TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF H.R. 5901, THE "REAL ESTATE JOBS AND INVESTMENT ACT OF 2010"

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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CONTENTS

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of the revenue provisions of H.R. 5901, the "Real Estate Jobs and Investment Act of 2010." Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of H.R.5901, the "Real Estate Jobs and Investment Act of 2010,"* (JCX-41-10), July 29, 2010. This document can also be found on our website at www.jct.gov.

A. Exception from Foreign Investment in Real Property Tax Act (FIRPTA) For Certain Stock of Real Estate Investment Trusts (REITS) (sec. 1 of the bill and sec. 897 of the Code)

Present Law

In general

A foreign person is taxable on its taxable income which is effectively connected with the conduct of its trade or business within the United States ("effectively connected income") at the income tax rates applicable to U.S. persons.[2]

For non-effectively connected income, the United States generally imposes a flat 30-percent tax, collected by withholding, on the gross amount of U.S.-source investment income payments, such as interest, dividends, rents, royalties and similar types of fixed and determinable annual and periodical income, to nonresident alien individuals and foreign corporations ("foreign persons").[3] Under its income tax treaties, the United States may reduce or eliminate such taxes. Even taking into account U.S. treaties, the tax on a dividend generally is not entirely eliminated. Instead, U.S.-source portfolio investment dividends received by foreign persons generally are subject to U.S. withholding tax at a rate of at least 15 percent. In contrast, certain interest income from U.S. sources is not subject to U.S. tax.[4]

Except in the case of a foreign person who is an individual present in the United States for 183 days or more during the taxable year, a foreign person that is not engaged in business in the U.S. generally is not taxed on capital gain from U.S. sources.

The Foreign Investment in Real Property Tax Act ("FIRPTA")[5] 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. income tax return under the normal rules relating to receipt of income effectively connected with a U.S. trade or business.[6]

The payor of FIRPTA effectively connected income to a foreign person is generally required to withhold U.S. tax from the payment. Withholding is generally 10 percent of the sales

[2] Secs. 871(b)(1) and 882(a)(1).

[3] Secs. 871(a), 881, 1441, and 1442.

[4] Certain interest paid on portfolio obligations to foreign investors is not subject to tax. See secs. 871(h) and 881(c).

[5] 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).

[6] Sec. 897(a).

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").[7] 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 its USRPIs is 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.[8] 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 the five-year period ending on the date of disposition of the stock.[9]

Special rules for certain investment entities

REITs and RICs are generally passive investment entities. 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.[10] A REIT or RIC may designate a capital gain dividend to its shareholders, who then treat the amount designated as capital gain.[11] 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).

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[7] 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.

[8] Sec. 897(c)(2).

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

[10] Secs. 852(a)(1) and 852(b)(2)(A); 857(a)(1).

[11] Secs. 852(b)(3); 857(b)(3).

FIRPTA contains special rules for REITs and RICs.[12]

Stock of a "domestically controlled" REIT is excluded from the definition of a USRPI. The term "domestically controlled" is defined to mean that less than 50 percent in value of the REIT 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.[13] Thus, stock of a domestically controlled REIT 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, including a REIT,[14] to a foreign shareholder, to the extent attributable to gain from a REIT's sale or exchange of USRPIs, is generally treated as FIRPTA gain to the shareholder. The FIRPTA character is retained if the distribution occurs through a tier of U.S. REITs or RICs.[15] An IRS notice states that this rule applies to both nonliquidating and liquidating distributions to a REIT shareholder and that the IRS will issue regulations to that effect.[16] An exception 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 5 percent of the class of stock at any time during the one-year period ending on the date of the distribution.[17] Where the exception applies, the 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.[18]

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[12] Sec. 897(h).

[13] Sec. 897(h)(2) and (h)(4)(B). For 2005 through 2009, 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).

[14] A "qualified investment entity" means any REIT. It also includes, for purposes of this distribution rule and related withholding 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, 2009, 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).

[15] In 2006, Pub. L. No. 109-222 clarified the retention of this FIRPTA character and added statutory withholding requirements.

[16] 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 US trade or business, proceeds distributed from the sale of US real property interests are not exempt from tax under section 892.

[17] Sec. 897(h)(1), second sentence.

