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Conference Committee Rejects Controversial U.S. Senate Income Tax Treaty Override and Taxation of 10-Percent Offshore Shareholders

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The Conference Committee of the United States Senate and House of Representatives on this year's budget reconciliation bill (H.R. 2491, now renamed the "Balanced Budget Act of 1995") has rejected the Senate's "Kohl amendment." In the frenzied rush leading up to passage of its original version of H.R. 2491, the Senate adopted the "Kohl amendment" to provide tax relief in connection with the sale of certain farm assets (H.R. 2491, § 12881). In order to offset the revenue loss attendant to this beneficence, Senator Kohl revived a 1992 proposal to tax offshore investors on gains realized on the disposition of stock of U.S. corporations (H.R. 2491, § 12882). In addition, the Kohl amendment imposed a "qualified resident" requirement on any foreign entity seeking the benefits of any U.S. income tax treaty and denied such benefits in all cases for "tax favored" income (H.R. 2491, § 12883). An excerpt from the Conference Committee report (H.Rpt. 104-350, Nov. 16, 1995) and the full text of sections 12882 and 12883 of H.R. 2491, as originally passed by the Senate, follow a general discussion of these provisions.

Treaty Override

Section 12883 of the original Senate version of H.R. 2491 would have added section 894(c) to the U.S. Internal Revenue Code. Under this provision, in order to be entitled to the benefits of a U.S. income tax treaty with a particular country, a foreign entity would have been required to be a "qualified resident" of that country. A foreign entity resident in a particular country under prevailing rules was considered a qualified resident unless either–

1. Fifty percent or more (by value) of the stock or beneficial interests of such entity were held (directly or indirectly) by individuals who were neither residents of such country nor citizens or residents of the United States, or

2. Fifty percent or more of the income of such entity was used (directly or indirectly) to meet liabilities to persons who were neither residents of such country nor citizens or residents of the United States.

A foreign resident of a particular country was also a qualified resident of such country if interests in such entity were primarily and regularly traded on an established securities market in such country. Other exceptions existed for subsidiaries of publicly traded entities.

In addition, no benefits under an income tax treaty with a particular country were to be available, even if the qualified resident requirement was satisfied, for income bearing a significantly lower rate of tax in that country than similar income from sources within that country realized by residents of that country.

The new statutory qualified resident requirement was similar to provisions contained in recent U.S. income tax treaties and, together with the tax favored income exclusion, was to have been effective on January 1, 1996, and was to have applied, "to any treaty whether entered into before, on or after such date."

One of the likely reasons for rejection of the treaty override in conference was strong opposition by the U.S. Treasury, business groups and several U.S. treaty partners.

Taxation of Stock Gains

Section 12882 of the Senate version of H.R. 2491 would have added section 899 and a companion withholding provision, section 1447, to the U.S. Internal Revenue Code. Under new section 899, any offshore "10-percent shareholder" of a U.S. corporation would have been subject to tax (at the normal graduated rates and including an alternative minimum tax), enforced through a new withholding regime, on gain realized upon disposition of any stock of that corporation.

A 10-percent shareholder was any person holding 10 percent or more (by vote or value) of the stock of the U.S. corporation at any time during the five-year period ending with the date of disposition (or, if shorter, the period beginning on January 1, 1996 and ending on such date). The traditional constructive ownership rules of Internal Revenue Code section 318 applied, with modifications reflecting the 10 percent threshold.

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"Stock" included any option or other right to acquire stock, the conversion feature of a convertible debt instrument and, to the extent provided in regulations, any interest in a U.S. corporation, other than an interest solely as a creditor. Thus, these various interests would have potentially become subject to tax when held by offshore investors, but would also have been taken into account to determine whether the 10-percent shareholder test had been met.

New section 899 drew heavily on that portion of section 897 (enacted by FIRPTA, the Foreign Investment in Real Property Tax Act of 1980) which imposes tax on offshore investors' gains from dispositions of stock of "U.S. real property holding corporations." For example, the various nonrecognition provisions of the Internal Revenue Code could have applied to defer taxation under section 899 only to the extent that in an otherwise nontaxable exchange the property received by an offshore investor remained potentially subject to U.S. income taxation.

