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SYNTHETIC RUTILE

DECEMBER 15 (legislative day, NOVEMBER 29), 1979.—Ordered to be printed

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Mr. LONG, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 2297]

The Committee on Finance, to which was referred the bill (H.R. 2297) to continue until the close of June 30, 1982, the existing suspension of duties on synthetic rutile, having considered the same, reports favorably thereon with an amendment and recommends that the bill as amended do pass.

The amendment is shown in the text of the bill in italic.

House bill.—H.R. 2297, as it passed the House, would suspend duties on synthetic rutile for the period June 30, 1979, through June 30, 1982.

Committee bill.—The committee amendment deletes the provision relating to the suspension of duties on synthetic rutile, and adds provisions relating to the tax treatment of gain on sale of U.S. real estate by foreign investors, withholding tax on interest paid to foreign investors, and exception to private foundation "self-dealing" rules for certain leasing transactions. (The Subcommittee on Taxation and Debt Management Generally of the Committee on Finance held public hearings on June 25, 1979, on bills relating to the tax treatment of gain on the sale of U.S. property by foreign investors.)

I. SUMMARY

As passed by the House, this bill would provide for the suspension of duties on synthetic rutile through June 30, 1982. In lieu of this provision (the substance of which was added by the committee to H.R. 3122), the committee added an amendment in the nature of a substitute the following tax provisions.

Title I. Tax Treatment of Gain on Sale of U.S. Real Estate by Foreign Investors

Under present law, capital gains realized by foreign investors on the sale of U.S. property are generally not subject to U.S. tax unless the property is held in connection with a U.S. trade or business.

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The committee amendment would subject foreign investors to tax at a rate equal to one-third of the equivalent taxation on gains on the sale or other disposition of U.S. real property. Foreign investors also would be taxed at this rate on gains realized through the sale or exchange of an interest in a corporation, trust, or partnership which was formed or availed of to hold U.S. real property interests. Reporting requirements would be established to identify when taxable transactions had occurred. The tax would be collected through withholding requirements and related enforcement provisions.

(When added together to similar taxes imposed at a rate equal to one third of the equivalent taxation under committee amendments to H.R. 1319 and H.R. 1212, the three provisions would subject foreign investors to the full capital gains tax on the sale or other disposition of U.S. real property.)

The provision would be effective for sales or other dispositions of U.S. real property interests occurring on or after January 1, 1980. However, to the extent that a provision conflicts with a U.S. treaty obligation, the provision would not take effect until after 1984.

Title II. Other Provisions

Sec. 201. Withholding tax on interest paid to foreign investors

Under present law, a U.S. withholding tax of 30 percent is generally imposed on annuities, interest, dividends, rents, royalties, and similar payments by U.S. persons to foreign investors if the payments are not effectively connected with a U.S. trade or business. Exemptions from the withholding tax are provided in certain situations. In addition, certain U.S. tax treaties reduce or eliminate the withholding tax on interest paid to treaty country residents.

The committee amendment would repeal the 30-percent withholding tax on interest paid to foreign investors on portfolio indebtedness. The withholding tax on interest paid to foreign investors would generally be limited to situations where the foreign investor is related to the U.S. obligor or where the foreign investor is controlled by U.S. persons. Obligations, the interest on which is exempt under the bill, would also be exempt from U.S. estate and gift tax.

The provision would be effective for interest paid after the date of enactment of the bill.

Sec. 202. Exception to private foundation "self-dealing" rules for continuation of certain leasing arrangements

Present law generally prohibits certain "self-dealing" transactions, including leasing arrangements, between a private foundation and a "disqualified person." There is a 10-year transitional rule that permits continuation of an otherwise prohibited leasing arrangement pursuant to binding contract in effect on October 9, 1969 (or pursuant to renewals of such contract), if the leasing arrangement is at least as favorable to the foundation as an arm's length transaction with an unrelated party.

The committee amendment would provide a permanent exception from the "self-dealing" rules under Code section 4941 in certain circumstances where a private foundation leases office space from a disqualified person, if the lease is pursuant to a binding contract in effect on October 9, 1969 (or renewals thereof) and if at the time of execution the lease was not disadvantageous to the foundation. For the lease to qualify for this exception, the space must be leased to the foundation on a basis no less favorable than that on which such space would be made available in an arm's-length transaction, and the leased space must be in a building in which there are tenants who are not disqualified persons.

This provision would apply to the Moody Foundation of Galveston, Texas, and any other private foundation leasing arrangement meeting the specific requirements of the bill. The provision becomes effective for taxable years beginning after December 31, 1979.

II. EXPLANATION OF THE BILL

A. Tax Treatment of Gain on Sale of U.S. Real Property by Foreign Investors

(Title I of the bill and new secs. 897 and 1444 of the Code)

Present Law

General

Under the Code, nonresident aliens and foreign corporations engaged in a U.S. trade or business are generally taxed on the U.S. source income of that business in the same manner, and at the same rates, as U.S. persons. (However, their foreign source income not connected with that business is not taken into account in determining the applicable rates of U.S. tax.)