[18] Sec. 857(b)(3)(F). Based on statutory references to section 857(b)(3)(B) and (D), which refer to capital gain dividends, an Internal Revenue Service ("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

Some U.S. income tax treaties that apply a reduced tax rate to dividend distributions contain special provisions for distributions that are treated as ordinary dividends from REITs. These treaties generally restrict the treaty reduction in tax rate for REIT dividends to no lower than 15 percent, and also apply special rules to qualify for the 15-percent rate that limit the extent of a particular foreign shareholder's ownership of the REIT.[19] 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, but in some cases restricting that exemption depending on the ultimate beneficial ownership of that foreign investment entity.[20]

Explanation of Provision

The provision modifies certain present law FIRPTA rules that turn on a shareholder holding a no greater than five-percent interest over a specified time period in an entity that is regularly traded on an established securities market. The provision increases the ownership threshold to no more than 10 percent, but only in the case of REIT stock.

Thus, under section 897(c)(3), REIT stock of a class that is regularly traded on an established securities market is a USRPI only in the case of a person who, at any time during the relevant time period, held more than 10 percent of such stock. A sale of such regularly traded REIT stock held by a person that does not exceed the 10-percent holding threshold is not subject to FIRPTA.

Also, a distribution by a REIT to a foreign person with respect to a class of stock which is regularly traded on an established securities market located in the United States is not treated as gain recognized from the sale of a USRPI under section 897(h) if such foreign person did not own more than 10 percent of such class of stock at any time during the one-year period ending on the date of such distribution.[21]

The provision also provides an exception to the general rule that stock of a REIT is treated as a USRPI in the hands of a more than 10 percent shareholder, where the stock is held by a qualified shareholder. This exception provides that the stock of the REIT will not be treated as a USRPI except to the extent that an investor in the qualified shareholder holds (directly or

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shareholder. The 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.

[19] 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, article 10(4); 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, article 10(4).

[20] *Ibid*.

[21] Section 857(b)(3)(F) applies under the provision to such distributions as it does under present law with respect to no more than five-percent holders of publicly traded stock.

indirectly through the qualified shareholder) more than 10 percent of the stock of such REIT. A similar exception applies under the rule applicable to distributions. For these purposes, a "qualified shareholder" means a shareholder that would be eligible for a reduced rate of withholding under any income tax treaty of the United States with respect to ordinary dividends paid by the REIT even if the shareholder holds more than 10 percent of the stock of the REIT, and whose principal class of interests is listed and regularly traded on one or more recognized stock exchanges covered under such income tax treaty.

Effective Date

The provision applies to distributions with respect to REIT stock and to dispositions of REIT stock made after the date of enactment.

B. Application of Continuous Levy to Tax Liability of Certain Federal Contractors (sec. 2 of the bill and sec. 6330 of the Code)

Present Law

In general

Levy is the IRS's administrative authority to seize a taxpayer's property or rights to property to pay the taxpayer's tax liability.[22] Generally, the IRS is entitled to seize a taxpayer's property by levy if a Federal tax lien has attached to such property,[23] and the IRS has provided both notice of intention to levy[24] and notice of the right to an administrative hearing (referred to as a collections due process notice or "CDP" notice)[25] at least thirty days before the levy is made. A Federal tax lien arises automatically when: (1) a tax assessment has been made; (2) the taxpayer has been given notice of the assessment stating the amount and demanding payment; and (3) the taxpayer has failed to pay the amount assessed within 10 days after the notice and demand.[26]

The 30-day pre-levy notice requirements, the taxpayer's rights before, during, and following the CDP hearing, and the Federal payment levy program are discussed below.

Pre-levy notice requirements

The notice of intent to levy and the CDP notice must include a brief statement describing the following: (1) the statutory provisions and procedures for levy; (2) the administrative appeals available to the taxpayer; (3) the alternatives available to avoid levy; and (4) the provisions and procedures regarding redemption of levied property.[27] In addition, the CDP notice must include the following: (1) the amount of the unpaid tax; and (2) the right to request a hearing during the 30-day period before the IRS serves the levy.

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[22] Sec. 6331(a). Levy specifically refers to the legal process by which the IRS orders a third party to turn over property in its possession that belongs to the delinquent taxpayer named in a notice of intent to levy.

[23] Sec. 6331(a).

[24] Sec. 6331(d).

[25] Sec. 6330. The administrative hearing is referred to as the CDP hearing.

[26] Sec. 6321.

