

Back to Basics: The Fundamentals of FIRPTA

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Agenda

- ◆ **The Significance of FIRPTA**
- ◆ **The Substantive Tax – Taxing Gains on the Disposition of USRPI**
 - Interest in real property itself
 - Interest in certain domestic corporations -- USRPHC
 - Interest in a partnership that owns a USRPI
 - The meaning of “disposition”
- ◆ **The Withholding Tax – Acquisitions of USRPI**
 - When required, and when not
 - Withholding certificates
 - Liability for failure to withhold
 - Relief for late filing in certain cases
 - Corporate distributions and other special cases
- ◆ **Special situations**
 - REITS and foreign governments
 - Non-recognition transactions

Significance of FIRPTA

- ◆ **U.S. Persons – Subject to U.S. income tax on all sources of income.**
- ◆ **Foreign Persons – Subject to U.S. income tax only on: (1) income that is effectively connected to a U.S. trade or business (ECI); and (2) U.S.-source FDAP income (U.S.-source dividends, rents, royalties, etc.).**
- ◆ **Capital Gains – Foreign persons generally not subject to U.S. income tax on capital gains.**

Significance of FIRPTA

- ◆ **Liability for foreign persons who dispose of USRPIs**
- ◆ **Liability for Failure to Withhold FIRPTA tax – generally applies to all acquirers of USRPIs**
- ◆ **Corporate Restructuring**
 - Overrides Nonrecognition
 - Must make timely filings to qualify plus additional requirements
 - Presumption that stock of US corporation is USRPI subject to FIRPTA tax and withholding
 - Must make timely filings to rebut presumption
 - USRPHC opinions
 - Valuation issues
- ◆ **Other Considerations – Branch Profits Tax (§884) and Sovereign Wealth Funds (§892).**

The Substantive Tax - Section 897

Types of US Real Property Interests, Dispositions

General Rule – Section 897(a)

- ◆ Gains and losses realized by a nonresident alien or a foreign corporation from the “disposition” of a United States real property interest (“USRPI”) is taken into account as though the foreign person were engaged in a US trade or business and the gain or loss was effectively connected with a US trade or business.
- ◆ **Treaties**
 - Section 897 overrides treaties; can't rely on a gains article to avoid the tax.

USRPI Defined – Section 897(c), Reg. sec. 1.897-1(c)

◆ USRPI

- Any interest (other than solely as a creditor) in real property located in the U.S. or U.S. VI.
- Any interest (other than solely as a creditor) in a domestic corporation that is a U.S. Real Property Holding Corporation (“USRPHC”).
- Partnership Interests – proportionate share

◆ Real Property

- Land and unsevered natural products of the land
- Improvements inherently permanent structures (§48 Standards), and
- Certain property associated with specified uses of real property (e.g., equipment used in mining, farming forestry; to improve real property (earth moving equipment); and personal property used in lodging facilities, or rental of offices, etc.

Types of US Real Property Interests



Directly or Indirectly Held
US Real Property



October 2008 Infrastructure Notice

- ◆ In order to raise funds US state and local governments have leased government owned toll roads to US corporations owned by foreign investors who agree to maintain and operate the toll road for a number of years.
 - The transaction usually includes the grant of a license or permit that allows the operating entity to charge and collect tolls.
 - Taxpayers have taken the position that the license or permit is a business asset but not a USRPI.
 - The US corporation that owns the lease and operates the toll road may therefore not be a USRPHC.

October 2008 Infrastructure Notice

The notice states:

“The IRS and the Treasury Department are considering issuing proposed regulations regarding the definition of an interest in real property that would address certain licenses, permits, franchises, or other similar rights granted by a governmental unit (including, for purposes of section 897, an agency or instrumentality thereof) that are related to the value of the use or ownership of an interest in real property. The proposed regulations would address how the fair market value of such licenses, permits, franchises, or other similar rights should be taken into account when determining the fair market value of a corporation’s USRPIs and interests in real property located outside the United States under section 897(c)(2).”

