Tax Briefs

Levin & Weiser, LLC
Attorneys and Counselors at Law

950 S. Cherry St., Suite 1000
Denver, Colorado 80246
(303) 504-4242
Fax (303) 691-9719
www.lw-law.com

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LEAD STORY: United States Taxation of Resident and Nonresident Aliens – Part III: Taxation of Investments In U.S. Property

In the first article of this series we began our review of the U.S. income tax laws with an analysis of the various tests used to determine whether an individual is considered a resident alien or nonresident alien of the U.S. The distinction, we learned is important, as the latter are subject to U.S. income tax on their worldwide income, and the former are generally only subject to U.S. income taxes on income earned from U.S. sources.

Last month we examined the U.S. income taxation of non-resident aliens, a group that often includes temporary residents of the U.S. We learned that earnings from a U.S. trade or business are ordinarily subject to U.S. income taxes on a net basis, meaning that certain deductions are allowed in arriving at taxable income. We also reviewed the taxation of fixed or determinable, annual or periodical gains, profits, and income (otherwise known as "FDAP"). Certain types of income are included in the definition of FDAP, including dividends, interest (subject to several exceptions), rents, salaries and wages. Specifically excluded from the definition of FDAP are capital gains. Income taxes are ordinarily imposed upon gross FDAP at a flat 30 percent rate, and are ordinarily withheld from the payment of such income by the payor, who remits these funds to the Internal Revenue Service.

This month we continue with our focus on the taxation of nonresident aliens, and specifically the taxation of investments in real estate.

Special rules apply to the taxation of real estate owned by nonresident aliens. To best understand these rules it is useful to briefly review how real estate investments would be taxed under the rules we learned last month. For example, if an investment in real estate constitutes a U.S. trade or business, rental income will be taxed on a net basis (deductions allowed) subject to ordinary graduated tax rates. If an investment in real estate does not constitute a U.S. trade or business any rental income generated by such property would be U.S. source FDAP, subject to the 30 percent withholding tax without any allowance for deductions.[1] Most significantly, if the investment is not a U.S. trade or business, any capital gains from the disposition of the investment would be exempt from U.S. taxes (since capital gains are not included in FDAP). Similarly, the nonresident alien could form a U.S. corporation through which the investment could be held. The corporation would be subject to income taxes on a net basis and pay capital gains taxes much like any other U.S. corporation, the only differences coming when profits are distributed from the corporation to its nonresident alien shareholder. These examples illustrate exactly how, until 1980, real estate owned by nonresident aliens was taxed.

Congress was concerned that foreign investors, whether individuals or corporations, were often able to escape all U.S. taxes upon the disposition of U.S. real estate held for investment or personal use. Congress realized that foreign owners of foreign corporations holding U.S. real estate were also able to avoid U.S. taxes when they sold their stock (since such sales were foreign source income, not subject to U.S. income taxes). Congress viewed the disparity between the taxation of U.S. citizens and residents investing in U.S. real estate and nonresidents investing in real estate as violating tax policy principles. As a result, Congress passed the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).

FIRPTA essentially forces nonresident alien taxpayers to pay U.S. income tax at ordinary graduated rates on net income (certain deductions allowed) derived from U.S. real estate, generally a benefit to nonresidents. However, FIRPTA also insures that gains from the disposition of U.S. real property are also subject to U.S. income taxes. Owning real property through corporations provides no escape from FIRPTA.

FIRPTA imposes U.S. tax on income and gains from the operation and disposition of "U.S. real property interests" (USRPIs) by nonresident aliens and foreign corporations. A USRPI generally refers to any interest in U.S. real property (including interests in mines, wells and other unsevered natural resources, improvements and some personal property associated with the use of real property) and any interest in certain U.S. corporations (U.S. real property holding companies). It should be noted that a USRPI also exists with respect to real property located in the Virgin Islands (but not other U.S. possessions).

