PRESENT LAW AND BACKGROUND RELATED TO U.S. ACTIVITIES OF FOREIGN PERSONS

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SUBCOMMITTEE ON SELECT REVENUE MEASURES
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HOUSE COMMITTEE ON WAYS AND MEANS
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INTRODUCTION AND SUMMARY

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a public hearing for June 23, 2011, on tax reform and foreign investment in the United States. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides data on foreign investment in the United States and describes the U.S. tax rules applicable to U.S. activities of foreign taxpayers.

In 2009, foreign persons received approximately $488 billion in income from U.S. investments. $151 billion of that $488 billion of income was from foreign direct investment in the United States.[2] With significant exceptions, foreign persons' income from foreign investment in the United States is subject to U.S. tax.

Nonresident individuals and foreign corporations are subject to U.S. taxation on U.S.-source income (and on very limited categories of foreign-source income). Category-by-category rules determine whether income has a U.S. source or a foreign source. The U.S. tax rules for foreign persons' income potentially subject to U.S. taxation apply differently to two broad categories of income. U.S.-source "fixed or determinable annual or periodical gains, profits, and income" is, with exceptions for investment and bank deposit interest, subject to a 30-percent gross-basis withholding tax (subject to reduction or elimination under bilateral income tax treaties), and income that is effectively connected with the conduct of a U.S. trade or business is subject to the same net-basis taxation that applies to U.S. persons.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Related to U.S. Activities of Foreign Persons* (JCX-37-11), June 22, 2011. This document can also be found on our website at www.jct.gov.

[2] As described in section I below, direct investment is investment that provides the owner some degree of control.

I. TRENDS IN FOREIGN INVESTMENT IN THE UNITED STATES

Overview

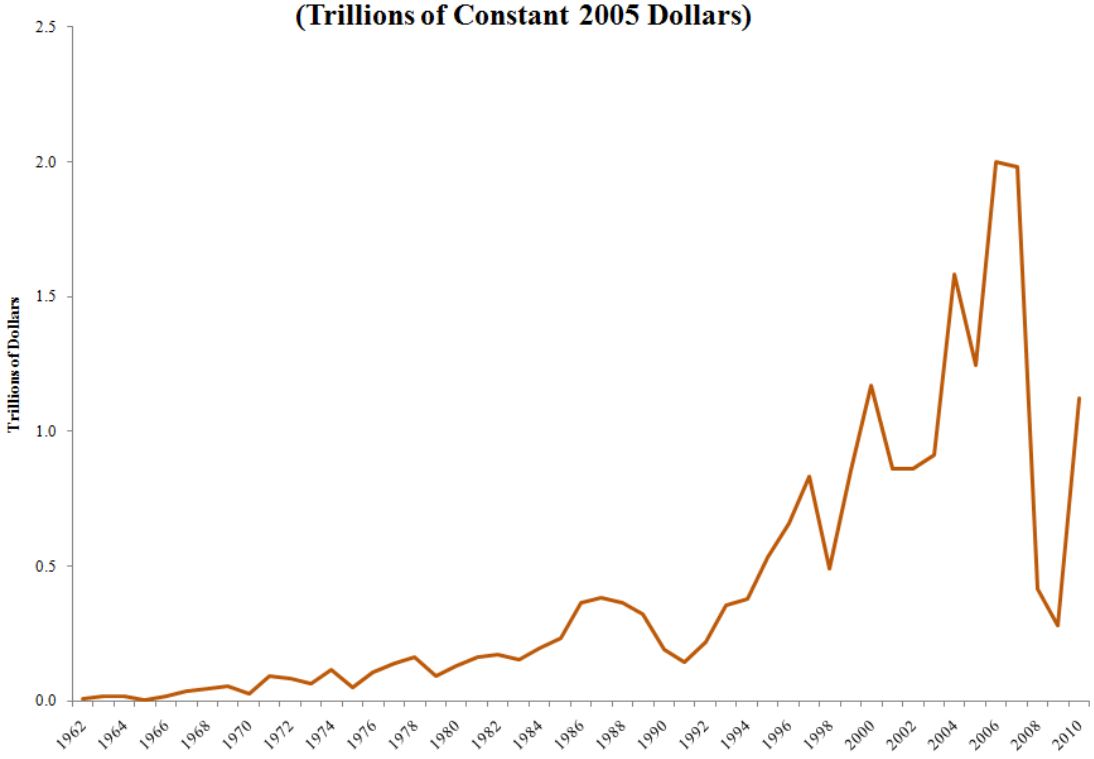
Since the early 1980s, the United States has been a large net importer of capital. In addition, the domestic saving rate has declined. As a consequence of both of these trends, net foreign investment has become a larger proportion of total domestic investment than in the past. In 2009, gross investment in the United States was $2.09 trillion and net foreign investment was $380.3 billion, or 18.2 percent of gross domestic investment. In 1993, net foreign investment was equal to 6.8 percent of gross domestic investment.[3] With significant exceptions, income generated by foreign investments in the United States is subject to U.S. tax. Recent trends in foreign investment in the United States and income payments to foreign investors are discussed in this section; the subsequent section describes the U.S. tax treatment of that income.

Growth in foreign-owned assets in the United States

Net foreign investment in the United States is measured by the U.S. financial account. The financial account measures the increase in U.S. assets abroad compared to the increase in foreign assets in the United States. For this purpose, foreign-owned assets in the United States means assets situated or based in the United States that are held by foreign persons. Figure 1 plots the annual increase of foreign-owned assets in the United States for the period 1962-2010 in constant, inflation-adjusted 2005 dollars. Foreign-owned assets in the United States increased by $1.20 trillion in 2005, $1.86 trillion in 2006, and $1.86 trillion in 2007 in nominal dollars. The 2008 recession resulted in a slowdown in foreign acquisition of U.S. assets, but in 2010 foreign-owned assets again increased by over $1 trillion.

[3] *Economic Report of the President*, Table B-32. In 2008, net foreign investment totaled 25.7 percent of gross domestic investment.

Figure 1.-Annual Increase in Foreign-Owned Assets in the United States, 1962-2010 (Trillions of Constant 2005 Dollars)



Source: Department of Commerce, Bureau of Economic Analysis

Note: Figures for 2010 are preliminary.

Measured in constant dollars, the amount of foreign-owned assets in the United States grew at an annual rate of more than 10 percent per year between 1980 and 2009. The total amount of foreign-owned assets in the United States exceeded $20 trillion by the end of 2009.[4] These investments are calculated with direct investment measured at their so-called "current cost." The Bureau of Economic Analysis estimates the values of U.S. foreign direct investment abroad and foreign direct investment in the United States using three different bases: historical cost, current cost, and market value. Using the historical cost base, assets are measured according to values carried on taxpayers' books. Thus, investments reflect the price level of the year in which the asset was acquired. Under the current cost measure, a parent's share of its affiliates' tangible assets (property, plant, and equipment and inventories) is revalued from historical cost to replacement cost. Under the market value measure, an owner's equity in foreign assets is revalued to current market value using indexes of stock prices.[5] Figure 2 and Figure 3 display the value of foreign-owned assets in the United States for selected years measured in constant 2005 dollars, the former under current cost and the latter on the basis of estimates of current market values.

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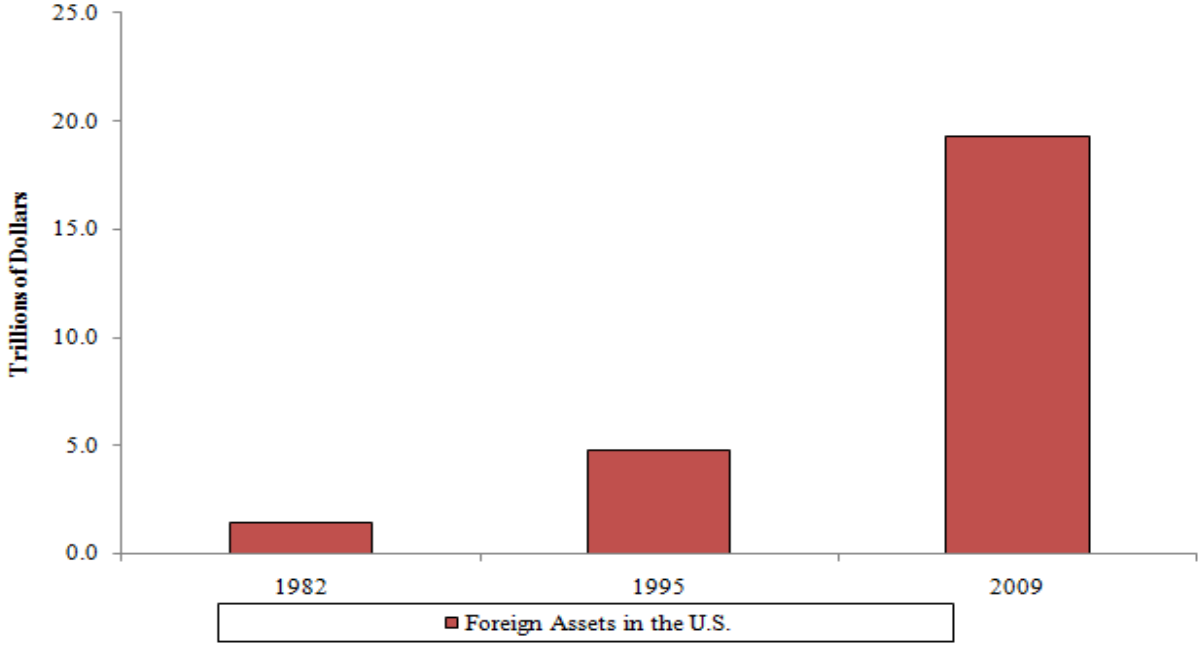
[4] U.S. Department of Commerce, Bureau of Economic Analysis, "International Investment Position of the United States at Year-End, 1976-2009." *http://bea.gov/international/xls/intinv09_t2.xls*

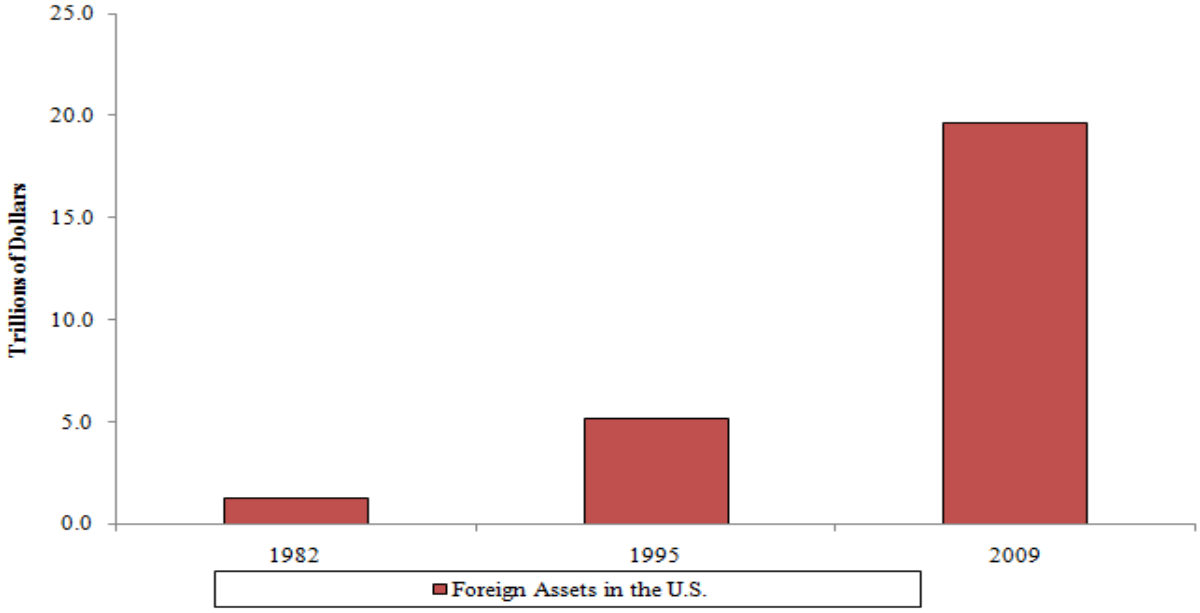
[5] The distinction between book valuation and market valuation is only relevant for the category of investment labeled "direct investment," not for "portfolio investment." The distinction between direct and portfolio investment is explained in the text below.

Figure 2.-Foreign-Owned Assets in the United States, 1982, 1995, and 2009 in Constant 2005 Dollars (Direct Investment Component Measured at Current Cost)



Source: Department of Commerce, Bureau of Economic Analysis Note: Figures for 2009 are preliminary.

