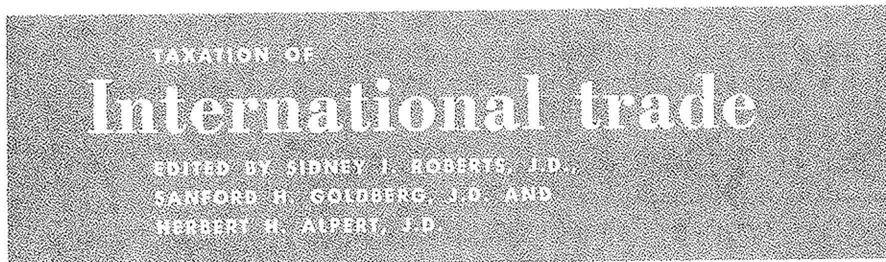

Onerous FIRPTA reporting requirements replaced by new broad withholding rules

by **FRED FEINGOLD** *and* **PETER A. GLICKLICH**

The new law imposes a scheme of withholding by transferees and other persons where a foreign person realizes an amount on the disposition of a U.S. real property interest. The authors analyze the new rules as they affect corporations, partnerships, and others.

THE DEFICIT REDUCTION ACT of 1984, P.L. 98-369, 7/18/84 (the "Act") introduced new and extremely broad withholding rules that generally will require tax to be withheld in connection with the disposition after 1984 by a foreign person of a U.S. real property interest ("USRPI"). The new rules treat the person acquiring a USRPI from a foreign person (and in certain cases agents of the buyer or seller, as well as certain other persons) as withholding agents, making them liable for the tax required to be withheld. Because it is contemplated that at least in most cases all or a significant portion of the tax liability arising from the disposition of a USRPI by a foreign person will be collected by withholding at the source, the new provisions no longer attempt to enforce the collection of such tax by information reporting-requirements. Thus, the new provisions relieve many foreign persons from filing information returns with respect to USRPIs held through intermediate foreign entities.

Background

FIRPTA[1] added Sections 897 and 6039C to the Code. In general, Section 897 treats gains and losses of a foreign person from the disposition of a USRPI as income or loss which is "effectively connected" with a U.S. trade or business deemed to be carried on and, as a result, subjects such gains in excess of such losses to Federal income tax under Sections 871(b)(1) and 882(a)(1). "USRPI" is broadly defined to include not only directly-held real property "interests" but also "interests"[2] in a U.S. corporation if, at any time during the specified test period (generally, the five years preceding the date of the disposition of the stock in question, but ignoring any period prior to 6/19/80), the corporation qualified as a United States real property holding corporation ("USRPHC"). A corporation is considered to be a USRPHC for any calendar year if, on any "determination date"[3] during such year, 50% in value of the corporation's assets[4] consisted of USRPIs. USRPI does not include stock of a foreign corporation; however, compensating rules apply to distributions of USRPIs made by foreign corporations. In some circumstances a foreign corporation and its shareholders can elect to have the corporation treated for purposes of Sections 897 and 6039C as if it were a U.S. corporation.[5]

FIRPTA imposed a comprehensive set of reporting requirements that, in a number of cases, could have required the disclosure of the identity of a foreign person who was unlikely to have had any liability for the tax imposed as a result of FIRPTA, simply because the foreign person held a beneficial interest in intermediate foreign entities. Pursuant to a somewhat unusual provision, persons otherwise required to file information reports could avoid doing so by entering into a security agreement with IRS and by providing the Service with adequate security for the payment of any tax that could be imposed as a result of FIRPTA. The implementation of the reporting requirements and related security agreement procedures was left to Regulations. Temporary Regulations under Section 6039C were not issued until 1982, but those Regulations raised a number of problems. Before they could go into effect, all reporting and related security agreement requirements under Section 6039C were suspended, pending the issuance of a set of modified Regulations,[6] which were never issued.

Limited information reporting

The Act substantially modified the reporting requirements of Section 6039C, effectively eliminating the old provision that, absent a security agreement, required disclosure of the identity of foreign owners of foreign corporations which owned U.S. real estate. While amended Section 6039C permits Regulations to be adopted that will require reporting, the Regulations may do so only (1) if a foreign person has a direct investment in a USRPI that has a value of $50,000 or more and (2) if the foreign person is not otherwise engaged in a U.S. trade or business.[7]

For purposes of determining whether the $50,000 threshold is met, USRPIs held in a partnership, trust, or estate are treated as owned proportionately by the partners or beneficiaries. However, a foreign person who owns shares in a foreign corporation that owns real estate in the U.S. will not be required to file an information return regarding his indirect ownership, but the foreign corporation holding the real estate either will have to file income tax returns as under prior law (if it is engaged in a U.S. trade or business) or, to the extent provided in Regulations to be promulgated, will have to file information returns under Section 6039C (if the interest is worth at least $50,000). Since the shares of a U.S. corporation (or of a foreign corporation electing to be treated as a U.S. corporation for purposes of Section 897 and 6039C) can be (and indeed are presumed to be) USRPIs, foreign shareholders may be required to report their ownership of such shares. Non-U.S. persons who wish to avoid FIRPTA reporting entirely will be required to hold investments in U.S. real property through foreign corporations that have not elected treatment as a U.S. corporation.

Section 1445 withholding rules

Subject to certain "exemptions" and "limitations," new Section 1445 generally provides that a "transferee," as well as certain other persons, is required to

deduct and withhold a tax in connection with the *realization* by a foreign person of an amount relating to the *disposition* of a USRPI.