In contrast, the U.S. source income of a nonresident alien or foreign corporation which is not effectively connected with a U.S. business is generally subject to a different tax regime. The Code provides that a foreign individual or corporation is ordinarily subject to a 30-percent withholding tax on the *gross* amount of certain passive income such as rents, dividends, and interest, which is received from U.S. sources and is not effectively connected with a U.S. business. This withholding tax generally satisfies the taxpayer's U.S. income tax liability on the income. Capital gains not effectively connected with a U.S. business are not subject to any U.S. income tax, except in the limited situation of nonresident individuals who were present in the United States 183 days or more during the year, who are taxed at the flat rate of 30 percent on the gains.

Foreign investment in U.S. property

Whether a foreign investor in U.S. real property is engaged in a U.S. trade or business depends on all the facts and circumstances. For example, a foreign investor who enters into a single long-term net lease (under which the lessee is responsible for operation of the property and pays the expenses) probably would not be engaged in a U.S. trade or business, whereas a taxpayer who owns and manages a number of commercial buildings would be so engaged.

If a foreign taxpayer is not actually engaged in a U.S. trade or business, he is permitted under the Code to elect to be treated as if he were so engaged with respect to all his real property held for the production of income. This election is provided because rental income, unlike other types of passive income, ordinarily has associated with it significant expenses. Therefore, a tax equal to 30 percent of the gross rentals could frequently exceed the entire economic income from the property. If the election is made, the taxpayer may reduce his gross income from the real property by the deductible expenses, such as depreciation, mortgage interest, and real property taxes. The taxpayer is then taxed on the net income at the graduated rates which generally apply to U.S. taxpayers rather than paying 30 percent on his gross rental income. Often, as a result of the election, the investor will pay no tax on the current income because depreciation, mortgage interest, real property taxes and other expenses exceed gross income. (This result would be the same if a U.S. person owned the property.) However, by making the election, the taxpayer will also subject himself to U.S. tax on any capital gains from the sale or exchange of the property. The election once made, is binding on the taxpayer in all subsequent years unless consent to revoke it is obtained from the Internal Revenue Service.

Apart from the Code election, a number of planning techniques exist whereby a foreign investor may obtain the advantages of being taxed on current income from real property on a net basis. However, unlike the Code election, these techniques also offer the opportunity to avoid tax on the capital gain which would result on the sale of the property. Also, unlike the Code election, they may be employed on a property-by-property basis. For example, a foreign investor who is actually engaged in a U.S. real estate business will be taxed on current income from the property on a net basis (which might result in no current tax because of the allowable deductions). He may sell the property on the installment basis and receive most or all of the payments in years following the year of the sale. If he is not actually engaged in a U.S. trade or business in later years when the installment payments are received (and has not made the election to be treated as if he were), the gain would not be treated as effectively connected with a trade or business in the later years and would therefore go untaxed.

Secondly, a foreign investor could generally exchange his U.S. real property held for productive use or investment for other property of a like kind, whether within or without the U.S., without recognition of gain. If the property he acquired in the exchange were outside the U.S., the gain he would recognize on the ultimate sale of the property received in the exchange would not be subject to U.S. tax. This would be the case even if the investor were actually engaged in a U.S. trade or business or had made the election to be so treated.

A taxpayer may also obtain the benefits of current taxation on a net basis and exemption from tax on the gain by investing in U.S. real property indirectly through a foreign holding company which either is actually engaged in U.S. business or makes the election. The holding company would be subject to tax on the income it receives from the property, but, as noted earlier, often there would be no taxable income on a current basis. Moreover, the corporation often could reduce or eliminate its taxable income by paying deductible interest to its investors. Ordinarily, dividends and interest paid by a foreign corporation deriving most of its income from U.S. sources are subject to U.S. withholding taxes. However, these taxes are sometimes waived on a reciprocal basis, under tax treaties between the United States and other countries. If the corporation is entitled to such a treaty benefit, income paid currently by the corporation would escape that U.S. tax. (Foreign investors frequently utilize U.S. treaties applicable to the Netherlands Antilles and British Virgin Islands because the treaties contain the necessary waivers or reductions and because these jurisdictions impose low or no taxes on the income.)

The investors in the holding company could avoid U.S. tax on the gain from the sale of the property by either of two methods. First, if the corporation sells the property and follows a plan of liquidation meeting certain requirements, the corporation will not be taxable on the gain under a general rule of the Code which exempts liquidating corporations from tax on gains from the sale of property (sec. 337). Moreover, the shareholders and security holders will generally not be taxable when they exchange their stock and securities in liquidation for the proceeds of the sale of the real property because, as foreign investors, they generally are not subject to U.S. capital gains tax. Even though the corporation is engaged in a U.S. trade or business, that business is not imputed to its investors. Since mere ownership or sale of stock is generally not a trade or business, the gains ordinarily would not be effectively connected with a U.S. business and thus would escape U.S. tax.

Second, if the investors instead sell their stock or securities, they would generally not be subject to tax on the gain for the same reasons that they would generally not recognize gain in a liquidation. Assuming that the sales price reflected the appreciated value of the real property, the purchaser of the corporation, even if a U.S. person, could then liquidate it without realizing a gain subject to U.S. tax because his basis in the stock for purposes of determining his gain on the liquidation would be his purchase price for the stock. He would also get a stepped-up basis for the real property equal to his purchase price for the stock.

