

REPORT #694

TAX SECTION

New York State Bar Association

Proposed Technical Corrections

July 3, 1991

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July 3, 1991

The Honorable Fred T. Goldberg, Jr.
 Commissioner of Internal Revenue
 1111 Constitution Avenue, N.H.
 Washington, D.C. 20224

Re: Proposed Technical Corrections Act
 Amendment to Section
 1445(e)(3) (FIRPTA Withholding on
Corporate Distributions)

Dear Commissioner Goldberg:

H. R. 1555, the proposed Technical Corrections Act of 1991 ("the Bill"), was introduced in the House on March 21, 1991.¹ The purpose of this letter² is to recommend changes in section 103(c) of the Bill. This provision would modify the rules governing withholding under section 1445³ on certain distributions with respect to stock of a United States real property holding corporation ("USRPHC").

¹ An identical bill, S-750, was introduced on the same day in the Senate.

² This letter was prepared principally by Kenneth R. Silbergleit, Co-Chair of the Committee on U.S. Activities of Foreign Taxpayers.

³ Except where otherwise indicated, all section references herein are to sections of the Internal Revenue Code of 1986 ("Code") or the regulations thereunder.

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Section 1445(e)(3) generally requires a USRPHC to deduct and withhold a tax equal to lot of the amount realized by a foreign shareholder on any distribution of property by the USRPHC to which section 302 (distributions in redemption) or part II of subchapter C of the Code (distributions in liquidation) applies. Section 103(c) of the Bill would add the following sentence at the end of section 1445(e)(3):

Rules similar to the rules of the preceding provisions of this paragraph shall apply in the case of any distribution to which section 301 applies and which is not made out of the earnings and profits of such a domestic corporation.

The Joint Committee on Taxation's explanation of this provision⁴ notes that a section 301 distribution in excess of earnings and profits, like a redemption or liquidating distribution, is treated as a disposition by the shareholder. The provision would subject such distributions to the same FIRPTA withholding obligations.

Recommendations

We agree that FIRPTA withholding should apply in appropriate circumstances to section 301 distributions. We believe, however, that the enactment of section 103(c) of the Bill in its current form would lead to complexity and confusion and possible duplicative withholding. It is improper to place a withholding agent in a position where its obligations are uncertain and it risks either alienating its payees or subjecting itself to personal liability for taxes. A withholding agent's obligations should be clearly defined.

The problem we see with the legislation is that it fails to provide a mechanism to deal properly with the section 301(c)(1), 301(c)(2) and 301(c)(3) components of distributions and to

⁴ See Highlights & Documents, March 22, 1991, 2961-2962.

coordinate section 1441 and section 1445 withholding. We strongly recommend that the legislation either be modified to provide such a mechanism or, more realistically and as was the case with section 1445(e)(5), be made effective only upon the issuance of regulations providing such a mechanism.

One factor favoring the latter approach is that the Internal Revenue Service ("Service") is in the process of revising the section 1441 regulations (see Announcement 90-64, 1990-19 I.R.B. 1) and it would seem sensible to append new section 1445(e)(3) withholding to this project. The new section 1445(e)(3) requirements could then become effective upon the effective date of the revised section 1441 rules.

Whether the solution is provided by legislation or regulations, in order to provide withholding agents time to implement appropriate procedures, the withholding obligation should not be effective earlier than 30 days after the legislation is enacted or the regulations are promulgated.

Discussion

Under section 301(c)(1), to the extent a section 301 distribution by a corporation is a dividend (generally, is paid out of the corporation's earnings and profits), the distribution is included in income by the shareholder as ordinary income. Under section 301(c)(2), any portion of a distribution that is not a dividend is first applied against and reduces the adjusted basis of the shareholder's stock in the corporation. Finally, section 301(c)(3) treats any excess over the shareholder's adjusted basis in the stock as gain from the sale or exchange of property.

With respect to substantive tax liability, a foreign person is generally subject to 30% U.S. tax (unless reduced by treaty) on the dividend (i.e., section 301(c)(1)) portion of the distribution. Sections 871(a)(1)(A); 881(a)(1). The section 301(c)(2) portion is a non-taxable

return of capital. The section 301(c)(3) portion is gain which, in the case of a distribution by a USRPHC, is treated under section 897(a) as effectively connected with a U.S. business, and is subject to tax at the graduated rates of up to 31% for nonresident alien individuals (28% for long-term capital gains) and 34% for foreign corporations.