While Section 1445 appears in Chapter 3 of the Code (Section 1441 *et seq.),* the obligation to "deduct and withhold" a tax under Section 1445 may be broader than the obligation to withhold a tax contained elsewhere in Chapter 3.[8] While a person's liability to deduct and withhold a tax under the provisions of Chapter 3 other than Section 1445 appears to be limited to the amount with respect to which he was actively involved and over which he had control,[9] no such limitation appears in Section 1445.[10] Thus, as used in Section 1445, the phrase "deduct and withhold" could possibly be interpreted to mean "pay," regardless of whether there are sufficient proceeds over which the person liable to deduct and withhold has custody. For example, it is clear that for purposes of Section 1445 the amount realized by the transferor includes the amount of any liabilities assumed by the transferee or to which the property is subject, even though the amount represented by such liabilities would not appear to be within the control of the transferee.[11] Similarly, the full amount realized in an installment sale will be subject to withholding, even though payment of only a small fraction of the total contract price is made in the year of sale.

For Section 1445(a) to be applicable, there must be a disposition of a USRPI in which an amount is realized, *i.e.,* there generally must be a sale or exchange or other transaction that would result in a taxable gain or loss in the absence of a nonrecognition provision. Thus, gifts of USRPIs and USRPIs passing on death would, generally, not give rise to an amount realized. However, in the case of a part-gift, part-sale (*e.g.,* where there was a mortgage in excess of basis), there could be an amount realized.

Significantly, the requirement of withholding applies to sales or exchanges of USRPIs by foreign persons regardless of whether gain is recognized on the sale or exchange. In this connection, pursuant to Section 897(e), nonrecognition provisions ordinarily do not apply in the case of a sale or exchange of a USRPI by a person to whom Section 897 applies. However, until Regulations provide otherwise, an exchange of a USRPI for an interest the sale of which would be subject to tax may still obtain nonrecognition treatment. Notwithstanding this, such a transfer appears to be covered by the general rule that requires withholding under Section 1445. To avoid withholding in such a case, a request must be made to the Service for a determination that the maximum tax liability is less (*i.e.,* zero) pursuant either to Sections 1445(b)(4) or 1445(c)(1)(B) or, possibly, Section 1445(c)(2) (see the discussion below).

By way of illustration, assume P, a Panama corporation, owns a USRPI that it "contributes" to the capital of a wholly-owned U.S. corporation (a USRPHC) in a transaction qualifying under Section 351. Even though no gain is recognized, Section 1445 will have to be considered. If an amount were realized by P on the transfer, then, subject to Section 1445(b) or (c), the U.S. corporation would have an obligation to withhold a tax unless one of the specified exemptions or limitations applied. In this connection, the result under Section 1445 may depend on whether P received stock (and/or securities) in exchange; if not, then arguably no amount was realized.[12]

It appears that whether or not stock were issued by the domestic corporation receiving the contribution, such corporation would not have realized anything. Of course, if the corporation to which the USRPI had been contributed was a foreign corporation with respect to which a Section 897(i) election was not in effect, the transferor woud recognize gain under Section 897(j).

Now assume P is a wholly-owned subsidiary of N, also a Panama corporation, and P distributes a USRPI to N pursuant to a liquidation that qualifies under Section 332. In that case, Section 897(d)(1)(B)(i) will apply to the distribution; consequently, no gain will be recognized as a result of Section 897(d). It appears that gain will not be realized by P on such distribution[13] and that, therefore, the general rule requiring withholding also will not apply. This conclusion appears to be supported by Section 1445(e)(2), which provides that in the case of a distribution by a foreign corporation in which gain is recognized under Section 897(d) or (e), the foreign corporation is to deduct a tax (equal to 28% of the amount of gain recognized), possibly implying that if gain were not recognized under those sections, there need be no withholding under the general rule. As discussed below, this will have additional significance in the case of a foreign corporation to which a Section 897(i) election is in effect (an "electing foreign corporation").

[1] Foreign Investment in Real Property Tax Act of 1980, P.L. 96-499. As used herein, "FIRPTA" also refers to subsequent amendments of Sections 897 and 6039C other than the amendments made by the Deficit Reduction Act.

[2] "Interest" is broadly defined to include any economic interest other than "solely as a creditor." See Section 897(c)(1)(A)(ii); Temp. Reg. 6a.897-1(d)(7); Prop. Reg. 1.897-1(d)(5). The latter phrase is, in turn, defined narrowly to exclude any indebtedness which has an equity feature (*e.g.,* a conversion privilege or a right to share in appreciation in value or in gross or net profits). Temp. Reg. 6a.897-1(d)(4); Prop. Reg. 1.897-1(d)(3). See generally Feingold, "FIRPTA—An Overview of the New Proposed Regulations," 32 *Canadian Tax J.* 147 (Jan.-Feb. 1984); Feingold and Alpert, "Observations on the Foreign Investment in Real Property Tax Act of 1980," 1 *Va. Tax Rev.* 105 (1981).

[3] The Temporary and Proposed Regulations provide that such determinations need only be made for specified dates. See Temp. Regs. 6a.897-2(c), 6a.897-2(d)(1)(v), 6a.897-2(e); Prop. Regs. 1.897-2(b), (c). *Cf.* Section 897(c)(1)(A)(ii).

[4] Generally speaking, a corporation's assets for this purpose include only its USRPIs, its interests in foreign real property, and its other assets "used or held for use in a trade or business." See Section 897(c)(2)(B).

[5] See generally Silbergleit, *The 897(i) election: Impact of Prop. Regs. on affected foreign corporations, shareholders,* 60 JTAX 103 (February 1984); Silbergleit, *The 897(i) election: Whether and when to elect and other planning considerations,* 60 JTAX 178 (March 1984).

[6] See IR-83-7, 1/10/83; TD 7890, 1983-1 CB 304; TD 7940, IRB 1984-12, 9.

[7] Section 6039C(b); Section 6039C(b)(3) treats USRPIs held by the spouse or minor child of an individual as owned by that individual.

[8] See generally Dale, "Withholding Tax on Payments to Foreign Persons," 36 *Tax L. Rev.* 49 (1980); see also Roberts and Warren, *U.S. Income Taxation of Foreign Corporations and Nonresident Aliens,* at VIII-1 to -63 (1968).

[9] See, *e.g., Bank of America NT & SA v. Chaco,* DC Guam, 2/14/79.