Figure 3.-Foreign-Owned Assets in the United States, 1982, 1995, and 2009 in Constant 2005 Dollars (Direct Investment Component Measured at Market Value)



Source: Department of Commerce, Bureau of Economic Analysis Note: Figures for 2009 are preliminary.

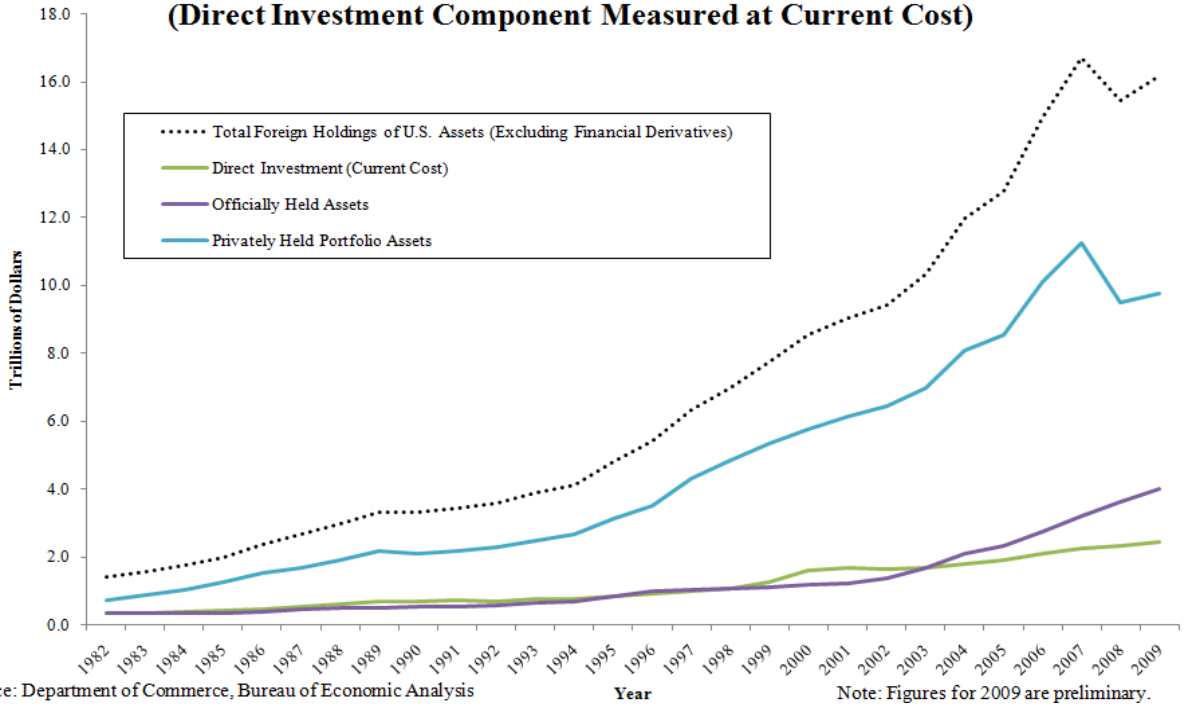
Direct investment, nondirect (portfolio) investment, and official investment

Foreign-owned assets in the United States can be categorized as direct investment, nondirect investment, and official assets. Direct investment constitutes assets over which the owner has direct control. The Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interests in an unincorporated business.

The largest category of outbound and inbound investment is nondirect investment held by private (nongovernmental) foreign investors, commonly referred to as portfolio investment. For most of the past decade, foreign portfolio investment annually has greatly exceeded foreign direct investment, making portfolio investment responsible for the majority of growth in foreign ownership of U.S. assets. Foreign portfolio investment consists mostly of holdings of corporate equities, corporate and government bonds, and bank deposits. The portfolio investor generally does not have control over the assets that underlie the financial claims. Foreign investment in bonds, corporate equities, and bank deposits, like other types of financial investment, provide a source of funds for investment in the United States but also represent a claim on future U.S. resources.

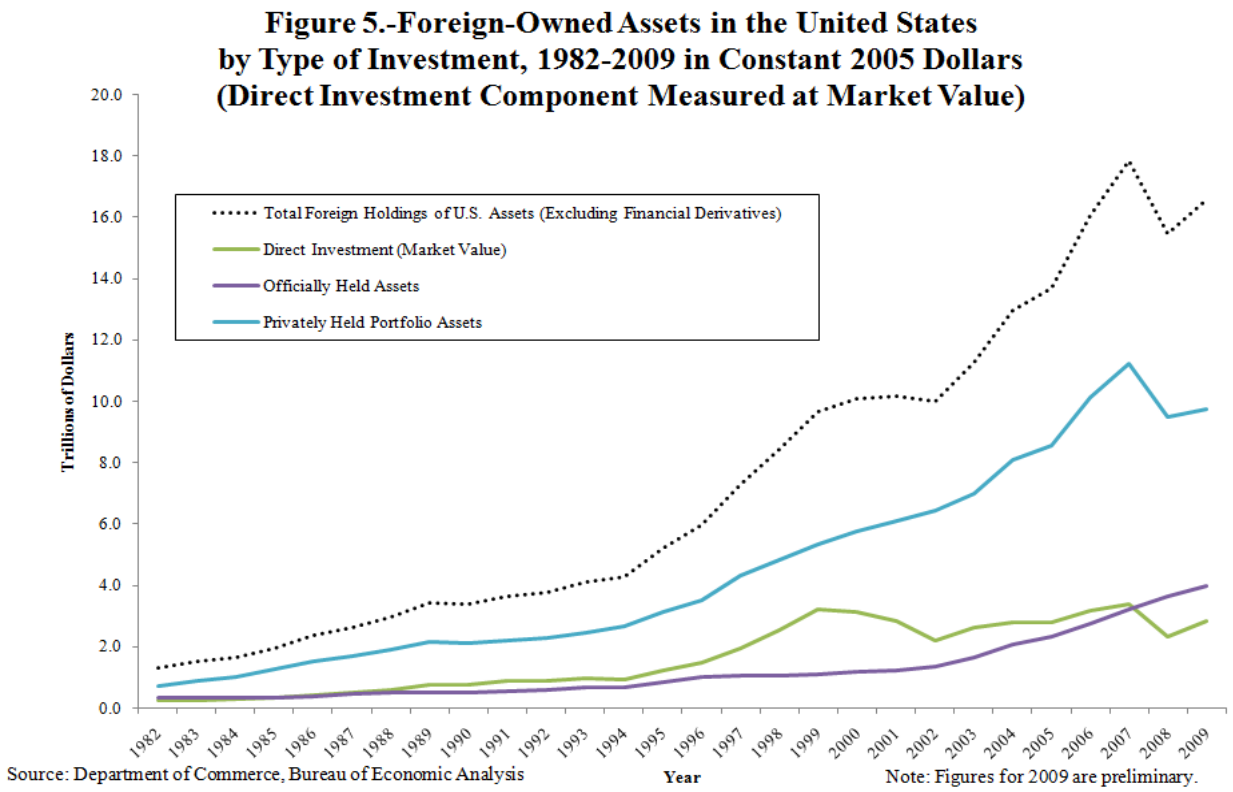
The final category of foreign-owned U.S. assets is official (nondirect) assets: for example, U.S. assets held by governments, central banking systems, and certain international organizations. The foreign currency reserves of other governments and banking systems, for example, are treated as official assets. Figures 4 and 5, below, report the value of investment in each of these categories since 1982 (with direct investment measured at current cost in the former and at market value in the latter).

Figure 4.-Foreign-Owned Assets in the United States by Type of Investment, 1982-2009 in Constant 2005 Dollars (Direct Investment Component Measured at Current Cost)



Source: Department of Commerce, Bureau of Economic Analysis

Note: Figures for 2009 are preliminary.



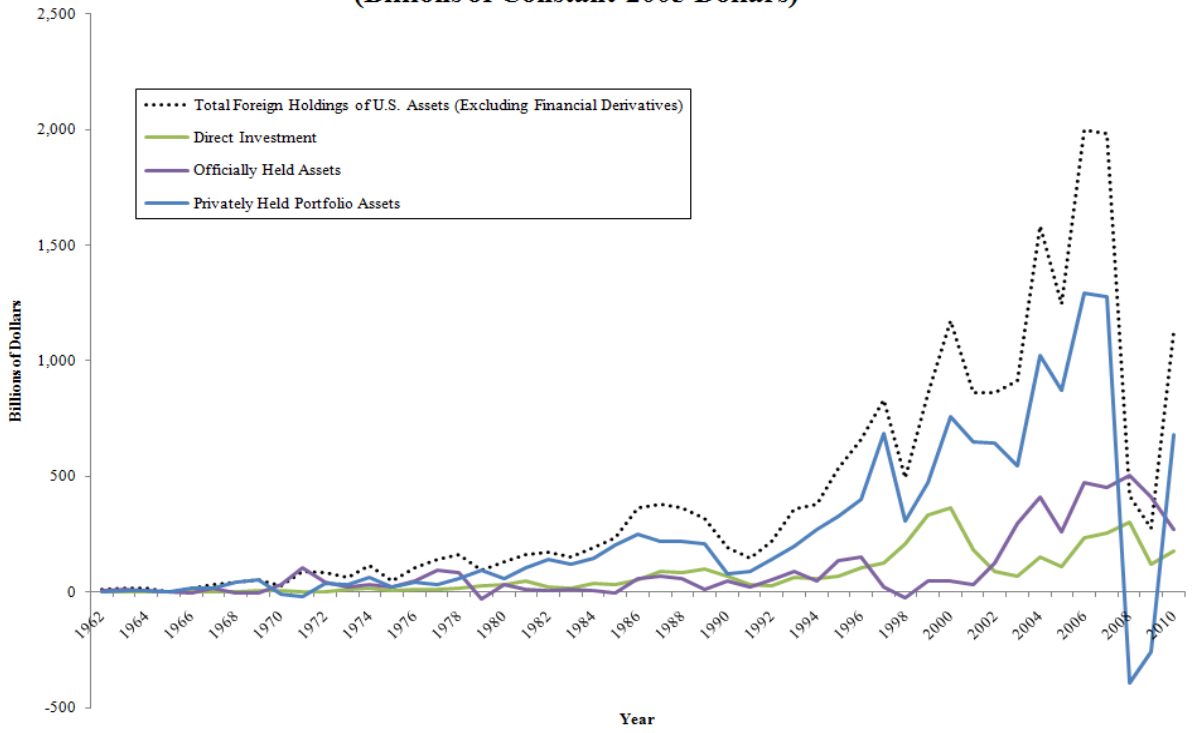
Whether measured in terms of current cost or market value, the value of foreign direct investment has increased nearly fourfold since 1990. Foreign persons held direct investments of $2.7 trillion in the United States in 2009, having grown from $127 billion in 1980.[6]

However, since 1990, the majority of new foreign investment in the United States has come in the form of portfolio investment. In 2009, portfolio assets of foreign persons in the United States were about four times the recorded value of direct investment, $10.7 trillion compared to $2.7 trillion, respectively. Bank deposits account for nearly one-third of this total ($3.6 trillion), and reflect, in part, the increasingly global nature of banking activities.

Levels of assets held by foreign official entities have also grown substantially since 2002, and have increased more rapidly than private direct investment during that period. In 2002, foreign official assets were estimated to be $1.25 trillion (nominal dollars). In 2009, foreign official assets were estimated to be $4.4 trillion. Figure 6 displays the annual increase in investment in each of these categories since 1962.

[6] This values the direct investment at current cost. The Bureau of Economic Analysis estimate for 2009, when valued at market value, is $3.1 trillion.

Figure 6.-Annual Increase in Foreign-Owned Assets in the United States by Type of Investment, 1962-2010 (Billions of Constant 2005 Dollars)



Source: Department of Commerce, Bureau of Economic Analysis

Note: Figures for 2010 are preliminary.

