Selected U.S. Tax Developments

Editor: Sidney I. Roberts*

SOURCE OF INCOME FROM SALES OF PERSONAL PROPERTY

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The new statutory rules for the source of income from sales of personal property may increase the U.S. tax on Canadians with a U.S. permanent establishment in certain circumstances.

The issue of whether the United States has attempted to enforce its tax laws extraterritorially rarely arises,[1] in part because the United States does not assert any right to tax the income of non-U.S. persons that either does not arise in the United States or does not arise from a U.S. business activity. Of course, the United States does tax its citizens and residents and U.S. corporations on their worldwide income, generally without any limitation. That, however, can hardly be considered to raise jurisdictional issues. Moreover, in the case of U.S. persons subject to tax on worldwide income, the United States unilaterally and by treaty cedes to the source country the primary right to impose its tax, with the United States's retaining, in effect, through what has become a very complicated foreign tax credit mechanism, only a residual right to tax non-U.S.-source income of U.S. persons.

Much, therefore, depends on whether income is considered to be from a U.S. source. In the case of U.S. persons, the source of income affects the ability to claim a foreign tax credit, and in the case of foreign persons, source generally affects liability to U.S. tax. In this connection, the Internal Revenue Code[2] provides different source rules for different categories of income.[3] In many cases, however, resolution of a source of income issue often first requires a proper characterization of the income. Whether income represents gain from the sale of property or another category of income, for example, may be at issue.[4] Furthermore, amounts that properly

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[1] Compare *Frank W. Ross*, 44 BTA 1 (1941) (dissenting opinion); Rev. Rul. 80-362, 1980-2 CB 208.

[2] Except as otherwise noted, all statutory references are to the Internal Revenue Code of 1986 (herein referred to as the "Code" or "IRC").

[3] For example, sections 861, 862, and 863.

[4] Or, for example, whether payments represent income for personal services or royalties. *Ingram v. Bowers*, 57 F.2d 65 (2d Cir. 1932); *Pierre Boulez*, 83 TC 584 (1984).

are characterized as gain from the sale of property may, under certain circumstances, be treated as a dividend, interest, or a royalty[5] for source purposes. Moreover, for certain purposes, amounts that otherwise would be treated as income from a foreign source are treated as U.S. source income.[6]

Even a brief discussion of the various source rules is well beyond the scope of this article. Rather, this article deals only with new section 865,[7] the provision that provides the new source rules for gain from the sale of personal property,[8] and particularly with the application of the new rules to foreign persons.

PRIOR LAW

Under prior law, apart from the special rules applicable to contingent payments for intangibles and sales of property produced by the taxpayer,[9] amounts properly characterized as gain from the sale of personal property were generally considered to be sourced at the place of sale. That place generally was determined by reference to the place where the seller's right, title, and interest to the property passed to the buyer (the so-called title passage rule).[10] Since passage of title could often be arranged to occur at the most convenient place from a tax viewpoint, this rule often permitted a foreign taxpayer the choice of being subject to U.S. jurisdiction with respect to gain on the property being sold.

To be sure, the applicable regulations have long provided that the mere arrangement of the passage of title at a place for the principal purpose of tax avoidance was not to be given effect. In such circumstances, the sale would be deemed to occur at the place where its substance occurred, taking into account the place of negotiations, the place of execution of the agree-

[5]Sections 1248, 1276(a)(4), and 865(d)(1)(B) respectively.

[6]See section 904(f), which requires foreign income to be recharacterized as U.S. source income, for foreign tax credit purposes, to the extent of an "overall foreign loss."

[7]Added to the Code by section 1211(a) of the Tax Reform Act of 1986, Pub. L. no. 99-514, enacted on October 22, 1986 (herein referred to as "the Act").

[8]Special rules cover gain from certain specified types of personal property, including gain from the sale of "U.S. real property interests" (section 861(a)(5)), foreign exchange gains and losses (section 988(a)(3)) and, in certain cases, gain from the disposition by a U.S. person of intangibles in a tax-free rollover transaction (section 367(d)(2)).

[9]Under prior law, if a taxpayer sold personal property in one country but produced that property in another country, the Regulations generally required that one-half of the gain be sourced at the place where the property was sold and one-half at the place where the property was produced: Treas. Reg. section 1.863-2(b)(3), example 2. The new law limits this allocation to inventory only. In the case of sales of intangibles, prior law required that any fixed amount paid therefor be sourced under the rules generally applicable to sales of personal property and that any contingent amount be treated as a royalty (and sourced at the place of use): sections 861(a)(6), 862(a)(6), 861(a)(4), 862(a)(4), and 871(e)(2) of the Internal Revenue Code of 1954, as amended (herein referred to as "IRC of 1954"). Under a special rule, which no longer exists, if contingent payments exceeded fixed payments for a year, all payments were considered to be contingent: IRC of 1954, section 871(e).

[10]Treas. Reg. section 1.861-7(c).

ment, the location of the property, and the place of payment.[11] Notwithstanding the in terrorem effect of the language of the cited regulation, a taxpayer generally felt comfortable that a sale would be deemed to occur where title passed so long as there was some contact with that place, and if title passed outside the United States, the gain was foreign source.[12]

As has been noted, whether gain was U.S. or foreign source was of considerable significance given the United States's restraint in exerting tax jurisdiction over foreign source income of a foreign person. Under prior law, apart from tax treaty considerations, for a foreign taxpayer to be subject to U.S. tax on foreign source gain, it had to be engaged in a banking or financial business, a licensing business, or a business involving exporting inventory. In addition, it had to maintain an office or other fixed place of business in the United States, and the U.S. office or fixed place of business had to participate materially in the realization of the income. Furthermore, in the case of foreign sales of inventory that was sold for use or consumption outside the United States, no other office of the taxpayer outside the United States could materially participate in the sale.[13]

Thus, gain from sales outside the United States of depreciable personal property that a foreign taxpayer used in a U.S. trade or business or of portfolio assets of a taxpayer that was not in a financial industry was never subject to U.S. tax. Moreover, even assuming that the foreign taxpayer's foreign gain was taxable under the above rules (for example, because it constituted inventory sold through a U.S. office), tax could be avoided if the taxpayer were entitled to the benefits of a treaty that precluded the United States from taxing "foreign" source income.[14]

THE NEW RULES

Foreign Persons with Income Attributable to an Office or Other Fixed Place of Business in the United States

Under the new rules, foreign source gain of a foreign person is never subject to U.S. tax.[15] Gain attributable to a U.S. office or fixed place of business, however, is now designated "U.S. source," except where a foreign office of the taxpayer materially participates in the sale and where the personal property sold is inventory and is for use or consumption outside the United States. As a result, all gains that were foreign source but subject to U.S. tax

[11] Ibid.

[12] Compare IRS Ltr. Rul. 7502281430A, February 28, 1975. For commercial reasons, title passed at a point *on* the boundary between the United States and a contiguous country. Because title did not pass *over* the boundary, gain was U.S. source, not non-U.S.-source.

[13] IRC of 1954, section 864(c)(4)(B) and 5.

[14] Switzerland-U.S. income tax treaty, article III; Netherlands Antilles-U.S. income tax treaty, article III(1).

[15] Section 864(c)(4)(B) still contains references to foreign source gains that may be attributable to a U.S. fixed place of business and subject to U.S. tax. These references are no longer correct and should have been corrected when section 865 was enacted. Once gains are deemed to be attributable to a U.S. fixed place of business, they become U.S. source under section 865. See section 865(c)(2).

under prior law are still subject to tax but are now designated U.S. source.[16] In addition, any other personal property gain that is attributable to a U.S. office or fixed place of business of a foreign person is also U.S. source. Of course, merely designating such gain U.S. source does not subject it to U.S. tax. Generally, it must also be an effectively connected gain.[17]

Canadians are usually subject to U.S. tax on these gains since articles VII and XIII(2) of the Canada-U.S. income tax treaty (the "Canada-U.S. treaty") generally do not exempt such gains from U.S. tax.

Foreign Persons with Gains Not Attributable to a Fixed Place of Business in the United States

If a foreign taxpayer does not have a U.S. office or fixed place of business or if the sale of personal property is not made through any such office or fixed place of business, the source of the gain from the sale is determined under the following rules:

- Gains and losses on inventory purchased and sold by the taxpayer are generally sourced under the title passage rule of prior law. If title passes in the United States, such gain is U.S. source. In other cases, subject to the in terrorem language of the regulations, the gain is foreign source.

