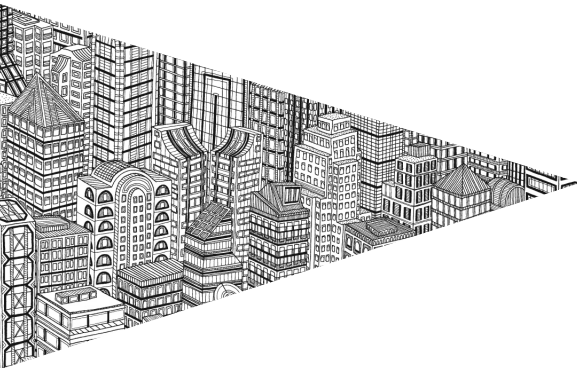


# International Tax Alert



## Stock price changes may affect USRPHC determinations

### Executive summary

The significant changes in stock trading prices experienced over the past five years (in particular between 2008 and 2010) may have caused dramatic fluctuations in the enterprise value of publicly traded corporations during this period. Recent market experience has shown that these enterprise value fluctuations may lead to unexpected results when a domestic corporation is asked to certify that it has not been a United States real property holding corporation (USRPHC) prior to the sale of its stock by a foreign person, as required by the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) rules.

### Detailed discussion

A foreign person is subject to tax on gain derived from the disposition of a US real property interest (USRPI) under Sections 897 and 1445 of the FIRPTA rules. These rules treat a foreign person's gain from the sale of a USRPI as income that is effectively connected with a US trade or business, even if the foreign person's US activities would not otherwise create a US trade or business. Under Section 897(c)(1), a USRPI is any interest in real property located in the United States or the Virgin Islands, and any interest, other than an interest solely as a creditor, in any domestic corporation that qualifies as a USRPHC at any time during the shorter of five years, ending on the date of disposition of the interest, or the period during which the taxpayer held such interest. Under Section 897(c)(2), a corporation is a USRPHC if the fair market value of its USRPIs equals or exceeds 50% of the sum of the fair market value of its USRPIs, its interests in real property located outside the

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United States and its assets used or held for use in a trade or business. Note that under Section 897(c)(3), stock in a publicly traded domestic corporation is not considered a USRPI, and the FIRPTA tax will not apply to its sale, provided that the seller owns 5% or less of that class of stock, in which case a certificate is not necessary to avoid withholding.<sup>1</sup>

Section 897(c)(1) contains two key principles. One is that a US corporation is presumed to be a USRPHC unless the person disposing of an interest in that corporation affirmatively demonstrates that it is not. The other is that a US corporation will be a USRPHC on the date of disposition if the corporation was a USRPHC at any time during the shorter of the five-year period preceding the disposition or the period during which the taxpayer held the interest in the corporation.

The FIRPTA tax is collected in part by withholding at the source. Thus, under Section 1445(a), any person purchasing stock in a US corporation from a foreign seller generally must withhold and pay over to the IRS 10% of the “amount realized” on the disposition of the stock (which is generally 10% of the sales price), unless an exception applies. The most common exception is that the corporation (or the IRS) provides a certificate that the corporation is not a USRPHC, per Treas. Reg. Section 1.897-2(g).

Whether a company is a USRPHC is generally determined on a facts-and-circumstances basis. There are no

bright-line tests for determining the fair market value of a company or its assets, although the regulations provide guidelines and “preferred methods” described only in general terms. The regulations (Treas. Reg. Section 1.897-2(b)(2)) do provide a rebuttable presumption that a corporation is not a USRPHC if the “book value” of its USRPIs represents 25% or less of the total book values of the three classes of assets otherwise taken into account for purposes of the USRPHC test, but this can be a relatively low threshold for certain corporations, especially those in the retail sector that lease retail space, because leasehold interests are considered real property interests under the FIRPTA rules, per Treas. Reg. Section 1.897-1(b)(3).

Many public corporations rely on the sum of their equity market capitalization plus debt (enterprise value) for purposes of determining the value of their total assets in testing for USRPHC status. The enterprise value of many public corporations, however, declined dramatically (particularly during 2008 and 2009) as a result of reduced stock market valuations. A dramatic decline in enterprise value may lead to unexpected results when a corporation is making a USRPHC determination based in part upon such value. For example, a retailer that has below market leases with respect to stores in certain geographic areas or tenant-owned improvements to the leaseholds (which are considered real property

interests for FIRPTA purposes per Treas. Reg. Section 1.897-1(d)(2)) may discover that those assets represented more than 50% of its enterprise value at the bottom of the stock market valuations, generally in 2008 or 2009, (even though those assets represent a small portion of the corporation’s total assets currently). Because the rules require a corporation to look back as much as five years in determining whether it is a USRPHC, companies that never considered that they could be USRPHCs because they do not own traditional real property outright may encounter unexpected results when they examine their USRPHC status due to fluctuations in enterprise value during prior years.

## Implications

Many corporations do not realize they must provide a certificate of non-USRPHC status at the request of a foreign seller until a deal is near closing, and may then incur considerable time and expense in making the USRPHC determination in a compressed amount of time. Corporations with meaningful amounts of real property interests (including leasehold interests, tenant improvements or other types of assets that the FIRPTA rules consider real property interests even though they are not “real property” in the traditional sense) should carefully examine their particular facts and circumstances prior to drawing a conclusion as to their USRPHC status. In particular, they should proactively review whether

fluctuations in their enterprise value based upon the trading price of their stock over the past five years may have caused them to be considered a USRPHC prior to issuing a non-USRPHC certificate, which is signed under penalties of perjury.

Similarly, buyers and foreign sellers of stock should carefully consider whether a target may be a USRPHC far enough in advance of a sale to allow adequate time for the corporation to review its particular

facts and circumstances during the preceding five years, so that it may issue the non-USRPHC certificate if appropriate and thereby avoid the 10% withholding tax that would otherwise apply.

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## Endnote

1. Legislation has been introduced to increase the percentage of stock of a publicly traded corporation that a taxpayer can own without triggering FIRPTA from 5 to 10%. See Tax Tax Alert, *New FIRPTA Proposals Would Affect REITs*, dated 3 December 2011 ([Tax Alert 2011-1671](#)).

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