[10] This is particularly significant because Section 1461 makes any person who is required to deduct and withhold a tax under Chapter 3 liable for the tax. This Section generally has been interpreted as imposing liability on a "withholding agent" (a term used in Section 1463) not only for the tax he has deducted and not paid over as required, but also for a tax he has inadvertently failed to deduct and withhold. In this connection, it may be possible to argue that Section 1461 merely renders a person liable for the tax he has actually withheld and has not paid over but does not render him liable for a tax he has inadvertently failed to withhold. Such an argument would appear to be consistent with (1) the imposition of the 100% penalty under Section 6672 only for a *willful* failure to withhold, (2) the issuance of Rulings excusing a failure to withhold based on reliance on an affidavit of ownership (see Reg. 1.1461-1(a); *Rev. Rul.* 68-237, 1968-1 CB 391), and (3) the Service's own internal policy under which it would not seek to impose a liability for "the tax" under Section 1461 and a 100% penalty under Section 6672 (see 1 IRM (CCH) P-5-60). However, the courts have thus far not been confronted with such an argument. See, *e.g., Coastal Chemical Corp.,* 546 F.2d 110 (CA-5, 1977) (assuming that Section 1461 applied to a failure to withhold); *S-K Liquidating Co.,* 64 TC 713 (1975) (similar). *Cf.* Sections 6651 (penalty for failure to file a statement or return); 6653 (negligence penalty for underpayment of tax); 6656(a) (penalty for failure to deposit a tax); 6601(a) (payment of interest).

Persons against whom there may be withholding. In general, withholding applies in the case of a disposition of a USRPI by a foreign person. "Foreign person" is defined by Sections 1445(f)(3) and 7701(a)(30) so as to include a nonresident alien, a foreign corporation, a foreign partnership, and a nonresident estate or trust. Since that term does not include a U.S. partnership or U.S. resident estate or trust, no withholding will be required on the disposition by such an entity of a USRPI, but compensating rules in Section 1445(e)(1) provide that some withholding may be required in connection with sales or other dispositions of USRPIs by such persons (discussed below).

A Section 897(i) election allows a foreign corporation (which is entitled to make the election) to be treated as a domestic corporation for purposes of Sections 897 and 6039C but not for purposes of Section 1445.[14] Thus, notwithstanding that for FIRPTA purposes an electing foreign corporation is generally to be treated no worse than a U.S. corporation in similar circumstances, Section 1445 treats such an electing foreign corporation as subject to withholding under Section 1445 whereas a domestic corporation is not so treated.[15] While in many cases withholding against an electing foreign corporation will not result in a major problem (such a corporation will be able to credit the tax withheld against its tax liability), there will be cases where problems will arise, only one of which appears to have been contemplated.

In the case of gain from a sale by an electing foreign corporation qualifying for Section 337 nonrecognition treatment, the foreign corporation will not be subject to tax on the sale of a USRPI. Nevertheless, the transferee of a USRPI must withhold a tax from the electing foreign corporation unless an agreement is obtained absolving it from this responsibility. If withholding were required, there could conceivably be "double" withholding. This is because it appears that the electing foreign corporation, if its shares are USRPIs, also would be required to withhold on the distribution to its foreign shareholders in exchange for their shares.[16] In an attempt to mitigate the burden imposed in the case of an electing foreign corporation entitled to nonrecognition as a result of Section 337, the Conference Report contemplates that the IRS will prescribe Regulations allowing foreign shareholders in an electing foreign corporation to credit any tax withheld on a qualifying Section 337 liquidation-related sale of a USRPI "against their FIRPTA tax liability" on a liquidating distribution.[17]

While not certain, the Regulations may provide that the tax withheld against the electing foreign corporation is to be treated as cash distributed to the foreign shareholders, in effect providing such shareholders with an indirect credit and a gross-up. If this approach is adopted, the Regulations may further provide that the electing foreign corporation is to be deemed to have withheld against its foreign shareholders the amount withheld against it, and that such withholding is to be in lieu of or at least is to be credited against the amount the electing foreign corporation would otherwise have to withhold on the distribution to its foreign shareholders.

Even if the Regulations were to adopt this approach, other problems would continue to exist. For example, the Conference Report limits the contemplated pass-through credit to foreign shareholders. If such a limitation is imposed, U.S. shareholders of electing foreign corporations will be treated worse than foreign shareholders.[18]

Persons who must withhold. In general, unless one of the enumerated exemptions[19] apply, a transferee of a USRPI must withhold the appropriate amount of tax under Section 1445. Not surprisingly, "transferee" is broadly defined in Section 1445(f)(2) to include any person (whether or not a U.S. person) acquiring a USRPI. As so defined, a transferee would include not only a purchaser of a USRPI, but any persons receiving a USRPI in a contribution to or distribution from an entity as well.[20] Nevertheless, while "transferee" literally includes persons acquiring USRPIs from any person (with certain exceptions noted below), under Section 1445(a) a withholding liability can arise only where a *foreign* person has disposed of a USRPI.

In addition to transferees, certain other persons are required to withhold under Section 1445. Included in this category is a foreign corporation distributing a USRPI in a transaction in which gain is recognized under Section 897(d) or (e). Under Section 1445(e)(2), such a foreign corporation is required to "withhold" its own tax. In addition, it would appear that the distributee of such USRPI is a transferee with respect thereto and therefore also must withhold against the distributing foreign corporation. Since it is unlikely that Congress intended to require two withholdings on the same gain, one by the distributing foreign corporation and one by the distributee, it appears reasonable to assume that Section 1445(e)(2) preempts the application of the general rule of Section 1445(a). Otherwise, to avoid the anomalous result of overwithholding, a clearance would have to be obtained from the Service.

If the foreign corporation were an electing foreign corporation, it would not be required to withhold its own tax since it would not recognize gain under Section 897(d) or (e). However, it would be possible for the electing foreign corporation to be viewed as a transferee pursuant to Section 1445(e)(3) if a distribution were in liquidation or in redemption.