- Gain on inventory produced by the taxpayer in one country and sold in another is allocated between the two countries, generally one-half to each.

- Gain from the sale of depreciable personal property is allocated between the portion of the gain that is equal to previously allowed or allowable depreciation adjustments (depreciation recapture) and the portion, if any, that is in excess of depreciation. The portion of the gain in excess of depreciation is sourced under the rules for inventory discussed above. The portion of the gain attributable to depreciation recapture is sourced in the United States to the extent of the proportion of the depreciation adjustments that were allowable for the purpose of determining U.S. taxable income.

Thus, for example, assume that a foreign person sold depreciable equipment used in its trade or business for $1,100, that the sale took place outside the United States, and that no U.S. office participated in the sale. Further assume that the equipment had an original cost of $1,000 and an adjusted basis of $100. Finally, assume that 70 percent of the depreciation was allowable to U.S. taxable income.

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[16] Section 865(e)(2).

[17] Sections 881 and 871(a)(2); section 864(c)(2) and Treas. Reg. section 1.864-4(c)(2)(iv). The Senate Report states that once income is U.S. source because it is attributable to a U.S. fixed place of business, it is effectively connected under the general rules: S. Rep. no. 313, 99th Cong., 2d Sess. 332 (1986). Although this is generally true under the "force of attraction" rule of section 864(c)(3), it is not the result in the case of sales of capital assets because of the requirement under section 864(c)(2) that the gain must meet either the "asset use" or "material income-producing factor" test. Compare Treas. Reg. section 1.864-5(a), last sentence.

Under prior law, the entire $1,000 gain would be considered to be a foreign source gain under the title passage rule and would be computed as follows:

Amount realized	$1,100
Basis	(100)
Gain	$1,000

Under the new provision, $630 of the $1,000 gain would be treated as U.S. source, determined as follows:

Gain from previous depreciation	$900
U.S. proportion of depreciation	70%
U.S. source gain from depreciation recapture	$630

The remaining $370 would be treated as foreign source, determined as follows:

Gain from previous depreciation		$900
Foreign proportion of depreciation		30%
Foreign source gain from depreciation recapture		$270
Gain in excess of all depreciation		
	$1,000	
	(900)	
		$100
Total foreign source gain		$370

If, in the above illustration, the equipment were sold in the United States, an additional $100 of the gain would be U.S. source, but $270 of the gain would continue to be foreign source, computed as follows:

U.S. source gain from previous depreciation		$630
Gain in excess of all depreciation		
	$1,000	
	(900)	
		100
Total U.S. source gain		$730
Gain from previous depreciation		$900
Foreign source portion of depreciation		30%
Foreign source gain		$270

This should be compared with the result under prior law in which, in the case of a sale in the United States, the entire $1,000 gain would be U.S. source gain.

If in either of the above illustrations, the sale were made through the U.S. office of the foreign person, the entire gain would be considered to be from U.S. sources.

• Gain from the sale of intangibles other than goodwill is sourced, to the extent of any contingent payments, under the royalty source rule (that is, source follows place of use). To the extent of any fixed payments, the source is determined under either the depreciable property rule noted above or the residual rule noted below, depending on whether the property is depreciable property.

• Gain attributable to goodwill is sourced where the "goodwill was generated."

• All other gains (residual gains), principally gains on stocks and bonds, are generally sourced in the taxpayer's country of "residence." Thus, for example, gain realized by a non-resident from the sale of stock of a U.S. corporation that is not a U.S. real property holding corporation is considered to be foreign source, unless the sale is attributable to a U.S. office or fixed place of business.[18] It is unclear whether this is also the result in the case of gain realized by a shareholder on the liquidation of a company.[19]

In most cases, Canadians without a U.S. permanent establishment are not subject to tax on any gains that are U.S. source under these new rules because of the exemptions provided by articles VII and XIII(4) of the Canada-U.S. treaty.

"Resident" Classifications

It makes considerable difference whether the person realizing the gain is regarded as a U.S. resident.[20] Significantly, for purposes of these provisions, the term "U.S. resident" may not mean the same as it means under U.S. internal law or under an applicable fiscal domicile provision of a treaty. To be sure, a U.S. corporation is, and a foreign corporation is not, considered to be a U.S. resident for these purposes. An individual is treated as a U.S. resident if his "tax home"[21] is in the United States. A U.S. citizen and a resident alien may be regarded as a non-resident under these rules. Similarly, a non-resident alien may be regarded as a resident under the above rules if his

[18]Compare section 877.

[19]Compare *William C. Hay*, 2 TC 460 (1943), aff'd 145 F.2d 1001 (4th Cir. 1944), which held that gain on the liquidation of a U.S. corporation was U.S. source.

[20]The source rules described above that are applicable to the income of non-residents that is *not attributable* to a U.S. fixed place of business generally apply to U.S. residents whether or not the income is attributable to a U.S. fixed place of business.

[21]Section 911(d)(3) and Treas. Reg. section 1.911-2(b). The statute does not require that the taxpayer establish that he has a tax home outside the United States or that he have a tax home at all in order to be a non-resident for these purposes. It merely states that if his tax home is in the United States, he is a U.S. resident. Occasionally, an individual has no tax home. An example is a travelling salesman who lives in hotels wherever he goes. *James v. United States*, 308 F.2d 204 (9th Cir. 1962). If, however, the taxpayer has a regular or principal place of business in the United States, his tax home is in the United States. If he has a regular or principal place of business outside the United States, even if his abode is in the United States, he does not have a U.S. tax home and is not a resident for purposes of these source rules. One can have a tax home in the United States and be a resident for source purposes and not be a resident subject to tax on worldwide income.

tax home is in the United States. The effect of treating a Canadian individual as a U.S. resident for source rule purposes, however, is very limited.[22]

Impact on Gains Realized Through Partnerships and Trusts

A partnership created under the laws of the United States[23] is regarded as a resident for source purposes, whereas a partnership created under non-U.S. law (for example, Canadian law) is regarded as a non-resident. Similarly, a trust taxed as a U.S. resident trust is considered to be a resident, whereas a trust taxed as a non-resident is treated similarly for source purposes. Thus, it appears that a Canadian partnership is considered to realize foreign source income on residual gain (unless the gain is attributable to a U.S. office). A U.S. resident partner of such a partnership appears to obtain foreign source gain with respect to his distributive share of such gain[24] (unless, perhaps, the partnership is treated as an aggregate for this purpose). Similarly, a Canadian partner of a U.S. partnership is treated as realizing U.S. source gain on the residual gains of the partnership.[25]

EXPANSION OF U.S. TAXING JURISDICTION

As noted, the new source rules may, in certain limited cases, expand the scope of the U.S. taxing jurisdiction over foreign persons by broadening the category of income considered to be U.S. source and subject to U.S. tax. Canadians will be affected in cases where such gains would not have been subject to tax under old law but may be taxed under the Canada-U.S. treaty. It was possible, for example, under old law to avoid U.S. tax on gain from the sale of business property other than inventory, even if the gain were attributable to a U.S. permanent establishment, simply by selling the property outside the United States. It was also possible to avoid U.S. tax on gain from the sale of portfolio assets, even when those assets represented the U.S. branch's working capital, by selling them outside the United States (for example, on a foreign stock exchange). It was even possible to avoid tax on the sale of inventory, but that required the use of a third country corporation resident in a country having a treaty with the United States that exempted from tax all foreign source income.[26]

The new provisions tax gain in these cases. Moreover, articles VII and XIII(2) of the Canada-U.S. treaty do not bar the United States from taxing such gain if it represents business profits of, or is realized from the sale of property forming part of the business property of, a U.S. permanent estab-

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[22]In the absence of a U.S. permanent establishment, gains otherwise subject to U.S. tax are generally exempt from U.S. tax under article XIII(4) of the Canada-U.S. treaty.

[23]For example, pursuant to the Uniform Limited Partnership Act (ULPA) of a state. See, for example, N.Y. Partnership Law, article 8 (McKinney, 1948).

[24]Section 702(b); *Foster v. United States*, 329 F.2d 717 (2d Cir. 1964).

[25]Section 865(a)(1). The special exception of section 865(e)(1) probably does not apply even if the sale is attributable to a foreign office of the partnership since the partnership is not likely to incur a foreign tax.