Of particular interest to private investment funds (generally organized as partnerships) having offshore investors is the provision which would have caused any offshore partner in a partnership to be subject to U.S. taxation on the disposition by the partnership of stock in a U.S. corporation if (i) the partnership was a 10-percent shareholder in that corporation and (ii) at least 10 percent of the capital or profits interests in the partnership was held (directly or indirectly) by nonresident alien individuals or foreign corporations. Fortunately, this rule did not apply, except to partners owning at least 50 percent of the partnership's capital or profits interests, if certain diversification requirements were met.

Under new section 1447 the withholding rate with respect to dispositions of stock subject to section 899 was 10 percent of the amount realized (*i.e.*, gross proceeds). Withholding certificates were to have been available where the amount of gain was small enough so that the maximum U.S. tax payable on that gain would have been less than 10 percent of the amount realized. No withholding was required on the disposition of stock of a U.S. corporation, if that stock was part of a class regularly traded on an established securities market, unless the stock involved constituted at least one percent (by vote or value) of the U.S. corporation's outstanding stock.

New section 899 would have been effective for stock dispositions after December 31, 1995, but the withholding provisions would not have applied until the date six months after the date of enactment.

Excerpt from the Conference Report on H.R. 2491, the Balanced Budget Act of 1995 (H.Rpt. 104-350, Nov. 16. 1995, pp. 1504-1506)

37. TAXATION OF CERTAIN STOCK GAINS OF FOREIGN PERSONS (SECS. 12882 AND 12883 OF THE SENATE AMENDMENT)

Present law

Disposition of stock in domestic corporations

Foreign persons generally are subject to a 30-percent U.S. tax on dividends received from a U.S. corporation. Foreign persons generally are not subject to U.S. tax on gain realized on the disposition of stock in a U.S. corporation (other than a U.S. real property holding corporation), unless the gain is effectively connected with the conduct of a trade or business in the United States. Many U.S. income tax treaties contain provisions that preclude the imposition of U.S. tax on such gains realized by treaty-country residents.

Limitation on treaty benefits

The United States has entered into bilateral income tax treaties with many foreign countries. A function served by these treaties is to reduce the U.S. tax on U.S. source income earned by a resident of a treaty country. Tax treaty abuse (or "treaty shopping") occurs when a person who is not a resident of either country seeks certain benefits under the income tax treaty between the two countries. Newer treaties negotiated by the United States usually contain a "Limitation on Benefit" article that may deny treaty benefits to foreign persons that wish to "treaty-shop" the U.S. treaty network. However, not all of the U.S. income tax treaties now in force contain such an article.

House bill

No provision.

Senate amendment

Disposition of stock in domestic corporation

Under the Senate amendment, where a foreign person owns, or has owned at any time during the previous 5 years, 10 percent or more of the stock in a U.S. corporation, gain or loss from the disposition of the stock is subject to U.S. income tax at graduated rates. Constructive ownership rules apply in determining whether a foreign person is a 10-percent shareholder. In addition, certain ownership interests are treated as stock for purposes of this provision.

Certain nonrecognition provisions that would otherwise apply to dispositions of U.S. stock are suspended, and the Secretary of the Treasury is authorized to prescribe regulations providing the extent to which nonrecognition provisions will apply for purposes of this provision. Special alternative minimum tax rules apply in the case of nonresident aliens who recognize net gains on dispositions of stock that are subject to this provision.

This tax generally is collected through withholding at the rate of 10 percent of the proceeds of the disposition giving rise to the liability. Exceptions apply in cases of dispositions of stock that is regularly traded on an established securities market. Amounts withheld in excess of the tax liability are refundable.

This provision does not override any current U.S. income tax treaty obligations. However, in certain cases where a treaty prevents the imposition of U.S. tax on stock gains of a qualified resident of a treaty country (as defined below), the provision treats as dividends gain resulting from any distribution in liquidation or redemption that would (but for the treaty) be subject to U.S. tax. Dividend treatment only applies to such gain to the extent of the earnings and profits of the distributing corporation which are attributable to the stock with respect to which the distribution is made.

Effective date.–The provision generally is effective for dispositions after December 31, 1995. The withholding requirements are applicable only to dispositions occurring 6 months or more after the date of enactment.