Outbound payments of income on foreign-held U.S. assets

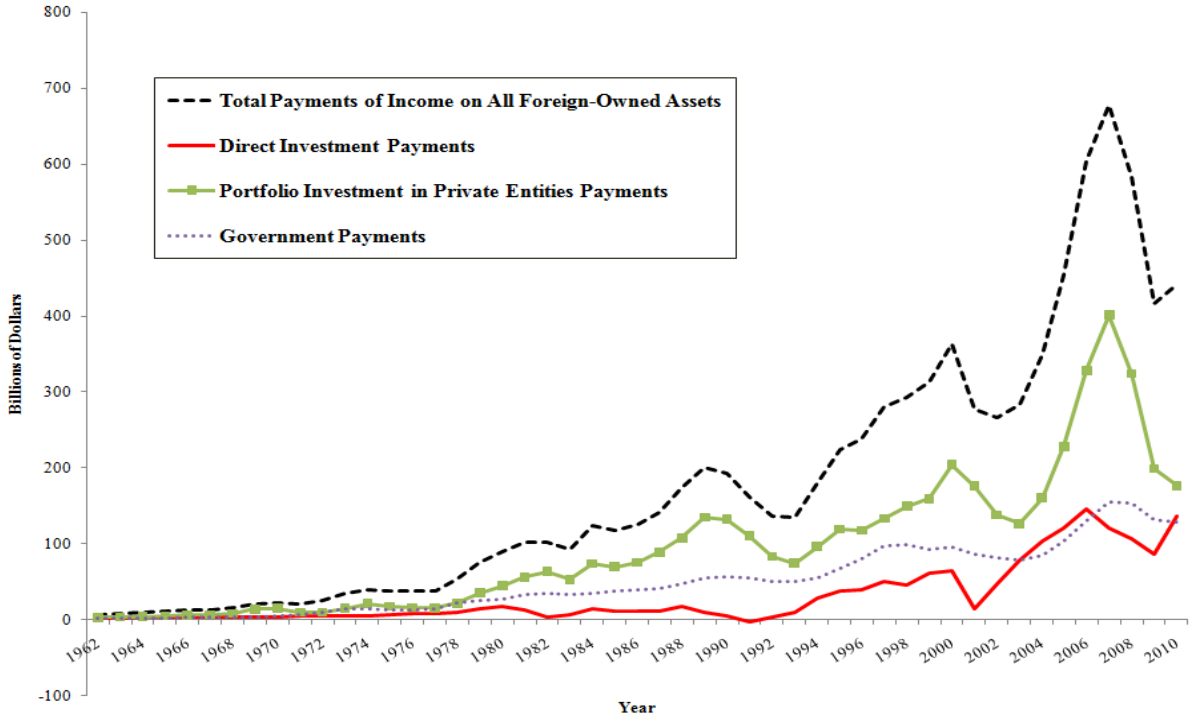
Assets in the United States held by foreign persons generate income that is paid to the holders overseas. In 2009, approximately $488 billion was paid overseas as income. Of that total, $151 billion was income generated by foreign direct investment in the United States. Since the mid-1980s, income payments on foreign direct investment has increased nearly twentyfold. While the outbound income generated by portfolio investments in private U.S. entities lagged during the recent economic downturn, there was little decline in income derived from direct investment in the United States. Since 1980, income paid to foreign persons on U.S. government assets has increased steadily.[7] Figure 7 reports annual payments of income to foreigners on different types of assets since 1962, and Figure 8 breaks down outbound income payments on portfolio investments in private entities since 1999 into the component categories.

These outbound payments generated by assets held by non-US persons in the United States are generally subject to U.S. taxation as modified by U.S. bilateral treaties and certain exceptions in the Internal Revenue Code. Section II presents the rules on how these outbound

[7] U.S. government assets may be held either by foreign official entities or by private persons (as portfolio investments).

payments are taxed, including how such payments are sourced and what type of U.S. taxation applies.

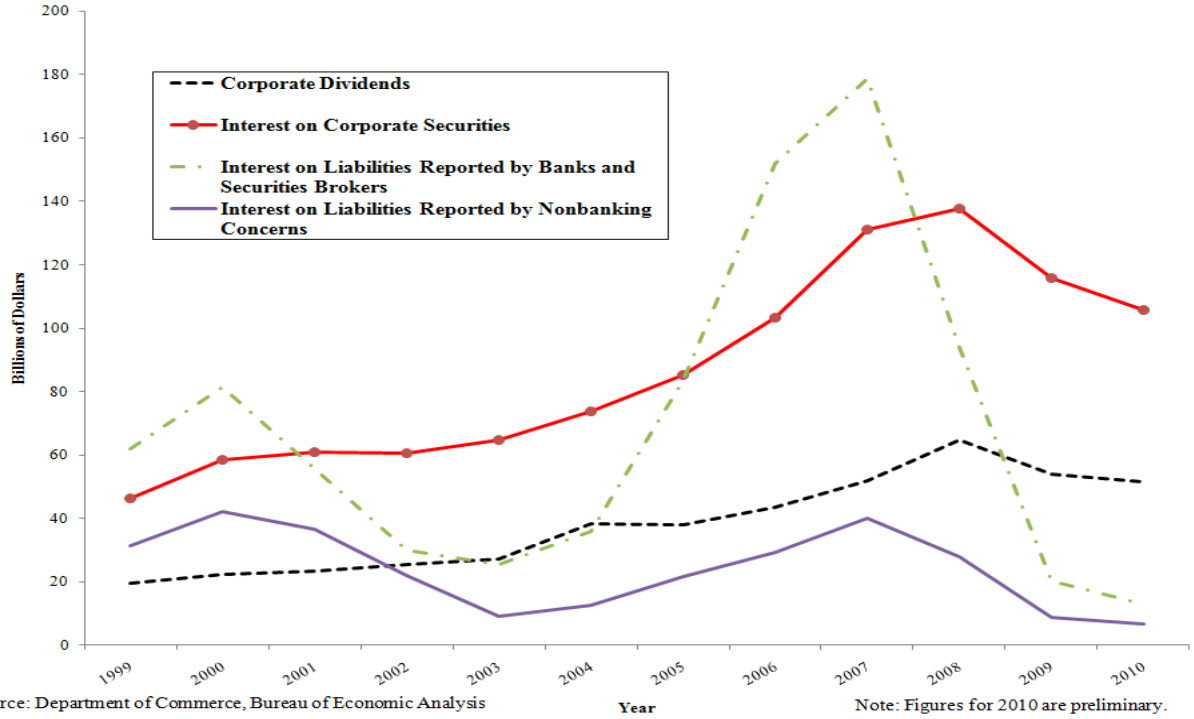
Figure 7.- Payments of Income to Foreign Persons on Assets in the United States, 1962-2010 (Billions of Constant 2005 Dollars)



Source: Department of Commerce, Bureau of Economic Analysis

Note: Figures for 2010 are preliminary.

Figure 8.- Payments of Income to Foreign Persons on Portfolio Investments in Private U.S. Entities, 1999-2010 (Billions of Constant 2005 Dollars)



Source: Department of Commerce, Bureau of Economic Analysis

Note: Figures for 2010 are preliminary.

II. U.S. TAX RULES APPLICABLE TO U.S. ACTIVITIES OF NON-U.S. PERSONS

A. In General

Resident individuals and domestic corporations are subject to U.S. tax on all their income, both U.S. and foreign source. By contrast, nonresident individuals and foreign corporations are generally subject to U.S. tax only on their U.S.-source income.

Category-by-category rules determine whether income has a U.S. source or a foreign source. For example, compensation for personal services generally is sourced based on where the services are performed, dividends and interest are, with limited exceptions, sourced based on the residence of the taxpayer making the payments, and royalties for the use of property generally are sourced based on where the property is used. These and other source rules are described below in more detail.

The U.S. tax rules for U.S. activities of foreign taxpayers apply differently to two broad types of income. U.S.-source "fixed or determinable annual or periodical gains, profits, and income" ("FDAP income") generally is subject to a 30-percent gross-basis withholding tax. Much FDAP income and similar income is, however, exempt from withholding tax or is subject to a reduced rate of tax under the Code or a bilateral income tax treaty. The 30-percent withholding tax and exemptions from and reductions in that tax are described in section II.B below.

Income that is "effectively connected with the conduct of a trade or business within the United States" ("ECI") is generally subject to the same U.S. tax rules that apply to business income derived by U.S. persons. ECI is taxed at the same rates as apply to U.S. persons, and deductions are permitted in determining taxable ECI. The rules for U.S.-source FDAP and for ECI are discussed in more depth below.

Branch taxes, described below, are intended to provide rough equality in the taxation of branch and subsidiary operations in the United States. Also described below are special rules for the taxation of foreign persons' sales and other dispositions of U.S. real estate and for the treatment of interest on related-party indebtedness.

When a foreign person with U.S. activities has transactions with related U.S. taxpayers, the amount of income attributable to U.S. activities is determined in part by the same transfer pricing rules of section 482[8] that apply when U.S. persons with foreign activities transact with related foreign taxpayers.

[8] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

B. Source of Income Rules

The source and type of income received by a foreign person generally determines whether it is subject to U.S. income tax, and the mechanism by which it is taxed (as described below, either by gross-basis withholding or on a net basis through tax return filing). Various factors determine the source of income for U.S. tax purposes, including the location or nationality of the payor, the location or nationality of the recipient, the location of the recipient's activities that generate the income, and the location of the assets that generate the income.

Rules for determining the source of certain types of income are specified in the Code, as described briefly below. To the extent that the source of income is not specified in the statute, the Secretary may promulgate regulations that explain the appropriate treatment. Many items of income are not explicitly addressed by either the Code or Treasury regulations. On several occasions, courts have determined the source of such items by applying the rule for the type of income to which the disputed income is most closely analogous, based on all facts and circumstances.[9]

Interest

Interest is derived from U.S. sources if it is paid by the United States or any agency or instrumentality thereof, a State or any political subdivision thereof, or the District of Columbia. Interest is also from U.S. sources if it is paid by a resident or a domestic corporation on a bond, note, or other interest-bearing obligation.[10] Special rules apply to treat as foreign source certain amounts paid on deposits with foreign commercial banking branches of U.S. corporations or partnerships and certain other amounts paid by foreign branches of domestic financial institutions.[11] Interest paid by the U.S. branch of a foreign corporation is also treated as U.S.-source income.[12]

Dividends

Dividend income is generally sourced by reference to the payor's place of incorporation.[13] Thus, dividends paid by a domestic corporation are generally treated as entirely U.S.-source income. Similarly, dividends paid by a foreign corporation are generally treated as

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[9] *Hunt v. Commissioner*, 90 T.C. 1289 (1988).

[10] Sec. 861(a)(1); Treas. Reg. sec. 1.861-2(a)(1).

[11] Sec. 861(a)(1). Prior to January 1, 2011, all (or a portion) of a payment of interest by a resident alien individual or domestic corporation was treated as foreign source if such individual or corporation met an 80-percent foreign business requirement. This provision was generally repealed for tax years beginning after December 31, 2010). For purposes of FATCA reporting and withholding (discussed *infra*, in section II.C), the source rule in section 861(a)(1)(B) does not apply to interest paid by the foreign branch of a domestic financial institution, resulting in treating the payment as a withholdable payment. Sec. 1473(1)(C).

[12] Sec. 884(f)(1).

[13] Secs. 861(a)(2), 862(a)(2).

entirely foreign-source income. Under a special rule, dividends from certain foreign corporations that conduct U.S. businesses are treated in part as U.S.-source income.[14]

Rents and royalties

Rental income is sourced by reference to the location or place of use of the leased property.[15] The nationality or the country of residence of the lessor or lessee does not affect the source of rental income. Rental income from property located or used in the United States (or from any interest in such property) is U.S.-source income, regardless of whether the property is real or personal, intangible or tangible.

Royalties are sourced in the place of use of (or the place of privilege to use) the property for which the royalties are paid.[16] This source rule applies to royalties for the use of either tangible or intangible property, including patents, copyrights, secret processes, formulas, goodwill, trademarks, trade names, and franchises.

Income from sales of personal property

Subject to significant exceptions, income from the sale of personal property is sourced on the basis of the residence of the seller.[17] For this purpose, the term "nonresident" is defined to include any foreign corporation.[18] The term "nonresident" also is defined to include any nonresident alien who does not have a "tax home" in the United States.

Under several exceptions to the general rule, income from sales of property by nonresidents is treated as U.S.-source income. Gain of a nonresident on the sale of inventory property may be treated as U.S.-source income if title to the property passes in the United States or if the sale is attributable to an office or other fixed place of business maintained by the nonresident in the United States.[19] If the inventory property is manufactured in the United States by the person that sells the property, a portion of the income from the sale of such property in all events is treated as U.S.-source income.[20] Gain of a nonresident on the sale of depreciable property is treated as U.S.-source income to the extent of prior U.S. depreciation deductions.[21] Payments received on sales of intangible property are sourced in the same manner as royalties to

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[14] Sec. 861(a)(2)(B).

[15] Sec. 861(a)(4).

[16] *Ibid.*

[17] Sec. 865(a).

[18] Sec. 865(g).

[19] Secs. 865(b) and (e), 861(a)(6).

[20] Sec. 863(b).