[26]See footnote 14 and Rev. Rul. 74-63, 1971-1 CB 374.

lishment. To the extent that gain may be taxed in the United States in accordance with the treaty, such gain is considered by article XXIV(3)(a) to arise in the United States for the purpose of applying the Canadian foreign tax credit rules.

Notwithstanding this, there may be situations where double taxation can occur. Consider the case of a U.S. branch of a Canadian company that sells inventory outside the United States but through a U.S. fixed place of business. Under the new rules, gain from such sales is U.S. source and therefore the Canadian company cannot use a foreign tax credit in the United States for any foreign taxes imposed (including those imposed by the country where the sales occur) on the gain. If a U.S. company makes the sale instead, gain is considered to be foreign source because the title passage rule was retained for U.S. corporations exporting abroad, regardless of the location of their fixed places of business.[27] Thus, if a U.S. company exports inventory abroad and title passes abroad, the company receives foreign source income, which increases the availability of the foreign tax credit.

The title passage rule for U.S. residents was specifically retained by Congress to help U.S. companies exporting abroad.[28] In the version of the bill passed by the Senate, foreign companies would have been permitted to treat such income as foreign source for purposes of the foreign tax credit allowed to non-residents on effectively connected income.[29] This provision was changed, without explanation, during the conference between the two houses of Congress, apparently because the United States was unwilling to cede primary taxing jurisdiction to a third country in such cases. It is unclear how this disparity would fare under the non-discrimination provisions of tax treaties to which the United States is a party.[30]

Under the Act, the Treasury Department is required to conclude a study of the effect of the title passage rule as the source rule for sales of inventory property and to report to Congress by September 30, 1987. Bills were recently introduced in both houses, however, to delay this study until September 30, 1988.[31] It remains to be seen whether Congress will enact a change in this rule in the future.

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[27]See footnote 20.

[28]S. Rep., supra footnote 17, at 329.

[29]HR 3838, 99th Cong., 2d Sess., section 911 (1986).

[30]See, for example, Canada-U.S. treaty, article XXV(6).

[31]HR Rep. no. 1654, 100th Cong., 1st sess. (1987); S. Rep. no. 817, 100th Cong., 1st Sess. (1987).

COMPLIANCE BURDENS REDUCED IN FINAL FIRPTA WITHHOLDING REGULATIONS

Peter A. Glicklich

Effective generally for transfers of U.S. real property interests on or after January 24, 1987, final regulations ease some of the compliance problems under the withholding rules relating to the Foreign Investment in Real Property Tax Act (FIRPTA) and increase the benefits of obtaining a FIRPTA withholding certificate from the Internal Revenue Service. In addition, new temporary regulations have been issued affecting transfers of interests in publicly traded partnerships and trusts and in real estate investment trusts (REITs). Other regulations have been amended to reflect changes made to the FIRPTA withholding rules by the Tax Reform Act of 1986.

Any person (including a non-U.S. person with no previous contact with the United States) who acquires a U.S. real property interest (USRPI) from a non-U.S. ("foreign") person is subject to the special U.S. withholding rules enacted in 1984 to enforce the Foreign Investment in Real Property Tax Act (FIRPTA) of 1980, as amended. Entities that own USPRIs and that are themselves foreign or are owned at least in part by foreign persons also may be subject to these rules. The FIRPTA withholding rules are found in section 1445 of the Internal Revenue Code of 1986 (the "Code" or "IRC") and several sets of temporary and final Treasury regulations. Various aspects of these rules have been described in previous articles in this feature.[1] For the convenience of the reader, however, the general FIRPTA withholding rules are outlined very briefly below.

Section 1445(a) generally requires persons who acquire a USRPI from a foreign person to withhold 10 percent of the amount realized by the foreign person. The term USRPI is defined broadly to include direct and certain indirect interests in U.S. real property, including in particular an interest (other than solely as a creditor) in a U.S. corporation that at any relevant time during the past five years owned USRPIs that were worth more than its other trade or business assets. The term "foreign person" is defined as any person other than a U.S. citizen or resident individual and other than a U.S. corporation, partnership, trust, or estate. The term "amount realized" means the full purchase price in a sale transaction (without regard to the amount of the cash proceeds) and, in most other transactions, the full fair market value of the USRPI transferred. In all cases, the amount realized includes debts that the transferee assumes or to which the transferred property is subject.

[1] See generally Fred Feingold and Peter A. Glicklich, "Broad FIRPTA Withholding Rules Are Bound To Affect Canadians," in this feature (January-February 1985), 33 *Canadian Tax Journal* 170-88; Sanford H. Goldberg, "IRS Procedures for Obtaining a Withholding Certificate for Sales of U.S. Real Property Interests," in this feature (January-February 1986), 34 *Canadian Tax Journal* 218-27.

The amount to be withheld under section 1445(a) may be reduced or eliminated if the transfer qualifies under one of the exemptions or other special rules listed in section 1445(b). An exemption is provided from FIRPTA withholding where, for example, the interest transferred is stock in a publicly traded U.S. corporation. In addition, either the transferor or transferee may apply for a withholding certificate from the Internal Revenue Service (IRS) for a determination that a smaller amount (based on the transferor's recognized gain and maximum tax rate rather than on 10 percent of the full amount realized) may be withheld. Special rules also set forth the manner of proving that the transferor is not a foreign person or that an interest in a U.S. corporation is not a USRPI.

Under section 1445(e), dispositions of USRPIs by a U.S. partnership, trust, or estate with one or more foreign partners or beneficiaries, distributions of USRPIs by a foreign corporation, and redemptions of the stock or the liquidation of a U.S. real property holding corporation (USRPHC) by a foreign shareholder are currently subject to "entity" withholding rules. As specified in those rules, USRPHCs must withhold 10 percent of the amount realized by a foreign shareholder on a redemption or liquidation. Further, following certain recent amendments, foreign corporations and U.S. partnerships, trusts, and estates must withhold 28 (or 34) percent of the gain includible in the income of a foreign taxpayer.

Under section 1445(d), agents of transferees or transferors may be held liable for the FIRPTA withholding tax (but only up to the amount of their compensation derived from the transaction) if they fail to provide notice that any FIRPTA-related certification issued by their principal is false (for example, if the certification falsely claims that the transferor is not a foreign person or that stock in a U.S. corporation is not a USRPI).

THE FINAL SECTION 1445 REGULATIONS

Temporary regulations under section 1445 (the "former temporary regulations") originally were issued the day immediately before the withholding rules became effective on January 1, 1985.[2] Final section 1445 regulations were issued on December 24, 1986. In large part, the final regulations, which generally are effective with respect to dispositions of USRPIs occurring on or after January 24, 1987, retain the rules set forth in the former temporary regulations. The final regulations, however, simplify the withholding procedures and reduce or eliminate some of the more onerous compliance burdens that existed under the former temporary regulations. The final regulations also clarify a variety of FIRPTA withholding issues, as described below.

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[2]See TD 8000, 1985-1 CB 296 (December 31, 1984), which promulgated former Temp. Treas. Reg. sections 1.1445-1T through 1.1445-7T. Note that in June 1986, in connection with pending tax reform legislation, the Senate approved the *repeal* of FIRPTA and FIRPTA withholding, but the Senate amendment was not adopted in the final version of the Tax Reform Act of 1986, Pub. L. no. 99-514, enacted on October 22, 1986 (herein referred to as "the Act").

Simplification and Easing of Compliance Burdens

Among the changes made by the final section 1445 regulations that will simplify withholding and ease the compliance burdens are the following.

Period for Payment

The former temporary regulations generally required a transferee (or other "withholding agent") to pay over withheld amounts to the IRS within 10 days after the date of the transfer.[3] The final regulations delay the date for paying over withheld amounts until the *twentieth* day.[4]

Non-Recognition Notices

The former temporary regulations provided certain non-statutory exemptions from withholding. One such exemption under section 1445(a) applied to transfers between *unrelated* persons where the transfer was eligible either for exemption from U.S. tax under a treaty or for non-recognition treatment under the Code.[5] In order to qualify for this exemption, the transferor had to provide notice to the transferee that the transfer qualified for exemption or non-recognition treatment, and the transferee had to send a copy of the notice to the IRS by the tenth day after the date of the transfer.[6] Related persons[7] were generally not entitled to rely on these procedures. This limitation theoretically required withholding in many common transactions in which no substantive tax liability would be payable, such as the transfer of a foreign person's USRPI to a wholly owned U.S. corporation in exchange for shares, and resulted in the filing of a significant number of withholding certificate applications that the IRS had to process.