USRPHC Defined – Section 897(c)(2), Reg. sec. 1.897-2

◆ USRPHC

- Any corporation if FMV of its USRPIs equal at least 50% of FMV of specified assets during measuring period
 - Look-thru rule (e.g., property owned through 50% owned corporations; pro rata rule for partnerships). Reg. sec. 1.897-2(d), (e).
 - Measuring period is shorter of 5 years prior to disposition or period held by foreign person

◆ **USRPHC = USRPI \geq .50x (USRPI+FRPI + T/B Assets)**

Presumption for Stock of US Corporation

- ◆ **Stock of U.S. corporation presumed to be USRPI unless foreign shareholder rebuts. Reg. sec. 1.897-2(g)(1)(i).**
- ◆ **Exceptions**
 - Shares of publicly traded corporations, and interests in publicly traded partnerships and trusts, provided interest not greater than 5%. Reg. sec. 1.897-2(c)(2)(iii) and (iv).
 - Domestically controlled REIT stock. Reg. sec. 1.897-1(c)(2)(i)
 - Foreign shareholder requests and obtain certification from U.S. corporation under penalties of perjury.
 - Exception: holder of 5% or less interest in regularly traded corporations not required to make request. Reg. sec. 1.897-2(g)(3).
 - Foreign shareholder requests and obtains determination from IRS.

USRPHC – Asset Valuation Alternatives

◆ FMV – General Rule

- A corporation generally is a USRPHC if at least 50% of the FMV of the company's specified assets is attributable to assets that are U.S. real property interests.
 - Specified assets: U.S. real property, foreign real property, and business assets.
 - Business assets – does not include cash in excess of current business needs.

◆ Safe Harbor – Based on GAAP financial statement

- If book value of USRPIs is 25% (or less) of specified assets, U.S. corporation is presumed not to be a USRPHC, which presumption is rebuttal by IRS.

Partnership Interests

- ◆ **Section 897(g) look-through rule**
 - USRPI only to extent gain on disposition is attributable to USRPIs held through partnership (and not to cash, cash equivalents, or other property held through the partnership). Reg. sec. 1.897-7T(a).
 - Section 897(g) is self-executing - Notice 88-72, 1988-2 C.B. 383.
- ◆ **Gain from disposition of partnership interest may be subject to taxation to the extent of USRPIs, and full withholding. Reg. sec. 1.897-7T(a). Alternatively, may be subject to partial taxation and no withholding.**
 - See Reg. sec. 1.1445-11T(b).

Meaning of “disposition”

- ◆ A “disposition” means any transfer that would constitute a disposition for any purpose of the Code or regulations.
 - Sale or exchange
 - Section 301 distributions, liquidating distributions, etc.
 - Section 897(a) generally overrides nonrecognition provisions of the Code. Section 897(e).

The Withholding Tax

Section 1445

Withholding Requirements

- ◆ **General rule:** Any person (transferee) acquiring USRPI from foreign person (transferor) generally must deduct and withhold 10% of amount realized by transferor. Section 1445(a); Reg. sec. 1.1445-1(b).
- ◆ **Payment of tax withheld:** Generally deposit tax within 20 days using Form 8288 and 8288-A. Reg. sec. 1.1445-1(c)(1).
- ◆ **Transferor's obligation to file:** Withholding by transferee does not relieve transferor of obligation to file a US tax return and report gain or loss on disposition of USRPI. Reg. sec. 1.1445-1(f).
 - Tax withheld under section 1445 is allowed as a credit in determining transferor's liability.

Exceptions to Withholding

- ◆ **Transferor certifies non-foreign status. Reg. sec. 1.1445-2(b).**
- ◆ **Interest in domestic corporation is not a USRPI. Reg. sec. 1.1445-2(c)**
 - Transferee receives statement that interest in domestic corporation is not a USRPI.
 - Any class of stock is regularly traded on an established securities market. Exception: Acquisition from a single 5% SH in a single transaction.
 - Still a section 897(a) taxable USRPI to > 5% foreign owners.
- ◆ **USRPI is a residence and amount realized does not exceed \$300,000.**
- ◆ **Transferor provides notice of nonrecognition and transferee provides copy of the notice to the IRS by the 20th day following the transfer. Reg. sec. 1.1445-2(d)(2).**
- ◆ **Transferee is the United States, a state, possession or political subdivision of same.**

Exceptions to Withholding

- ◆ **Transferor provides withholding certificate by date of disposition. Reg. sec. 1.1445-1(b)(4) and -3(a), Rev. Proc. 2003-35.**
- ◆ **Bases for Withholding Certificates**
 - Nonrecognition treatment
 - Transferor's Maximum Tax Liability less than the withholding amount
 - Installment Sales
 - Security Agreement
 - Other

Relief for Failure to File or Withhold

- ◆ **Prior Remedy – 9100 relief if not USRPI, or nonrecognition applies**
- ◆ **Effective June 27, 2008 - Rev. Proc. 2008-27: Request Reasonable Cause Relief from Ogden Service Center**
 - In lieu of 9100 Relief
 - Effective June 27, 2008
 - Make late filing and also request reasonable cause from Ogden
 - Simplified method to request relief for late filings under sections 897 and 1445
 - May request 9100 relief if reasonable cause request denied

