5th STATE BAR INTERNATIONAL LAW WEEKEND

The Failing or Failed Joint Venture -- International Tax Considerations

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1. INTRODUCTION.

This presentation deals with certain key tax issues which are likely to face an international joint venture which is failing or has already failed. We will assume that the joint venture has at least one U.S. component (the joint venture itself or at least one, if not both, of the joint venture partners). We focus therefore on U.S. tax considerations applicable to both inbound and outbound joint ventures. By inbound, we mean a joint venture whose principal operations are in the United States; by outbound, one whose principal operations are outside the United States.

What are the recurrent themes in the tax treatment of business failure? If there is a common unifying thread, it is the need to deal with the distortions created by timing and the demands of accounting on an annual basis for profit and loss for tax purposes. A second theme is the desire of tax authorities the world over to limit the use and benefit

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of tax losses to the taxpayer who incurred the loss. A third theme is the need to deal with the tax consequences of debt restructuring or forgiveness.

In the United States, these themes are reflected in the complex rules relating to the carryover and carryback of tax losses and the treatment of built-in losses and gains, the rules relating to taxation or exemption of income from discharge of indebtedness and the concomitant problem of determining when an indebtedness is deemed to have been modified to the point that income or loss should be taken into account. Other countries have faced these problems, although perhaps not with the mind-numbing penchant for pursuing theoretical and economically correct results. U.S. tax policy also is burdened with the fact that inadvertent or half-advertent technical errors, however egregious, can rarely be rectified if they happen to raise revenue.

In the international joint venture, purely domestic tax concerns are overlaid by additional issues, such as the impact of the United States' complex withholding tax régimes, which cheerfully impose withholding and sometimes actual tax burdens in the context of failed business activities, occasionally on the wrong person.

2. THE TREATMENT OF LOSSES.

2.1 Identifying the Loser.

Joint ventures may be structured as partnerships or corporations for tax purposes. This outline will not delve into the ways of differentiating the two for tax purposes, for which reference is to be made to the well loved Treas. Reg. § 301.7701-4 regulations. It is to be hoped that by the time tax counsel has to consider tax problems facing a failing or failed joint venture, the proper characterization of the joint venture entity will have been determined, even in cases involving hybrid entities such as limited liability companies and public limited partnerships and foreign entities such as the German GmbH (*Gesellschaft mit beschränkter Haftung*, for those who care about such things), the English unlimited liability company) or the Dutch C.V. (*commanditaire vennootschap*, for those who care, etc.) or the Brazilian *limitada*.

Assuming we know what kind of entity we are dealing with, the question will arise who may make use of the losses incurred by the economic failure of the business. The following table summarizes the results:

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	Foreign Corporate Joint Venture	Domestic Corporate Joint Venture	Partnership Joint Venture
The Venture	Losses available only if allocable to U.S. trade or business	Losses available	Venture is not taxable
U.S. Venturer	Losses available when shares either sold or become worthless	Losses available when shares either sold or become worthless, but note problems for corporate shareholder with 80% or more holding	Losses available as incurred and upon liquidation
Foreign Venturer	Losses unavailable	Losses unavailable unless joint venture is a U.S. real property holding corporation	Losses allocable to U.S. trade or business available as incurred; questionable if loss available on liquidation

(a) **The Corporate Joint Venture.** When a joint venture is incorporated, the primary taxpayer is the corporation itself in the absence of an S election. If the corporation is domestic, its losses are fully deductible to the corporation; if the corporation is foreign, losses are allowable only to the extent properly allocable to a U.S. trade or business of the corporation. The losses, when allowable, will typically be ordinary losses derived from the operation of the business or under the rules of IRC section 1231 of the Internal Revenue Code of 1986, as amended (the "IRC").

The shareholder may not deduct a loss from a partial decline in the value of the shares in the corporation. Instead, a loss is deductible only when realized by sale of the shares (which includes liquidation of the corporation). The shareholder may also realize the loss if the decline in value is complete by claiming a worthless security loss. Where the shareholder is foreign, the loss will not be allowable unless the joint venture corporation is domestic and the shares are treated as a U.S. real property interest.

(b) **Partnership Joint Venture.** When the joint venture is in the form of a partnership, losses are passed through to the partners as they are incurred. For this reason, the place of organization of the partnership is not relevant. For a foreign partner, losses are allowable only to the extent allocable to a U.S. trade or business.

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The partner may also deduct a decline in the value of the partnership interest if the interest either is sold or liquidated at a loss or if it becomes valueless.