The determination of whether a domestic corporation is a U.S. real property holding company (USRPHC) is made based on the percentage of assets owned by the corporation that constitute USRPIs during a defined time period. The defined period is the shorter of (i) the period during which the taxpayer held the interest in the corporation, or (ii) the five year period ending on the date of disposition of the corporation. In general, a domestic corporation is a USRPHC if the fair market value of its USRPIs is equal to or greater than 50 percent of the fair market value of the corporation's worldwide real property interests and all other assets used in a trade or business. The rules concerning USRPHCs are quite complex and several exceptions apply, including one exception applicable to corporations that previously sold all of their USRPIs, and another applicable to 5 percent-or-less owners of publicly traded USRPHCs.

[1] It should be noted that taxpayers may elect to treat U.S. real property income (e.g. rents) as income effectively connected with a trade or business, even if the ownership of such real estate ordinarily does not constitute a trade or business. This election is often beneficial as the 30 percent withholding tax with no allowance for deductions often creates an unduly harsh tax result. This election has been largely superceded by FIRPTA (see below).

It should also be noted that special rules apply concerning other types of business entities (e.g., partnerships). Generally, an interest in a partnership is not a USRPI. Instead, a "look-through" treatment is applied when the partner receives a payment from the partnership. If the partner sells his interest in the partnership the amount of money or other property received by the partner to the extent attributable to USRPIs, is treated as an amount exchanged for a USRPI.

Like other aspects of the U.S. tax laws applicable to nonresidents, FIRPTA is enforced through a withholding tax. If a nonresident alien disposes of a USRPI, the buyer must withhold 10 percent to the total purchase price of the USRPI and remit that amount to the IRS within 20 days of the transaction. This creates a problem where the sales price exceeds the amount of cash in the transaction (for instance, where the nonresident seller carries back a note on the property). No withholding is required if the buyer can establish that the seller is not a foreign person, that the interest transferred is not a USRPI, that the seller is not subject to taxation on the transaction (for a variety or reasons), or that the seller qualifies for reduced withholding (e.g. under certain tax treaties) or has qualified for a withholding certificate.

To obtain a withholding certificate and an exemption from withholding taxes, the nonresident seller should complete IRS Form 8288-B. That form requires a description of the USRPI being sold, the sales price, a calculation of the maximum tax owed, and evidence that the seller has no unsatisfied FIRPTA withholding obligations with respect to the purchase of the USRPI. If the withholding certificate is obtained, the nonresident alien must file a U.S. tax return for the year of sale and pay the appropriate amount of tax due at that time.

An investment in U.S. real estate may also create significant complexities in the estate and inheritance tax context. The U.S. has entered into estate tax treaties with several countries that serve to eliminate double estate and inheritance taxation by different countries. These treaties generally operate by subjecting a deceased person's estate to taxation only in the country in which the person was domiciled (intended to permanently reside) immediately prior to death. However, exceptions exist, particularly with regard to real estate. For example, the estate of an individual domiciled in the Federal Republic of Germany owning real estate in the U.S., is primarily subject to German inheritance taxes. However, U.S. estate taxes will apply with respect to the U.S. real estate. As a result of the investment, the deceased person's estate must deal with the complexities of estate tax treaties, transfer taxes payable in two countries, estate or inheritance tax returns in multiple jurisdictions, U.S. probate, and a host of other issues. Often, these rather expensive complexities can be avoided with proper estate planning.

For example, the German domiciliary in the above example could have held his interest in the U.S. real property through a German corporation. Under the tax treaty between the two countries the stock in the German corporation would not have been subject to U.S. estate taxes, thus providing complete protection from U.S. estate taxes. Note, that transfers of U.S. property to foreign corporations always involve complex tax issues and you should always seek assistance from a qualified tax professional when dealing with such transactions.

In summary, FIRPTA causes foreign (including some temporary residents) investment in U.S. real estate to be taxed in much the same way as U.S. citizen or resident alien investment in U.S. real estate. Generally, taxes are imposed on net incomes from foreign owned real estate at graduated tax rates. Taxes are also imposed upon the disposition of such real estate, with a portion of such taxes withheld from the buyer's purchase price and remitted to the IRS. When considering an initial investment in real estate, extreme care should be given to the estate tax consequences, particularly if the investor intends to permanently reside outside the U.S.