[21] Sec. 865(c).

the extent the payments are contingent on the productivity, use, or disposition of the intangible property.[22]

Personal services income

Compensation for labor or personal services is generally sourced to the place-of-performance. Thus, compensation for labor or personal services performed in the United States generally is treated as U.S.-source income, subject to an exception for amounts that meet certain de minimis criteria.[23] Compensation for services performed both within and without the United States is allocated between U.S. and foreign source.[24]

Insurance income

Underwriting income from issuing insurance or annuity contracts generally is treated as U.S.-source income if the contract involves property in, liability arising out of an activity in, or the lives or health of residents of, the United States.[25]

Transportation income

Generally, income from furnishing transportation that begins and ends in the United States is U.S.-source income.[26] Fifty percent of other income attributable to transportation which begins or ends in the United States is treated as U.S.-source income.

Income from space or ocean activities or international communications

In the case of a foreign person, generally no income from a space or ocean activity is treated as U.S.-source income.[27] The same holds true for international communications income unless the foreign person maintains an office or other fixed place of business in the United States, in which case the income attributable to such fixed place of business is treated as U.S.-source income.[28]

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[22] Sec. 865(d).

[23] Sec. 861(a)(3). Gross income of a nonresident alien individual, who is present in the United States as a member of the regular crew of a foreign vessel, from the performance of personal services in connection with the international operation of a ship is generally treated as foreign-source income.

[24] Treas. Reg. sec. 1.861-4(b).

[25] Sec. 861(a)(7).

[26] Sec. 863(c).

[27] Sec. 863(d).

[28] Sec. 863(e).

Amounts received with respect to guarantees of indebtedness

Amounts received from a noncorporate resident or from a domestic corporation for the provision of a guarantee of indebtedness of such person are income from U.S. sources, whether received directly or indirectly.[29] The scope of the provision includes payments that are made indirectly for the provision of a guarantee. For example, the provision would treat as income from U.S. sources a guarantee fee paid by a foreign bank to a foreign corporation for the foreign corporation's guarantee of indebtedness owed to the bank by the foreign corporation's domestic subsidiary, where the cost of the guarantee fee is passed on to the domestic subsidiary through, for example, additional interest charged on the indebtedness. In this situation, the domestic subsidiary has paid the guarantee fee as an economic matter through higher interest costs, and the provision treats the additional interest payments made by the subsidiary as indirect payments of the guarantee fee and, therefore, as U.S. source.

Such U.S.-source income also includes amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of indebtedness of that foreign person if the payments received are connected with income of such person which is effectively connected with conduct of a U.S. trade or business. Amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of that person's debt, are treated as foreign source income if they are not from sources within the United States under section 861(a)(9).

[29] Sec. 861(a)(9). This provision effects a legislative override of the opinion in *Container Corp. v. Commissioner*, 134 T.C. No. 5 (February 17, 2010), *aff'd* 2011 WL1664358, 107 A.F.T.R.2d 2011-1831 (5th Cir. May 2, 2011). The Tax Court held that fees paid by a domestic corporation to its foreign parent with respect to guarantees issued by the parent for the debts of the domestic corporation were more closely analogous to compensation for services than to interest, and determined that the source of the fees should be determined by reference to the residence of the foreign parent-guarantor. As a result, the income was treated as income from foreign sources.

C. Gross-Basis Taxation of U.S.-Source Income

Non-business income received by foreign persons from U.S. sources is generally subject to tax on a gross basis at a rate of 30 percent, which is collected by withholding at the source of the payment. As explained below, the categories of income subject to the 30-percent tax and the categories for which withholding is required are generally coextensive, with the result that determining the withholding tax liability determines the substantive liability.

1. Types of income subject to gross-basis taxation

The income of non-resident aliens or foreign corporations that is subject to tax at a rate of 30-percent includes U.S.-source interest, dividends, rents, royalties, or other similar types of income that are fixed or determinable, annual or periodical gains, profits and income, commonly known as "FDAP income," that is not effectively connected with the conduct of a U.S. trade or business.[30] The items enumerated in defining FDAP income are illustrative; the common characteristic of types of FDAP income is that taxes with respect to such income may be readily computed and collected at the source, in contrast to the administrative difficulty involved in determining the seller's basis and resulting gain from sales of property.[31] The words "annual or periodical" are "merely generally descriptive" of the payments that could be within the purview of the statute and do not preclude application of the withholding tax to one-time, lump sum payments to nonresident aliens.[32]

FDAP income encompasses a broad range of types of gross income, but has limited application to gains on sales of property, including market discount on bonds and option premiums.[33] Capital gains received by nonresident aliens present in the United States for fewer than 183 days are treated as foreign source and are thus not subject to U.S. tax, unless the gains are effectively connected with a U.S. trade or business; capital gains received by nonresident aliens present in the United States for 183 days or more[34] are treated as U.S.-source and may be

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[30] Secs. 871(a), 881. If the FDAP income is effectively connected to a U.S. business, it is taxed on a net basis, at graduated rates, as explained in section II.D., below.

[31] *Commissioner v. Wodehouse*, 337 U.S. 369, 388-89 (1949). After reviewing legislative history of the Revenue Act of 1936, the Supreme Court noted that Congress expressly intended to limit taxes on nonresident aliens to taxes that could be readily collectible, i.e., subject to withholding, in response to "a theoretical system impractical of administration in a great number of cases. H.R. Rep. No. 2475, 74th Cong., 2d Sess. 9-10 (1936)." In doing so, the Court rejected P.G. Wodehouse's arguments that an advance royalty payment was not within the purview of the statutory definition of FDAP income.

[32] *Commissioner v. Wodehouse*, 337 U.S. 369, 393 (1949).

[33] Although technically insurance premiums paid to a foreign insurer or reinsurer are FDAP income, they are exempt from withholding under Treas. Reg. sec. 1.1441-2(a)(7) if the insurance contract is subject to the excise tax under section 4371. Treas. Reg. sec. 1.1441-2(b)(1)(i), -2(b)(2).

[34] For purposes of this rule, whether a person is considered a resident in the United States is determined by application of the rules under section 7701(b).

subject to gross-basis taxation.[35] In contrast, gains from the sale or exchange of intangibles are subject to tax, and subject to withholding if they are contingent upon productivity of the property sold and are not effectively connected with a U.S. trade or business.[36]

Withholding on FDAP payments to foreign payees is required unless the withholding agent,[37] i.e., the person making the payment to the foreign person receiving the income, can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.[38] The principal statutory exemptions from the 30-percent withholding tax apply to interest on bank deposits, and portfolio interest.[39]

Interest on bank deposits

Interest on bank deposits may qualify for exemption on two grounds, depending on where the underlying principal is held on deposit. Interest paid with respect to deposits with domestic banks and savings and loan associations, and certain amounts held by insurance companies, are U.S. source but are not subject to the U.S. withholding tax when paid to a foreign person, unless the interest is effectively connected with a U.S. trade or business of the recipient.[40] Interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not treated as U.S.-source income and is thus exempt from U.S. withholding tax (regardless of whether the recipient is a U.S. or foreign person).[41] Similarly, interest and original issue discount on certain short-term obligations is also exempt from U.S. withholding tax when paid to

[35] Sec. 871(a)(2). In addition, certain capital gains from sales of U.S. real property interests are subject to tax as effectively connected income (or in some instances as dividend income) under the Foreign Investment in Real Property Tax Act of 1980, discussed *infra* at section II.E.2.

[36] Secs. 871(a)(1)(D), 881(a)(4).

[37] Withholding agent is defined broadly to include any U.S. or foreign person that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. Treas. Reg. sec. 1.1441-7(a).

[38] Secs. 871, 881, 1441, 1442; Treas. Reg. sec. 1.1441-1(b).

[39] A reduced rate of withholding of 14 percent applies to certain scholarships and fellowships paid to individuals temporarily present in the United States. Sec. 1441(b). In addition to statutory exemptions, the 30-percent withholding tax with respect to interest, dividends or royalties may be reduced or eliminated by a tax treaty between the United States and the country in which the recipient of income otherwise subject to withholding is resident.

[40] Secs. 871(i)(2)(A), 881(d); Treas. Reg. sec. 1.1441-1(b)(4)(ii).

[41] Sec. 861(a)(1)(B); Treas. Reg. sec. 1.1441-1(b)(4)(iii).

a foreign person.[42] Additionally, there is no information reporting with respect to payments of such amounts.[43]

Portfolio interest

Portfolio interest received by a nonresident individual or foreign corporation from sources within the United States is exempt from 30 percent withholding.[44] For obligations issued before March 19, 2012, the term "portfolio interest" means any interest (including original issue discount) that is paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person, as well as interest paid on an obligation that is not in registered form and that meets the foreign targeting requirements of section 163(f)(2)(B). Portfolio interest, however, does not include interest received by a 10-percent shareholder,[45] certain contingent interest,[46] interest received by a controlled foreign corporation from a related person,[47] or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.[48]

For obligations issued after March 18, 2012, the term "portfolio interest" no longer includes interest paid with respect to an obligation not in registered form. This narrowing of the scope of the portfolio interest exemption is a result of the repeal of the exception to the registration requirements for foreign targeted securities in 2010, effective for obligations issued two years after enactment.[49]

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[42] Secs. 871(g)(1)(B), 881(a)(3); Treas. Reg. sec. 1.1441-1(b)(4)(iv).

[43] Treas. Reg. sec. 1.1461-1(c)(2)(ii)(A), (B). To comply with the obligations of the United States under the United States-Canada income tax treaty, regulations require a bank to report interest if the recipient is a resident of Canada and the deposit is maintained at an office in the United States. Treas. Reg. secs. 1.6049-4(b)(5) and 1.6049-8. The IRS and the Treasury Department recently proposed regulations that would expand the required annual reporting to include U.S. bank deposit interest paid to any nonresident alien. Prop. Treas. Reg. sec. 1.6049-4, 76 Fed. Reg. 1105 (Jan. 7, 2011). The proposed regulation is similar to an earlier, short-lived proposal. See 66 Fed. Reg. 3925 (Jan. 17, 2001), withdrawn at 67 Fed. Reg. 50,386 (Aug. 2, 2002).

[44] Secs. 871(h), 881(c). In 1984, to facilitate access to the global market for U.S. dollar-denominated debt obligations, Congress repealed the withholding tax on portfolio interest paid on debt obligations issued by U.S. persons. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, pp. 391-92.

[45] Sec. 871(h)(3).

[46] Sec. 871(h)(4).

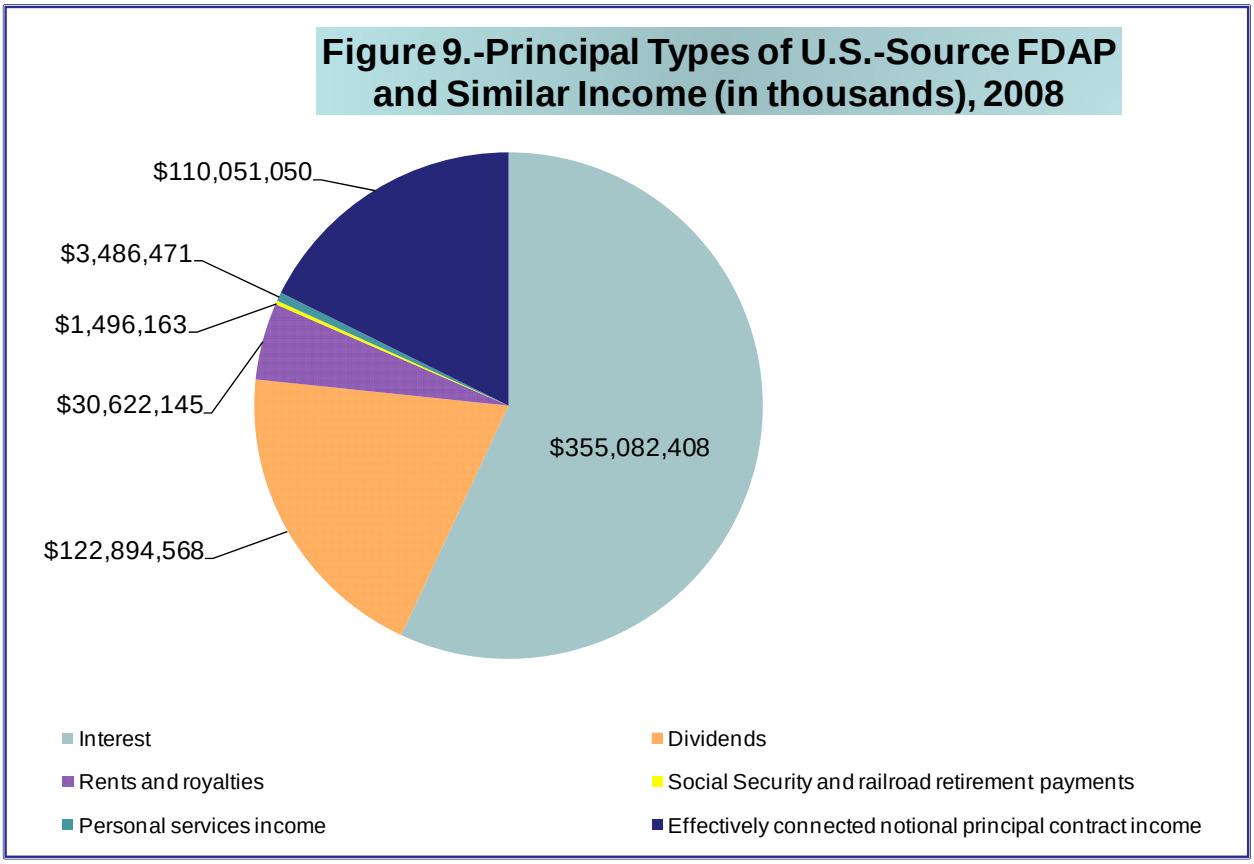
[47] Sec. 881(c)(3)(C).