2.2 Characterizing the Loss. The United States continues to differentiate between ordinary and capital losses. Capital losses receive less favorable treatment, being allowable only against capital gains whereas ordinary losses are allowable against both ordinary income and capital gain.[1]

A pernicious example of the effect of the differentiation between ordinary and capital losses relates to the treatment of partnership losses. A full discussion of this subject is probably beyond the scope of a treatise, let alone a conference outline, but the following simple example will serve to give the flavor of the type of problem:

> A partnership's assets have a tax basis of $1,000 and a fair market value of $1,600. Taxpayer A purchases a 25% interest in the partnership for $400. The partnership fails to make an IRC section 754 election to step up the basis of its assets. The partnership's assets subsequently are sold for fair market value. 25% of the gain of $600, or $150, is allocated to A. A's basis in the partnership interest thereby increases to $550. The partnership then liquidates and distributes to A a 25% share of the net assets, or $400. A has a loss of $150 on liquidation of the partnership.
>
> Is the $150 allocation of gain to A offset by the $150 of loss? The answer is often in the negative. The loss will be a short-term capital loss, which may be used to offset any kind of capital gain; it may be a long-term capital loss, which can only offset long-term losses. In neither case will A be permitted to apply the $150 loss to offset any gain which is ordinary income. And, if the liquidation occurs in a year after the income is realized, the loss may only be carried back three years in the case of a corporate partner, and not at all in the case of an individual.

The differential treatment should not be regarded as a force of nature, however. The taxpayers involved in a failing joint venture should make some effort to time their losses. For example, a partner in a partnership will have ordinary losses (regular or resulting from the application of IRC section 1231, which requires business capital gains and losses to be netted and treats any excess loss as ordinary) if the partner remains a partner; by contrast, if the partner bails out, whether by sale or redemption of its partnership interest, any loss will be capital.

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[1] One might have argued that capital losses are treated less favorably to offset the more favorable treatment from time to time afforded to capital gains. However, there is no evidence that this *quid pro quo* was in the minds of those who devised or maintained the present system.

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2.3 Timing the Loss. Another important issue concerns the timing of a loss. Timing depends largely on the type of loss. The following table summarizes the rules:

Type of Loss	Allowability and Timing of Loss
Decline in value of an asset	Not allowed -- but see discussion of *Cottage Savings* at 3.1(c)(1) below
Wholly or partially worthless debt	In the year in which the debt becomes wholly or partially worthless; specific charge-off or compliance with bad debt reserve rules required; special rules for banks and savings institutions
Worthless security	On the last day of the taxpayer's fiscal year in which the security becomes worthless
Modification of debt (creditor's position)	Upon a modification constituting an exchange; otherwise, not a taxable event
Worthless asset (other than debt or security)	Not allowed *per se*; asset must be sold, abandoned or expropriated
Sale of asset, including shares in corporation or partnership interest	Upon sale
Corporate liquidation	Upon the deemed exchange of the stock in return for liquidation proceeds (if any)
Partnership liquidation	Gain recognized if and when cash exceeds basis in partnership interest; partnership distributions generally not otherwise taxed
Nonliquidating corporate distribution	Loss not allowed; proceeds are treated, upon receipt, as distribution to the extent of earnings and profits, then return of capital, then capital gain
Partnership loss	Allocated to the partner on the last day of partnership fiscal year
Expropriation	Depends on method of expropriation: Generally, loss occurs at the earlier of legal expropriation and practical loss of control

Overlaying all of these rules are the passive activity loss rules, which can delay the allowability of losses. IRC § 469. This area is also a fit subject for a treatise.

2.4 Survival of Losses.

(a) Corporate Joint Ventures.

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(1) **In General.** Any consideration of failed joint ventures must include various provisions of the Code designed to prevent trafficking in corporate losses. The idea is that the losses of an enterprise should not be sold or otherwise made available to an unrelated enterprise that did not incur them. Whatever the philosophical merits of this idea, it is one which has prevailed in most countries and is reflected in legislation of varying degrees of specificity intended to counter the transfer of losses.