The final regulations broaden the exemption for non-recognition transactions by extending its application to transfers between related parties.[8] The final regulations also extend the time for providing a copy of the non-recognition notice to the IRS from 10 to 20 days after the date of the transfer.

Withholding Certificates

The former temporary regulations included procedural rules explaining how a transferor, transferee, entity, fiduciary, or "relevant taxpayer" could

[3]Former Temp. Treas. Reg. sections 1.1445-1T(c)(1) and 1.1445-5T(b)(5).

[4]Treas. Reg. sections 1.1445-1(c)(1) and (2) and 1.1445-5(b)(5)(i).

[5]Former Temp. Treas. Reg. section 1.1445-2T(d)(2). A transferee could not rely on a non-recognition notice if he knew or had reason to know that the transferor was not entitled to the claimed non-recognition treatment: former Temp. Treas. Reg. section 1.1445-2(d)(ii)(C); see also Treas. Reg. section 1.1445-2(d)(ii)(B) (similar final regulation provision).

[6]Former Temp. Treas. Reg. section 1.1445-2T(d)(2)(i).

[7]Former Temp. Treas. Reg. section 1.1445-2T(d)(2)(ii)(A). For this purpose, the term "related person" was broadly defined to include not only the individual members of a family, but also certain 50 percent directly or indirectly owned entities and commonly controlled entities: see Treas. Reg. section 1.897-1(i). Related parties *could* rely on the exemption for non-recognition transfers under the entity withholding rules of IRC section 1445(e). See former Temp. Treas. Reg. section 1.1445-5T(b)(2).

[8]Treas. Reg. section 1.1445-2(d)(2).

apply to the IRS for a withholding certificate that would permit reduced or zero withholding.[9] The IRS also published procedures for withholding certificate applications involving instalment sales, agreements (with security) for payment of the tax arising as a result of FIRPTA, and requests for "blanket" withholding certificates.[10] Under the temporary regulations, if an application for a withholding certificate were submitted at least *30 days before the date of the transfer*, the date for paying over to the IRS the amount otherwise required to be withheld under section 1445 was postponed until 10 days after the final determination was made on the application.[11]

Although the former temporary regulations provided that the postponed payment rule would not be available if the application were submitted with "a principal purpose of delaying" payment to the IRS of the amount withheld, there was no indication that the IRS interpreted this limitation broadly (since postponement of payment would apparently be a significant reason for applying for many withholding certificates). To prevent abuse, the IRS appeared to be relying instead on the former temporary regulations' rebuttable presumption of tax avoidance purpose, which applied when the amount to be withheld under the certificate as determined by the IRS was 90 percent or more of the amount that otherwise would have been required to be withheld under section 1445 in the absence of a certificate.[12] The final regulations retain this rule.

The final regulations also eliminate the requirement that a withholding certificate application be filed 30 days in advance of a transfer of a USRPI in order to postpone the date for paying over to the IRS the full amount otherwise required to be withheld under section 1445. Under the final regulations, as long as the application is filed *on or before* the date of the transfer (and there is no "principal purpose" to delay paying the amount withheld to the IRS), the due date for paying over withheld amounts is automatically postponed until 20 days after the IRS's final determination on the application.[13]

Although inconsistent with any deferred payment rule, the former temporary regulations also stated in general that a withholding certificate *obtained before* the transfer of a USRPI could be used to reduce the amount to be withheld and paid over to the IRS, but that a withholding certificate

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[9]Former Temp. Treas. Reg. sections 1.1445-3T and 1.1445-6T. See also Rev. Proc. 85-41, 1985-2 CB 482.

[10]Rev. Proc. 85-41, supra.

[11]Former Temp. Treas. Reg. sections 1.1445-1T(c)(2)(i) and 1.1445-5T(b)(5)(ii)(A). Although not specified in the former temporary regulations, the IRS's practice was to treat an application that was properly addressed, stamped, and posted in the U.S. mail by the thirtieth day preceding the date of the transfer as "submitted" on the date that it was mailed. The final section 1445 regulations expressly include such a rule: see Treas. Reg. section 1.1445-1(c)(2)(i).

[12]Former Temp. Treas. Reg. section 1.1445-1T(c)(2)(iii). No such presumption applied to withholding certificates applied for under the entity rules of IRC section 1445(e): see former Temp. Treas. Reg. section 1.1445-5T(b)(5)(ii)(C).

[13]Treas. Reg. sections 1.1445-1(c)(2) and 1.1445-5(b)(5).

obtained after the transfer would only authorize a refund or an "early refund" as provided for in those regulations.[14] The final regulations retain this apparently inconsistent rule.

Under the statute, the IRS has only 90 days in which to act on a withholding certificate application.[15] The former temporary regulations stated that in certain cases more time might be required, in which event the applicant would be notified within 45 days after the application was filed.[16] The final regulations also retain this rule. They clarify, however, that the period for an IRS response does not begin until "all information necessary" for the IRS to make a determination is provided. Perhaps as a result of the 30-day pre-filing rule mentioned above, the IRS apparently received many incomplete applications.[17] Elimination of the 30-day pre-filing requirement should reduce this problem. (Note that the IRS apparently has internal guidelines providing that withholding certificate applications should be issued or denied within *60* days from the date that the IRS receives them.)

In other cases, the IRS found that factual details were changed before a USRPI transfer, and the IRS had no established policy regarding the effect of an amendment to an application on the 90-day period during which an application had to be acted upon.[18] The final regulations provide that an amendment, other than a "substantial" amendment, extends the date by which the IRS must act upon the application by 30 days. A "substantial" amendment extends the date for an IRS response by 60 days. Furthermore, if the IRS receives an amendment after the withholding certificate has been signed by the responsible IRS official but before the certificate is mailed to the applicant, the date by which the IRS must respond is extended by 90 days.

In some cases, FIRPTA withholding applications must be accompanied by security to assure the IRS that the amount of either the substantive U.S. tax liability arising as a result of FIRPTA or the withholding tax set forth in section 1445 will be paid. The former temporary regulations provided that the amount of the security must be sufficient to cover either 125 percent of the "transferor's maximum tax liability" (a defined term), or the amount required to be withheld under section 1445 *plus interest* for the full period between the date of the agreement and the date by which the transferor's

[14]Presumably, there was also a large class of withholding certificates *applied* for before a USRPI transfer but *obtained* after the transfer. In that event, issuance of a withholding certificate probably affected the amount to be paid over to the IRS and did not require the filing of a refund claim.

[15]IRC section 1445(c)(3)(B). The consequences of the IRS's failure to meet this deadline remain uncertain.

[16]Former Temp. Treas. Reg. sections 1.1445-3T(a) and 1.1445-6T(a)(1).

[17]TD 8113 (December 24, 1986), preamble to final section 1445 regulations. There was no indication that the IRS refused to consider the 30-day pre-filing requirement met where the application was incomplete as submitted. The final regulations require the application to be substantially complete before the 90-day period of IRC section 1445(e)(3)(B) begins to run: Treas. Reg. section 1.1445-3(a).

[18]TD 8113, supra.

substantive tax payment was due.[19] Practitioners objected to both the required oversecuritization of the transferor's maximum tax liability (that is, the additional 25 percent, which was supposed to secure interest and penalties for any failure of the transferor to file a U.S. income tax return and to pay his U.S. taxes) and the required payment of interest for periods *before* the date by which withheld amounts would otherwise be paid to the IRS.[20] The final regulations do not require payment of interest for the period before the date by which the withholding agent would otherwise have to pay over withheld amounts to the IRS,[21] but continue to require the additional 25 percent security in other cases.

There was a technical problem under the former temporary regulations that arose in certain transactions (such as the liquidation of a U.S. corporation) that were subject to the withholding rules of *both* section 1445(a) and section 1445(e). Under the former temporary regulations, since the exemptions from withholding were not the same, it was possible for an exemption to apply under only section 1445(e) but not section 1445(a). This was true, for example, where a non-recognition provision applied in a transaction between related parties that was described in both section 1445(a) and section 1445(e) (for example, before 1987, upon the liquidation of a U.S. corporation by its 80 percent foreign corporate shareholder). The rule in the temporary regulations to coordinate withholding under the two sets of withholding rules did not resolve the type of problem noted above.[22] This problem was solved in the final regulations, which expressly state that no withholding is required under section 1445(a) if a transfer of a USRPI described in section 1445(e) is exempt from withholding under the final regulations.[23]

Foreclosures

An exemption provided in the former temporary regulations for foreclosures[24] is extended by the final regulations to transfers of real property by a deed in lieu of foreclosure to a single secured creditor if there is no cash or other property paid on the transfer and if certain notice requirements are met.[25]

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[19]Former Temp. Treas. Reg. sections 1.1445-3T(e)(2) and 1.1445-6T(e)(2).