A person acquiring a USRPI from a domestic partnership, trust, or estate need not withhold on such acquisition since the entity making the transfer is not a foreign person. However, under Section 1445(e)(1), the partnership, trust, or estate must withhold with respect to the amount attributable to the disposition of a USRPI which is includable in the income of a foreign person (see discussion below). In addition, all partnerships, trusts, or estates (whether foreign or domestic) may be required to withhold 10% of the fair market value of any USRPI distributed to a foreign person if such distribution would constitute a taxable distribution pursuant to as-yet unproposed Regulations to be promulgated under Section 897(g). It is not clear why this rule has been inserted. If, for example, the distribution of the USRPI by a partnership were pro rata to all partners, it would seem that the normal nonrecognition rule of Section 731 would apply.[21] In the event the distribution were non-pro rata, it would be possible for the Regulations to treat the USRPI in the same manner as "hot assets" are treated under Section 751 (b).[22] However, in such circumstances it

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would seem that the foreign person acquiring the USRPI would be deemed to have purchased it, not disposed of it. It would seem odd for withholding to be required on the purchase of a USRPI by a foreign person, so perhaps something else is intended.

Under a somewhat related provision, a person acquiring an interest in a partnership, trust, or estate may be treated by Regulation in the same manner as a transferee of a USRPI, at least to the extent of USRPIs held by such entity.[23] Absent this special provision, a person acquiring an interest in a partnership would *not* be required to withhold because such an interest is not a USRPI.

Not only are the above persons required to withhold but in certain cases so is a transferor's or transferee's agent. However, for an agent to have any liability under Section 1445, the agent (1) must have been required to provide the transferee with notice that reliance on a "nonforeign affidavit" of the transferor, or on a statement to the effect a domestic corporation is and was not a USRPHC, would be misplaced and (2) must not have given such notice. A transferor's or transferee's agent is required to provide such notice if he has actual knowledge of the false statement. In this connection, in the case of a foreign *corporate* transferor, its agents are deemed to have actual knowledge of the falsity of a nonforeign affidavit provided by such transferor.[24]

For this purpose, a transferor's or transferee's agent is any person who represents the transferor or transferee in any negotiation related to the transaction or in settling the transaction, but a person who merely receives or disburses funds in connection with the the transaction or records any document relating thereto is expressly excluded.[25]

In the event a transferor's or transferee's agent fails to provide the required notice, he will be liable as a withholding agent. However, under Section 1445(d)(2)(B), his liability cannot exceed his compensation in connection with the transaction.

Amount to be withheld. While in general the amount to be withheld is 10% of the amount realized from the disposition of the USRPI, there are several exceptions to the general rule.

First, in the case of distributions by foreign corporations of USRPIs, under Section 1445(e)(2), the amount to be "withheld" is 28% of gain recognized.

Second, under Section 1445(e)(1), U.S. partnerships, trusts, and estates are to "withhold" 10% of the amount *within their custody* that is both (1) attributable to the disposition of a USRPI and (2) includable in the income of a foreign person (*e.g.*, partner or beneficiary). While the emphasized language, if taken literally, may permit the argument that the amount subject to withholding in the case of a disposition by a partnership does not include liabilities assumed or taken subject to in connection with such disposition, whether such a different result was intended here appears questionable.

Third, under Section 1445(c)(1), the amount to be withheld cannot exceed the *transferor's maximum tax liability* as determined by the Service upon a request made to it. In this connection, "transferor's maximum tax liability" means the sum of (1) the maximum amount that the Service determines can be imposed as a result of Section 871(b)(1) or 882(a)(1) by reason of the disposition, plus (2) the amount the Service determines to be the transferor's unsatisfied withholding liability. For this purpose, under Section 1445(f)(5), the "transferor's unsatisfied withholding liability" means not only the withholding obligation, if any, imposed by Section 1445 on the transferor's acquisition of the USRPI, but also includes any withholding obligation imposed by Section 1445 on "the acquisition of a predecessor interest," to the extent such obligation has not been satisfied.

Assume foreign person A sells a USRPI to U.S. person B for $100, B fails to withhold the required $10, and A has not paid the tax; B then transfers the USRPI to C, a foreign person, for $200 and C sells it to D for $200. In connection with the last sale, C obviously does not wish to have $20 withheld since C has no gain and can have no income tax liability. Unfortunately for C, his maximum liability is $10. *i.e.*, the unpaid prior withholding liability of B. Notwithstanding that C's maximum tax liability is $10, a question arises as to whether in the situation posited D will have any liability if he does not withhold. In this connection, Section 1463 provides that if any tax required to be withheld is paid by the recipient of the income (or by a withholding agent), it shall not be re-collected from the withholding agent. It further provides that in such case no penalty will be imposed.[26]

Fourth, the amount to be withheld may be reduced or eliminated if the transferee receives a "qualifying statement" from the Service pursuant to Section 1445(b)(4) both to the effect that (1) either the transferor (or transferee) has reached agreement for the payment of the tax imposed by Section 871(b)(1) or 882(a)(1) on any gain recognized by the transferor on the disposition of the USRPI, or the transferor is exempt from tax on such gain, and (2) the transferor or transferee has satisfied any transferor's unsatisfied withholding liability or has provided adequate security to cover such liability.

Presumably, the IRS will agree, pursuant to a request for a qualifying statement, to the first requirement where gain is not recognized by the transferor (for example because of a special basis

[11] See H. Rep't No. 98-861, 98th Cong., 2d Sess. 942-43 (1984); *Crane*, 331 U.S. 1 (1947). Apparently, the reasons for including the full amount realized in the general withholding computation under Section 1445 relate to the administrative convenience available from a rule requiring withholding at a flat rate (*i.e.*, 10%) which does not require the transferor of a USRPI to prove his tax basis to the transferee, and to the flexibility built into the statute by involving the Service in determining whether the withholding obligation should be reduced. An analogous withholding problem might arise in the case of a net lease of real estate. See *Rev. Rul.* 73-522, 1973-2 CB 226 (nonresident alien net lessor subject to withholding on amounts paid by net lessee in addition to net rents, to the extent such amounts constituted gross rental income). However, a net lessor may obtain relief through a net election pursuant to Section 871(d) or 882(d) or an applicable treaty provision.