Unfortunately, the rules are frequently drawn quite broadly and may inhibit the recapitalization of failing enterprises. For example, imagine a joint venture set up to develop some technology-based business which has experienced losses and needs to raise significant additional capital which is not available from the existing equity partners. An investor approaches the corporation and offers to invest sufficient funds to restore the corporation's fiscal health and enable it to complete the development and marketing of the technology. If the investor acquires more than 50% of the equity share capital of the corporation, the corporation will be deemed to have undergone a change in ownership. As a result, Section 382 will restrict the "new" corporation's use of its losses to an annual percentage of the net worth of the corporation prior to the ownership change. The percentage is the "long-term tax-exempt rate", as defined in IRC section 382(f) using an adjustment to the Federal long-term rate under IRC section 1274(d), as to which see 3.1(c)(2) below. Typically, that net worth may be negligible, especially if the corporation's original capital has been used to defray deductible research and development expenditures.

If debt is being restructured at the same time as equity control shifts to new investors, it is essential to time any cancellation of indebtedness to precede the equity structure shift, so that the past losses can be used to offset the income from discharge of the debt.

(2) **Section 382 - Sale of Loss Companies.** IRC section 382 and its siblings, IRC sections 383 and 384, apply to limit two types of tax benefits:

(A) existing benefits such as net operating loss carryovers, capital loss carryovers and carryovers of unused credits, including foreign tax credits; and

(B) potential benefits, such as built-in losses, meaning losses which would be realized if the corporation sold an asset at fair market value.

Section 382 applies whenever there is a change in corporate ownership during a testing period (generally three years) such that the percentage of shares held by shareholders holding at least 5% of the shares has increased by more than 50 percentage points. Section 382 also applies where there are various forms of corporate reorganizations, but reorganizations in a title 11 or similar case are excluded if the former shareholders and creditors own 50% or more of the stock of the corporation immediately after the ownership change occurring under the court's supervision. However, the losses

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must be computed as if all interest accrued or paid (in the three-year taxable years preceding the year of the ownership change and the portion of the taxable year preceding the ownership change) on debt converted into stock had been disallowed. A number of other technical rules apply. See IRC § § 382(l)(5).

(3) **Section 269.** Section 269 is a general anti-avoidance provision which applies to a variety of corporations where the principal purpose of the transaction is the avoidance or evasion of Federal income taxes by securing the benefit of deductions, credits or allowances which would otherwise be unavailable.

(A) Specifically, section 269(a) applies (i) to the acquisition, directly or indirectly, of control of a corporation and (ii) the acquisition by one corporation of the assets of a transferor corporation not previously under the control of the acquiring corporation or its shareholders, where the acquiring corporation inherits the basis of the transferor corporation. Transactions in which basis is inherited in this manner are generally reorganizations or taxfree incorporations.

(B) Section 269 also applies to an acquisition with respect to which the acquirer does not make a section 338 election and within two years liquidates the target. Under section 338, a corporate acquirer of another corporation may cause the target to elect to treat itself as if it had sold all of its assets at fair market value to a new corporation. Such elections are rarely made because, since 1986, the target must recognize gain on the notional sale.

Generally, section 269 has been an ineffective remedy against tax-motivated acquisitions and corporate reorganizations because a key element is that the principal purpose of the transaction was tax avoidance or evasion. Taxpayers have often been able to find non-tax related "principal purposes" for their transactions.

(4) **Consolidated Returns.**

(A) **The SRLY Rules.** The regulations governing consolidated returns restrict the availability of losses (including built-in losses) incurred by a loss corporation at a time when it was not a member of the group. The loss corporation's use of the losses is not restricted but the losses may not be applied against income of other group members. Treas. Reg. § § 1.1502-15, -21 and -22. These rules are most likely to affect a failing joint venture in corporate form where a U.S. joint venturer wishes to acquires an 80% controlling interest in the corporation.

(B) **Disposition or Deconsolidation of Subsidiary Company Stock.** Highly controversial regulations finalized in 1991 after several years of debate provides that no deduction is allowed for any loss recognized by a member of a consolidated group with respect to disposition of stock in a subsidiary. Treas. Reg. § 1.1502-20. A disposition not only includes a sale of stock but also a transaction in

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which a company otherwise ceases to be a member of the consolidated group or the stock is cancelled or redeemed in full. The regulations are extensive and again require extensive elaboration but the basic principle is very hostile to a consolidated group.

(C) Dual Consolidated Losses. The Tax Reform Act of 1986 added section 1503(d), which denies the use of a "dual consolidated loss" to a consolidated group other than the member which incurred the loss. A dual consolidated loss is one incurred by a domestic corporation which is subject to a foreign income tax irrespective of the source of its income or is subject to tax in the foreign country on the basis that it is resident there. The purpose of this rule is to prevent dual resident companies from using expenses, particularly interest expense, to reduce taxable income both in the United States and another country, formerly a common planning technique with respect to inbound and outbound investment where the other country was the United Kingdom or Australia. The temporary regulations under section 1503(d) have been criticized for broadening the scope of the provision to catch non-abusive situations.