Finally, some U.S. tax treaties (such as the treaties with the Netherlands Antilles and the British Virgin Islands) provide for a real property election similar to that in the Code, but the election may be made on a year-by-year basis. A foreign investor entitled to the benefits of such a treaty and not actually engaged in a U.S. business could use the treaty election to be taxed on a net basis in years prior to the year of sale. In the year of sale, the taxpayer would not make the treaty election and would not be taxed on the gain on the sale of the property because of the absence of a U.S. trade or business.

A number of U.S. tax treaties (not including, however, the protocols with the Netherlands Antilles or the British Virgin Islands) contain reciprocal provisions which prevent the United States from taxing certain types of U.S. source capital gains of foreign investors who are entitled to the treaty benefits. While these provisions reciprocally exempting capital gains generally do not apply with respect to real estate (that is, they do not restrict either country from taxing gains on sales of its real estate derived by residents of the other), they generally would apply with respect to stock in corporations formed or availed of to hold real estate. The Code provides that these treaty exemptions are to prevail if they require the exclusion from gross income of gains which the United States would otherwise tax (sec. 894(a); *cf.* also sec. 7852(d)).

Reasons for Change

The committee believes that 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 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.

The committee further believes that the tax should generally be imposed at a flat rate of one-third of 28 percent, currently the maximum rate which a U.S. investor would pay on long-term capital gains. It is not appropriate to follow foreign investors to be taxed on part or all of the gain at the lower graduated rates at which a U.S. investor might pay tax because foreign investors generally are taxed on their U.S. source income. Their foreign source income would not be taken into account in determining the rates at which the U.S. tax would be imposed. However, if because part or all of the gain is treated as ordinary income tax at one-third of the amount of tax which would be imposed if the full amount of the gain were subject to tax at graduated rates would be higher than one-third of 28 percent, tax at the lower flat rate allowed for long-term capital gain would be inappropriate.

In order to impose a tax on gains from the sale of U.S. real estate, it is also necessary to impose a similar tax on gain from the disposition of interests in entities which hold substantial U.S. real property. Otherwise, a foreign investor could, as under present law, avoid tax on the gain by holding the real estate through a corporation, partnership, or trust and disposing of his interest in that entity rather than having the entity itself sell the real estate.

Finally, the committee believes that, to assure effective enforcement, it is necessary to provide for withholding of the tax by the purchaser. This withholding mechanism is similar in many respects to the withholding system now in effect for other types of investment income, such as interest and dividends, paid to foreign investors. However, to protect the U.S. purchaser from liability in cases of unintentional failure to withhold, the obligation only arises if he knows that the seller is a foreign investor or receives a notice to that effect. Moreover, to prevent interference with routine transactions, the withholding obligation will not apply in the case of certain sales of personal residences or the trading of stock in an established securities market.

Explanation of Provisions

General

Under the provision, foreign investors would be taxed on gains on the disposition of U.S. real property. Foreign investors would also be taxed on gains realized through the sale or exchange of an interest in a real property holding organization (RPHO). An RPHO generally is a closely-held corporation, trust, or partnership at least half of the assets of which are U.S. real property interests. Reporting requirement would be established to identify when taxable transactions had occurred.

The tax would be collected through withholding requirements and related enforcement provisions. Foreign investors would be required to notify purchasers of their U.S. real property interests of their status prior to the sale. Where such notice is given (or where the purchaser knows that the seller is a foreign person), the purchaser generally would be required to withhold the smallest of (a) one-third of 28 percent of the purchase price, (b) one-third of the tax on the seller's gain plus the full amount of any tax which was not paid on a previous sale of the property by a foreign person, or (c) the proceeds under his control. This withholding requirement could be waived (or reduced) if a certificate were obtained from the IRS indicating that no tax was due (e.g., there was no gain on the sale or adequate security had been provided to the IRS) or allowing withholding in a reduced amount.

No withholding would be required in the case of a sale of a single-family residence to be used as the purchaser's principal residence unless the gross sales price exceeded $150,000. No withholding would be required in the case of RPHO stock sold on an established securities market.

Tax imposed on seller

Amount of tax

In the case of any nonresident alien individual or foreign corporation, the tax imposed by the provision for each taxable year generally is equal to one-third of 28 percent of the excess (if any) of (i) the amount of the gain realized by the taxpayer during the taxable year from the sale of U.S. real property interests, over (ii) the amount of the loss realized by the taxpayer during the taxable year from the sale of U.S. real property interests. However no tax is due if the excess is $5,000 or less. Gains of certain related parties are aggregated for purposes of the $5,000 exception. In the case of an installment sale, the entire amount to be realized is taken into account in the year of the sale for purposes of one exception.

"U.S. real property interests" include both U.S. real property held directly and interests in U.S. real property holding organizations, as described below. The tax is imposed separately from, and in addition to, other U.S. taxes which may be imposed on the foreign investor's income. In order to prevent double taxation in the case of a sale of a U.S. real property interest which is effectively connected with a U.S. trade or business (or which the foreign investor has elected to have so treated), any gain or loss realized on the sale of a U.S. real property interest is not to be taken into account for purposes of applying the provisions governing effectively connected gains (secs. 871 and 882). However, in order to prevent a foreign investor from paying less tax than one-third of the amount that he would have been required to pay if the gain were treated as effectively connected with a U.S. trade or business, the tax imposed under the provision will be at least equal to one-third of the tax that would be paid if the income were effectively connected and subject to graduated tax rates (after allowance of the long-term capital gains deduction where it is appropriate).