[48] Sec. 881(c)(3)(A).

[49] Hiring Incentives to Restore Employment Law of 2010, Pub. L. No. 111-147, sec. 502(b).

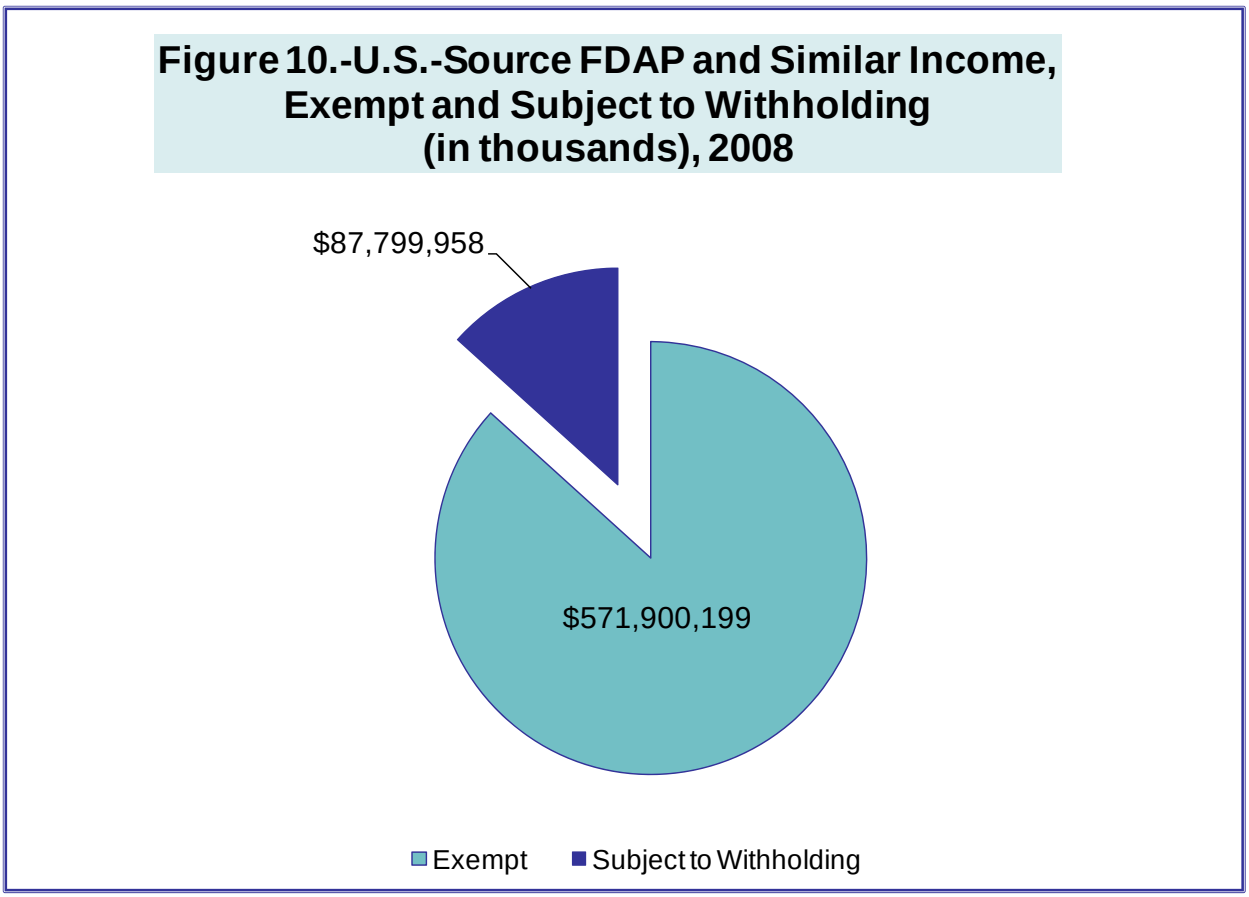
2. Data related to income subject to withholding

Figures 9, 10, and 11 show the principal categories of U.S.-source FDAP and similar income, the amounts of that income subject to, and exempt from, withholding, and the principal countries of residences of the recipients of that income. As Figure 10 illustrates, much FDAP and similar income is exempt from withholding (because, for instance, it is portfolio interest). Because rates of withholding tax are often reduced under treaties (described below), the average withholding tax rate imposed on non-exempt FDAP and similar income is significantly below 30 percent.



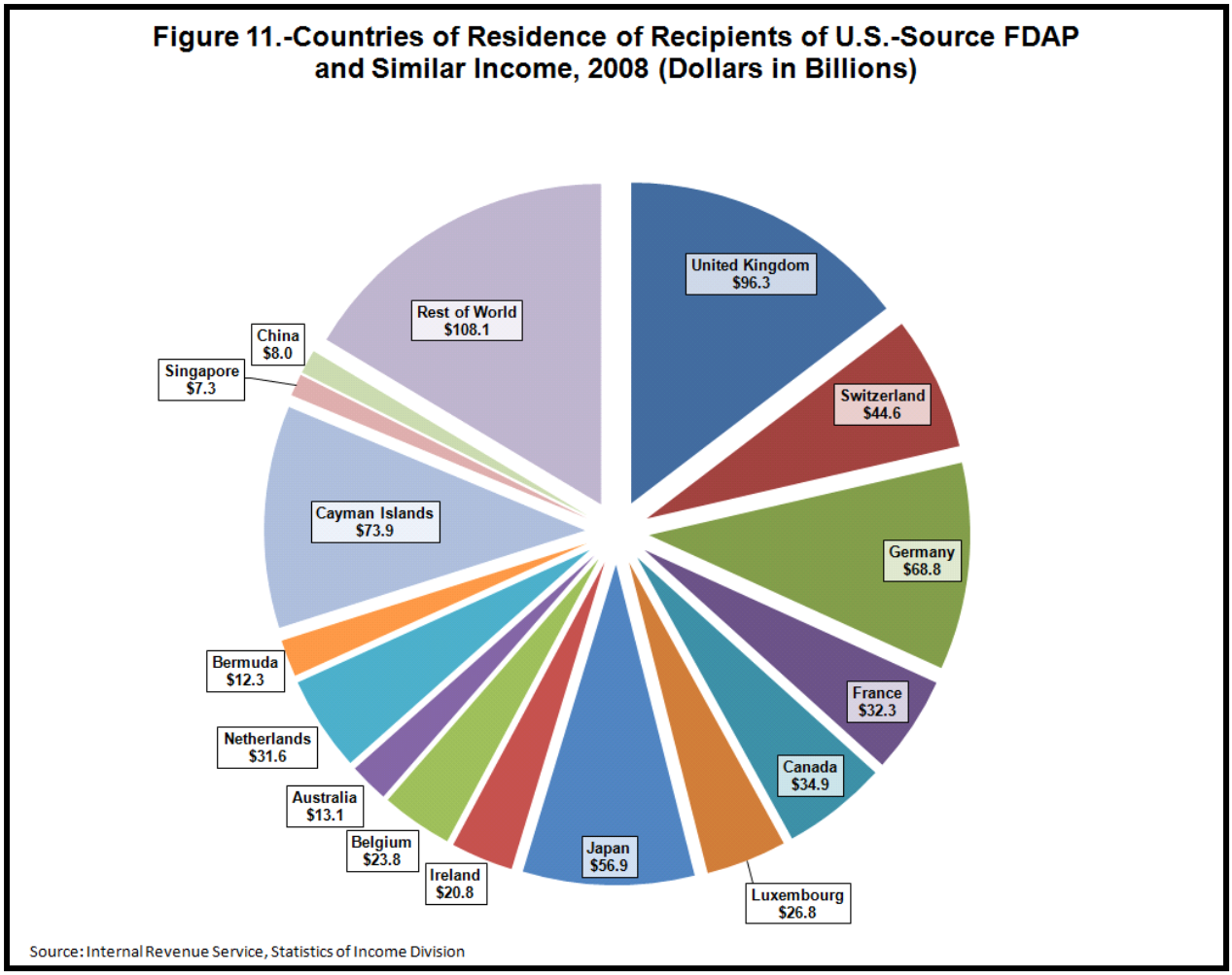
Source: Internal Revenue Service, Statistics of Income Division.

The $624 billion of U.S.-source FDAP and similar income reported on IRS Form 1042-S in 2008 does not include bank deposit interest or capital gains. These amounts are not required to be reported.



Note: U.S. tax withheld: $9,197,703; average tax rate on amounts subject withholding: 10 percent.

Source: Internal Revenue Service, Statistics of Income Division.



3. Reduced and zero rates of withholding under tax treaties

The 30-percent withholding tax on U.S.-source FDAP income is reduced or eliminated under bilateral income tax treaties that cover a large portion of that income. Because each treaty reflects considerations unique to the relationship between the two treaty countries, treaty withholding tax rates on each category of income are not uniform across treaties. The United States, however, has set forth its negotiating position on withholding rates and other provisions in the United States Model Income Tax Convention of November 15, 2006 (the "U.S. Model Treaty"). The following table illustrates treaty reductions of withholding tax and the U.S. Model Treaty rates.

Withholding Tax Rates Under Selected U.S. Bilateral Income Tax Treaties			
	Royalties	Interest	Dividends
Bangladesh	10	10 (0 or 5 in limited cases)	10 / 15
Canada	0 (if criteria met; if not, 10)	0	5 / 15
Germany	0	0	0 / 5 / 15
Japan	0	0 (if criteria met; if not, 10)	0 / 5 / 10
Malta	10	10 (15 if Malta-source contingent interest)	5 / 15
United Kingdom	0	0	0 / 5 / 15
U.S. Model Treaty	0	0 (15 for contingent interest)	5 / 15

Note: The dividend withholding tax rates vary based on the percentage of stock of the dividend-paying company owned by the recipient of the dividend. Treaties provide lower withholding tax rates (five percent, for example) at ownership levels of ten percent and greater. When available, zero percent withholding rates require ownership of at least 80 percent (in the case of Japan, 50 percent).

4. Imposition of gross-basis tax and reporting by U.S. withholding agents

The 30-percent tax on FDAP income is generally collected by means of withholding.[50] In many instances, the income subject to withholding is the only income of the foreign recipient that is subject to any U.S. tax. No U.S. Federal income tax return from the foreign recipient is required with respect to the income from which tax was withheld. Accordingly, although the 30-percent gross-basis tax is a withholding tax, it is also generally the final tax liability of the foreign recipient.

[50] Secs. 1441, 1442.

A withholding agent that makes payments of U.S.-source amounts to a foreign person is required to report and pay over any amounts of U.S. tax withheld. The reports are due to be filed with the IRS by March 15 of the calendar year following the year in which the payment is made. Two types of reports are required: (1) a summary of the total U.S.-source income paid and withholding tax withheld on foreign persons for the year and (2) a report to both the IRS and the foreign person of that person's U.S.-source income that is subject to reporting.[51] The nonresident withholding rules apply broadly to any financial institution or other payor, including foreign financial institutions.[52]

To the extent that the withholding agent deducts and withholds an amount, the withheld tax is credited to the recipient of the income.[53] If the agent withholds more than is required, and results in an overpayment of tax, the excess may be refunded to the recipient of the income upon filing of a timely claim for refund.