Spin-Off of Website Ruled A Tax-Free Reorganization

In Rev. Rul. 2003-38, the IRS concluded that the spin-off of a retailer's website, was entitled to tax free treatment. The ruling is significant due to its applicability to historical "brick-and-mortar" businesses that choose to operate a website, for purposes of continuing in the same line of business through the Internet.

The facts of the ruling are as follows:

A corporation (the "Corporation") operated a retail shoe store business for seven years before creating an Internet website through which it sold shoes at retail. To a significant extent, the operation of the website drew on the Corporation's experience and know-how in selling shoes at retail, and also relied on the Corporation's favorable name recognition, customer loyalty, and other elements of goodwill. After approximately two years of operation, the Corporation transferred all of the website's assets and liabilities to a new wholly owned subsidiary ("Newco"), and subsequently distributed the stock of Newco pro rata to the Corporation's shareholders.

Under IRC § 355(a), a corporation may distribute stock and securities in a controlled subsidiary to its shareholders in a tax-free reorganization, provided that among other requirements, (i) both the distributing and controlled corporation are engaged, immediately after the distribution, in the active conduct of a trade or business, (ii) each trade or business has been actively conducted throughout the five-year period ending on the date of distribution, and (iii) neither trade or business was acquired in a taxable transaction within the five-year period. At issue in the ruling was whether the website was considered an expansion of the Corporation's business and, therefore, entitled to share the Corporation's five-year history at the time of the website's distribution.

The applicable treasury regulations provide that if a corporation engaged in the conduct of one trade or business during the five-year period purchased, created, or otherwise acquired another trade or business in the same line of business, the acquisition is treated as merely an expansion of the original business. As an expansion of the original business, the newly purchased, created or acquired business may share the original business' history, for purposes of satisfying the five-year active conduct requirement. If, however, the trade or business purchased was in a new line of business, the five-year period will not be satisfied with respect to the newly acquired business.

The IRS concluded that the product held for sale by the retail stores and website were consistent (shoes), and the principal business activities of the retail stores were identical to the activities of the website (purchasing shoes at wholesale and reselling them at retail). Although operation of the website required some know-how not ordinarily associated with operating retail stores, the website drew upon the Corporation's existing experience and know-how, and the website's success depended in large measure, on the goodwill associated with the Corporation. Therefore, the creation of the website was deemed to be an expansion of the Corporation's existing business. Both the Corporation and Newco were entitled to treat the distribution of Newco stock to the Corporation's shareholders as a tax-free reorganization.

Congress Unable to Settle on President's Jobs and Growth Plan Before Easter Break; Elimination of Double Taxation of Dividends Doubtful

In the January 15, 2003 issue of *Tax Briefs*, we first reported to you the details of the President's stimulus plan and his hope and desire that Congress would pass all parts of his plan before departing for their two-week Easter break. Unfortunately Congress has been unable to pass the President's plan, and as we have been reporting to you, it is almost a certainty that many parts of the President's plan will not be enacted at all, including the much publicized elimination of double taxation of corporate dividends.

As reported in the last edition of *Tax Briefs*, the Senate passed an amendment to a budget resolution slicing from $726 billion to $350 billion, the President's planned tax cuts. Since then, Congressional taxwriters put on hold any new plans to draft a new tax act until a budget could be finalized. In last minute dealings before their Easter break, the House and Senate passed budgets carving out approximately $550 billion for a future tax cut. The budget narrowly passed in the Senate with Vice-President Dick Cheney casting the decisive and tie-breaking vote. However, in order to gain support for the budget in the Senate, Republican leaders promised moderate Senate Republicans lead by Olympia Snowe (R-Maine) that the final tax cut sent to the White House would not exceed $350 billion, all but insuring that the President's proposal to end the double taxation of corporate dividends will not become law (provided, Republican leaders hold true to their word). Instead it is more likely that the President's small business and family relief proposals will be included in any final tax act.

Congress returns from its Easter break on April 29th.