For purposes of imposing the tax, any disposition of a U.S. real property interests will be treated as a sale. Moreover, because the tax is imposed on the amount realized, thetax is imposed without regard to any provisions of the Code providing for nonrecognition of realized income unless nonrecognition for purposes of this tax is provided for by regulations. It is anticipated that, for example, if nonrecognition treatment is otherwise available, and if collection of the tax imposed by the provision would not be jeopardized, a foreign person would be permitted under the regulations to exchange one U.S. real property interest for another without recognition of gain and payment of the tax. The tax would not be payable on dispositions by gift or inheritance because there is no amount realized.

The tax is imposed on the beneficial owner of the property, rather than the nominee, trustee, executor, etc., who holds record title. However, the record title holder may be a "seller's agent" under the withholding provisions (discussed below).

Direct interest in U.S. real property

The tax is imposed on gains from the sale of interests in real property (including an interest in a mine, well, or other natural deposit) located in the United States. The term "interest in real property" includes fee ownership and co-ownership of land or improvements, leasements, and options to acquire leaseholds of land or improvements. Such an interest would, for example, include a mineral royalty. Moreover, the term includes partial interests such as life estates, remainders, reversions, and rights of refusal in real property. Movable walls, furnishings, and other similar personal property associated with the use of real property are considered real property for purposes of the bill.

U.S. Real Property Holding Organizations

Also included in the definition of U.S. real property interests are certain holdings in a U.S. real property holding organization (RPHO). Thus, gain on the sale of such holdings would be subject to the tax.

Generally, the holdings subject to the tax are stock in a corporation, or an interest (other than solely as a creditor) in a partnership or trust, which during the shorter of the period during which the taxpayer held his interest or the 5 years preceding his sale of the interest, is or was an RPHO. However, the interest would not be a U.S. real property interest if the RPHO recognized gain on all its U.S. real property interests prior to sale of the interest in the RPHO. Since convertible debt of an RPHO is an interest in an RPHO other than solely as a creditor, such convertible debt would be a U.S. real property interest.

An RPHO is a corporation, partnership, or trust, whether domestic or foreign, if (i) at any time during the taxable year, a controlling interest in the organization is owned by or for not more than 10 persons, and (ii) U.S. real property interests constituted at least 50 percent of the assets of the organization. For purposes of the 10-owner rule, if the organization can not identify holders of interest (e.g., bearer shares), it is intended that the unidentified interests will be presumed to be held by one person unless shown otherwise. In addition, to the extent that their effect is to make an organization an RPHO attribution rules similar to those applied to ownership of personal holding companies will be applied under regulations. A "controlling interest" is, in the case of a corporation, 50 percent or more of the total combined voting power of all classes of stock or 50 percent or more of the fair market value of all classes of stock; in the case of a partnership 50 percent or more of the capital or profits interest; and, in the case of a trust, 50 percent or more of the beneficial interests (actuarially determined). For purposes of applying the assets test, cash, certain savings deposits, marketable securities, accounts or notes receivable, or other assets which are readily marketable, in excess of a reasonable amount of working capital, are not counted. This rule is intended to prevent the investors in an RPHO from converting it into a non-RPHO merely by infusing liquid assets.

The Treasury Department is to prescribe regulations setting forth "look through" rules under which, if a person controls an entity, that person is deemed to own directly a pro rata share of the assets of the entity.

Tax withheld by purchaser

Requirement of withholding

To enforce the provision, withholding obligations are imposed on purchasers of a United States real property interest (and certain other persons involved in the transactions) who know or receive a notice (described below) that the seller is foreign. As discussed below, in certain situations a withholding obligation is also imposed on certain other persons involved in the disposition of a U.S. real property interest. The purchaser or other withholding agent is to deduct and withhold a tax equal to the smallest of (i) one-third of 28 percent of the amount realized on the disposition, (ii) the "seller's maximum tax liability" (discussed below), or (iii) the fair market value of that portion of the sale proceeds which is within the withholder's control. The "seller's maximum tax liability" is the maximum amount which the Treasury determines that the seller could owe as his tax under the provision as a result of the disposition of a United States real property interest plus any unsatisfied prior withholding tax liabilities of foreign persons under the provision with respect to that interest. Thus, for example, if a U.S. person sells a U.S. real property interest to a foreign investor for $1 million, if that foreign investor sells the property for $1.5 million to a second foreign investor and no tax under this provision is paid, and if that second foreign investor in turn sells the property to a third foreign investor for $2 million and again no tax is paid, the unsatisfied prior withholding liability on the subsequent sale of the property by the third foreign investor would be one-third of $280,000 (assuming the gain of the first two foreign investors is long-term capital gain)—the sum of the unsatisfied withholding tax liabilities of the second and third foreign investors (which would be the amount of the maximum tax liabilities of the previous holders). Therefore, if the third investor sold the property for $2.5 million, his "maximum tax liability" would be one-third of $420,000—one-third of the sum of his $280,000 unsatisfied prior withholding liability plus the $140,000 tax due by reason of his disposition.