The U.S. withholding tax rules are administered through a system of self-certification. A nonresident investor seeking to obtain withholding tax relief for U.S.-source investment income must certify to the withholding agent, under penalty of perjury, the person's foreign status and eligibility for an exemption or reduced rate. This self-certification is made on the relevant IRS form, similar to those used by U.S. persons to establish an exemption from the rules governing information reporting on IRS Form 1099 and backup withholding.[54]

The United States imposes tax on the beneficial owner of income, not its formal recipient. To avoid cascading imposition of the withholding tax as payments move through intermediaries to the beneficial owner, a formal recipient must alert the U.S. withholding agent, who in turn reflects that status in reports to the IRS. For example, a payee may receive a payment of U.S.-source income as an intermediary on behalf of the beneficial owner of that income. The intermediary certifies its eligibility for exemption in a form submitted to the IRS and accompanied by documentation furnished by the beneficial owner attesting to the owner's foreign status. The intermediary may then withhold tax upon remitting the payment to the beneficial owner.

<u>The qualified intermediary program</u>

If the intermediary is a qualified intermediary ("QI"), a withholding foreign partnership, or a withholding foreign trust,[55] the series of disclosures described above may be simplified. A

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[51] Treas. Reg. sec. 1.1461-1(b), (c).

[52] See Treas. Reg. secs. 1.1441-7(a) (definition of withholding agent includes foreign persons).

[53] Sec. 1462.

[54] See Treas. Reg. sec. 1.1441-1(b)(5).

[55] A withholding foreign partnership or trust is a foreign partnership or trust that has entered into an agreement with the IRS to collect appropriate IRS Forms W-8 from its partners or beneficiaries and act as a U.S. withholding agent with respect to those persons. Rev. Proc. 2003-64, 2003-32 I.R.B. 306 (July 10, 2003).

QI is defined as a foreign financial institution or a foreign clearing organization, other than a U.S. branch or U.S. office of such institution or organization, which has entered into a withholding and reporting agreement (a "QI agreement") with the IRS. The definition also includes: a foreign branch or office of a U.S. financial institution or U.S. clearing organization; a foreign corporation for purposes of presenting income tax treaty claims on behalf of its shareholders; and any other person acceptable to the Internal Revenue Service.[56] A foreign financial institution that becomes a QI is not required to forward beneficial ownership information with respect to its customers to a U.S. financial institution or other withholding agent of U.S.-source investment-type income to establish their eligibility for an exemption from, or reduced rate of, U.S. withholding tax.[57] Instead, the QI is permitted to establish for itself the eligibility of its customers for an exemption or reduced rate, based on information as to residence obtained under the "know-your-customer" rules to which the QI is subject in its home jurisdiction as approved by the IRS or as specified in the QI agreement. The QI certifies eligibility on behalf of its customers and provides withholding rate pool information to the U.S. withholding agent as to the portion of each payment that qualifies for an exemption or reduced rate of withholding.

In exchange for entering into a QI agreement, the QI is able to shield the identities of its customers from other intermediaries (for example, other financial institutions in the chain of payment that may be business competitors of the QI) in certain circumstances and is subject to reduced information reporting duties to the IRS compared to those that apply in the absence of the QI agreement. This ability to shield customer information is limited, however, with respect to accounts of U.S. persons for which it acts as QI, because the QI is required to furnish Forms 1099 to its U.S. customers if it has assumed primary reporting and backup withholding responsibility for these accounts, or to provide Forms W-9 or information sufficient to complete a Form W-9, to the withholding agent in cases in which the QI has not assumed such primary responsibility.

The terms of a QI agreement include presumptions to apply to different scenarios to determine whether to withhold. U.S.-source investment income that is paid outside the United States to an offshore account is presumed to be paid to an undocumented foreign account holder, thus requiring the QI to withhold at a 30-percent rate and report the payment as a payment to an unknown account holder on IRS Form 1042-S.[58] Foreign-source income and broker proceeds paid outside the United States to an offshore account are presumed to be paid to a U.S. exempt recipient and thus are exempt from withholding.

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[56] Treas. Reg. sec. 1.1441-1(e)(5)(ii).

[57] U.S. withholding agents are allowed to rely on a QI's Form W-8IMY without any underlying beneficial owner documentation. By contrast, nonqualified intermediaries are required both to provide a Form W-8IMY to a U.S. withholding agent and to forward with that document Form W-8s or W-9s for each beneficial owner.

[58] U.S.-source deposit interest and interest or original issue discount on short-term obligations that are paid outside the United States to an offshore account are statutorily exempt from nonresident withholding when paid to non-U.S. persons, but may be subject to other withholding requirements under regulations or the terms of the QI agreement.

Foreign Account Tax Compliance Act ("FATCA")

In contrast to the QI regime focus on tax compliance of foreign persons with U.S. source income, a new reporting and withholding regime, commonly referred to as the Foreign Account Tax Compliance Act,[59] was added to the Code as Chapter 4 to address compliance of U.S. persons with foreign source income.[60] FATCA made a number of changes to U.S. tax law to improve tax compliance, including changes with respect to foreign accounts and cross-border transactions. Chapter 4 requires reporting of specific information by third parties for certain U.S. accounts held in foreign financial institutions ("FFIs").[61] Information reporting is encouraged by requiring that a withholding tax of 30 percent of the gross amount of payments to FFIs be withheld unless the FFI enters into and complies with an information reporting agreement with the Secretary of the Treasury.[62]

[59] Foreign Account Tax Compliance Act of 2009 is the name of the House and Senate bills in which the provisions first appeared. See H.R. 3933 and S. 1934 (October 27, 2009).

[60] Hiring Incentives to Restore Employment ("HIRE") Act of 2010, Pub. L. No. 111-147.

[61] Under section 1471(c), an FFI must report (1) the name, address, and taxpayer identification number of each U.S. person or a foreign entity with one or more substantial U.S. owners holding an account, (2) the account number, (3) the account balance or value, and (4) except as provided by the Secretary, the gross receipts and gross withdrawals or payments from the account.

[62] The information reporting requirement under the HIRE Act generally applies to payments made after December 31, 2012.

D. Net-Basis Taxation

Income from a U.S. business

The United States taxes on a net basis the income of foreign persons that is "effectively connected" with the conduct of a trade or business in the United States.[63] Any gross income derived by the foreign person that is not effectively connected with the person's U.S. business is not taken into account in determining the rates of U.S. tax applicable to the person's income from the business.[64]

U.S. trade or business

A foreign person is subject to U.S. tax on a net basis if the person is engaged in a U.S. trade or business. Partners in a partnership and beneficiaries of an estate or trust are treated as engaged in the conduct of a trade or business within the United States if the partnership, estate, or trust is so engaged.[65]

The question whether a foreign person is engaged in a U.S. trade or business is factual and has generated much case law. Basic issues include whether the activity constitutes business rather than investing, whether sufficient activities in connection with the business are conducted in the United States, and whether the relationship between the foreign person and persons performing functions in the United States in respect of the business is sufficient to attribute those functions to the foreign person.

The trade or business rules differ from one activity to another. The term "trade or business within the United States" expressly includes the performance of personal services within the United States.[66] If, however, a nonresident alien individual performs personal services for a foreign employer, and the individual's total compensation for the services and period in the United States are minimal ($3,000 or less in total compensation and 90 days or fewer of physical presence in a year), the individual is not considered to be engaged in a U.S. trade or business.[67] Detailed rules govern whether trading in stocks or securities or commodities constitutes the conduct of a U.S. trade or business.[68] A foreign person who trades in stock or securities or commodities in the United States through an independent agent generally is not treated as engaged in a U.S. trade or business if the foreign person does not have an office or other fixed place of business in the United States through which trades are carried out. A foreign person who trades stock or securities or commodities for the person's own account also generally is not

[63] Secs. 871(b), 882.

[64] Secs. 871(b)(2), 882(a)(2).

[65] Sec. 875.

[66] Sec. 864(b).

[67] Sec. 864(b)(1).

[68] Sec. 864(b)(2).

considered to be engaged in a U.S. business so long as the foreign person is not a dealer in stock or securities or commodities.

For eligible foreign persons, U.S. bilateral income tax treaties restrict the application of net-basis U.S. taxation. Under each treaty, the United States is permitted to tax business profits only to the extent those profits are attributable to a U.S. permanent establishment of the foreign person. The threshold level of activities that constitute a permanent establishment is generally higher than the threshold level of activities that constitute a U.S. trade or business. For example, a permanent establishment typically requires the maintenance of a fixed place of business over a significant period of time.

Effectively connected income ("ECI")

A foreign person that is engaged in the conduct of a trade or business within the United States is subject to U.S. net-basis taxation on the income that is "effectively connected" with the business. Specific statutory rules govern whether income is ECI.[69]

In the case of U.S.-source capital gain and U.S.-source income of a type that would be subject to gross basis U.S. taxation, the factors taken into account in determining whether the income is ECI include whether the income is derived from assets used in or held for use in the conduct of the U.S. trade or business and whether the activities of the trade or business were a material factor in the realization of the amount (the "asset use" and "business activities" tests).[70] Under the asset use and business activities tests, due regard is given to whether the income, gain, or asset was accounted for through the U.S. trade or business. All other U.S.-source income is treated as ECI.[71]

A foreign person who is engaged in a U.S. trade or business may have limited categories of foreign-source income that are considered to be ECI.[72] Foreign-source income not included in one of these categories (described next) generally is exempt from U.S. tax.

A foreign person's foreign-source income generally is considered to be ECI only if the person has an office or other fixed place of business within the United States to which the income is attributable and the income (1) is rents or royalties for the use of patents, copyrights, secret processes or formulas, good will, trade-marks, trade brands, franchises, or other like intangible properties derived in the active conduct of the trade or business; (2) is interest or dividends derived in the active conduct of a banking, financing, or similar business within the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account; or (3) is derived from the sale or exchange (outside the United

[69] Sec. 864(c).

[70] Sec. 864(c)(2).

[71] Sec. 864(c)(3).

[72] This income is subject to net-basis U.S. taxation after allowance of a credit for any foreign income tax imposed on the income. Sec. 906.

States), through the U.S. office or fixed place of business, of inventory or property held by the foreign person primarily for sale to customers in the ordinary course of the trade or business, unless the sale or exchange is for use, consumption, or disposition outside the United States and an office or other fixed place of business of the foreign person in a foreign country participated materially in the sale or exchange.[73] Foreign-source dividends, interest, and royalties are not treated as ECI if the items are paid by a foreign corporation more than 50 percent (by vote) of which is owned directly, indirectly, or constructively by the recipient of the income.[74]

In determining whether a foreign person has a U.S. office or other fixed place of business, the office or other fixed place of business of an agent generally is disregarded. The place of business of an agent other than an independent agent acting in the ordinary course of business is not disregarded, however, if either the agent has the authority (regularly exercised) to negotiate and conclude contracts in the name of the foreign person or the agent has a stock of merchandise from which he regularly fills orders on behalf of the foreign person.[75] If a foreign person has a U.S. office or fixed place of business, income, gain, deduction, or loss is not considered attributable to the office unless the office was a material factor in the production of the income, gain, deduction, or loss and the office regularly carries on activities of the type from which the income, gain, deduction, or loss was derived.[76]

Special rules apply in determining the ECI of an insurance company. The foreign-source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code is treated as ECI if the income is attributable to its United States business.[77]

Income, gain, deduction, or loss for a particular year generally is not treated as ECI if the foreign person is not engaged in a U.S. trade or business in that year.[78] If, however, income or gain taken into account for a taxable year is attributable to the sale or exchange of property, the performance of services, or any other transaction that occurred in a prior taxable year, the determination whether the income or gain is taxable on a net basis is made as if the income were taken into account in the earlier year and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the later taxable year.[79] If any property ceases to be used or held for use in connection with the conduct of a U.S. trade or business and the property is disposed of within 10 years after the cessation, the determination whether any income or gain attributable to the disposition of the property is taxable on a net

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[73] Sec. 864(c)(4)(B).

[74] Sec. 864(c)(4)(D)(i).

[75] Sec. 864(c)(5)(A).

[76] Sec. 864(c)(5)(B).

[77] Sec. 864(c)(4)(C).

[78] Sec. 864(c)(1)(B).

[79] Sec. 864(c)(6).

basis is made as if the disposition occurred immediately before the property ceased to be used or held for use in connection with the conduct of a U.S. trade or business and without regard to the requirement that the taxpayer be engaged in a U.S. business during the taxable year for which the income or gain is taken into account.[80]

Allowance of deductions

Taxable ECI is computed by taking into account deductions associated with gross ECI. For this purpose, the apportionment and allocation of deductions is addressed in detailed regulations. The regulations applicable to deductions other than interest expense set forth general guidelines for allocating deductions among classes of income and apportioning deductions between ECI and non-ECI. In some circumstances, deductions may be allocated on the basis of units sold, gross sales or receipts, costs of goods sold, profits contributed, expenses incurred, assets used, salaries paid, space used, time spent, or gross income received. More specific guidelines are provided for the allocation and apportionment of research and experimental expenditures, legal and accounting fees, income taxes, losses on dispositions of property, and net operating losses. Detailed regulations under section 861 address the allocation and apportionment of interest deductions. In general, interest is allocated and apportioned based on assets rather than income.