With respect to withholding tax liability, pursuant to sections 1441(a) and 1442(a), a corporation is generally required to deduct and withhold tax at the rate of 30% (or lower treaty rate) on the amount of "dividends" paid to a foreign shareholder. In order to deal, however, with the problem that earnings and profits for the entire year generally will not be known at the time of the distribution, Treas. Reg. section 1.1441-3(b)(1)(ii) requires the corporation to withhold on the entire amount of any distribution (that is, on the section 301(c)(2) and (c)(3), as well as (c)(1), portion of the distribution). While an exception applies to any amount treated as "a distribution in part or full payment in exchange for stock," Revenue Ruling 72-87, 1972-1 C.B. 274, sets forth the Service's view that a section 301(c)(3) distribution, unlike a liquidating distribution, is not treated as a distribution in exchange for stock for this purpose.⁵

⁵ Revenue Ruling 72-87 is unobjectionable insofar as it authorizes a corporation to withhold on distributions in order to protect itself from liability where the corporation cannot be certain of the amount of its earnings and profits. The result in the ruling is questionable, however, insofar as it operates to require withholding on a distribution where a corporation is confident that the distribution is not out of earnings and profits and this ultimately proves to be the case. We believe that Revenue Ruling 72-87 unduly limits the phrase "payment in exchange for stock" under Treas. Reg. section 1.1441-3(b)(1)(ii) (at least to the extent the ruling requires withholding), or that Treas. Reg. section 1.1441-3(b)(1) is itself

Accordingly, while the proposed revision of section 1445(e)(3) would exclude dividend distributions from section 1445 withholding, the section 1441 regulations (as interpreted by the Service) do not exclude nondividend distributions from section 1441 withholding; thus, if the proposed revision were enacted, duplicative withholding could potentially result. However, pursuant to Treas. Reg. section 1.1445-5(b)(1), if tax is required to be withheld under section 1441 or 1442, no withholding is required under section 1445 or Treas. Reg. section 1.1445-5. Thus, unless this anti-duplication rule is modified or is considered to be overturned by the proposed revision of section 1445(e), it appears the revision would rarely apply. It is doubtful that the proposed legislation is intended to have such a limited scope. On the other hand, it would make no sense to require withholding under both sections 1441 and 1445.

Other mechanical issues need to be addressed. First, while the proposed revision of section 1445(e)(3) excludes dividend distributions from section 1445 withholding, it does not provide any mechanism for determining what part of a distribution is out of earnings and profits and, therefore, not subject to section 1445 withholding. As noted above, it is because of this difficulty that the section 1441 regulations require withholding on the full amount.

Second, how is a corporation to determine whether shareholders receiving a section 301 distribution are foreign persons and, therefore, subject to withholding? While the section 1441 regulations permit reliance on the payee's address (Treas. Reg. section 1.1441-3(b)(3)), the regulations under section 1445(e) require a corporation to obtain a certificate of non-foreign status from its shareholders to fully protect itself*

* overbroad if it is read to mandate withholding on amounts that are not "dividends" as required by section 1441. However, Revenue Ruling 72-87 remains the position of the Service.

from liability for failing to withhold (Treas. Reg. section 1.1445-5(b)(3)).

Another problem relates to section 301(c)(2) distributions. Such distributions are treated as a return of capital and, accordingly, no gain is recognized for purposes of section 897. Yet, the proposed revision to section 1445(e)(3) would appear to apply to section 301(c)(2) distributions. Some mechanism should be provided to eliminate any withholding on the section 301(c)(2) portion of a distribution.⁶ The regulations provide an exception to the withholding requirement in the case of nonrecognition transactions if proper notice is given (see Treas. Reg. section 1.1445-5(b)(2)), but it is doubtful whether section 301(c)(2) qualifies as a nonrecognition provision. While it would be possible to apply to the Service for a withholding certificate under Treas. Reg. section 1.1445-6 to reduce or eliminate the required withholding, this procedure is cumbersome as applied to a series of routine corporate distributions. We suggest the implementation of a simpler mechanism similar to Treas. Reg. section 1.1441-3(d)(2), whereby the shareholder notifies the corporation of the amount of its basis so as to enable the corporation to determine the portion, if any, of the distribution that will result in gain to the share-holder.