The limitation to the value of the proceeds in the withholder's control limits the amount of withholding in sales where part of the consideration is the assumption of a mortgage or where payments are to be made in installments. If the amount withheld exceeds the seller's liability for failure to withhold on a prior transaction and for gain on the sale, the excess is refundable to the seller. The purchaser is indemnified against any claims by the seller if he withholds the lesser of one-third of 28 percent of the amount realized or the amount set forth in a "qualifying statement" (discussed below) from the IRS. If a purchaser fails to withhold when he had a duty to do so, he is relieved of liability to the extent that the tax is paid by the seller or some other person.

A person receiving a U.S. real property interest from a foreign person in an exchange is considered to be the purchaser of the interest for purposes of this provision and is required to withhold the appropriate amount of tax from the property transferred to the foreign person in the exchange. Thus, for example, in the case of a liquidation of an RPHO, the liquidating corporation is treated as the purchaser of stock exchanged by foreign shareholders for the liquidating distribution and is required to withhold from the liquidating distribution.

Where there are multiple sellers, the withholding rules apply to the portion of the proceeds which reflect the interests of sellers who are foreign persons. Where there are multiple purchasers, the withholding liability of each is limited, as described above, to the proceeds under his control.

Knowledge or notice requirement

The withholding requirements is not to apply to a purchaser of a United States real property interest unless, as of the time for settling the transaction, he knows that the seller is a foreign person or has received a notice from the seller or the seller's agent that the seller is a foreign person. However, if after the time for settling the transaction, the purchaser has any portion of the sale proceeds under his control and immediately before the purchaser pays any of those proceeds to the seller he knows or receives notice from the seller or the seller's agent that the seller is a foreign person, then the purchaser will be required to withhold with respect to the later payment.

The seller is required to notify the purchaser that the seller is a foreign person. The seller's agent (which can be the seller's nominee, broker, settlement attorney or any person holding any of the sale proceeds) is also required to notify the purchaser that the seller is a foreign person if, as of the time for settling the transaction, the agent has reason to believe that the seller may be a foreign person. The notice requirement for both the seller and his agents will be satisfied if at least one party gives the purchaser the required notice.

Other withholding agents

A domestic partnership, the trustee of a domestic trust, or the executor of a domestic estate will be required to deduct and withhold from distributions to foreign partners or beneficiaries to the extent that the distributions are attributable to the sale of a United States real property interest.

Failure to give notice

If a seller's agent is required to notify the purchaser of a United States real property interest that the seller is a foreign person and fails to give the notice, the agent is liable for the amount of the unpaid tax which the purchaser would have been required to withhold if the agent had given the purchaser the required notice. As in the case of other withholders under this provision, the liability of the seller's agent is limited to the proceeds under his control. For this purpose, however, compensation received by the agent in connection with the transaction is treated as proceeds under his control. A seller's agent who fails to make reasonable inquiry is treated as required to give notice.

Exemptions from and reductions of withholding

A purchaser will not be required to withhold if: (i) the seller furnishes a "qualifying statement" (described below) to the person required to withhold, (ii) the property being sold is a single family residence which is to be used by the purchaser as his principal residence and the amount realized by the seller on the sale is $150,000 or less, or (iii) the property being sold is stock of a corporation and the sales transaction takes place on an established securities market. For this purpose, "established securities market" would generally include those included for purposes of section 453(b)(3) and also any comparable foreign securities market. It would not include negotiated transactions. A "qualifying statement" is a statement by the Treasury that the seller either (i) has reached agreement with the Treasury on the payment of the tax imposed by section 897 and has satisfied or provided adequate security for unsatisfied prior tax liabilities under section 897, or (ii) is exempt from tax imposed by section 897 and has satisfied or provided adequate security for unsatisfied prior tax liabilities under section 897. The Treasury may prescribe a reduced amount to be withheld if the Treasury upon request by the purchaser or the seller determines that such reduced amount will not jeopardize the collection of the withholding tax or the tax under section 897.

Related legislation

The committee intends that the taxes imposed under similar provisions of H.R. 1319 and H.R. 1212 are to be paid in addition to the taxes imposed under this provision.

Reporting requirements

Requirement to file a return

If, at any time during a calendar year, (i) a corporation, partnership, or trust has United States real property interests which constitute more than 40 percent of the fair market value of its assets, (ii) 10 or fewer persons have a controlling interest (other than solely as a creditor) in the entity, and (iii) at least one foreign person has an interest (other than solely as a creditor) in the entity, the entity is required to file an information return for the year. The return is to set forth the following information: (i) the name and address of any person who held an interest (other than solely as a creditor) in the entity at any time during the calendar year, (ii) the composition of the assets of the entity at such time or times during the calendar year as the Treasury may prescribe by regulations, (iii) any information with respect to transfers during the calendar year of interests in the entity which the Treasury may prescribe by regulations, (iv) whether such entity is a United States RPHO at any time during the calendar year, and (v) any other information which the Treasury may prescribe by regulations.

In addition to the information return, the reporting entity is also required to furnish a written statement to every person who held an interest (other than solely as a creditor) in the entity during the calendar year setting forth the name and address of the entity making the return, whether the entity is a United States RPHO at any time during the calendar year, and any other information that the Treasury may prescribe through regulations. The return will be furnished to the person having the interest no later than January 31 of the year following the year for which the return was made.

Failure to make a return or furnish a statement

A penalty for failure to file a tax return or to furnish a statement will be imposed in an amount equal to the greater of (i) $25 for each day during which such failure continues but not to exceed $25,000, or (ii) the amount of the tax imposed by section 897 which is not paid and which is attributable to transfers (other than those made in an established securities market) occurring during the calendar year for which the return or statement was required. However, if it is shown that the failure to file the return or to furnish the notice is due to reasonable cause and not to willful neglect, no penalty will be imposed.