[20]TD 8113, supra footnote 17. Certain practitioners also pressed for an internal IRS procedure pursuant to which an adverse IRS determination could be appealed, as well as for elimination of the principal purpose limitation described above. Other practitioners apparently considered it inappropriate to require a foreign transferor to file a U.S. federal income tax return if his U.S. federal income tax liability was fully satisfied by withholding under section 1445, but the final section 1445 regulations do not change this requirement.

[21]See Treas. Reg. sections 1.1445-3(e)(2)(ii) and 1.1445-6(e)(2)(ii).

[22]Former Temp. Treas. Reg. section 1.1445-5T(b)(1).

[23]Treas. Reg. section 1.1445-5(b)(1).

[24]The rules relating to foreclosures are also modified to require the involvement of a court or trustee with jurisdiction over the foreclosure action: Treas. Reg. section 1.1445-2(d)(3)(i)(A). Not all foreclosure sales are made under the scrutiny of a court or trustee.

[25]Treas. Reg. sections 1.1445-2(d)(3)(i)(B), 1.1445-2(d)(3)(ii) and (iii).

Initial Public Offerings

The final regulations expand the statutory exemption relating to dispositions of interests in a publicly traded U.S. corporation to cover dispositions "incident to an initial public offering" of registered stock.[26] The reason for this exemption is not clear. Perhaps it is meant to cover activities of foreign underwriters or foreign persons who capitalize such corporations with USRPIs.

Agent Liability

The category of transferor's or transferee's agent is narrowed to exclude any person who is responsible solely for obtaining title or other reports concerning the real property to be transferred or for transmitting or delivering documents between the parties.[27] The members of the governing body of a condominium association or residential cooperative corporation are also generally excluded from the "agent" category.[28] In addition, under the final regulations, an agent is not liable for failing to provide a notice of false certification if the certificate was provided before the agent was hired.[29]

Other Changes

In addition to the changes described above, the final section 1445 regulations include several substantive changes and clarifications. The most important of these changes and clarifications are described below.

"Interest Charge" on Failure to Withhold

The former temporary regulations stated that a withholding agent could be held liable for payment of the FIRPTA tax to be withheld, as well as for civil and criminal penalties for failure to withhold.[30] The temporary regulations did not, however, address the issue of what would happen to a withholding agent if he failed to withhold or failed to pay over withheld amounts to the IRS where the transferor separately paid its U.S. taxes in full or filed a U.S. return showing that it had no U.S. tax liability (for example, as a result of the application of other losses or loss carryovers).

Section 1463 appears to prevent the IRS from asserting liability for taxes or penalties (in the absence of fraud) against a withholding agent where the transferor pays the tax. But section 1463 does not address whether a withholding agent may be liable for interest on the amount required to be withheld. In the absence of an interest charge, a transferee would not have an incentive to withhold if he received sufficient assurance from the transferor that the latter would pay its tax. Finally, very little authority pre-

[26]Treas. Reg. section 1.1445-2(c)(2).

[27]Treas. Reg. sections 1.1445-4(f)(3)(iv) and (v).

[28]Treas. Reg. section 1.1445-4(f)(4). The exclusion does not apply if an individual member's activities include advising the transferor or transferee with respect to the transfer.

[29]Treas. Reg. section 1.1445-4(a)(2).

[30]Former Temp. Treas. Reg. sections 1.1445-1T(e) and 1.1445-5T(b)(6). See IRC section 1461.

viously existed to assure the transferee that section 1463 would apply to protect him where the transferor had no tax liability (for example, as a result of other losses) or, if section 1463 did apply, how it would protect him.[31]

Since section 1463 does not on its face prevent a withholding agent from being held liable for interest on any amount required to be withheld under the foreign withholding provisions of the Code, it appeared that the IRS could assert an interest charge against the withholding agent.[32] The final section 1445 regulations specifically provide for such an interest charge. They state that if a withholding agent fails to withhold the amount required under section 1445, he is liable for interest on the *entire* amount required to be withheld for the period from the last date on which the tax was required to be paid over (generally the twentieth day after the date of the transfer for transfers occurring on or after January 24, 1987) to the earliest of the following: the date on which the tax is actually paid,[33] the date on which the transferor files its tax return and pays the tax due,[34] and the date on which a withholding certificate is issued establishing that the transferor's maximum tax liability is zero.[35] If a withholding certificate that provides for withholding of a reduced amount is issued while interest is running, then for the period beginning on the date *after* the certificate is issued, interest runs only on the reduced amount.

These interest charge rules leave several questions unanswered. For example, although the result should be clear, the regulations do not expressly provide that no interest will run if a *timely* filed application for a withholding certificate is pending on the date of the transfer. In addition, it is not clear whether the IRS will assert an interest charge against a withholding agent with respect to a transfer of a USRPI occurring on or before January 23, 1987.

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[31]See Rev. Rul. 54-584, 1954-2 CB 212 (decided under a predecessor to IRC section 1463).

[32]See Feingold and Glicklich, supra footnote 1, at discussion accompanying footnote 56. In taking the position described below, however, the final section 1445 regulations require a different result than that applicable to the other Code withholding rules dealing with payments to foreign persons. Compare IRC section 1461; Treas. Reg. sections 1.1461-2 and 1.1461-3. Moreover, under the approach of the final regulations, it is possible for the IRS to collect interest twice on the same amount, once from the withholding agent and once from the foreign transferor. Compare Rev. Rul. 58-577, 1958-2 CB 744, dealing with domestic wage and salary withholding. Thereunder, interest may be payable by the withholding agent, but it stops running on the due date for the wage earner's tax return.

[33]This probably includes payment by the transferee, the transferor, or any other person. There is no indication here that the transferor must file its U.S. income tax return to end the interest charge period. If a partial payment is made, it seems clear that the payment should stop additional interest from accruing on that amount. If a late payment is made, query whether the payer can designate that the entire payment be treated as tax, rather than payment of tax and interest.

[34]If, upon an audit of the transferor, it appears that the transferor has not paid its tax in full, query whether the transferee will be liable for interest after the due date of the timely filed return. A transferee who does not satisfy the withholding requirements (which should limit his liability) may wish to protect himself from such exposure by obtaining enforceable indemnities from the transferor.

[35]Treas. Reg. sections 1.1445-1(e)(2)(ii), 1.1445-1(e)(3), 1.1445-1(e)(4), and 1.1445-5(b)(6).

Buyers of USRPIs may be surprised to discover that the regulations provide that, for purposes of ending the interest charge period, the *transferee* is required to provide sufficient information to the IRS to prove that any tax due by the *transferor* has been paid. It is far from clear how the transferee will be in a position to do this unless his purchase agreement requires that, upon reasonable notice, the transferor will provide whatever information the IRS may demand.

In this connection, it should be noted that under the final regulations, a foreign corporation that distributes a USRPI to its shareholders and that must withhold with respect to its own tax liability under section 1445(e)(2)[36] may be liable for at least a partial interest charge even if it timely files its U.S. tax return, pays its required U.S. tax, and pays any required estimated U.S. taxes.

It should also be noted that the IRS is not obligated to pay interest on early refund applications submitted pursuant to the regulations by either the transferee or the transferor. Moreover, no mechanism is provided in the final section 1445 regulations for refunding amounts *to the withholding agent* if the transferor pays its U.S. tax in full and if the withholding agent does not withhold any amount but makes a late payment to the IRS to cut short the running of the interest charge described above. Other regulations, however, appear to provide guidance on this issue.[37]

Joint Transferors; Tax Credit Methods

Joint Transferors

The former temporary regulations did not provide a rule for allocating the amount realized on a joint transfer of a USRPI between or among foreign and U.S. transferors. Ordinarily, purchase agreements made such allocations, but there was a concern that a buyer could be held liable for any misrepresentations concerning ownership made by the sellers of a USRPI. The final section 1445 regulations therefore provide that where a USRPI is transferred jointly by U.S. and foreign persons, the amount subject to withholding is to be determined by allocating the amount realized among the transferors based on the "capital contribution" of each and by aggregating the amounts allocated to the foreign transferors.[38] For this purpose, a husband and wife are each deemed to have contributed 50 percent of their aggregate contributed capital. The term "capital contribution" is not defined in the regulations, however, and thus does not resolve all the issues raised in this area.