[12] But *cf*. Sections 367(c)(2), 897(j).

[13] See *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1936). But see Section 311(d).

[14] H. Rep't No. 98-861, *supra* note 11 at 946-47. The Proposed Regulations under Section 897 require that, as a condition to making the election, the electing foreign corporation agree to be subject to tax on the disposition of a USRPI as if it were a domestic corporation. Prop. Reg. 1.897-3(c)(3).

[15] It does not appear that this unequal treatment would violate a nondiscrimination provision of an applicable tax treaty, because the ultimate tax liability is not affected.

[16] Assuming the corporation qualified as a USRPHC, the foreign shareholders would be realizing an amount on the disposition of a USRPI (*i.e.*, their shares of the electing foreign corporation), and the electing foreign corporation would appear to be a transferee with respect thereto.

[17] H. Rep't No. 98-861, *supra* note 11 at 947.

[18] The problem also arises in the case of other asset transfers that qualify for nonrecognition treatment. See, *e.g.*, Sections 351, 361.

[19] See Section 1445(b) and discussion *infra*.

[20] See, *e.g.*, Sections 1445(e)(2), (3), and (4).

[21] *Cf*. Section 897(e)(1).

[22] Regs. 1.751-1(b)(2) and (3).

[23] Section 1445(e)(5).

[24] H. Rep't No. 98-861, *supra* note 11 at 941; Section 1445(d)(1)(B)(i).

[25] Sections 1445(d)(3), (4), and (5).

provision of an applicable treaty[27] or an applicable nonrecognition provision), or where any recognized gain is offset by other "effectively connected" recognized losses.

Fifth, Section 1445(c)(2) gives the Service the authority to prescribe a reduced amount to be withheld under Section 1445 if the Service determines that such reduced amount will not jeopardize the collection of the tax imposed by Section 871(b)(1) or 882(a)(1). The Conference Report is silent as to when and under what circumstances the Service will act under this provision. It appears unlikely, however, that the Service would willingly reduce the amount to be withheld to the tax liability of the transferor computed without regard to the "transferor's unsatisfied withholding obligation." Whether a court will insist otherwise, at least insofar as that obligation pertains to predecessor transferors, may be a different issue.

In some cases, there will not be sufficient proceeds to pay the amount required to be deducted and withheld, absent a statement from the Service providing for a reduced amount of withholding. This is because, as noted above, the amount realized by a foreign person relating to the disposition of a USRPI includes the amount of any liabilities assumed by the transferee or to which the property disposed of is subject.[28] In such cases it may be possible, pursuant to Section 1445(c)(2) or 1445(b)(4), for the transferor or transferee to obtain the Service's agreement to a reduced

A Transactional Perspective

Dispositions by corporations. Different withholding rules may apply depending on whether the corporation is foreign or domestic, whether the corporation is disposing of a USRPI or other property, and whether the disposition is to shareholders or to others; if the disposition is a distribution to shareholders, the rules may vary depending on whether the distributing corporation is foreign or domestic (and, if foreign, whether it is an electing foreign corporation), whether property or cash is being distributed (and if property, whether the property constitutes a USRPI), whether the distribution is a dividend, a Section 301(c)(3) distribution, a distribution covered by Section 302 (other than Section 302(d)), or a distribution in liquidation, and whether the shareholder receiving the distribution is a foreign person.

1. Distributions by U.S. corporations. *To U.S. persons:* No withholding is required under Section 1445 in this case, regardless of whether the property being distributed is a USRPI and regardless of whether the distribution is a dividend, is in redemption, or is in liquidation.

To foreign persons: To the extent the distribution constitutes a dividend, no withholding is required under Section 1445, but withholding may be required under other Code sections (depending on the source of the distribution and other factors) at a 30% rate (or such lower rate as may be prescribed by treaty).

To the extent the distribution is not treated as a dividend, and is treated as a disposition in exchange for stock of the foreign shareholder, whether the distribution falls under Section 301, 302, or is in liquidation, as long as the U.S. corporation is (or during the applicable period was) a USRPHC, the corporation would be required to withhold on the distribution under Section 1445 to the extent it was acquiring a USRPI in connection with the distribution (for example, by way of cancellation of shares in redemption or liquidation). In the case of a nondividend distribution in which there is no cancellation of shares, it is unclear whether withholding would be required under Section 1445. This is because the distributing corporation would not appear to be acquiring a USRPI as a result of such distribution and therefore, would literally not be a transferee. Contrast that situation with one in which there is a cancellation of shares. For example, Section 1445 (e)(3) provides for withholding in cases where there is a distribution of property in liquidation or in redemption of shares qualifying under Section 302. In both of these cases, the distributing corporation would be acquiring its own shares. Significantly, in the case of an interim distribution by a domestic USRPHC as to which gains were realized by a foreign shareholder by virtue of Section 301(c)(3), the foreign shareholder's gain would be subject to FIRPTA. If the domestic corporation were not a transferee with respect to that distribution, however, it might not be required to withhold on the distribution. It would be difficult to rationalize such a different result under Section 1445 in that case as a matter of tax policy.

2. Distribution by nonelecting foreign corporations. *USRPIs:* If gain is recognized under Section 897(d) or (e) on a distribution of a USRPI by a foreign corporation, the foreign corporation must withhold against its own liability at a rate equal to 28% of the gain recognized (Section 1445 (e)(2)). This withholding requirement applies regardless of whether the shareholder is a foreign person and regardless of whether the distribution is a dividend, a return of capital, or in liquidation.

Cash or property other than USRPIs: No withholding is required under Section 1445 on such a distribution, but withholding may be required under the other provisions of Chapter 3 of the Code with respect to distributions treated as a dividend from U.S. sources.