3. RESTRUCTURING DEBT.

3.1 Consequences to the Debtor.

(a) Basic Rule -- Debt Relief is Taxable. IRC section 61(a)(12) confirms that gross income includes income from discharge of indebtedness. Any restructuring of a joint venture's debt must include a consideration of the effect of this rule. Therefore, a critical issue for a debtor is whether the restructuring of debt will result in discharge of indebtedness income.

(1) What Constitutes Debt Relief? Debt is discharged not when a creditor writes off the debt in its own books but rather when the debtor ceases to be obligated to pay the debt. Debt may be discharged as a result of an agreement with the creditor either to forgive the debt or to sell it back to the debtor for a lower amount or as a result of the operation of the applicable statute of limitations. Debt relief does not occur when one obligation is substituted for another, except to the extent of the excess of the principal amount of the old debt compared with the principal amount of the new debt. Other exceptions are described below.

(2) Acquisition or Guarantees of Related Party Debt. In addition, regulations under IRC section 108(e)(4) treat the acquisition of debt by a related party of the debtor from an unrelated party as if the debtor itself had acquired the debt. In consequence, the debt will be deemed discharged for whatever the related party paid, which if less than the amount of the debt will result in income from discharge of indebtedness.

(b) Exceptions. There are quite a number of exceptions to the rule requiring recognition of income from discharge of indebtedness. Most of these require

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the debtor to give up dollar for dollar tax attributes such as loss carryovers or tax basis in assets.

(1) Bankruptcy and Insolvency. In general, no income from discharge of indebtedness arises if the discharge occurs in a title 11 case or when (but only to the extent) the taxpayer is insolvent. IRC § 108(a)(1)(A) and (B).

The reference to discharge under title 11 (the U.S. Bankruptcy Code) only applies to income of a taxpayer under the jurisdiction of a U.S. court if the debt is discharged by order of the court or in a plan approved by the court. One consequence of this is that the bankruptcy exception is not available to banks, which are covered not by title 11 but by the Federal or State banking laws relating to conservatorship of insolvent institutions. A similar issue arises for insurance companies.) In the international context, the reference to a case under title 11 means that discharges under foreign bankruptcy or insolvency proceedings are not covered. Therefore, if a debt is discharged in a foreign proceeding, the taxpayer can rely only the insolvency exception, which applies only to the amount by which the taxpayer is insolvent. IRC § 108(a)(3). Compare this with section 368(a)(3) and 382(l)(5)(A) and (G), both of which apply to a "title 11 or similar case", meaning a case under title 11 or a receivership, foreclosure or similar proceeding in a Federal or State (but not foreign) court.

(A) Bankruptcy and Insolvency Exception Tested at the Partner Level. The bankruptcy and insolvency rules, as well as the related rules governing the reduction in tax attributes, are applied at the partner level. IRC § 108(d)(6). Therefore, a solvent partner not in bankruptcy must recognize his or its allocable share of income from discharge of partnership debt even though the partnership was in bankruptcy and/or was insolvent. Moreover, an insolvent partner not in bankruptcy will be protected only to the extent of such partner's insolvency.

(B) Repeal of "Qualified Business Indebtedness Exception". The 1986 Tax Reform Act eliminated the exception previously allowed in the case of "qualified business indebtedness". Under pressure from farmers, Congress substituted a limited exception for "qualified farm indebtedness".

(2) Forgiveness of a Deductible Amount. As a general rule, if an amount forgiven would have been deductible by the debtor if paid, the debtor need not treat the amount as income from discharge of indebtedness. IRC § 108(e)(2). This provision may be difficult to apply if various limitations on deductibility of interest apply or if the payment, had it been made, would have been required to be capitalized under the so called uniform capitalization (or UNICAP) rules. IRC § 263A.

Subject to the application of these limitations, a cash method taxpayer generally can exclude income from forgiveness of accrued interest since the interest would be deductible as it was paid. In the case of an accrual method taxpayer, on the other hand,

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this beneficial treatment may not be available because the interest, if paid, usually would not be deductible. The reason is that the interest will already have been deducted when it first accrued.