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[36]See IRC section 1445(e)(2) and Treas. Reg. section 1.1445-5(d). See also Treas. Reg. section 1.1445-5(b)(7).

[37]See IRC section 1464 and Treas. Reg. section 1.1464-1.

[38]The regulations do not state whether any adjustment to such an allocation should be made for particular and identifiable liabilities of one or more of the several transferors. Moreover, while no withholding is currently required on the transfer of a partnership or trust interest or on a distribution from a partnership or trust, query how future regulations will measure capital contributions in this context.

In most cases, a buyer will be required to ask for additional representations from the sellers of a USRPI regarding the capital contribution of each. Sellers should be willing to make this information available to ensure that an appropriate amount is withheld and credited to each of the sellers. Since the buyer, however, may still be liable for misrepresentations made by the sellers, the buyer may have to demand security or other assurances to limit his exposure for FIRPTA withholding tax, interest, and related penalties.

The former temporary regulations also provided that each foreign transferor would be credited with such portion of the amount withheld as the transferors mutually agreed. That agreement was to be reflected on the withholding forms filed by the transferee, based on a request made by the transferors. The final regulations add that if the transferors *fail to request* such an allocation by the fifteenth day after the date of the transfer, the transferee must allocate the amount to be withheld *equally* among the transferors. If the transferee so acts, the final regulations state that he will be indemnified *under the Code* against any claim by a transferor relating to the division of credits.[39] Nevertheless, a transferee should be aware that there is little authority addressing the scope of the protection afforded to withholding agents under the "indemnification" provision included in the Code. As under the other foreign withholding rules, a withholding agent appears to have a problem under section 1445 whether he underwithholds or overwithholds.[40]

Tax Credits for U.S. Persons

Since section 1445 was designed to enforce FIRPTA, a provision dealing with dispositions of USRPIs by *foreign* persons, the former temporary regulations did not specifically deal with the effect on U.S. transferors of withholding under section 1445. The final regulations clarify that U.S. persons can either credit the amount withheld under section 1445 against their U.S. income tax or apply for an early refund under the normal FIRPTA withholding procedures.[41]

Credit for Withheld Amounts: Proof

Under the former temporary regulations, it appeared that if for any reason the transferor did not receive an IRS-stamped copy of form 8288-A that the transferee had to submit and was therefore unable to attach that copy of the form to its return or claim for refund, the transferor would not be credited with the amounts withheld and paid over to the IRS.[42] Since this rule seemed too harsh, the final regulations provide special procedures under

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[39]Treas. Reg. section 1.1445-1(f)(iv); see IRC section 1461.

[40]See generally Harvey P. Dale, "Withholding Tax on Payments to Foreign Persons" (Fall 1980), 36 *Tax Law Review* 49-100.

[41]Treas. Reg. section 1.1445-1(f)(3)(ii). See generally IRC sections 33 and 1462; compare IRC sections 35, 1464, and 6401(b).

[42]Former Temp. Treas. Reg. sections 1.1445-1T(f) and 1.1445-5T(b)(7).

which the transferor can establish in other ways the amount of tax withheld.[43]

Determination of Amount Realized

The final regulations have been amended to clarify that for purposes of determining the amount to be withheld, the amount realized is not intended to include stated or "imputed" interest.[44] The amendment may be too narrowly drafted,[45] however, and therefore may be read restrictively by the person obligated to withhold under section 1445.

The final section 1445 regulations also provide that no withholding is required if the amount realized on a transfer of a USRPI is zero.[46] That would have appeared self-evident under the statute. Less clear, although implied in the regulations,[47] is that filing of the FIRPTA withholding forms 8288 and 8288-A is excused if, as a result of an exemption, an IRS determination, or any other reason, the amount to be withheld under section 1445 is zero.

Treatment of Options

An option to acquire an interest in U.S. real property is a USRPI.[48] The temporary regulations, however, did not provide any special rules for determining the amount to be withheld on the grant, transfer, exercise, or lapse of an option to acquire a USRPI granted by a foreign person. Based on substantive tax law, it appeared that a grantee of an option was not obligated to withhold 10 percent of the option payment (that is, the amount paid to obtain the option from the grantor) upon the grant or lapse of the option, but was obligated to withhold 10 percent of the full contract price (including the option payment) when the option was exercised. The amount to be withheld on a sale of an option by a foreign option holder to a third party appeared to be based on the full amount realized by the transferor.

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[43]Treas. Reg. sections 1.1445-1(f)(3)(i) and 1.1445-5T(b)(7).

[44]Treas. Reg. section 1.1445-1(g)(5).

[45]The exception for interest is applied only to the amount of cash received or to be received. If interest is payable other than by payment of cash (for example, in foreign currency or in a deferred exchange for real property) or if interest is imputed under IRC section 483 or 7872 (rather than under IRC section 1274), the regulation as drafted may perhaps incorrectly suggest that the amount realized *includes* such interest.

[46]Treas. Reg. section 1.1445-2(d)(8).

[47]See Treas. Reg. sections 1.1445-1(c)(1), 1.1445-1(d), and 1.1445-5(b)(5)(i).

[48]See Treas. Reg. section 1.897-1(d)(2)(ii)(B). The regulation simply states that an option to acquire a USRPI is an interest in real property other than solely as a creditor. Treas. Reg. section 1.897-1(c)(1) provides, in part, that any interest in real property located in the United States or the Virgin Islands other than an interest solely as a creditor constitutes a USRPI. An option to dispose of real property (a so-called put option) would not be covered by Treas. Reg. section 1.897-1(d)(2)(B). It is unlikely, however, that a taxpayer would ever transfer the right to dispose of such property separately from the property itself.

The final section 1445 regulations confirm these results and set forth the option withholding rules in some detail.[49] They do not, however, answer the question whether an amount paid by a grantor to a foreign grantee to *cancel* an option will be treated under the lapse rule, the transfer rule, or some other rule. Presumably, analogies under existing law will be applied to characterize payments for such cancellations.

Note that *two* levels of withholding may be required by a purchaser (but not the original grantee) of an option that was granted by one foreign person to another: once on the acquisition of the option by the third party and again on the exercise of the option (with respect to the full contract price). Note also that, as with any executory contract (that is, one not yet "closed") to acquire a USRPI, an option contract to acquire a USRPI should include a provision authorizing the option holder (or contract buyer) to withhold any required amounts in the event that the owner of the property, at the time of exercise (or closing), is a foreign person.[50]

WITHHOLDING BY U.S. PASS-THROUGH ENTITIES

The following paragraphs describe (1) changes made by the Act to section 1445(e) that are also reflected in the final section 1445 regulations, (2) other changes made to the withholding rules applicable to U.S. trusts and estates, and (3) changes made by new temporary regulations to the FIRPTA withholding rules applicable to distributions by publicly traded partnerships and trusts and by real estate investment trusts (REITs).

1986 Amendments

The Act amended section 1445(e) to change the measure of the amount to be withheld by a U.S. partnership, trust, or estate with one or more foreign partners or beneficiaries on a disposition of a USRPI. Before the amendment, a U.S. partnership, the trustee of a U.S. trust, or the executor of a U.S. estate was required to withhold 10 percent of the amount over which the partnership, trustee, or executor had *custody* and that was both attributable to a disposition of a USRPI and includible in the distributive share of a foreign partner or in the income of a foreign beneficiary. The former temporary regulations read the term "custody" out of the statute and required withholding of 10 percent of the full amount realized on a disposition of a USRPI, the income from which was includible in the distributive share of a foreign partner or in the income of a foreign beneficiary.

As a result of amendments made by the Act, effective for dispositions of USRPIs made on or after November 22, 1986, section 1445(e)(1) now requires a U.S. partnership or the fiduciary of a U.S. trust or estate to

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[49] Treas. Reg. sections 1.1445-1(b)(3) and 1.1445-1(b)(3)(iii).

[50] Compare Treas. Reg. section 1.1445-2(b)(4)(iv), which provides that if a foreign seller disposes of the buyer's note, the *original* buyer is not required to withhold on payments made to the *new* note holder if the original buyer receives a "belated notice" from his agent or the seller's agent to the effect that the original seller's certification of non-foreign status was false.

withhold on a certain percentage of the *gain* (rather than on 10 percent of the amount realized or of the amount in its custody) to the extent that the gain is allocable to a foreign partner or beneficiary.