In summary, since withholding on the full amount of a distribution is already required under the section 1441 regulations, it is unclear why the revision to section 1445(e) is being proposed. Is it due to concern that taxpayers are not complying with the section 1441 regulations on the (perhaps proper) ground that they are an invalid extension of

⁶ If a mechanism for eliminating withholding on section 301(c)(2) distributions is provided, it would seem proper to require withholding at the rate of 34% (or perhaps 31% or 28% for individual shareholders), rather than 10%, on the section 301(c)(3) portion of a distribution because that portion constitutes gain in full. Compare sections 1445(e)(1) and (e)(2).

the statute? Is it due to concern with the exceptions to section 1441 withholding, such as for effectively connected income, or concern that treaties may reduce the dividend withholding rate to as low as 5%? Is it due to concern that the rule permitting a withholding agent to rely on a U.S. address results in improper avoidance of section 1441 withholding?

Whatever the particular problem that spawned the proposed legislative change, the proper response is not to impose an additional layer of withholding that will leave withholding agents confused about their withholding obligations and possibly result in duplicative withholding. The approach should be to provide rules that clearly define and properly coordinate the section 1441 and section 1445 withholding obligations as they relate to section 301(c)(1), (c)(2) and (c)(3) distributions. At a minimum, if Treas. Reg. section 1.1441-3(b)(1)(ii) is retained, the coordinating rules should limit the withholding agent's obligation so that withholding is required only once at the greater of the section 1441 or the section 1445 rate (generally the section 1441 rate, unless the section 1441 rate is reduced to less than 10% by treaty).

Effective Date

The proposed revision to section 1445(e)(3) applies to distributions made after the date of enactment of the provision. We believe it is inappropriate to provide an immediate effective date for a withholding provision, since it is necessary to provide time for a withholding agent to implement withholding procedures. We would suggest that the effective date be delayed for at least 30 days. However, the clock should not begin to run before clear rules are provided coordinating sections 301, 1441 and 1445, as described above. If those rules are provided by statute, then the effective date should be at least 30 days after the date of enactment. If, however, the solution is left to regulations, then the effective date should be no earlier than 30 days after the

promulgation of those regulations in temporary or final form. Compare Treas. Reg. section 1.1445-11T(e).

Current Law

While the Joint Committee's description states that no inference is intended as to the FIRPTA withholding requirements applicable to periods prior to the effective date of the new provision, the description also states that the new provision "clarifies" existing law. We believe the legislative history should not suggest that withholding is required with respect to section 301 distributions under current law.

Ordinarily Treas. Reg. section 1.1445-5(b)(1), referred to above, would eliminate any section 1445 withholding for distributions subject to section 1441 or 1442 withholding. Even without regard to this exception, section 1445(e) does not apply on its face, so that the only question is whether section 1445(a) could apply. It could be argued that in a section 301 distribution there is of section" in section 1445 (a) and the inclusion of a specific subsection (e) dealing with distributions logically indicates an intention to give section 1445 (e) sole authority with respect to distributions. This argument finds support in the language in Treas. Reg. section 1.1445-5(e)(1)(ii)(B) and, in particular, section 1.1445-7(c) (re section 897 (i) electing foreign corporations) describing the requirement of a USRPHC to withhold on section 301 distributions. The language refers to sections 897 (f), 1441 and 1442, but not to section 1445 (a) and the regulations thereunder.

Finally, the argument that section 1445 withholding is not currently required for section 301 distributions is particularly strong for a section 301 (c)(2) distribution. Such distributions, unlike section 301 (c)(3) distributions, are not deemed to be a sale or exchange and, given that the holder in fact continues to own the stock, would not

appear to involve a disposition of stock within the meaning of section 1445(a).

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In closing, we recommend that section 103(c) of the Bill be modified to deal with the concerns expressed herein. We would be pleased to discuss these issues with you or members of your staff.

Very truly yours,

James M. Peaslee
Chair

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