</sup> A USRPHC is defined as a corporation where the fair market value of its USRPIs equals or exceeds 50 percent of the fair market value of its global real property interests and other assets used in a trade or business.<sup>6</sup>

## **Exemptions**

Even if a non-U.S. seller sells property that is (or may be) a USRPI, the non-U.S. seller may, nevertheless, be exempt from withholding under FIRPTA in certain circumstances. For example, FIRPTA withholding would not be required in connection with the sale by a

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non-U.S. seller of an interest in a domestic corporation if any class of stock of such corporation is “regularly traded” on an “established securities market,” provided that the non-U.S. seller did not hold more than 10 percent (formerly five percent) of such class of interest during the applicable period.<sup>7</sup> There are several methods of establishing whether a market is an “established securities market,” and there are two established options for determining whether a class of interests is “regularly traded” on such market.

### **“Established Securities Market”**

A market is an “established securities market” if it is:

- A national securities exchange which is registered under the Securities Exchange Act of 1934;
- A foreign national securities exchange which is officially recognized, sanctioned, or supervised by a governmental authority; or
- An over-the-counter market. An over-the-counter market is any market reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets which are prepared and distributed by a broker or dealer in the regular course of business and which contain only quotations of such broker or dealer.

### **“Regularly Traded”**

A class of interests that is traded on an

established securities market is considered to be “regularly traded” on that market for any quarter during which it satisfies the following four requirements:<sup>8</sup>

1. Trades in the class are affected in non-*de minimis* quantities on at least 15 days during the calendar quarter;
2. The aggregate number of interests in the class that are traded during the quarter is at least 7.5 percent of the average number of interests in the class outstanding during the quarter (or at least 2.5 percent, if the relevant class of interests are held by 2,500 or more shareholders);
3. At no point during the quarter is 50 percent or more of the outstanding interests in the relevant class owned by 100 or fewer persons; and
4. In the case of interests traded on foreign securities market, certain reporting requirements are met.

As an alternative to the methodology above, a class of interests that is traded on an established securities market located in the United States is also considered to be “regularly traded” for any calendar quarter during which it is regularly quoted by brokers or dealers making a market in the interests. For purposes of this rule, a broker or dealer “makes a market” in a class of interests only if the broker/dealer holds itself out to buy or sell interests in the class at the quoted price.

In addition to the above-referenced exemption, the relevant statute<sup>9</sup> provides that FIRPTA withholding would not be required where:

- The seller provides to the buyer an affidavit stating that it is not a foreign person and certifying to certain other facts; or
- In the case of any interest in a domestic corporation, the non-U.S. seller obtains and provides to the buyer an affidavit from the domestic corporation, under penalty of perjury, that such domestic corporation is not a USRPHC or that an interest in such corporation is not a USRPI.

### Restructurings and FIRPTA Considerations

By its nature, FIRPTA is (or should be) a significant area of focus for sophisticated foreign shareholders of domestic corporations that are USRPHCs, but likely of lesser concern for domestic U.S. creditors and lenders active in the U.S. markets, whose interests are expressly excluded under FIRPTA. However, as lenders are keenly aware, in a restructuring, lenders may receive a mix of assets in exchange for their claims. As a result, loan market participants may sell an interest in a loan, but upon a restructuring of the borrower, such loan market participants may ultimately hold a mix of cash, new loans, debt securities, and/or equity securities in exchange for their claims related to the original loan.

In the majority of restructurings, FIRPTA does not pose an issue for loan market participants looking to sell their mixed-asset recoveries. First, FIRPTA is only applicable to USRPIs (including equity ownership in a USRPHC), and not to cash, debt securities and loans. Second, FIRPTA is only applicable to non-U.S. sellers, and not to domestic sellers. Third, as discussed above, an exemption for withholding may be available. However,

if an exemption is not available and the buyer is responsible, on its own, to make a determination that withholding on account of FIRPTA is required for a particular transfer, then it must take proper steps to effect such withholding in accordance with its internal policies and applicable law.

### The Loan Trading Market

For a variety of reasons, in the loan trading market, loan market participants often agree to trades of loans that do not settle prior to the effectiveness of a borrower's plan of reorganization or restructuring transaction. In some cases, settlement of all pending loan trades prior to effectiveness is not feasible. In such cases, as emergence looms, loan market participants should consider whether or not FIRPTA may present an issue for settling a pending trade.

There are several avenues of inquiry available for investigating an issuer's anticipated FIRPTA status upon emergence, such as an examination of the borrower's plan of reorganization or disclosure statement, or internal discussions with analysts covering the borrower. Also, upon emergence, a foreign holder may request an affidavit from the post-emergence issuer regarding such issuer's FIRPTA status. If such an investigation reveals that FIRPTA may pose an issue with respect to pending trades, it may introduce added incentive on the part of both the buyer and the seller to get a trade settled prior to effectiveness of the restructuring. One approach to settlement that has been used by buyers of loans is to prioritize and focus settlement efforts on outstanding purchases from non-U.S. sellers prior to emergence, thus eliminating

the possibility of FIRPTA issues for those transactions.