The applicable rate under *both* the partnership transfer rules of section 1445(e)(1) *and* the foreign corporate distribution rules of section 1445(e)(2) is 34 percent on transfers made in taxable years beginning on or after January 1, 1987, and 28 percent on earlier transfers. *Note that these rules may call for withholding at a 34 percent rate, even though the partner or beneficiary, if an individual, will usually be subject to U.S. tax at a rate of only 28 percent.* Presumably, a partnership, foreign corporation, or any other relevant taxpayer may obtain a withholding certificate from the IRS reflecting his or its actual tax rate. Moreover, the effective dates for the new withholding rates are not well coordinated with the effective date for the new corporate tax rate on net capital gains. Corporations are subject to the new 34 percent tax rate on net capital gains recognized on or after January 1, 1987 *without regard to their taxable year.*

Other FIRPTA Withholding Rules Relating to Partnerships, Trusts, and Estates

The former temporary regulations provided that until future FIRPTA regulations were promulgated, no withholding was required on a transfer of an interest in a partnership, trust, or estate or on a distribution of a USRPI therefrom.[51] The former temporary regulations also provided elective rules for withholding by a U.S. partnership or trust with more than 100 partners or beneficiaries on a distribution (rather than on a disposition of a USRPI).[52] The final regulations continue to provide that until future FIRPTA regulations are promulgated, no withholding is required on a disposition by a foreign person of an interest in a partnership, trust, or estate or on a distribution of a USRPI by a partnership, trust, or estate, whether the partnership, trust, or estate is foreign or domestic.[53] However, the rules for distributions from a U.S. trust or estate out of its "USRPI account" (described in the following paragraphs) must be considered.[54] The final section 1445

[51] Former Temp. Treas. Reg. sections 1.1445-5T(b)(8)(iv) and (v).

[52] Former Temp. Treas. Reg. section 1.1445-5T(c)(3).

[53] See Treas. Reg. sections 1.1445-5(b)(8)(iv) and (v) and 1.1445-5(c)(2)(i). The final regulations also provide that a U.S. partnership having another U.S. partnership as one of its partners is not required to withhold "to the extent that the amount realized is attributable to that partnership's interest" until the effective date of future regulations that include rules governing such tiered partnerships.

The Act also enacted new section 1446, which requires 20 percent withholding on a distribution from a partnership with U.S. effectively connected income. The section 1446 rules will apply to distributions made after future regulations become effective but probably no sooner than January 1, 1988. The future regulations are to coordinate withholding under IRC sections 1445 and 1446. See IRC section 1446(a)(3) and HR Rep. no. 841, 99th Cong., 2d Sess. II-654 (1986).

[54] Treas. Reg. section 1.1445-5(c)(1)(iii).

regulations also continue the elective form of withholding by a partnership or trust with more than 100 partners or beneficiaries.[55]

New U.S. Trust and Estate Withholding Rules

The new FIRPTA withholding rules in the final regulations diverge from the statute in their application to U.S. trusts and estates. Those regulations shift the event requiring withholding from a transfer of a USRPI by the trust or estate to a distribution to a foreign beneficiary out of the trust's or estate's "USRPI account." *Such an account must be established for every U.S. trust or estate that has a foreign beneficiary and that owns a USRPI, effective for the trust's or estate's first year that includes or follows January 24, 1987.*

A USRPI account includes all gains and losses from dispositions of USRPIs occurring during the taxable year and is reduced by distributions made to beneficiaries during the year.[56] The balance in a USRPI account at any time thus represents the undistributed net gain or loss from dispositions of USRPIs by the trust or estate during the current year. Amounts remaining in the account at the end of the year are assumed to be taxable to the trust or estate. The USRPI account balance is reduced to zero before the start of each new taxable year of the U.S. trust or estate.

Foreign Trusts and Estates

Since a foreign trust or estate may be a foreign person under section 1445(f)(3), under the final regulations, as under the former temporary regulations, FIRPTA withholding is required on a disposition of a USRPI by such a trust or estate.

New Temporary Regulations for Publicly Traded Partnerships and Trusts and for REITs

New detailed temporary regulations have been issued that require FIRPTA withholding on a *distribution* made by a publicly traded partnership or trust or by a REIT to its foreign interest holders.[57] Those regulations were published on the same day that the final section 1445 regulations were published and are generally effective with respect to distributions made on or after

[55]See Treas. Reg. section 1.1445-5(c)(3). The final regulations, unlike the former temporary regulations, provide that the election may *not* be revoked without the consent of the IRS. In addition, no election may be made if any interest in a large partnership or trust is regularly traded on an established securities market or if the interest is in a REIT. With respect to these latter interests, see new Temp. Treas. Reg. section 1.1445-8T, described below. Compare former Temp. Treas. Reg. section 1.1445-5T(c)(3)(iii). A further election is provided to such a large partnership or trust that makes recurring sales of growing crops or timber. The extra election permits withholding on a distribution to a foreign partner or beneficiary in an amount representing an allocable portion of 10 percent of the amount realized by the entity (rather than 34 percent of the gain attributable to the foreign partner or beneficiary).

[56]Distributions are deemed to come first from the balance in the USRPI account. The withholding rate applicable to such distributions depends on the trust's or estate's taxable year in which the distributions occur. The rate is 28 percent for taxable years beginning before January 1, 1987, and 34 percent for taxable years beginning on or after January 1, 1987.

[57]TD 8114 (December 24, 1986) and Temp. Treas. Reg. section 1.1445-8T.

January 24, 1987. Certain persons treated as withholding agents (as determined under the new temporary regulations) may, however, elect to apply the new rules to any distributions made after December 24, 1986.[58] The new temporary regulations govern highly specialized situations. Therefore, only a general overview of those rules is provided below.[59]

With respect to distributions from a publicly traded partnership or trust, the *optional* FIRPTA withholding method available to a partnership or trust with more than 100 partners or beneficiaries *must* be used.[60] However, the person who is to withhold with respect to a distribution from the partnership or trust to a foreign partner or beneficiary may be a nominee for the interest holder rather than the partnership itself or the fiduciary of the trust. A "nominee" is defined for this purpose as any U.S. person who holds an interest in the distributing entity on behalf of another U.S. or foreign person.[61] A nominee is responsible for withholding in such cases if he receives both (1) a distribution (attributable to a disposition of a USRPI) directly from the partnership or trust or indirectly through another nominee and (2) a notice of the distribution, in a form that complies with certain U.S. securities laws.[62] Additional persons may be subject to these withholding obligations in other cases.[63]

With respect to distributions from a REIT, the REIT itself or a nominee for the interest holder must withhold 34 percent of any distribution that is made on or after January 1, 1987 with respect to each share of the REIT stock owned by a foreign person and that is designated by the REIT as a capital

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[58]TD 8114, supra, preamble.

[59]Pursuant to Treas. Reg. section 1.897-1(c)(2)(iv), if any class of interest in a partnership or trust is "regularly traded on an established securities market," then for purposes of the FIRPTA withholding rules and certain FIRPTA rules, an interest in the entity is not treated as an interest in a partnership or trust. Instead, the interest is treated as an interest in a publicly traded *corporation*. Therefore, a holder of 5 percent of the beneficial interest in such a partnership or trust could be subject to FIRPTA and FIRPTA withholding on a disposition of the interest. (It is not clear whether it matters for this purpose whether the partnership or trust is a foreign or U.S. partnership or trust. There appears to be nothing in the regulations that requires an interest in a *foreign* partnership or trust to be considered to be an interest in a *U.S.* corporation.) In addition, a disposition of a USRPI by a publicly traded *U.S.* partnership or trust is subject to the FIRPTA withholding rules of section 1445(e)(1); but see Temp. Treas. Reg. section 1.1445-8T. Note, however, that the temporary regulations are not by their terms restricted to publicly traded *U.S.* partnerships or trusts.

The new temporary regulations also provide that the early refund procedure set forth in the final section 1445 regulations does *not* apply to a person with respect to whom amounts have been overwithheld under those regulations: Temp. Treas. Reg. section 1.1445-8T(h). The withholding agent and the relevant taxpayer are to rely instead upon regulations promulgated under other Code provisions relating to adjustments to withheld amounts on U.S.-source payments: see Treas. Reg. section 1.1461-4. But see section 6402(b)(l) (foreign corporate partner may not be entitled to a *refund* of overwithheld amounts).