There are some interesting variations on this issue. First, if the creditor is a related tax exempt person, deduction of the interest by an accrual method taxpayer may have been deferred or disallowed because of the operation of the earning stripping in Section 163(j). A related disallowance are the rules of Section 163(e), which disallows the deduction of original issue discount accrued in favor of a related foreign person until actual payment. In both these cases, the exception for debt which if paid would be deductible may operate differently than in the case of forgiveness of interest or original issue discount accrued in favor of a regular domestic corporation.

Wherever in this outline reference is made to the amount of debt being forgiven, that reference is to the principal amount of the debt as well as to any accrued interest which would not be entitled to relief under IRC Section 108(e)(4).

(3) **Reduction in Purchase Price.** Where a seller of an asset takes back a note or otherwise extends credit to a purchaser and subsequently forgives a portion of the purchase price, the forgiveness is treated as a reduction in purchase price rather than as income IRC Section 108(e)(5). This rule does not apply if the reduction occurs in a title or similar case or when the purchaser is insolvent.

The purchase price reduction rule does not necessarily mean that there will be no immediate tax effect, however. The reduction will cause basis in the asset to be adjusted downward. If, in the interim, the basis of the asset has been reduced because of depreciation or other reasons, the reduction in the purchase price could be greater than the amount of remaining basis, thereby giving rise to a gain. Further, where the property concerned is inventory, a downward adjustment in basis will result in a lower closing value for inventory, leading to an increase in gross income.

(4) **Capitalization of Debt.**

(A) **Corporation.** Where a debt is contributed to a corporation in exchange for stock, the corporation is treated as satisfying the debt with the fair market value of the stock. IRC § 108(e)(10)(A). As a practical matter, this will give rise to income from discharge of indebtedness if the stock is worth less than the debt. An exception is therefore made for debtors in title 11 or similar cases or in any other case to the extent the debtor is insolvent. IRC § 108(e)(10)(B).

If the debtor is a shareholder who does not receive stock in exchange for debt, the corporation is treated as having satisfied the debt with an amount equal to the shareholder's adjusted basis in the stock. IRC § 108(e)(6).

(B) **Partnership.** The situation with a debt contributed to a partnership in exchange for a partnership interest is more complex. There are no statutory rules comparable to those of IRC Sections 108(e)(6) and (10). The Internal Revenue Service is currently considering the position, but the law appears for now to be that the partnership does not recognize income when a debt is converted to a capital interest. However, to the extent the debt of the noncreditor partners is reduced as a result of the contribution of the debt, those partners are deemed to receive a distribution of cash equal to their allocable share of the debt. A distribution, deemed or actual, of cash results in gain for the distributee partner to the extent the distribution exceeds the partner's basis in the partnership interest. IRC § 731(a)(1).

(5) **Assumption by Foreign Parent.** Many foreign investors and businesses hold their U.S. joint venture interest through a separate U.S. subsidiary corporation. An unresolved tax question concerns the effect of the following quite common fact pattern: The U.S. corporation liquidates and dissolves and the foreign investor assumes its share of the liabilities. Subsequently, the liability is forgiven or becomes uncollectible. Is the foreign investor taxable on income from the discharge of the indebtedness in question?

This question generally must be answered by analyzing whether the foreign investor is engaged in a U.S. trade or business. If so, the question arises whether the income is effectively connected with that trade or business. If not, the question is whether the income is "fixed or determinable, annual or periodic" income, taxable under IRC Sections 871(a) or 881(a) at a flat rate of 30%. Neither of these questions has been addressed by case law or Treasury regulation.

An interesting question is how debt forgiveness is treated in foreign countries. A quick survey of the field suggests that the United States is unique in the level of attention it pays to discharge of indebtedness income issues. This reinforces the potential benefits planning for debt restructuring by shifting the debt to a foreign affiliate before the debt is forgiven.

(c) **When Does a Debt Restructuring Result in Discharge of Indebtedness Income.** A number of questions must be answered in this regard: First, does the restructuring of the debt amount to an exchange of one obligation for another? Second, is the principal amount of the debt after the exchange less than the principal amount of the debt before the exchange? The answer to both these questions should be the same from the point of view of both debtor and creditor.

(1) **Has Debt Been Exchanged?** The question of whether debt has been exchanged for new debt or has simply been modified has been addressed extensively in case law and commentary. Most notable has been the recent U.S. Supreme Court's decision in the *Cottage Savings* case. *Cottage Savings* arose out of the desire of many savings institutions in the late 1970's and early 1980's to realize losses for

tax purposes on assets which they had been forced to realize losses for accounting and regulatory purposes.

