Tax-Attribute Carryforwards of Inactive US Real Estate

Holding Companies — A Valuable and Often-Overlooked Asset

Bruce Hood, Wiggin and Dana LLP

Background

Many foreign investors in US real estate have found themselves owning US or foreign companies with substantial US tax-attribute carryfowards resulting from investments that have been disposed of by the companies. The carryforwards may have arisen from economic losses, deductions generated by interest on related-party debt or both. The carryforwards may be isolated in a company that no longer owns any real estate even though the foreign investor continues to hold real estate through other companies. On the other hand, the carryforwards may be attached to companies that are owned by overseas concerns that have totally ceased their US real estate investment program. The question in all cases is how to obtain the maximum value from the carryforwards.

The current maximum federal income tax rate for corporations is 35 percent, and state and local tax rates can be as high as 17 percent (e.g., in New York City). As a result, the value of a tax attribute carryforward can be as high as 46 percent (the state and local taxes are deductible against federal taxable income). The two principal tax attributes that can be carried forward are net operating losses and disallowed interest deductions. Net operating losses can be carried forward for 20 years (losses from years prior to 1998 can be carried forward for 15 years only), whereas disallowed interest carryforwards can be carried forward indefinitely. The ordering rules require that disallowed interest carryforwards be used prior to net operating loss carryforwards.

For corporations, a net operating loss carryforward is the excess of the corporation's deductions over its income. A disallowed interest carryforward is the amount of a corporation's interest deduction that is disallowed for a particular year under the "earnings-stripping rules" of Internal Revenue Code (I.R.C.) section 163(j). Under these rules, interest paid to a related tax-exempt lender (such as a resident of a country having a tax treaty with the United States that provides for a zero rate of withholding tax on interest payments from US borrowers) will not be deductible to the extent that the total interest paid by the taxpayer exceeds 50 percent of its "adjusted taxable income." Adjusted taxable income is basically taxable income computed without taking into account interest income and deductions, depreciation deductions and depreciation recapture in connection with the disposition of depreciable property. Disallowed interest carryforwards are subject to the same test of deductibility in subsequent years.

"De Facto Liquidation"

A threshold issue that must be taken into account in dealing with a company that has disposed of its assets is whether it must maintain a certain level of activity in order to retain its tax-attribute carryforwards. A doctrine referred to as "de facto liquidation" has been advanced by the Internal Revenue Service (IRS) to address situations in which companies remain dormant for a lengthy period of time before commencing new activities. The IRS has not been particularly successful with this theory, particularly if the company maintains even a minimal level of activity. Nevertheless, it is recommended that a company that has disposed of its property document in its corporate records that it is not in a state of liquidation and intends to maintain its corporate existence.

Combinations of Related Companies

If a foreign investor in US real estate uses multiple corporations to hold its properties (in order, for example, to be in a position to liquidate a corporation following the sale of a property in order to avoid dividend withholding taxes on the repatriation of the sales proceeds or, in the case of a foreign corporation, to allow the investor to effectuate a sale of its property via a sale of the stock of the corporation without triggering FIRPTA taxation), it may need to transfer the carryforwards of the dormant corporation to an affiliate that still owns real estate. Although it is possible to transfer carryforwards under I.R.C. section 381 in connection with certain tax-free reorganizations and liquidations involving related companies, there are some hurdles to clear. For example, in order to be tax-free, a combination of two companies must have a business purpose independent of the reduction of the companies' federal income tax liability and must also involve the continuation of an existing business.

Although it is possible to combine related companies through a liquidation, and there is generally no requirement that there be a business purpose or a continuation of a business for a liquidation to be tax-free, there are other issues in this type of transaction. For example, the IRS has taken the position that the liquidating company must be solvent, and if the stock of one of the companies is transferred prior to the liquidation, the transaction can be recharacterized as a reorganization that must meet the tests described above. An attempt to combine companies in order to utilize the carryforwards of one of the companies must be carefully analyzed because if a company is liquidated in a transaction that is not covered by I.R.C. section 381, its tax attributes will disappear for good.

Joint Ventures

If a foreign investor has totally ceased its US real estate investment program, it may not be in a position to obtain any benefit from its tax-attribute carryforwards unless it engages in other types of taxable US activities (e.g., certain private equity funds). It may also be possible to monetize the tax attributes through a joint venture with other investors who can supply assets that generate income that will be offset by the carryforwards.