[60]Temp. Treas. Reg. section 1.1445-8T(c)(1).

[61]Temp. Treas. Reg. section 1.1445-8T(d).

[62]Temp. Treas. Reg. section 1.1445-8T(b)(1).

[63]See, for example, Temp. Treas. Reg. section 1.1445-8T(b)(2).

significant burdens under the FIRPTA withholding rules have come to rest on U.S. buyers of U.S. real property, U.S. entities with foreign investors, and foreign corporations operating in the United States, rather than on the archetypical foreign investors in U.S. real estate with no other U.S. contacts.

The final section 1445 regulations simplify and reduce some of the burdens imposed upon buyers of USRPIs and other FIRPTA withholding agents. However, while the extension of the non-recognition notice procedure to related party transfers may reduce somewhat the number of withholding certificate applications, the elimination of the 30-day advance filing requirement for a withholding certificate application and the imposition of an interest charge for a failure either to withhold the full statutory amount or at least to file for a withholding certificate on or before the date of the transfer of a USRPI can be expected to result in a substantial *increase* in the number of FIRPTA withholding certificate applications filed with the IRS. This will increase paperwork for both the taxpayers and the IRS. Moreover, additional FIRPTA rules (for example, those governing dispositions of interests in and distributions from partnerships) and a related complex of additional FIRPTA withholding rules remain to be issued.

Advisers to Canadian buyers or sellers of USRPIs may have to study the present rules in detail. They should also be prepared for further developments.

FURTHER DEVELOPMENTS

Although the fast pace of U.S. tax developments makes it impracticable to bring readers up to date on all topics discussed in previous articles in this feature, significant developments have been selected for review in this section.

REPEAL OF U.S. TAX ON PORTFOLIO INTERESTS[1]

In the last episode of the portfolio interest saga, it was noted that disagreement had erupted among certain members of Congress on the issue of whether the 1984 Congress had intended to limit the scope of the portfolio interest exemption solely to interest on obligations "of a type offered to the public." That issue has, at least for the moment, been put to rest. In December 1986, the Treasury Department issued amended temporary regulations and adopted other final regulations affecting the U.S. tax exemption for U.S. source portfolio interest.[2]

[1] See Fred Feingold and Richard G. Fishman, "Elimination of the 30 Per Cent Tax on Portfolio Interest," in this feature (September-October 1984), 32 *Canadian Tax Journal* 983-96; "Further Developments," in this feature (September-October 1985), 33 *Canadian Tax Journal* 1064-67.

[2] TD 8111 (December 19, 1986).

Perhaps the most important change in these regulations is the retroactive elimination of the prerequisite that the underlying obligations be "registration required."[3] The effect of this change is to extend the exemption for portfolio interest to interest paid on obligations *other than* those of a type offered to the public,[4] obligations that would not have qualified for the exemption under the temporary regulations that were initially issued in 1984.[5]

Portfolio interest does not include interest received by a 10 percent shareholder or partner. The December 1986 temporary regulations initially set forth a strict 10 percent ownership test that would have limited the portfolio interest exemption to a very narrow class of obligations.[6] In February 1987, however, the Treasury Department withdrew the temporary regulation dealing with 10 percent ownership, effective retroactively. Therefore, privately placed obligations of a U.S. issuer, for example, should qualify for the exemption so long as the prohibited 10 percent ownership does not in fact exist and so long as other technical requirements are met.

BRANCH LEVEL TAXATION

In our recent article on the new branch level taxes enacted by the Tax Reform Act of 1986,[7] we noted that the branch profits tax (as opposed to the branch level tax on excess interest) is imposed on a base roughly equivalent to the amount that a foreign corporation subject to the tax could distribute by way of dividend out of its current earnings that are effectively connected with any U.S. trade or business, including any after-tax gain realized on the disposition of its U.S. business assets. Since the amount of any incremental investment in U.S. business activities is not generally available for distribution, the imposition of the branch profits tax is deferred by such additional investment. This deferral terminates, however, whenever there is a reduction in U.S. investment.

The above rules would literally require that the branch profits tax be imposed on any after-tax gain realized on the sale of all the U.S. business assets of a foreign corporation. The rules would also effectively require that any previously deferred branch profits tax be imposed on the transfer of a foreign corporation's U.S. branch to a wholly owned U.S. subsidiary or on the liquidation of a foreign corporation, because the corporation's direct ownership of U.S. business assets is reduced. In many cases, this would result in greater taxes on U.S. business activities carried on by branches of foreign corporations than on activities carried on by their U.S. subsidiaries. Apparently this was not intended.

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[3]See Temp. Treas. Reg. sections 35a.9999-5(a), Q&A-1, and 35a.9999-5(b), Q&A-8.

[4]The exemption is also extended to interest on obligations of individuals and obligations with maturities of one year of less. The exemption does not apply to bank loans.

[5]TD 7967, 1984-2 CB 329 (August 17, 1984).

[6]Temp. Treas. Reg. section 35a.9999-5(f) (withdrawn).

[7]See Fred Feingold and David M. Rozen, "Branch Level Taxation—A Second Level of Concern," in this feature (September-October 1986), 34 *Canadian Tax Journal*, 1192-1207.

In Notice 86-17,[8] the Internal Revenue Service announced that regulations will provide that, except in certain abusive cases, the branch profits tax will not be imposed for any year in which a foreign corporation completely terminates all of its U.S. businesses. Thus, under the regulations to be promulgated, a branch profits tax will not result if either a foreign corporation sells all its U.S. business assets to an unrelated party or the foreign corporation is liquidated following such a sale. In addition, if the U.S. business assets of a foreign corporation are transferred to a U.S. corporation in a tax-free rollover or if there is a non-taxable reorganization or liquidation of a foreign corporation that has U.S. business assets, the transfer of the U.S. business will not be treated as a reduction in the U.S. investment, although the foreign corporation will be subject to the branch profits tax in the year that the U.S. business is transferred.

Stay tuned for further developments in this area to see whether the language of the regulations actually promulgated truly equates doing business in U.S. corporate solutions with doing business in foreign corporate solutions.

MORE RESIDENCE RULES

As previously noted in this feature,[9] section 7701(b) of the Internal Revenue Code provides that an alien is a "resident alien" subject to U.S. tax on his worldwide income if he spends 183 days or more in the United States during a calendar year or if he spends a weighted average of 183 days there that takes into account his presence in the two prior calendar years. As a result, if an individual is not a U.S. resident in year one (say, 1986), does not spend significant time in the United States in year two (1987), then moves to the United States in the latter part of year two, and remains there during year three (1988), he is not a resident until year three. During year two, as a non-resident alien, he is not entitled to the tax benefits to which a resident alien is entitled.

The Tax Reform Act of 1986 (the "new law") permits an alien who is a resident in year three to elect to be taxed as a resident for a portion of year two (the "election year"). He may make the election if

- he is present in the United States for at least 31 consecutive days in the election year, and
- during the period beginning with the first of those 31 consecutive days and ending on the last day of the year (the "testing period"), he is present for at least 75 percent of the number of days in the testing period, less 5 days.

For the purpose of calculating the number of eligible days, days on which the individual is an exempt individual (such as a teacher or foreign government relative individual) or is unable to leave for medical reasons do not

[8] 1986-52 IRB 19.

[9] Sidney I. Roberts and Marlene F. Schwartz, "New Statutory Definition of Resident Alien," in this feature (September-October 1984), 32 *Canadian Tax Journal* 969-82.

count. Days on which the individual commutes from Canada to work in the United States, which do not count for the presence tests, do count for the purpose of determining eligibility under this election.

The election must be made by attaching a statement to the individual's resident income tax return for the year of election. The election may not be made until the individual satisfies the substantial presence test for the year following the election year. Resident income tax returns are due on April 15 of the year following the year to which they relate. By this date, an individual will probably not have been present for enough days to be a resident in the third year. Accordingly, he may request an extension of time for filing his tax return until he is present for a sufficient number of days to qualify. With the extension request, however, he must pay the tax that would be payable by a non-resident.

In addition, under prior law, a teacher or trainee who was admitted under the appropriate provision of the Immigration and Naturalization Act and was in compliance with certain conditions could avoid resident classification for two out of any six years. The new law exempts a teacher or trainee for four out of six years if he is compensated only by a foreign employer.

The new law also does not count the days that a professional athlete spends in the United States competing in a charitable sports event that meets certain technical requirements.