3. Distributions by electing foreign corporations. Complications can arise in this case because an electing foreign corporation is treated as a domestic corporation for the substantive provisions of FIRPTA but as a foreign corporation for purposes of Section 1445.

Thus, for example, since Sections 897(d) and (e) have no application to an electing foreign corporation, if an electing foreign corporation were to distribute a USRPI in *liquidation,* Section 336 would (subject to new Section 367(e)) provide for nonrecognition treatment to the corporation. (Section 367(e), added by the Act, is applicable to liquidating distributions by U.S. corporations to foreign shareholders; literally, it would not apply to an electing foreign corporation. This point may be dealt with by Regulations; *cf.* Prop. Reg. 1.897-3(c)(3). Section 336 will continue to apply until Regulations are

amount.[29] In this connection, it appears questionable that a transferee would be held liable for an amount of tax which is in excess of the proceeds payable to or for the account of the seller.[30] Nevertheless, assuming that none of the exemptions from withholding (described below) apply, it is probably wise for the transferee to require, as a condition of closing, that a formal indication be obtained from the Service that the transferee will not be held liable beyond the proceeds payable to the seller.

Whatever the answers to these issues, it is clear under Section 1445(c)(3)(B) that the Service must "take action" within 90 days of receipt of a request under Section 1445(b)(4) (request for a qualifying statement), 1445(c)(1)(B) (request for a determination of the transferor's maximum tax liability), or 1445 (c)(2) (request for a reduced amount of withholding). However, neither the statute nor the Conference Report indicates what type of action must be taken by the Service. Presumably, the mere acknowledgement of a request would not constitute the required action. Whether a final decision is required within 90 days may be another issue, although the Conference Report states that "[i]n some cases, the Service's action in response to these requests may not establish the amount of tax due."[31]

What would be the effect if the Service were not to "take action" within the period allowed? It might conceivably be argued by an aggressive taxpayer that the request should be deemed to have

promulgated.) As a result, new Section 1445(e)(2) (relating to distributions of USRPIs by foreign corporations in which gain *is* recognized as a result of Section 897(d) or (e)) would not apply. Moreover, Section 1445(e)(3) (relating to distributions by domestic corporations) would not apply. Nevertheless, the electing foreign corporation might be required to withhold as a *transferee* in connection with the disposition by its shareholders of shares in the corporation (*e.g.*, in a redemption or liquidation), assuming that shares in the corporation were USRPIs.

In addition, the shareholders of the electing foreign corporation would be required to withhold as transferees on the disposition by the electing foreign corporation of any USRPIs distributed in liquidation. Assuming gain were not recognized by the liquidating electing foreign corporation, the corporation or its shareholders should be able to obtain a qualifying statement or other agreement eliminating the requirement that its *shareholders* withhold against it on the distribution of a USRPI. (See Sections 1445(b)(4), (c)(1)(B) and (c)(2).) On the other hand, if the electing foreign corporation recognized gain on the distribution of USRPIs, the shareholders would have to withhold as transferees of a USRPI, but in that case, depending on whether Section 897(c)(1)(B) were to apply, the electing foreign corporation might not have to withhold a tax either against its own tax liability or against that of its shareholders on the distribution.

Partnership, trusts, and estates.

1. Dispositions of USRPIs by a foreign partnership, trust, or estate to a third party. Since such an entity is a foreign person, disposition of a USRPI by such entity would require withholding by the transferee, absent an applicable exemption.

2. Disposition of USRPIs by a U.S. partnership, trust, or estate to a third party. Since such entities are not foreign persons, they are not subject to withholding on dispositions of USRPIs. The identity of a partner of the partnership is not controlling. Thus, a foreign partnership with U.S. partners is subject to withholding, but a domestic partnership with foreign partners is not. In the latter case, the domestic partnership *would* have to withhold the tax respecting gain includable in the income of its foreign partners; the U.S. partnership must withhold a tax of 10% on the *portion* of the *amount within its custody* which is attributable to a disposition of a USRPI, *and* which is *includable* in the income of a foreign person. (Section 1445(e)(1). This requirement applies regardless of whether the partnership, trust, or estate makes a distribution in connection with the disposition. Significantly, unless Regulations provide otherwise, a partnership, trust, or estate may not be able to rely on a nonforeign affidavit from its partners or beneficiaries because they are not transferors, and the partnership is not a transferee; see Section 1445(b)(2).)

3. Distributions of USRPIs by a partnership, trust, or estate (whether foreign or domestic). On a distribution of a USRPI to a foreign person by a partnership, trust, or estate, withholding of 10% of the fair market value of the property distributed will be required if, pursuant to Regulations to be promulgated under Section 897(g), such a distribution is a taxable event. Section 897(g) deals with gain from the sale of interests in partnerships, trusts, or estates. Presumably, Section 1445(e)(4) contemplates, for example, Regulations dealing with non-pro rata distributions.

Under Section 731, a partner recognizes gain to the extent cash distributed by a partnership exceeds his basis in the partnership. Under Section 752, cash is deemed to be distributed to a partner to the extent his share of partnership liabilities is reduced. The Regulations should address whether any such distribution would be subject to withholding under Section 1445(e)(4). (Such a determination may arise as a consequence of Section 707(a)(2), added by the Act.)

4. Disposition of an interest in a partnership, trust, or estate (whether foreign or domestic). Pursuant to Regulations to be promulgated, a transferee of any partnership interest or an interest in a trust or estate may be required to withhold a tax equal to 10% of the amount realized on the disposition (Section 1445(e)(5)). Presumably, the Regulations will cover partnerships (and trusts or estates) that own USRPIs and will provide for a lesser amount of withholding if the partnership (trust or estate) owns other property (*cf.* Section 897(g)). Alternatively, a transferor or transferee could obtain a statement from the Service, under the procedures noted above, that a lesser amount should be withheld. ☆

been granted if no action were taken in the allotted time. Still other issues may arise in connection with action that is taken that is not to the liking of the taxpayer. For example, would the decision of the Service be reviewable by the courts and, if so, what standard of review would be used?[32]

Exemptions from withholding. In addition to the special rules limiting the amount to be withheld, there are a series of exemptions which permit a transferee to avoid withholding altogether, and sometimes without any action by the Service. First, under Section 1445 (b)(2), no withholding is required if the transferee has obtained a "nonforeign affidavit" of the transferor (to the effect that the transferor is not a foreign person; the transferor must include his taxpayer identification number on the affidavit). Second, under Section 1445(b)(3), a transferee of an interest in a domestic corporation will be excused from withholding if it has received an affidavit from the domestic corporation to the effect that it is not then nor at any time during the applicable five-year period was a USRPHC.