Miscellaneous amendments

Source of income.—Income from the disposition of a United States real property interest will be United States source income.

Examination of taxpayer.—Section 7605(b) will not apply to an inspection of a taxpayer's books of account for purposes of sections 897 or 1444.

Effective date

The amendments made by the provision will generally apply to dispositions after December 31, 1979. However, for a five-year period, gain will not be taxed to the extent required by treaty obligations of the United States. After that five-year period for the renegotiation of conflicting treaty provisions (i.e., after December 31, 1984) the provision will prevail over any conflicting treaty provisions remaining in effect.

Revenue effect

It is estimated that this provision will increase budget receipts by $25 million in fiscal year 1980, $35 million in 1981, $39 million in 1982, $43 million in 1983 and $47 million in fiscal year 1984.

B. Exemption From Withholding Tax and Estate Tax for Portfolio Investments in the United States of Nonresident Aliens and Foreign Corporations

(Sec. 201 of the Bill and Secs. 872, 883, 1441, 1442, and 2105 of the Code)

Present law

Present law provides, in general, that interest, dividends and other similar types of income of a nonresident alien or a foreign corporation are subject to a 30-percent tax on the gross amount paid [1] if such income or gain is not effectively connected with the conduct of a trade or business within the United States (secs. 871(a) and 881).[2] However, a number of exemptions have been provided from this 30-percent tax on gross income. Interest from deposits with persons carrying on the banking business are exempt (secs. 861(a)(1)(A) and 861(c)). Any interest and dividends paid by a domestic corporation which earns less than 20 percent of its gross income from sources within the United States is also not subject to the 30-percent tax (secs. 861(a)(1)(B) and 861(a)(2)(A)). Under the expired interest equalization tax (IET), interest on certain debt obligations which were part of an issue with respect to which an election had been made for IET purposes are exempt (secs. 861(a)(1)(G) and 4912(c) of the code). Moreover, there is no estate tax liability with respect to a debt obligation or a bank deposit if the interest on such obligation or deposit would not be subject to the 30-percent withholding tax if it were received by the decedent at the time of his death (secs. 2104 and 2105).

In addition to the above exemptions provided in the Internal Revenue Code, various income tax treaties of the United States provide for either an exemption or a reduced rate of tax for interest and dividends paid to foreign persons if the income is not effectively connected with the conduct of a trade or business within the United States.

Reasons for change

The committee believes that the imposition of a withholding tax on obligations issued by U.S. persons can impair the ability of U.S. corporations to raise capital in foreign markets. International bond issues are often exempt from withholding taxes and estate taxes imposed by foreign governments. In contrast, the United States' withholding tax is generally imposed, although as indicated above there are numerous exceptions to the general rule depending upon the nature of the issuer or the residence of the recipient of the interest income. The lack of a broad exemption under present law has in some cases made it difficult to trade U.S. obligations in international bond markets, since holders of international obligations wish to be assured that there will be no withholding tax imposed on any interest income which they may derive. To satisfy this desire of foreign lenders, U.S. borrowers often have to agree to reimburse holders of its debt instruments for any U.S. withholding tax which may be due. This raises the cost which a U.S. borrower must incur when it goes into foreign markets to raise capital.

Prior to the termination of the IET, U.S. borrowers were able to secure an exemption for foreign lenders by electing to have the U.S. obligations subject to the IET. In this way, interest paid with respect to such obligations was exempt from the 30-percent withholding tax. However, the termination of the IET on June 30, 1974, again made it more difficult for U.S. borrowers to obtain funds from foreign markets. In order to enable U.S. borrowers to obtain funds for their domestic as well as foreign capital needs your committee believes that an

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[1] This tax is generally collected by means of withholding by the person making the payment to the foreign recipient of the income (secs. 1441 and 1442).

[2] If the interest, dividend or other similar income is effectively connected with a U.S. trade or business, that income is included in the normal income tax return which must be filed for the business.

exemption should be provided for interest paid to foreign lenders (other than direct investors) except where the income is effectively connected with the conduct of a trade or business in the United States by the foreign lender or the interest is paid to a controlled foreign corporation.

Explanation of provisions

Withholding tax

For the reasons indicated above, under the committee amendment, interest paid by a U.S. person would generally be exempt from U.S. tax (under Code secs. 871(a) and 881) if received by a nonresident alien individual or a foreign corporation. The term "United States person" has the meaning assigned to it in Code section 7701(a)(30) and means a citizen or a resident of the United States, a domestic partnership, a domestic corporation, and any estate or trust (other than a foreign estate or trust). In addition, the exemption applies to interest paid by the United States Government or any agency or instrumentality thereof, or by any State or political subdivision thereof. For purposes of this provision the term "interest" includes original issue discount.

Interest is not entitled to the exemption from U.S. tax if it is effectively connected with the conduct of a trade or business within the United States. Also, interest is not exempt if it is paid to a foreign person having a direct ownership interest in the U.S. payor. In the case of payments from domestic corporations, direct ownership exists if the recipient of the interest owns or is considered as owning 10 percent or more of the total combined voting power of all classes of stock entitled to vote of that corporation. In the case of interest paid by a domestic partnership, direct ownership exists if the recipient of the interest owns or is considered as owning 10 percent or more of the capital or profits interest of the partnership.