European Commission Issues Guidelines On E-VAT Directive

In the March 17, 2003 edition of *Tax Briefs* we reported to you that the European Commission was expected to issue guidance concerning non-European Union retailers' responsibilities for collected value added tax (VAT) on online sales of digital goods. The European Commission has done so.

The guidelines clarify the definition of "electronically supplied services" subject to VAT. Electronically supplied services include services delivered via the Internet or similar electronic network that are heavily dependent on information technology, meaning that the service is essentially automated, requiring little human intervention. Electronically supplied services would include, software and software upgrades downloaded from the Internet, services supporting a business or presence on an electronic network like a website or webpage, or services automatically generated from a computer via the Internet or electronic network, in response to specific data input by the customer. The use of the Internet or electronic networks by parties to merely communicate with respect to transactions does not give rise to a service subject to VAT. For example, services of lawyers, accountants and financial consultants are not subject to VAT because the services rely to a substantial degree on human intervention, and the Internet or electronic network is used merely as a means of communication.

The United Kingdom also issued a related statement concerning place of supply rules for electronically supplied services. The statement provides that non-European Union (EU) suppliers of electronically supplied services providing such services to private individuals or non-business organizations in the EU must register and account for EU VAT.

In Summary . . .

Tax Freedom Day is April 19th according to the Tax Foundation. This means that U.S. taxpayers will work, on average, 109 days before paying off their 2003 federal tax burden. . . . **The new tax treaty between the U.S. and United Kingdom** completely eliminates withholding taxes on cross-border dividend payments between subsidiaries and their parent companies. This is the first U.S. income tax treaty to eliminate such withholding taxes. The treaty also coordinates the tax treatment of U.S. and U.K. pension plans, allowing individuals to freely move between the two countries for employment without adverse tax consequences to their pension benefits. Although the effective date of the treaty is March 31, the zero rate on withholding taxes for dividends does not go into effect until May 1. . . . **Portugal has abolished its inheritance tax**. Complete repeal of the inheritance tax likely will not go into effect until 2004. Portugal will become one of a few European countries without any kind of wealth, gift or inheritance tax. . . . **Military personnel and their families** can find tax assistance on the IRS website. The website will contain features addressing special benefits available to military personnel in combat

zones, extensions for filing tax returns and assistance concerning the exclusion of certain pay from income taxes. . . . **Plans for a new Iraqi tax system are under way**. The Bush administration has established a task force on the issue and has asked for assistance from the International Monetary Fund and World Bank. John Taylor, undersecretary for international affairs and others have been given the responsibility of drafting a preliminary budget and tax policy for post-war Iraq. . . . **The Senate has passed a new charitable giving package**. The bill would allow certain taxpayers to make tax-free distributions from their IRAs to charitable organizations and allow certain non-itemizing individuals the opportunity to deduct charitable donations in excess of $250 ($500 for joint filers). The bill also codifies the economic substance doctrine, long a principle of common law. It also increases several tax penalties designed to curtail the use of tax shelters. . . . **A bipartisan bill was introduced that would repeal the FSC Repeal and Extraterritorial Income Exclusion Act.** The bill provides some transitional relief through 2008, but thereafter provides a permanent deduction for U.S. production activities that would effectively reduce a company's overall effective tax rate. . . . **The President and Vice-President made public their 2002 tax returns last week.** The Bushes had taxable income of $771,940, including $397,534 in wages, $436,028 in interest, and approximately $24,000 in dividends. The Bushes made nearly $70,000 of charitable contributions. The Cheneys showed taxable income of $945,051, including wages of $190,134 and deferred compensation from Halliburton of $162,392. . . . **The City of New York is suing the governments** of India, Mongolia, Turkey, and the Philippines for $106 million. The City claims that the sums due are for back property taxes for years in which buildings used by each government were used for commercial or residential purposes that were not exempt from local taxation.

Q&A

If you have any questions on any tax matter feel free to write us at info@lw-law.com. We can't answer every question we receive, but if you ask a short question that can be answered concisely, we'll consider it for publication. Remember, questions answered are only intended to provide general information. Consult with your attorney before acting on information you see here.

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