[80] Sec. 864(c)(7).

E. Special Rules

1. Branch taxes

Present Law

A domestic corporation owned by foreign persons is subject to U.S. income tax on its net income. In addition, the earnings of the domestic corporation are subject to a second tax, this time at the shareholder level, when dividends are paid. As discussed above, when the shareholders are foreign, the second-level tax is imposed at a flat rate and collected by withholding. Similarly, as discussed above, interest payments made by a domestic corporation to foreign creditors are subject to a U.S. withholding tax in certain circumstances. Pursuant to the branch tax provisions, the United States taxes foreign corporations engaged in a U.S. trade or business on amounts of U.S. earnings and profits that are shifted out of, or amounts of interest deducted by, the U.S. branch of the foreign corporation. The branch level taxes are comparable to these second-level taxes, and under certain circumstances, may be reduced or eliminated under an applicable income tax treaty.

The United States imposes a tax of 30 percent on a foreign corporation's "dividend equivalent amount."[81] The dividend equivalent amount generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected with a U.S. trade or business.[82] The following earnings and profits attributable to income effectively connected with a U.S. trade or business are excluded from the imposition of branch profits tax: (1) certain earnings derived by a foreign sales corporation; (2) certain foreign transportation earnings; (3) earnings derived from the sale of any interest in U.S. real property holding corporations; (4) earnings derived by certain corporations organized in a U.S. possession; (5) earnings derived by certain captive insurance companies; and (6) certain exempt foreign government related income.[83]

In arriving at the dividend equivalent amount, a branch's effectively connected earnings and profits are adjusted to reflect changes in a branch's U.S. net equity (i.e., the excess of the branch's assets over its liabilities, taking into account only amounts treated as connected with its U.S. trade or business).[84] The first adjustment reduces the dividend equivalent amount to the extent the branch's earnings are reinvested in trade or business assets in the United States (or reduce U.S. trade or business liabilities). The second adjustment increases the dividend equivalent amount to the extent prior reinvested earnings are considered remitted to the home office of the foreign corporation.

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[81] Sec. 884(a).

[82] Sec. 884(b).

[83] Sec. 884(d)(2).

[84] Sec. 884(b).

Interest paid by a U.S. trade or business of a foreign corporation generally is treated as if paid by a domestic corporation and therefore is subject to U.S. 30-percent withholding tax (if the interest is paid to a foreign person and a Code or treaty exemption or reduction would not be available if the interest were actually paid by a domestic corporation).[85] Certain "excess interest" of a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation to a foreign parent and, therefore, is subject to U.S. 30-percent withholding tax.[86] For this purpose, excess interest is the excess of the interest expense of the foreign corporation apportioned to the U.S. trade or business over the amount of interest paid by such trade or business.

Legislative Background

The branch tax provisions were added to the Code in 1986.[87] Congress added the provisions "[t]o achieve greater parity between the remittance of branch profits and the distribution of subsidiary earnings."[88]

2. Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")

Present Law

In general

A foreign person that is not engaged in business in the U.S. (and is not an individual who is present in the U.S. at least 183 days in the year) generally is not subject to any U.S. tax on capital gain from U.S. sources.[89]

However, the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")[90] generally treats a foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") as income that is effectively connected with a U.S. trade or business, and thus taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain. A foreign person subject to tax on this income is required to file a U.S. tax return under the

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[85] Sec. 884(f)(1)(A).

[86] Sec. 884(f)(1)(B).

[87] Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1241. Technical corrections were made in 1988, 1989, 1996, and 2007. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, sec. 1012(q); Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, sec. 7811(i)(5); Small Business Job Protection Act of 1996, Pub. L. No. 104-188, sec. 1704(f)(3); Tax Technical Corrections Act of 2007, Pub. L. No. 110-172, sec. 11(g)(18).

[88] H.R. Rep. No. 99-841, p. II-647 (1986) (Conf. Rep.).

[89] Secs. 871(b), 882(a).

[90] Pub. L. No. 96-499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. See secs. 897, 1445, 6039C, 6652(f).

normal rules relating to receipt of income effectively connected with a U.S. trade or business.[91] In the case of a foreign corporation, the gain from the disposition of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

The payor of income that FIRPTA treats as effectively-connected with a U.S. trade or business ("FIRPTA income") to a foreign person is generally required to withhold U.S. tax from the payment. Withholding is generally 10 percent of the sales price, in the case of a direct sale by the foreign person of a USRPI, and 35 percent of the amount of a distribution to a foreign person of proceeds attributable to such sales from an entity such as a partnership, real estate investment trust ("REIT") or regulated investment company ("RIC").[92] The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's total U.S. effectively connected income and deductions (if any) for the taxable year.

USRPIs include interests in real property located in the United States or the U.S. Virgin Islands, and stock of a domestic U.S. real property holding company ("USRPHC"), generally defined as any corporation, unless the taxpayer establishes that the fair market value of the corporation's USRPIs was less than 50 percent of the combined fair market value of all its real property interests (U.S. and worldwide) and of all its assets used or held for use in a trade or business, at all times during the shorter of the taxpayer's ownership of the stock or the five-year period ending on the date of disposition of the stock.[93] However, any class of stock that is regularly traded on an established securities market is treated as a USRPI only if the seller held more than five percent of the stock at any time during such period.[94]

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[91] Sec. 897(a). In addition, section 6039C authorizes regulations that would require a return reporting foreign direct investments in U.S. real property interests. No such regulations have been issued, however.

[92] Sec. 1445 and Treasury regulations thereunder. The Treasury department is authorized to issue regulations that would reduce the 35 percent withholding on distributions to 15 percent during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 15 percent.

[93] Secs. 897(c)(1)(A)(ii), 897(c)(2).

[94] Sec. 897(c)(3). Constructive ownership rules apply under section 897(c)(6)(C).

Under these rules, for example, if a foreign person directly owns U.S. real estate, or owns U.S. real estate through a partnership, gain from the sale of the real estate will be subject to tax as FIRPTA income. Alternatively, if a foreign person owns U.S. real estate through a corporation that is a USRPHC that is not publicly traded, (or owns more than five percent of the stock of a publicly traded USRPHC during the relevant period) gain from sale of the corporate stock is generally subject to tax as FIRPTA income.

Special rules for certain investment entities (REITs and RICs)[95]

Certain investment entities

REITs and RICs are generally passive investment entities (though certain activities are permitted). They are organized as U.S. domestic entities and are taxed as U.S. domestic corporations. However, because of their special status, they are entitled to deduct amounts distributed to shareholders and, in some cases, to allow the shareholders to characterize these amounts based on the type of income the REIT or RIC received. Among numerous other requirements for qualification as a REIT or RIC, such entities are generally required to distribute to shareholders at least 90 percent of their income (excluding net capital gain) annually.[96] A REIT or RIC may designate a capital gain dividend to its shareholders, who then treat the amount designated as capital gain.[97] A REIT or RIC is taxed at regular corporate rates on undistributed income; but the combination of the requirement to distribute income other than net capital gain, plus the ability to declare a capital gain dividend and avoid corporate level tax on such income, typically results in little, if any, corporate-level tax paid by a REIT or RIC. Instead, the shareholder-level tax on distributions is the principal tax paid with respect to income of these entities. The requirements for REIT eligibility include primary investment in real estate assets (which assets can include mortgages). The requirements for RIC eligibility include primary investment in stocks and securities (which can include stock of REITs or of other RICs).

FIRPTA rules for REITs and RICs

Certain special rules under FIRPTA apply to REITs, and to certain RICs that are largely invested in U.S. real property interests. REITs and such RICs are called "qualified investment entities".[98] Stock of a "domestically controlled" qualified investment entity is excluded from the

[95] Sec. 897(h).

[96] Secs. 852(a)(1), 852(b)(2)(A), 857(a)(1). If a REIT or RIC does not distribute net capital gain (or deem it to be distributed), a corporate level tax is imposed on the retained income. Additional distribution requirements are imposed under section 4981 (for REITs) and section 4982 (for RICs).

[97] Secs. 852(b)(3), 857(b)(3).

[98] A "qualified investment entity" means any REIT. It also includes, for purposes of the special rules, any RIC which is a USRPHC or which would be a USRPHC if the exceptions provided in sections 897(c)(3) (regarding five-percent shareholders of publicly traded entities) and 897(h)(2) (regarding domestically controlled entities) did not apply to interests in any RIC or REIT. After December 31, 2011, a RIC is not included in the definition for purposes of the rule permitting stock of a "domestically controlled" qualified investment entity to be sold without FIRPTA tax. Sec. 897(h)(4)(A)(ii).

definition of a USRPI.[99] The term "domestically controlled" is defined to mean that less than 50 percent in value of the qualified investment entity has been owned (directly or indirectly) by foreign persons during the relevant holding period, generally the five-year period ending on the date of a disposition or distribution to which the exception applies.[100] Thus, stock of a domestically controlled REIT or of a domestically controlled RIC that is a qualified investment entity for this purpose can be sold without FIRPTA consequences. This exception applies regardless of whether the sale of stock is made directly by a foreign person, or by a REIT or RIC whose distributions to foreign persons of gain attributable to the sale of USRPIs would be subject to FIRPTA.

A distribution by a qualified investment entity to a foreign shareholder, to the extent attributable to gain from the entity's sale or exchange of USRPIs, is generally treated as FIRPTA income to the shareholder. The FIRPTA character is also retained if the distribution occurs from one qualified investment entity to another, through a tier of U.S. REITs or RICs.[101] An IRS notice states that this rule retaining the FIRPTA income character of distributions attributable to the sale of USRPIs applies to both nonliquidating and liquidating distributions to a qualified investment entity shareholder and that the IRS will issue regulations to that effect.[102] An exception to this rule applies if the distribution is made on a class of qualified investment entity stock that is regularly traded on an established securities market located in the United States and the foreign person has not held more than five percent of the class of stock at any time during the one-year period ending on the date of the distribution.[103] Where the exception applies, a distribution to the foreign shareholder is treated as the distribution of an ordinary dividend (rather than as a capital gain dividend), subject to 30-percent (or lower treaty rate) withholding. Such a dividend distribution is not exempt from U.S. tax as capital gain, but also is not treated as FIRPTA income that would require a U.S. tax return to be filed.[104]

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[99] Sec. 897(h)(2).

[100] Sec. 897(h)(2), (h)(4)(B). For 2005 through 2011, a similar exception applies to RIC stock if the RIC meets specific asset requirements taking into account its investment in REITs. Sec. 897(h)(4)(A)(ii).

[101] In 2006, the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"), Pub. L. No. 109-222 sec. 505, specified the retention of this FIRPTA character on a distribution to an upper-tier qualified investment entity, and added statutory withholding requirements.

[102] Notice 2007-55, 2007-2 C.B.13. The Notice also states that in the case of a foreign government investor, because FIRPTA income is treated as effectively connected with the conduct of a U.S. trade or business, proceeds distributed by a qualified investment entity from the sale of U.S. real property interests are not exempt from tax under section 892. The Notice cites and compares pre-existing temporary regulations and indicates that Treasury will apply those regulations as well to certain distributions. See Temp. Treas. Reg. secs. 1.892-3T, 1.897-9T(e), 1.1445-10T(b).

[103] Sec. 897(h)(1).

[104] Sec. 857(b)(3)(F). Based on statutory references to section 857(b)(3)(B) and (D), which refer to capital gain dividends, an IRS Chief Counsel Attorney Memorandum concludes that no tax is imposed in the case of a liquidating distribution to such a shareholder that would not be treated as a dividend to the shareholder. The

Some U.S. income tax treaties that apply a reduced withholding tax rate to dividend distributions contain special provisions for distributions that are treated as ordinary dividends from REITs or RICs. These treaties generally restrict the withholding tax rate reduction for such dividends to no lower than 15 percent. In the case of REITs, they also limit qualification for the 15-percent rate to foreign shareholders that own no more than a specified percentage of the REIT. The percentage varies depending on whether the REIT stock is held by an individual (generally 10 percent, sometimes more, e.g., 25 percent), or is held by any person in a diversified REIT (generally 10 percent) or, if neither of the other exceptions applies, generally five percent in the case of dividends paid with respect to a class of publicly traded stock.[105] Some treaties further provide an exception to these shareholder ownership limits to permit certain publicly traded investment entities of the other country to own more REIT stock than the otherwise applicable limit.[106] Under some such treaties, however, the shareholder REIT ownership limitations are applied separately, on a "look-through" basis, to any shareholder that the other country entity knows or should know owns more than five percent of such entity.[107]

Legislative Background

When FIRPTA was enacted in 1980, Congress was concerned that foreign investors in U.S. real property enjoyed an advantage over U.S. investors, because a foreign investor could (like a U.S. investor) enjoy the benefits of any U.S. tax rules that reduce tax on operating income from U.S., real estate, and at the same time (unlike a U.S. investor) could also enjoy exemption from tax on gain realized upon disposition of the property.