In applying the 10-percent ownership test, the committee's amendment provides specific attribution rules for determining what constitutes direct and indirect ownership. Stock owned directly or indirectly by or for a corporation, partnership, trust or estate is considered as being owned directly by the shareholders, partners or beneficiaries. If 50 percent or more in value of the stock in a corporation is owned directly or indirectly by or for any person, the corporation is considered as owning the stock owned directly or indirectly by or for that person. However, stock considered under these rules as being owned by a partnership, estate, trust or corporation is not considered as being actually owned by a partner, beneficiary or shareholder of such entity. Stock owned directly or indirectly by or for a partner or a beneficiary of an estate or a trust is considered as being owned by the partnership, estate or trust. Stock owned directly or indirectly, by or for a person who is considered the owner of any portion of a trust (under subpart E of part 1 of subchapter J (relating to grantor trusts)) is considered as being owned by the trust.

To prevent U.S. persons from indirectly taking advantage of this exemption, the bill provides that a foreign corporation which is a controlled foreign corporation (within the meaning of sec. 957) is not to be entitled to the exemption from gross income for interest.

Although the committee's amendment provides an exemption for payments of interest to foreign persons, the committee does not intend to waive the information reporting requirements which would be applicable under present law to these exempt amounts. Your committee expects that regulations will be prescribed under these provisions so that the Secretary can report back to the committee the foreign persons (and their country of residence) who are receiving the benefits of this exemption.

Under the committee's amendment, no person will be required to withhold any amount upon the payment to a nonresident alien or foreign corporation if the interest or original issue discount is exempt from withholding tax. In cases where the payor does not know the identity of the beneficial owner of the securities with respect to which the interest or original issue discount is paid, the Secretary of the Treasury may, under present law (section 1441(c)(2)), prescribe by regulations circumstances in which the payor, or any person having custody or control of the payment, will be required to withhold amounts as tax due. The committee contemplates that the Secretary will exercise this authority with respect to payments of original issue discount and interest to the extent necessary to ensure that the collection of the tax imposed upon payments of interest and original issue discount to persons owning a 10-percent or greater interest in the payor and to controlled foreign corporations.

Estate tax

In the case of nonresident alien individuals, the amendment also deals with the estate tax problem, formerly dealt with by the IET. That tax, before repeal, eliminated any potential U.S. estate tax liability in the case of obligations the income from which, if received by the decedent at the time of his death, would be exempt from tax.

As a result, the bill provides an exclusion from the estate tax for debt obligations if any interest received by a decedent at the time of his death would be eligible for the exclusion provided for by your committee.

Exemption made inapplicable

The bill provides that if the Secretary of the Treasury determines that the United States is not receiving sufficient information from a foreign country to identify the true beneficial recipients of the interest payments and if the Secretary believes such information is necessary in order to prevent evasion of taxes, the exemption will no longer apply to payments addressed to or for the account of persons within that country for future issuances of debt obligations. The termination is to continue until the Secretary determines that the exchange of information between the United States and that country is sufficient to identify the beneficial recipients of the interest. Any termination of the exemption for interest will also automatically terminate the exemption from the estate tax on the debt obligations.

Effective date

The amendments providing for the income tax exemption would apply to interest paid after the date of enactment. The amendments providing for an estate tax exclusion for debt obligations would apply to estates of decedents dying after the date of enactment.

Revenue effect

It is estimated that this provision will reduce budget receipts by $17 million in fiscal year 1980, $36 million in 1981, $39 million in 1982, $43 million in 1983 and $47 million in fiscal year 1984.

C. Exception to Private Foundation "Self-Dealing" Rules for Continuation of Certain Leasing Arrangements

(Sec. 202 of the bill and sec. 4941 of the Code)

Present law

The 1969 Tax Reform Act in effect prohibited certain transactions between a private foundation and "disqualified persons" with respect to that foundation, such as substantial contributors to the foundation. These prohibited transactions include leasing arrangements between a private foundation and disqualified persons (Code sec. 4941(d)(1)(A)).

The 1969 Act also provided a transitional rule permitting continuation—until taxable years beginning after December 31, 1979—of otherwise prohibited leasing arrangements pursuant to binding contracts in effect on October 9, 1969 (or pursuant to renewals of such contracts). In order to qualify for this 10-year transitional protection, the leasing arrangement must be at least as favorable to the foundation as an arm's-length transaction with an unrelated party (P.L. 91-172, sec. 101(l)(2)(C)).

Reasons for change

The committee believes that where a private foundation has been leasing office space from a disqualified person pursuant to an arrangement protected by the 10-year transitional rule, the foundation should be able to continue such arrangement thereafter if the space is made available to the foundation on a basis no less favorable than that in an arm's-length transaction and if the leased space is in a building in which there are tenants who are not disqualified persons.

The committee believes that, although self-dealing arrangements between private foundations and disqualified persons generally should be prohibited, it is not appropriate, in the limited circumstances addressed by the provision, to force a private foundation to discontinue a leasing arrangement which antedates the 1969 Tax Reform Act and which has not been disadvantageous to the foundation. Inasmuch as continuation of the lease is excepted from the self-dealing excise taxes only if there are other tenants in the building who are not related to the foundation, the committee believes that the "arm's-length" standard is enforceable by the Internal Revenue Service.