There are several hurdles that must be cleared in order to use the carryforwards successfully in this manner. The two major hurdles are I.R.C. sections 269 and 382. Section 269 provides that if there is an acquisition of 50 percent or more of the value of a corporation and the principal purpose of the acquisition is the avoidance of taxes, the IRS is empowered to disallow the use of any tax attributes that would otherwise be available to the acquirer. Section 382 provides that if more than 50 percent of the value of the stock of a company is acquired during a 3-year period of time, the use of the tax attributes of the acquired company in any subsequent year will be limited to the value of the company at the time of the acquisition multiplied by a rate that is designed to replicate the long-term tax-exempt interest rate in effect at that time.

Under section 382, stock does not include non-voting shares that do not meaningfully participate in the growth of the company, such as preferred stock. Since corporations are entitled to a dividends-received deduction, they are the logical candidates to invest in the company with the carryforwards. Of course, the strategy will only work if there is a positive spread between the amount that the issuing corporation can earn on its investments over the amount that it is able to pay to its preferred shareholders, as well as sufficient overall profits to offset any issuance costs.

The bulk of the capitalization of the loss company will typically come from the joint-venture partners, and, as a result, the preferred stock will be entitled to substantially all of the profits of the company. If section 382 is triggered, the negligible capitalization (as is usually the case) of the company prior to the introduction of the new shareholders plus the fact that the company has ceased its real estate business will make the tax-attribute carryforwards valueless. Since there is no definitive authority on the subject, one must conclude that the fixed-coupon rate and the right to redeem at par preclude the preferred stock from participating meaningfully in the growth of the issuing company. Likewise, one must conclude that section 269 has no application. Unlike section 382, under section 269 a change in control is measured by the value of all of the stock of the company with the tax-attribute carryforwards. As a result, the issuance of preferred stock will result in a change of ownership and the question is whether the requisite tax-avoidance purpose predominates. The conclusion that must be reached on this question is that the dividends-received deduction is available to the purchasers regardless of whether there is a change in control, so that the change in control, by itself, does not have the prohibited purpose.

In joint-venture transactions of this sort, the tax risk is typically placed on the company possessing the tax-attribute carryforwards, with the foreign parent being required to guarantee any liability to preferred shareholders. The basis for the liability will be the inability of the preferred shareholders to avail themselves of the dividends-received deduction with respect to all of the distributions to them, which will occur if net operating loss carryforwards or disallowed interest carryforwards do not extinguish the entire tax liability of the issuing company.

The return to the issuing company is the subject between the parties, and the actual rate will depend upon the amount of the spread between earnings on the invested funds and the dividend rate on the preferred stock, as well as the costs of issuing the preferred shares. However, a projected rate of between 10 percent and 15 percent of the carryforwards actually used is not uncommon. The issuer typically retains the right to redeem the shares at any time in order to protect itself if any of the assumptions underlying the venture prove to have been unfounded.

Conclusion

Tax-attribute carryforwards are valuable assets that are often ignored by investors that have disposed of the real estate owned by the companies possessing them. The companies may be liquidated without taking into account possible uses for the carryforwards, either by another company within the group or through the use of the company to invest in other types of taxable US investments. Even if the owner of the company does not contemplate making taxable investments in the near future, it costs very little to keep a dormant company alive, and it is not likely that the carryforwards would be lost (other than through the passage of time) as long as the company continues to observe basic corporate formalities.

The use of a company possessing tax carryforwards as a vehicle for investments by the owner in taxable activities, whether real estate or otherwise, will produce the greatest return because the owner will obtain the entire benefit of the carryforwards, which can be as high as 45 percent of the income offset. If a foreign investor does not anticipate being able to use the tax-attribute carryforwards within the carryforward period, it should consider exploring the possibility of monetizing the carryforwards by entering into a joint venture which, although it produces a lesser return, has the capacity to enable the investor to recover at least some of the value of the tax attributes generated by its real estate investments. ★

Bruce Hood is a partner in the New York office of Wiggin and Dana LLP, where he specializes in tax, real estate and corporate matters with an emphasis on inbound foreign investment. He is a graduate of Fairleigh Dickinson University, the University of South Carolina School of Law and New York University School of Law.