FIRPTA Nonrecognition Transactions – Overview

- ◆ **IRS guidance is found in three sources**
 - Regulations
 - Temporary regulations
 - Notices announcing intent to amend regulations (some expand situations eligible for nonrecognition)
 - Notice 2006-46
 - Notice 99-43
 - Notice 89-85
 - Notice 89-57

Overview of FIRPTA Nonrecognition Rules

◆ Substantive Rules

- Code
 - section 897(d) → Distributions of USRPIs
 - section 897(e) → Coordination with nonrecognition provisions
- Regulations
 - Reg. § § 1.897-5T and 1.897-6T
- Notices
 - Notices 89-57; 89-85; 99-43; 2006-46

◆ Procedural Rules

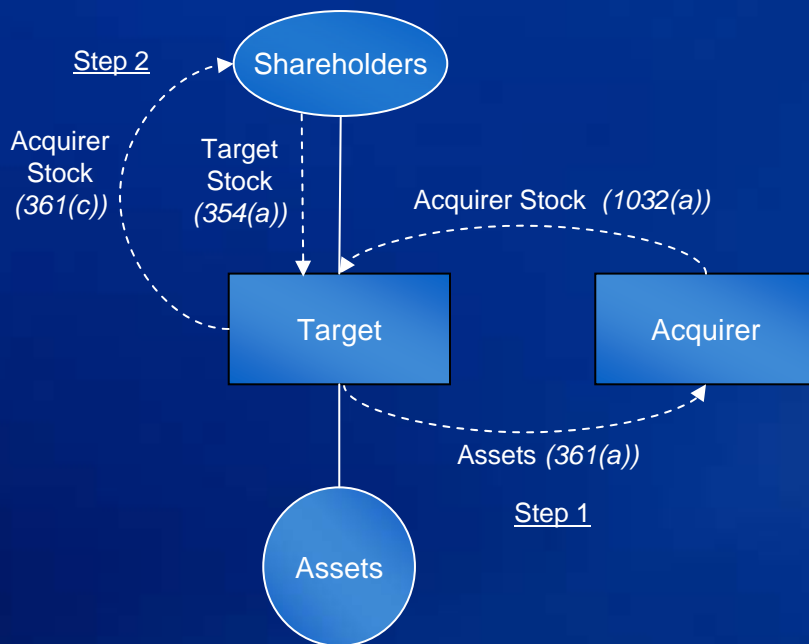
- Withholding Requirements → section 1445
- Filing Requirements → Reg. § 1.897-5T(d)(1)(iii), as modified by Notice 89-57

◆ **Must satisfy substantive and procedural requirements to avoid tax liability and return filing obligation**

- Must satisfy separate procedural requirements to avoid section 1445 withholding

Example of Tax-Free Asset Reorganization

Transaction Structure



Step 1 → Target transfers its assets to Acquirer for Acquirer stock and then merges into Acquirer or dissolves

Consequences to Target → Target does not recognize gain or loss on the transfer of assets to Acquirer solely for Acquirer stock (section 361(a))

Consequences to Acquirer → Acquirer does not recognize gain or loss on the issuance of its stock to Target for Target's assets (section 1032(a))

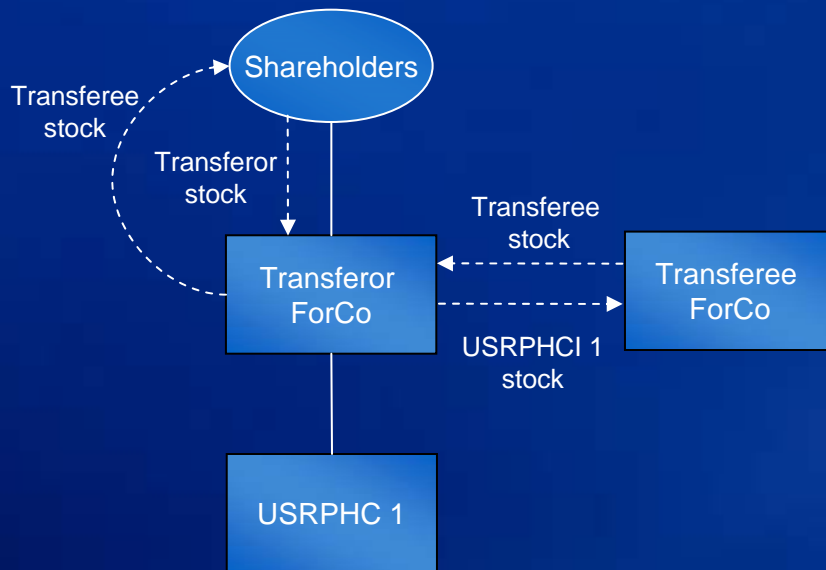
Step 2 → Target transfers the Acquirer stock to its shareholders in exchange for their Target stock