Cottage Savings, in common with many other savings institutions, sold a portfolio of defaulting home mortgages at an appropriate discount, thereby realizing a loss and acquiring in exchange another portfolio of mortgages with a very similar profile. Economically, the savings institution remained in the same position as before because of the similarity between its portfolios before and after the transaction but from a tax point of view, it was able to deduct the decline in value of its portfolio immediately rather than wait for individual debts to become worthless or, more likely, to result in foreclosure which the savings institutions would wish to avoid for nontax reasons. The Supreme Court decided that the sale of the portfolios did give rise to loss notwithstanding their exchange for very similar portfolios. It is not entirely clear why the Internal Revenue Service fought this case so hard, since the IRS argument that no exchange had taken place would appear to open the door for exchanges of securities and other assets of sufficient similarity without complying with the like kind exchange rules of IRC Section 1031.

Cottage Savings prompted the Internal Revenue Service to issue proposed regulations which, if adopted, will give significantly greater guidance in this area. The proposed regulations are somewhat controversial because they are very broad and general and numerous detailed technical comments as well as conceptual issues have been raised by commentators. It is therefore quite likely that the final regulations will make a number of changes from the proposed regulations. The substance of the proposed regulations is a listing of modifications to a debt instrument which, either together or separately, will constitute an exchange of the obligation and therefore potentially result in both loss to the creditor and income to the debtor. The proposed regulations also clarify that unilateral exercise of a remedy or the occurrence of an event contemplated and provided for by a loan agreement does not constitute a modification.

(2) Has the Amount of the Debt Been Reduced. Assuming that the changes to a restructured obligation amount to an exchange, the amount of loss (and the amount of the debtor's income from discharge of indebtedness) is determined by comparing the issue price of the new obligation and the amount of the debt.

The issue price is calculated using the original issue discount rules of IRC sections 1273 and 1274. Those sections provide, in essence, that the issue price is the stated principal amount if the instrument carries adequate stated interest (meaning interest at least equal to the applicable Federal rate ("AFR")). If the instrument carries a lower rate of interest, the issue price will be recalculated downwards to equal the sum of the present values of all payments due under the obligation, discounted back at the AFR. There are three versions of applicable Federal rate, which are calculated monthly by the Internal Revenue Service. The short-term AFR is for obligations with a maturity of three years or less; the mid-term AFR applies to obligations of more than three but not more than nine

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years; and the long-term AFR applies to all obligations with a maturity of nine years or more.

The effect of this rule is to discourage cuts in stated principal of a debt but to encourage interest rate cuts so long as the rate does not fall below the AFR applicable to the term of the instrument (as such term may have been modified).

(d) Character of Discharge of Indebtedness Income. Income from the discharge of indebtedness is ordinary income. This can cause significant problems if any offsetting losses are capital losses, which cannot be offset against ordinary income, except to a very limited extent in the case of individual taxpayers.

(e) Dividend and Withholding Issues for Joint Ventures. Discharge of indebtedness income not exempt under any of the various rules described above not only increases gross income, it also increases earnings and profits of a corporation, whether a joint venture corporation or a corporate partner in a joint venture partnership. If the restructuring involves a corporate distribution, it is necessary to consider the possibility that the distribution will be treated as a dividend. This can have some unexpected effects, as follows:

(1) A dividend is a payment by a corporation to its shareholder(s) made out of its "earnings and profits". Earnings and profits may be defined, very broadly and with a number of exceptions, as after-tax net income.

(2) Earnings and profits are calculated both on a cumulative basis and on a current year basis. That is, a corporation may have earnings and profits because it has accumulated undistributed earnings and profits in prior years even though no earnings and profits (or even a deficit) arise in the year in which the distribution is made. Conversely, earnings and profits may exist in the current year irrespective of whether the corporation in prior years had accumulated earnings or an accumulated deficit. The latter rule is known, somewhat colloquially, as the "nimble dividend" rule.

(3) If the shareholder is a U.S. citizen or resident, a dividend will be fully taxable. If the shareholder is a U.S. corporation, a dividends-received deduction applies, at either 100% where the shareholder owns 80% of the shares of the distributor corporation, 80% if the shareholder owns between 20% and 80%, and 70% if the shareholding is less than 20%. In most joint ventures, therefore, if cancellation of indebtedness generates a large amount of income in a single year, there may well be a nimble dividend despite the accumulation of years of losses.