The Senate Finance Committee reports to predecessor bills, and the Senate Budget Committee Report to the Revenue Reconciliation Act of 1980 in which the provision was enacted, all stated:

> The committee believes it is essential to establish equity of tax treatment in U.S. real property between foreign and domestic investors. The committee does not intend by the provisions of this bill to impose a penalty on foreign investors or to

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treatment provided under Notice 2007-55 to investors not qualifying for the publicly traded five-percent shareholder rule is also reiterated in the memorandum. IRS AM 2008-003.

[105] See, e.g., Convention Between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, August 6, 1982, as amended by the Protocol signed on September 27, 2001, article 10(4) ("U.S.-Australia Treaty") (certain REIT ownership interests existing before the date of the protocol are entitled to the 15-percent dividend rate without regard to the ownership limitations); see also Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, December 18, 1992, as amended by the Protocol signed on March 8, 2004, article 10(4) ("U.S.-Netherlands Treaty"); Convention Between the Government of the United States and the Government of the United Kingdom of Great Britain and Northern Ireland, as amended by the Protocol signed on July 24, 2001, article 10(4) ("U.S.- U.K. Treaty").

[106] See, e.g., the U.S.- Australia Treaty and the U.S.- Netherlands Treaty, *supra*.

[107] See, e.g., the U.S.-Australia Treaty, *supra*.

> discourage foreign investors from investing in the United States. However, the committee believes that the United States should not continue to provide an inducement through the tax laws for foreign investment in U.S. real property which affords the foreign investor a number of mechanisms to minimize or eliminate his tax on income from the property, while at the same time effectively exempting him from U.S. tax on the gain realized on disposition of the property.[108]

The original legislation contained many of the special present law rules relating to REITs. For example, it provided that stock in a domestically controlled REIT was not considered U.S real property holding corporation stock (and thus could be sold without FIRPTA tax).

The legislation also provided that if a REIT made a distribution to a foreign shareholder, to the extent the distribution was attributable to gain from the sale or exchange by the REIT of U.S. real property interests, the distribution would be treated by the foreign shareholder as gain from the sale of exchange of such interests (and hence subject to FIRPTA).

Over the period 2004 through 2006, adopting the changes contained in present law, Congress modified the FIRPTA rules for REITs, and also applied the rules to certain RICs that were largely invested in U.S. real property interests (including stock of REITs). The changes categorized such RICs and REITs as "qualified investment entities."[109] Qualified investment entities were permitted to make distributions of proceeds from the sale of U.S. real property interests to foreign shareholders, without treating such distributions as FIRPTA income, if the distribution is with respect to a class of stock that is regularly traded on an established securities market located in the U.S. and the foreign shareholder did not hold more than five percent of the such stock at any time during the taxable year of the dividend. However, any capital gain dividend thus excepted from FIRPTA income treatment was instead characterized as an ordinary dividend, subject to dividend withholding. Thus, such dividends were neither tax-free as capital gain, nor effectively-connected income that would require a U.S. tax return to be filed and would possibly be subject to foreign branch profits tax.

Congress provided that for a temporary period, stock of "domestically controlled" RICs treated as qualified investment entities could be sold without being subject to FIRPTA (the same rule that had previously applied only to REITs).[110] Also, along with REITs, such RICs were

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[108] S. Rep. No. 96-499, pp. 8-9 (1979); S. Rep. No. 96-504, 96th Cong, 1st Sess. (Dec. 15, 1979), p. 6 (1979); S. Rep. No. 96-532, pp. 12-13 (1979); Report to S. 2939 (the Revenue Reconciliation Act of 1980), Cong. Rec. S9311, S9317 (July 2, 1980).

[109] American Jobs Creation Act of 2004, Pub. L. No. 108-357, sec. 411(c); Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, sec. 403(p); TIPRA, sec. 504.

[110] This rule was enacted as a temporary rule and has been extended. Under present law, it ceases to apply to RICs after December 31, 2011.

subjected on a permanent basis to the rules that treat as FIRPTA income distributions by qualified investment entities of proceeds from the sale of U.S. real property interests.[111]

Also in 2006, Congress added several rules of present law directed at tightening the imposition of FIRPTA tax on certain distributions from qualified investment entities. One rule provided that distributions by one qualified investment entity to another (as well as distributions to ultimate foreign shareholders, explicitly covered by prior law) were subject to FIRPTA if such distributions were made from the proceeds of the sale of U.S. real property interests. Additional withholding rules were also provided. The stated reason for this 2006 change was a concern that a lower-tier REIT (or RIC) might sell U.S. real property interests and make a distribution to an upper-tier REIT (or RIC) that is a domestic entity, and thereafter the entities would take the position that because the distribution had been made to a U.S. entity, FIRPTA did not apply, and any further distributions up the chain to ultimate foreign shareholders of the upper-tier REIT or RIC were not subject to FIRPTA or FIRPTA withholding.[112] Certain "wash-sale" rules were also added, directed at foreign investors that might sell and repurchase stock of a domestically controlled RIC or REIT to avoid receipt of a distribution that would have been treated as FIRPTA income.[113]

3. Earnings stripping

Present Law

Foreign corporations are limited in their ability to reduce the U.S. tax on the income derived from their U.S. subsidiaries' operations through certain earnings stripping transactions involving interest payments. If the payor's debt-to-equity ratio exceeds 1.5 to 1 (a debt-to-equity ratio of 1.5 to 1 or less is considered a "safe harbor"), a deduction for "disqualified interest" paid

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[111] This portion of the rule including RICs as "qualified investment entities" is permanent and does not expire after December 31, 2011.

[112] TIPRA, sec. 505. The legislative history stated with respect to prior law:

> Although the law thus provides rules for taxing foreign persons under FIRPTA on distributions of gain from the sale of USRPIs by RICs and REITs, some taxpayers may be taking the position that if a foreign person invests in a RIC or REIT that, in turn, invests in a lower-tier RIC or REIT that is the entity that disposes of USRPIs and distributes the proceeds, then the proceeds from such disposition by the lower-tier REIT cease to be FIRPTA income when distributed to the upper-tier RIC or REIT (which is not itself a foreign person) and can thereafter be distributed by that latter entity to its foreign shareholders as non-FIRPTA income of such RIC or REIT, rather than continuing to be categorized as FIRPTA income. Furthermore, RICs may take the position that in the absence of regulations or a specific statutory rule addressing the withholding rules for FIRPTA capital gain that is treated as effectively connected with a U.S. trade or business, such gain should be considered capital gain for which no withholding is required.

H.R. Rep. No. 109-455, p. 287 (2006) (Conf. Rep.).

[113] TIPRA, sec. 506.

or accrued by the payor in a taxable year is generally disallowed to the extent of the payor's "excess interest expense."[114] Disqualified interest includes interest paid or accrued to (1) related parties when no Federal income tax is imposed with respect to such interest;[115] (2) unrelated parties in certain instances in which a related party guarantees the debt ("guaranteed debt"); or (3) to a REIT by a taxable REIT subsidiary of that trust. Excess interest expense is the amount by which the payor's "net interest expense" (i.e., the excess of interest paid or accrued over interest income) exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion). Interest amounts disallowed under these rules can be carried forward indefinitely and are allowed as a deduction to the extent of excess limitation in a subsequent tax year. In addition, any excess limitation (i.e., the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

The operation of these rules is illustrated by the following example. ForCo, a corporation organized in country A, wholly owns USCo, a corporation organized in the United States. ForCo's investment in USCo stock totals $6.5 million. In addition, USCo has borrowed $8 million from ForCo and $5 million from Bank, an unrelated bank. In 20XX, USCo's first year of operation, USCo's adjusted taxable income is $1 million (none of which is from interest income), and it also pays $400,000 of interest to ForCo and $300,000 of interest to Bank. Under the U.S.-country A income tax treaty, no tax is owed to the United States on the interest payments made by USCo to ForCo.

- USCo has a 2:1 debt-to-equity ratio (total borrowings of $13 million ($8 million + $5 million) and total equity of $6.5 million), so USCo's deduction for the $700,000 ($400,000 + $300,000) of interest it paid may be limited.
- USCo's disqualified interest is $400,000 (the amount of interest paid to a related party on which no Federal income tax is imposed).
- USCo's excess interest expense is $200,000 ($700,000 - ($1 million x 50%)).
- Accordingly, USCo may deduct only $500,000 ($700,000 - $200,000) for interest expense in year 20XX.
- The $200,000 of excess interest expense may be carried forward and deducted in a subsequent tax year with excess limitation.

Legislative Background

[114] Sec. 163(j).

[115] If a tax treaty reduces the rate of tax on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed under the treaty, bears to the rate of tax imposed without regard to the treaty. Sec. 163(j)(5)(B).

Section 163(j) was first enacted in 1989 in response to congressional concerns over earnings stripping.[116] Congress believed it was "appropriate to limit the deduction for interest that a taxable person pays or accrues to a tax-exempt entity whose economic interests coincide with those of the payor. To allow an unlimited deduction for such interest permits significant erosion of the tax base."[117]

In 1993, the earnings stripping rules were amended so that they applied to interest paid on unrelated party loans if guaranteed by a related party under certain circumstances.[118] Congress made this change because it was concerned about the distinction made under the existing earnings stripping rules between the situation in which unrelated creditors all lend to the parent of a group, which in turn lends to the U.S. subsidiary, and the situation in which the creditors lend directly to the U.S. subsidiary with a guarantee from the parent.[119] The existing rules applied to the first situation but not the second situation, even though the "same 'excess' interest deductions, and the same resultant 'shifting' of net income out of U.S. taxing jurisdiction, is obtainable through borrowing by U.S. corporations on [the parent's] credit."[120]

The definition of disqualified interest was expanded in 1999 to include interest paid or accrued by a taxable real estate investment trust ("REIT") subsidiary to a related REIT.[121]

In 2006, the earnings stripping rules were modified to apply to corporate owners of partnership interests.[122] Specifically, the modifications provided that for purposes of applying the earnings stripping rules when a corporation owns an interest in a partnership, (1) the corporation's share of partnership liabilities is treated as liabilities of the corporation, and (2) the corporation's distributive share of interest income and interest expense of the partnership is treated as interest income or interest expense, respectively, of the corporation. Treasury was also granted expanded regulatory authority to reallocate shares of partnership debt, or distributive shares of the partnership's interest income or interest expense.

The American Jobs Creation Act of 2004 required the Secretary of the Treasury to submit a report to the Congress by June 30, 2005, examining the effectiveness of the earnings stripping provisions of present law, including specific recommendations as to how to improve the

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[116] Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, sec. 7210.

[117] H.R. Rep. No. 101-247, p. 1241 (1989).

[118] Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, sec. 13228.

[119] H.R. Rep. No. 103-111, p. 683 (1993).

[120] *Ibid.*, p. 682.

[121] Tax Relief Extension Act of 1999, Pub. L. No. 106-170, sec. 544. Technical corrections were also made in 1996 and 2005. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, secs. 1703(n)(4), 1704(f)(2); Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, sec. 403(a)(15).

[122] Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, sec. 501 (2006).

provisions of the Code applicable to earnings stripping.[123] The Treasury Department submitted its report to Congress on November 28, 2007.[124] In summary, the report concludes that "[t]here is strong evidence that [inverted corporations] are stripping a significant amount of earnings out of their U.S. operations and, consequently, it would appear that section 163(j) is ineffective in preventing them from engaging in earnings stripping."[125] The report also concludes, however, that the evidence that foreign-controlled domestic corporations are engaged in earnings stripping is not conclusive, and that it is not possible to determine with precision whether section 163(j) is effective generally in preventing earnings stripping by foreign-controlled domestic corporations.[126]

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[123] Pub. L. No. 108-357, sec. 424.

[124] U.S. Department of the Treasury, *Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007). For a detailed discussion of the report, including an analysis of its methodology and conclusions, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal* (JCS-3-11), June 2011, pp. 259-65.

[125] U.S. Department of the Treasury, *Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 26.

[126] *Ibid*., pp. 25-26. In light of this inconclusive evidence, the report recommends gathering additional information from taxpayers relating to earnings stripping. Accordingly, in December 2008, the Treasury Department and Internal Revenue Service issued a new form, Form 8926, *Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information*, to gather additional information from corporate taxpayers relating to the determinations and computations under section 163(j).