Consequences to Target → Target does not recognize gain or loss on distribution of the Acquirer stock to its shareholders (section 361(c))

Consequences to Target Shareholders → The Target shareholders do not recognize gain or loss on the exchange of their Target stock solely for Acquirer stock (section 354(a))

Foreign-to-Foreign Acquisitive D and F Reorganizations

Transaction Structure

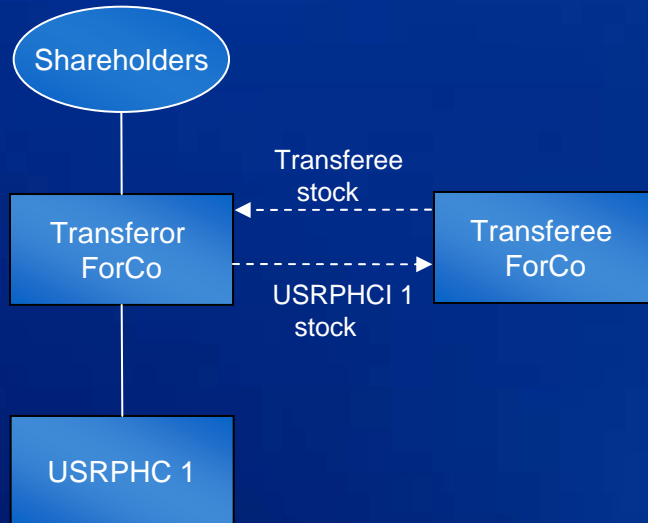


Under Reg. § 1.897-6T(b)(1)(i), as modified by Notice 2006-46, Transferor ForCo can enjoy nonrecognition treatment under section 361(a) on the exchange of a USRPI for foreign stock in connection with a section 368(a)(1)(D) or (F) reorganization if:

- 1) Transferee ForCo satisfies the subject to tax requirement for the USRPHC stock received in the exchange
- 2) The FIRPTA filing requirement is satisfied, and
- 3) Transferor ForCo distributes the Transferee ForCo stock to its shareholders in exchange for their Transferor stock in a distribution that qualifies for nonrecognition treatment under section 354(a)

Foreign-to-Foreign B Reorganizations and Section 351 Transactions

Transaction Structure



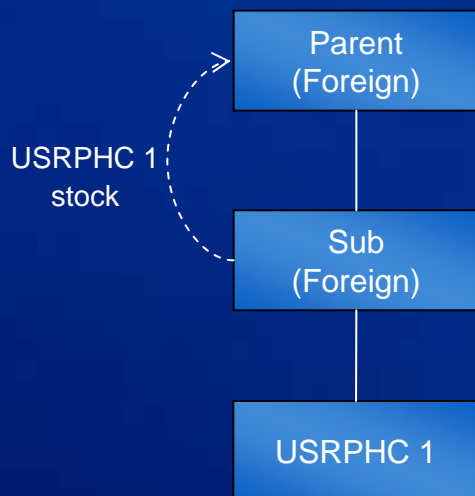
Under Reg. § 1.897-6T(b)(1)(iii), as modified by Notice 2006-46, Transferor ForCo will only enjoy nonrecognition treatment on the exchange of a USRPI for stock of Transferee ForCo in connection with a B reorganization or section 351 transaction if:

- (i) The USRPI being transferred is stock in a USRPHC
- (ii) Transferee ForCo satisfies the subject to tax requirement with respect to the transferred USRPHC stock
- (iii) Immediately after the exchange, substantially all of the outstanding stock of Transferee ForCo is owned by Transferor ForCo, and
- (iv) Transferor ForCo satisfies the FIRPTA filing requirement

If Transferor ForCo disposes of any of the Transferee ForCo stock within one year from the date of its receipt, however, Transferor ForCo must recognize a proportionate share of the gain inherent in the USRPHC stock that was transferred in the exchange

Foreign-to-Foreign Section 332 Liquidation

Transaction Structure



Section 897(d)(2) and Reg. § 1.897-5T (c)(2) provide that the foreign sub will not be required to recognize gain on the distribution of the USRPHC 1 stock to its foreign parent in connection with a section 332 liquidation if:

- 1) The Parent would be subject to U.S. tax on a subsequent disposition of the USRPHC 1 stock
- 2) The Parent's basis in the USRPHC 1 stock is not greater than the Sub's basis at the time of the distribution, and
- 3) The Parent complies with the FIRPTA filing requirement