(4) The United States imposes a tax on dividends received by a foreign person (individual or corporate) from a U.S. corporation. The tax is 30% unless the shareholder is entitled to a reduction under an income tax treaty. In theory, only dividends attract the 30% tax, unlike the U.K. rule which requires Advance Corporation

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Tax to be paid on all distributions to shareholders. Corporate distributions in excess of earnings and profits either are treated as a return of capital (and thus are taxfree) or, once the capital has been returned in full, as a capital gain which will be taxable, in the case of a non-U.S. shareholder, only if the shares in the distributing corporation are treated as a U.S. real property interest.

(5) The problem for foreign shareholders is that the 30% tax is collected by requiring the U.S. corporation to withhold tax on ***all*** distributions, other than distributions in the course of liquidation. The rationale for this rule is simple: At the time a distribution is made, the corporation cannot know for certain what its earnings and profits may be for the year, since earnings and profits may arise later in the year even if none are currently available or projected at the time of the distribution.

(6) To the extent the amount withheld exceeds the tax due by the foreign shareholder because the amount of the distribution exceeds the amount found to be a dividend, the foreign shareholder may seek a refund and it will be readily given. The problem is that no refund can be sought before the end of the taxable year and the Internal Revenue Service can take up to 45 days past the last date on which the return could have been timely filed before interest starts accruing on the refund.

(7) Prior to 1989, a U.S. corporation making a distribution to its foreign parent might have chosen not to withhold if it was absolutely sure that there would be no earnings and profits. Although failure to withhold was technically a violation, the penalties were trivial if it were found subsequently that the tax on the foreign shareholder was zero. However, after 1988, the law was revised to impose substantial penalties on a withholding agent that fails to withhold even though the foreign shareholder pays the tax in full or is not liable to tax for want of earnings and profits. In extreme cases, the penalty on the withholding tax can be as high as 100% of the tax, not including interest.

3.2 Consequences to the Creditor.

(a) In General. The typical creditor's principal concern in any debt restructuring will be the timing and character of its loss -- the converse of the debtor's problem. This issue has been addressed earlier in this outline at paragraph 3.1(c) from the debtor's viewpoint and the rules are essentially the same for both sides.

(b) Treatment of Interest Payments and Original Issue Discount. For those who advise foreign investors, a common question is how to avoid withholding tax on payments when it is fairly clear that the debtor is unable to pay the entire amount due and will in any event not be able to pay the full amount of interest and principal. Interest and original issue discount (OID) bears withholding tax at 30% or lower treaty rates. A payment of principal is not taxed to a creditor unless the debt is payment of purchase price which gives rise to income which either is, or under the Foreign Investment Real Property Tax Act is deemed to be, effectively connected with a U.S. trade or business.

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The first question is whether the interest payments provided for by the loan documents are treated as "qualified periodic interest payments" (QPIPs) or as "original issue discount" (OID). An interest payment is a QPIP if the amount is based on a fixed rate and payable unconditionally at fixed intervals of one year or less over the entire term of the debt. All other interest or compensation for use of funds is OID.

If the interest payment is a QPIP, then the character of any payment depends on the agreement of the parties; if there is no agreement, payments will normally be allocated to interest first unless the debtor is insolvent and unlikely to be able to pay the interest called for by the loan documents. See, *e.g.*, *Newhouse v. Commissioner*, 59 T.C. 783 (1973). If the interest is OID, then every payment must be allocated first to OID, which has accrued from the date of the loan to the date of payment; thereafter the payment is allocated to principal. The parties may not change this result by agreement although the insolvency exception might still apply. In other words, if interest is OID, there will be withholding whenever a payment is made under the loan agreement.

The loan documents should provide for qualified periodic interest payments, with interest payable at least annually and the amount of the interest readily determinable based upon the formula set forth by the facility letters. However, there is a risk that the payments would not be treated as payable "unconditionally" if the IRS felt that the agreement to make payments at least annually did not represent the real agreement of the parties. It is not sufficient simply to demand payment and then to debit the debtor's account.

If the interest is a QPIP, the parties may agree to allocate the payments to principal first. Case law indicates that an agreement of this kind is valid for tax purposes. Such an agreement should be in writing and both [parties must treat the payment consistently in their books and records.