Often, however, a pending trade cannot settle prior to the effective date of a reorganization despite the efforts of the buyer and the seller, and in such a situation, the buyer and the seller will generally settle the loan trade via a proceeds letter substantially in the applicable form published by The Loan Syndications and Trading Association, Inc. (the "LSTA").

As mentioned above, if the buyer makes a determination that FIRPTA withholding is required, then it should take proper steps to make a determinative determination and, if necessary, effect such withholding in accordance with its internal policies and applicable law. The ability to withhold in such a situation is expressly permitted by the form of LSTA Chapter 11 Plan Proceeds Letter Agreement for Post-Effective Date Settlement of Distressed Trades currently published by the LSTA, which states that a party may withhold any amount required by law, and that any amount so withheld shall be treated for all purposes of the proceeds letter as having been paid by the buyer to the seller. The effect of this should result in the non-U.S. seller's taking responsibility for establishing to the satisfaction of the buyer that withholding is not required, or to be prepared to accept a price for which a portion has been withheld.

### **FIRPTA Valuation Issues**

One complicating factor in the loan trading market, as it relates to FIRPTA, is mixed-asset recoveries. In a restructuring, lenders may receive a mix of assets in exchange for their claims. If such a lender entered into a loan

trade pursuant to an LSTA Distressed Trade Confirmation prior to such restructuring, the seller would still have an obligation to settle such transaction with its counterparty as it relates to the "proceeds" of the loan. A portion of the proceeds may consist of cash or debt securities, which is expressly excluded from FIRPTA withholding, but another portion may consist of stock in a USRPHC. Because FIRPTA withholding is only applicable to the portion of the purchase price that relates to the equity component of the recovery, a mixed-asset valuation issue arises, and the parties must establish the value applicable to such equity component.

There are varied approaches used to calculate the value applicable to the equity component of a mixed-asset recovery, and such approaches should generally involve asking one or more of the following key questions:

- Which resources do you use to establish value?
- What is the target date for valuation?
- What internal policies, tax or otherwise, must be followed?
- Will a range of values suffice, and if so, how should a point along such spectrum be chosen?
- Does the trading counterparty agree with your analysis?

Obviously, the party charged with withholding must take responsibility for determining the answers to all of these questions in a manner consistent with the requirements of applicable law.

## Conclusion

In conclusion, although interests in loans are expressly excluded from FIRPTA withholding, restructurings with mixed-asset recoveries can present traps for the unwary loan market participant. A thoughtful, considered approach well in advance of settlement may allow loan market participants to potentially avoid FIRPTA withholding altogether, or at a minimum, have a valuation protocol in place to allow pending trades to settle in the market as efficiently as possible.

## NOTES:

<sup>1</sup>26 U.S. Code § 1445.

<sup>2</sup>As defined in 26 U.S. Code § 897(c).

<sup>3</sup>26 U.S. Code § 1445(a). Under certain circumstances, a seller of U.S. real property that is a non-U.S. person, that is otherwise subject to FIRPTA withholding, may be entitled to reduce or eliminate such withholding by obtaining from the Internal Revenue Service (the "IRS") (and providing to the purchaser/payor/withholding

agent) a withholding certificate to such effect. Some of the circumstances under which such a withholding certificate may be obtained include, among others, where: (i) the selling non-U.S. person's maximum tax liability is less than the otherwise required withholding; (ii) the selling non-U.S. person is exempt from U.S. tax under a treaty or under the Internal Revenue Code of 1986, as amended, and the rules and regulations promulgated under it (the "Code") (such as certain sales of stock by foreign governmental entities); and (iii) the selling non-U.S. person successfully demonstrates to the IRS that reduced withholding will not jeopardize the collection of tax due.

<sup>4</sup>26 U.S. Code § 897(c)(1)(A). Under this section, a United States real property interest includes any interest in a mine, well, or other natural deposit, and as a result, corporations in the energy sector may qualify as a USRPHC due to their ownership interests in such assets. The definition of USRPI also includes real property interests in the Virgin Islands.

<sup>5</sup>26 U.S. Code § 897(c)(1)(A)(ii).

<sup>6</sup>26 U.S. Code § 897(c)(2).

<sup>7</sup>26 U.S. Code § 897(c)(3).

<sup>8</sup>For these requirements, trades between related persons are disregarded, trades between two persons that occur several times during a quarter may be disregarded, and (for the requirement (iii) only) related persons are treated as a single person.

<sup>9</sup>26 U.S. Code § 1445.