Explanation of provision

The bill would provide a permanent exception from the self-dealing rules under Code section 4941 in certain circumstances where a private foundation leases office space from a disqualified person, if the lease is pursuant to a binding contract in effect on October 9, 1969 (or renewals thereof) and if at the time of execution the lease was not disadvantageous to the foundation. For the lease to qualify for this exception, the space must be leased to the foundation on a basis no less favorable than that on which such space would be made available in an arm's-length transaction, and the leased space must be in a building in which there are tenants who are not disqualified persons.[1]

The provision would apply to the Moody Foundation of Galveston, Texas, and any other private foundation which has been leasing space from a disqualified person pursuant to an arrangement covered by the 10-year transitional rule and which lease also meets the specific requirements of the provision.

Effective date

The provision would apply to taxable years beginning after December 31, 1979.

Revenue effect

It is estimated that this provision will reduce budget receipts by less than $5 million annually, beginning with fiscal year 1981.

III. EFFECT OF THE BILL ON THE BUDGET AND VOTE OF THE COMMITTEE IN REPORTING THE BILL AS AMENDED

Budget Effect

In compliance with section 252(a) of the Legislative Reorganization Act of 1970, the following statement is made about the effect on the budget of this bill, H.R. 2297, as amended. The committee estimates that the amendments contained in the bill will increase budget receipts by $8 million in fiscal year 1980; reduce budget receipts by $4 million in fiscal year 1981, and by $3 million in each of fiscal years 1982–1984. These figures include $3 million for the provision which has been estimated at "less than $5 million." This amount represents the midpoint between zero and $5 million, rounded upward, and is used for budgetary purposes to take into account the revenue effects of those provisions for which only range-estimates are available.

The Treasury Department agrees with this statement.

New Budget Authority and Tax Expenditures

In accordance with section 308 of the Budget Act, after consultation with the Director of the Congressional Budget Office, the committee states that the changes made to existing law by this bill involve no new budget authority or new tax expenditures but would increase existing tax expenditures as follows: the provision relating to repeal of the withholding tax on interest paid to foreign portfolio indebtedness by $17 million in fiscal year 1980, $36 million in fiscal year 1981, $39 million in fiscal year 1982, $43 million in fiscal year 1983, and $47 million in fiscal year 1984. In addition, the provision relating to tax treatment of gain on the sale of U.S. real property by foreign investors would decrease tax expenditures by $25 million in fiscal year 1980, $35 million in fiscal year 1981, $39 million in fiscal year 1982, $43 million in fiscal year 1983, and $47 million in fiscal year 1984. This would result in a

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[1] The provision sets forth requirements which must be met as of the effective date in order for the permanent self-dealing exception provided by the bill to apply as of that date. The provision does not apply prior to the effective date.

net decrease of $8 million in tax expenditures for fiscal year 1980, a net increase of $1 million in fiscal year 1981, and no net change in fiscal years 1982–1984.

Consultation with Congressional Budget Office on Budget Estimates

In accordance with section 403 of the Budget Act, the committee advises that the Director of the Congressional Budget Office has examined the committee's budget estimates (as indicated above) and agrees with the methodology used and the resulting revenue estimates.

Vote of the Committee

In compliance with section 133 of the Legislative Reorganization Act of 1946, the following statement about the vote of the committee on the motion to report the bill, as amended. The bill, H.R. 2297, as amended, was ordered favorably reported by voice vote.

IV. REGULATORY IMPACT OF THE BILL

In compliance with paragraph 5 of Rule XXIX of the Standing Rules of the Senate, the following statement is made concerning the regulatory impact that might be incurred in carrying out the provisions of this bill, H.R. 2297, as reported by the committee.

Individuals and businesses regulated and economic impact of regulation.—The bill does not regulate any individuals or businesses, but amends certain provisions of the tax law. One provision (title I of the bill) would impose a tax on a portion of the gain on the sale of U.S. real property by foreign investors. Under this provision, certain reporting requirements would be established to identify when taxable transactions had occurred. The tax would be collected through withholding requirements and related tax enforcement provisions. A second provision (sec. 201) would repeal the 30-percent withholding tax on interest paid to foreign investors on portfolio indebtedness. Finally, the bill (sec. 202) would provide a permanent exception from the "self-dealing" rules under Code section 4941 in certain circumstances where a private foundation leases office space from a "disqualified person."

Impact on personal privacy.—The provisions under title I of the bill (relating to tax on gain on sale of U.S. real property by foreign investors) will involve some possible impact on the privacy of those involved in reporting and withholding with respect to the imposition and collection of the tax. The other provisions of the bill will have minimal impact on personal privacy.

Determination of paperwork involved.—The provisions under title I of the bill (relating to tax on gain on sale of U.S. real property by foreign investors) will involve some additional paperwork with respect to the reporting, withholding, and other related tax enforcement provisions regarding the imposition and collection of the tax. The provision eliminating the 30-percent withholding tax on interest paid to foreign investors on portfolio indebtedness will reduce the amount of paperwork and reporting by the payors of such interest. The other provision will involve minimal paperwork on the part of the affected foundation.

VI. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In the opinion of the committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, HR. 2297, as reported by the committee).

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