The application of the second exception to the case of an electing foreign corporation may yield surprising results. For example, a foreign corporation that makes a Section 897(i) election is treated as a U.S. corporation for the operative provisions of FIRPTA. Accordingly, a sale of shares of such a corporation will be subject to FIRPTA to the same extent a sale of shares in a U.S. corporation would be. Consider the case of a sale of shares in an electing foreign corporation that is not (and was not) a USRPHC. Both the Temporary and the Proposed Regulations provide procedures under which it can be established that a U.S. corporation (or an electing foreign corporation) is not a USRPHC.[33] If those procedures are followed, the seller will be able to avoid Section 897(a), but apparently he (and his transferee) will not be able to avoid Section 1445, unless another exemption applies or a clearance is obtained from the Service in the form of a qualifying statement or a qualifying statement or otherwise.

Under Section 1445(b)(7), a transferee will not be excused if he has actual knowledge that the affidavits referred to above are false. Nor will the transferee be excused if he has received a notice to that effect from the transferor's agent or his own agent. Furthermore, in the event Regulations are promulgated which require a transferee to furnish a copy of such affidavit to the Service and the transferee fails to do so, the above exceptions will not apply. Given that the acquisition of either of the two affidavits described above will be a complete defense in the absence of contrary knowledge or notice, in appropriate cases such affidavit should be included as part of the closing documents.

Third, under Section 1445(b)(5) no withholding is required if the property is acquired by the transferee for use by him as his residence (it need not be his principal residence) and the amount realized by the transferor in the transaction does not exceed $300,000. Significantly, this exception applies whether or not the transferor used the property as his residence.

If any class of stock of a corporation is regularly traded in an established securities market,[34] stock of such class is treated as a USRPI only in the hands of a 5%-or-greater owner of such stock.[35] Thus, a 5%-or-greater owner of publicly-traded stock of a domestic corporation is subject to FIRPTA on the disposition of such stock. Nevertheless, under Section 1445(b)(6), withholding is not required, regardless of the number of shares held by the transferor before or after such disposition.

Finally, as previously indicated, withholding is not required if the transferee receives a qualifying statement from the Service to the effect that the transferor has obtained an agreement for the payment of its tax liability or is exempt from tax on the transfer and that the unsatisfied withholding liability, if any, has been satisfied or adequately secured.[36]

Credit for tax withheld. Any amount of tax withheld under Section 1445 will be creditable against the tax liability of the person realizing an amount from the disposition of the USRPI.[37] In the event the tax withheld exceeds the tax liability of the foreign person in connection with the disposition of the USRPI, a refund may be obtained pursuant to what is apparently intended as a new quick refund procedure which allows for the processing of refund claims prior to the date prescribed for filing of the tax return for the year of transfer of the USRPI.[38]

Conclusion

Because the new FIRPTA-related withholding rules are so broadly drafted, practically every conceivable transaction involving a direct or indirect interest in U.S. real estate is or may be subject, at least *a priori*, to withholding under new Section 1445, even though the statute applies only where a foreign person realizes an amount from the disposition of a USRPI after 1984.

A person acquiring an interest in U.S. real property after 1984 should not assume, at least without some contrary proof, that the person who is the transferor of the interest is not a foreign person or that stock acquired (other than stock regularly traded on an established securities market) of a domestic

[26] See also Reg. 1.1463-1. Any amount withheld in these circumstances will be creditable to C; C will be able to obtain an early refund of any amounts withheld in excess of the "transferor's maximum tax liability." Section 1445(c)(1)(C) expressly provides for such refund, subject to Regulations to be promulgated, and the Conference Report indicates that the refund can be obtained even *before* a tax return is required to be filed. The existence of such a quick refund procedure suggests that Congress would expect D to withhold in the hypothetical situation described in the text. However, there may be a constitutional issue as to whether D could be held liable in this situation to satisfy another person's tax. *Cf. Hoeper v. Tax Commission of Wisconsin*, 284 U.S. 206 (1931) (holding as an unconstitutional violation of due process a Wisconsin statute that treated a wife's income as that of her husband and as to which graduated tax rates were applied).

[27] See the recently ratified U.S.-Canada Convention, Art. XIII(9).

[28] *Crane*, *supra* note 11.

[29] The Conference Report suggests that such requests made by the *transferee prior* to the disposition may not be routinely granted. See H. Rep't No. 98-861, *supra* note 11 at 942-43.

[30] To conclude otherwise would effectively preclude any person from acquiring a USRPI from a foreign person in a foreclosure sale, absent an agreement from the Service to a reduced amount of withholding. *Cf.* H. Rep't No. 98-861, *supra* note 11 at 942.

[31] H. Rep't No. 98-861, *supra* note 11 at 943.

[32] *Cf. Estate of Gardner*, 82 TC No. 74 (discretion granted the Secretary under Section 6081 to permit additional time to file an estate tax return is subject to review by a court for arbitrariness); Reg. 1.9100-1 (providing discretion to the Secretary to permit additional time to file certain elections).

[33] See Temp. Regs. 6a.897-2(b), (d), and (k); Prop. Reg. 1.897-2(g).

[34] See Prop. Regs. 1.897-1(m) and (n). *Cf.* Temp. Reg. 6a.897-1(m).

[35] Sections 897(c)(3) and 897(c)(6)(C).