4. SOME U.S. TAX TRAPS FOR JOINT VENTURES.

4.1 Withdrawing Assets from a U.S. Trade or Business. IRC section 864(c)(7) provides that if property ceases to be used or held for use in connection with a U.S. trade or business and is disposed of within a ten year period following the cessation, the determination of whether any income or gain (but not, it appears, loss) is effectively connected with a U.S. trade or business is required to be made as if the sale took place before the cessation. In other words, a foreign joint venturer who withdraws an asset from a U.S. business is subject to tax on sale of the asset within a ten year period, even if the foreign person is no longer engaged in a trade or business and even if all of the appreciation takes place after the asset was withdrawn from the United States. Treaty relief may apply in those cases where the U.S. limits its rights to tax to those foreign taxpayers with a U.S. permanent establishment and even those with a permanent establishment may argue that the income or gain is not "attributable" to such permanent establishment. At all events, as in many other cases where the United States makes it

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easy to invest but hard to disinvest, the most concise warning on this point was provided by a character in C. S. Lewis' *The Horse and His Boy*, "Easily in but not easily out, as the lobster said in the lobster pot."

4.2 Income Received after Termination of a U.S. Trade or Business. IRC section 864(c)(6) provides that income received by a taxpayer from the sale of property or the rendering of services is taxable after the foreign taxpayer ceased to be engaged in a U.S. trade or business, if the sale took place or the services were performed prior to cessation. This is a provision more readily understandable and modern U.S. treaties (such as the recently signed treaty with Mexico) clarify that parallel rules apply to property sold or services performed by the resident of a treaty partner through the U.S. permanent establishment.

4.3 Partnership Withholding. Withholding issues must be considered under IRC sections 1445 and 1446 if a partnership (foreign or domestic) allocates income to a foreign partner. As this outline has copiously illustrated, it would be a mistake to believe this cannot happen when the partnership is failing.

Regulations under section 1445 require that a partnership withhold 34% of each foreign partner's distributive share of gain realized by the partnership upon the disposition of a U.S. real property interest. Treas. Reg. § 1.1445-5(c)(1)(ii). The 34% rate applies irrespective of whether the foreign partner is an individual or a corporation. In determining the foreign partner's distributive share, partnership is directed to use the principles of section 704, even though section 704 is concerned primarily with allocation of net income rather than individual items of gross income.

Section 1446 requires a partnership to deduct and withhold a tax equal to the partner's distributive share of partnership income which is effectively connected with the conduct of a trade or business within the United States. The rate is the "applicable percentage", meaning the highest rate of tax applicable to the foreign partner under section 1 or 11, *i.e.*, currently 31% for individuals and 34% for corporations.

No regulations have been made or proposed under section 1446. However, the IRS published an extensive Revenue Procedure, which specifies the relationship between sections 1445 and 1446. This provides that where a domestic partnership is subject to the withholding requirements of section 1446, it shall not be subject to the payment and reporting requirements of section 1445(e). Rev. Proc. 89-31, 1989-1 C.B. 899, sec. 7.022(i). In most cases, therefore, section 1446 will override section 1445.

However, section 1446 presents a serious problem if any income is allocable to a foreign person. The income might be in the form of (i) an allocation of cancellation of indebtedness income (bearing in mind that the bankruptcy and insolvency exceptions are tested at the partner level, not the partnership level), (ii) recapture of depreciation caused by the tax depreciation which was faster than economic depreciation or (iii) the results of

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the fiction of treating the foreclosure of property subject to a non-recourse mortgage as being sold for at least the principal amount of the debt.

In many of these situations, no cash will be available because of amounts due by the partnership to its lenders. Therefore, the domestic general partners of the partnership will have a responsibility to withhold under section 1446 but with little or no access to any funds with which to discharge the obligation. Even if cash is available, cash otherwise distributable to the U.S. partners may have to be used to pay partnership withholding on account of a foreign partner. Even more ironic, or galling, is the fact that the foreign partner may be entitled to partner-level deductions or loss carryovers, or may be able to apply the cancellation of indebtedness income exception at the partner level. As a result, the foreign partner may be able to obtain a refund. The withholding rules thereby become a conduit for an unjustifiable payment from the general partners to the foreign partner. It is true that the foreign partner may have an obligation under the partnership agreement or as a result of having a negative capital account to repay the amount withheld on its behalf, but the ability to collect such obligation will be in doubt if the foreign partner bears any ill will to the partnership for its economic failure.

The IRS has received several comments about this problem and is considering some form of relief in regulations to be issued under section 1446. Nevertheless, the regulations were not listed on the Commissioner's 1992 Business Plan and we should not expect regulations until late in 1993 or 1994 at the earliest. The IRS has been unwilling to give any indication as to the nature of any possible relief. Informal inquiries specifically confirmed the IRS view that the unavailability of funds to the partnership or the partners required to withhold would not be regarded as excusing failure to pay the tax required to be withheld.

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