[27] Secs. 6330(a)(3) and 6331(d)(4). In practice, the notice of intent to levy and the CDP notice is provided together in one document, Letter 1058, *Final Notice, Notice of Intent to Levy and Notice of Your Right to a Hearing*. Chief Counsel Advice Memorandum 2009-041 (November 28, 2008).

Upon receipt of this information, the taxpayer may stay the levy action by requesting in writing a hearing before the IRS Appeals Office.[28] Otherwise, the IRS will levy to collect the amount owed after expiration of 30 days from the notice.

The notice of intent to levy is not required if the Secretary finds that collection would be jeopardized by delay. The standard for determining whether jeopardy exists is similar to the standard applicable in permitting the IRS to assess a tax without following the normal deficiency procedures.[29]

The CDP notice (and pre-levy CDP hearing) is not required if the Secretary finds that collection would be jeopardized by delay or the Secretary has served a levy on a State to collect a Federal tax liability from a State tax refund. In addition, a levy issued to collect Federal employment taxes is excepted from the CDP notice and the pre-levy CDP hearing requirement if the taxpayer subject to the levy requested a CDP hearing with respect to unpaid employment taxes arising in the two-year period before the beginning of the taxable period with respect to which the employment tax levy is served. The taxpayer, however, in each of these three cases, is provided an opportunity for a hearing within a reasonable period of time after the levy.[30]

CDP hearing

At the CDP hearing, the taxpayer may present defenses to collection as well as arguments disputing the merits of the underlying tax debt if the taxpayer had no prior opportunity to present such arguments.[31] In addition, the taxpayer is required to be provided the opportunity to negotiate an alternative form of payment, such as an offer-in-compromise, under which the IRS would accept less than the full amount, or an installment agreement under which payments in satisfaction of the debt may be made over time rather than in one lump sum, or some combination of such measures.[32] If a taxpayer exercises any of these rights in response to the notice of intent to levy, the IRS may not proceed with its levy.

After the CDP hearing, a taxpayer also has a right to seek, within 30 days, judicial review in the U.S. Tax Court of the determination of the CDP hearing to ascertain whether the IRS abused its discretion in reaching its determination.[33] During this time period, the IRS may not proceed with its levy.

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[28] Sec. 6330(b).

[29] Secs. 6331(d)(3) and 6861.

[30] Sec. 6330(f).

[31] Sec. 6330(c).

[32] Sec. 6330(c)(2).

[33] Sec. 6330(d).

Federal payment levy program

To help the IRS collect taxes more effectively, the Taxpayer Relief Act of 1997[34] authorized the establishment of the Federal Payment Levy Program ("FPLP"), which allows the IRS to continuously levy up to 15 percent of certain "specified payments," such as government payments to Federal contractors that are delinquent on their tax obligations. The levy generally continues in effect until the liability is paid or the IRS releases the levy.[35]

Under the FPLP, the IRS matches its accounts receivable records with Federal payment records maintained by the Department of the Treasury's Financial Management Service ("FMS"), such as certain Social Security benefit and Federal wage records. When the records match, the delinquent taxpayer is provided both notice of intention to levy and notice of the right to the CDP hearing 30 days before the levy is made. If the taxpayer does not respond after 30 days, the IRS can instruct FMS to levy its Federal payments. Subsequent payments are continuously levied until the tax debt is paid or IRS releases the levy.

Upon receipt of this information, however, the taxpayer may stay the levy action by requesting in writing a hearing before the IRS Appeals Office. Following the CDP hearing, a taxpayer has a right to seek, within 30 days, judicial review in the U.S. Tax Court of the determination of the CDP hearing to ascertain whether the IRS abused its discretion in reaching its determination. During this time period, the IRS may not proceed with its levy.

Explanation of Provision

The provision allows the IRS to issue levies prior to a CDP hearing with respect to Federal tax liabilities of Federal contractors identified under the FPLP. When a levy is issued prior to a CDP hearing under this proposal, the taxpayer has an opportunity for a CDP hearing within a reasonable time after the levy.

Effective Date

The provision applies to levies issued after December 31, 2010.

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[34] Pub. L. No. 105-34.

[35] Sec. 6331(h). With respect to Federal payments to vendors of goods or services (not defined), the continuous levy may be up to 100 percent of each payment. Sec. 6331(h)(3).