[36] Section 1445(b)(4). For a similar exemption, see the discussion relating to Section 1445(c), *supra*.

[37] Sections 33 and 1462. To take more advantage of the time value of the money withheld, based on the credit mechanism and the different withholding rules, a foreign corporation may choose to make a Section 897(i) election that it would not otherwise have made before the enactment of Section 1445, or to close a transaction earlier than it otherwise would have.

[38] Section 1445(c)(1)(C); H. Rep't No. 98-861. *supra* note 11 at 943. See *supra* note 26.

[39] *Cf.* Sections 861(a)(5), 862(a)(8), 6039C(d).

or foreign corporation is not a USRPI (*e.g.*, the stock of a foreign corporation may be a USRPI because of a Section 897(i) election). In each of the above cases, the buyer should demand appropriate affidavits and warranties to that effect.

Moreover, in order to be able to plan effectively, the inquiry as to whether withholding is required in any given transaction will have to be made early enough so that there will be sufficient time either to determine the amount to be withheld or to apply for a statement to permit reduction of the amount otherwise required to be withheld.

As has been noted, the Service is required to act on such requests within 90 days of any such application. Given the number of transactions potentially subject to withholding, however, if requests are made under Section 1445(b)(4), 1445(c)(1), or 1445(c)(2) even in a small percentage of those cases, it seems possible that the Service will not be able to deal fully with all such requests in a timely fashion. This suggests that there will be some difficulty in the administration of the new provisions. Moreover, the withholding rules fail to address certain issues, including their application to the mirror-tax system of the Virgin Islands.[39] The extent to which such difficulties will interfere with an orderly real estate market remains to be seen. ☆

When foreign tax credit accrues on contested tax

THE SERVICE, in *Rev. Rul.* 84-125, IRB 1984-34, 5, has given guidance on the timing of a foreign tax credit for an accrual basis taxpayer when the foreign tax assessment is contested by the taxpayer. According to the IRS, the credit accrues in the taxable year to which the tax relates and can be claimed in the year the tax is paid to the extent paid, even though the final determination of the liability comes later.

The facts ruled upon by the IRS involved an accrual basis domestic corporation, which in 1973 was assessed an additional tax liability by a foreign country for 1971. The taxpayer contested the assessment but paid a portion in 1973 nonetheless. In 1978, the final determination of the liability was made and taxpayer paid the remaining tax.

Section 905(a) prescribes that the foreign tax credit may be taken in the year in which the tax accrued. In *Rev. Rul.* 58-55, 1958-1 CB 266 the IRS had ruled that for purposes of the foreign tax credit, a foreign tax is accruable for the taxable year to which it relates even though it might be contested and not paid until a later date. That Ruling further noted, however, that since the timing of accrual is still governed by Section 461, the accrual will generally not be made until the contested liability is finally determined.

In *Rev. Rul.* 70-290, 1970-1 CB 160, the Service went one step further and ruled that where a portion of a contested foreign tax was actually paid, the accrual of that portion for the year to which it related could be made at the time of payment even though the final tax liability had not yet been determined. The reasoning was that Section 905(c) contemplated a credit for taxes paid to a foreign government and that a redetermination of the credit is to be made if taxpayer gets a tax refund.

Thus, based on the foregoing, the Service found that the taxpayer could claim the foreign tax credit in 1973 for the amount it paid in that year and which accrued in 1971. The credit for the remainder, which was also accrued in 1971 and was paid in 1978, could be claimed in 1978. Further, a claim for refund due to the increased foreign tax credit must be made within ten years from the date the return is due for the year in which the foreign tax accrued, in this case, 1971. ☆

New foreign decisions this month

No dependency exemptions allowed for children who were citizens and residents of Poland. *(TCM)*

Taxpayer, a Polish citizen and resident of the United States, claimed dependency exemptions for his two children by a prior marriage. The children were both citizens and residents of Poland. The Service disallowed the exemptions on the ground that neither child met the citizenship or residency requirement of Section 152(b)(3).

Held: For the Commissioner. The taxpayer's children are excluded from the statutory definition of dependent under Section 152(b)(3) because as citizens and residents of Poland, they were not citizens, nationals, or residents of the United States nor of a country considered contiguous to the United States. *Pike-Biegunski*, TCM 1984-288.

Temporary Regs. will soon be issued on information reporting with respect to foreign transactions. *(IR)*

The Service has announced that it will soon issue Temporary Regulations relating to the information reporting and backup withholding requirements for certain foreign-related transactions. The Temporary Regulations will outline the conditions under which certain foreign offices of U.S. brokers will not be required to file information reports for payments to foreign customers, and will provide that information reporting and backup withholding generally will not apply to foreign offices of foreign brokers making payments to U.S. customers. In addition, under the Temporary Regulations, the date on which U.S. offices of banks or brokers must begin backup withholding on pre-1984 accounts of foreign customers has been extended from 1/1/84 to 1/1/85. IR-84-73, 6/28/84.

Additional guidelines relating to the boycott provisions of Section 999 have been issued. *(Notice)*

Additional guidelines relating to the enforcement of the provisions of Section 999, which deny certain tax benefits for participation in, or cooperation with, international boycotts, have been issued. Generally, the guidelines clarify in question and answer form the operations in, or related to, a boycotting country which must be reported on Form 5713 and the actions that constitute participation in, or cooperation with, an international boycott under Section 999. *Notice*, 84-7, IRB 1984-22.

Incorrect line reference in Form 5735. *(Ann.)*

The March, 1984 version of Schedule P of Form 5735, Allocation of Income and Expenses under Section 936(h)(5), contains an error on line 4(b), Part II. It now reads "Cost sharing amount from line 7, Part I." It should read "Cost sharing amount from line 5, Part I." Corporations that have elected to be treated as a possessions corporation under Section 936 but not yet filed Schedule P should take this into account. Corporations that have already filed should take no further action until contacted by the IRS. A revised, corrected version of the form will be issued shortly. *Ann.* 84-88, IRB 1984-36, 31.