Limitation on treaty benefits

The Senate amendment imposes a qualified resident requirement as a prerequisite for the reduction of U.S. tax on a foreign entity under any treaty. For this purpose, a foreign entity that is a resident of a foreign country is a qualified resident of such country unless (1) 50 percent or more (by value) of the interests in such entity are owned (directly or indirectly) by individuals who are not residents of such country or citizens or residents of the United States, or (2) 50 percent or more of the entity's income is used (directly or indirectly) to meet liabilities to persons who are not residents of the foreign country or citizens or residents of the United States. Special rules apply in the case of entities that are publicly traded or that are wholly-owned by publicly-traded corporations. The Secretary of the Treasury may, in certain cases, treat a foreign entity as a qualified resident.

In addition, the Senate amendment provides that no person is entitled to benefits granted by the United States under a treaty with respect to any income that bears a significantly lower tax under the laws of the other treaty country than similar income arising from sources within such foreign country derived by residents of such foreign country.

Effective date.–The provision takes effect on January 1, 1996, and applies to any treaty whether entered into before, on, or after such date.

Conference agreement

The conference agreement does not include the Senate amendment.

Sections 12882 and 12883 of the Original Senate Version of the Budget Reconciliation Bill (H.R. 2491)

Section 12882. Disposition of Stock in Domestic Corporations by 10-Percent Foreign Shareholders.

(a) General Rule.–Subpart D of part II of subchapter N of chapter 1 (relating to miscellaneous provisions) is amended by adding at the end the following new section:

"Section 899. Disposition of Stock in Domestic Corporations by 10-Percent Foreign Shareholders.

"(a) General Rule.–

"(1) Treatment as effectively connected with United States trade or business.–For purposes of this title, if any nonresident alien individual or foreign corporation is a 10-percent shareholder in any domestic corporation, any gain or loss of such individual or foreign corporation from the disposition of any stock in such domestic corporation shall be taken into account–

"(A) in the case of a nonresident alien individual, under section 871(b)(1), or

"(B) in the case of a foreign corporation, under section 882(a)(1),

as if the taxpayer were engaged during the taxable year in a trade or business within the United States through a permanent establishment in the United States and as if such gain or loss were effectively connected with such trade or business and attributable to such permanent establishment. Notwithstanding section 865, any such gain or loss shall be treated as from sources in the United States.

"(2) 24-percent minimum tax on nonresident alien individuals.–

"(A) In general.–In the case of any nonresident alien individual, the amount determined under section 55(b)(1)(A) shall not be less than 24 percent of the lesser of–

"(i) the individual's alternative minimum taxable income (as defined in section 55(b)(2)) for the taxable year, or

"(ii) the individual's net taxable stock gain for the taxable year.

"(B) Net taxable stock gain.–For purposes of subparagraph (A), the term 'net taxable stock gain' means the excess of–

"(i) the aggregate gains for the taxable year from dispositions of stock in domestic corporations with respect to which such individual is a 10-percent shareholder, over

"(ii) the aggregate of the losses for the taxable year from dispositions of such stock.

"(C) Coordination with section 897(a)(2).–Section 897(a)(2)(A) shall not apply to any nonresident alien individual for any taxable year for which such individual has a net taxable stock gain, but the amount of such net taxable stock gain shall be increased by the amount of such individual's net United States real property gain (as defined in section 897(a)(2)(B)) for such taxable year.

"(b) 10-Percent Shareholder.–

"(1) In general.–For purposes of this section, the term '10-percent shareholder' means any person who at any time during the shorter of–

"(A) the period beginning on January 1, 1996, and ending on the date of the disposition, or

"(B) the 5-year period ending on the date of the disposition, owned 10 percent or more (by vote or value) of the stock in the domestic corporation.

"(2) Constructive ownership.–

"(A) In general.–Section 318(a) (relating to constructive ownership of stock) shall apply for purposes of paragraph (1).

"(B) Modifications.–For purposes of subparagraph (A)–

"(i) paragraph (2)(C) of section 318(a) shall be applied by substituting '10 percent' for '50 percent', and

"(ii) paragraph (3)(C) of section 318(a) shall be applied–

"(I) by substituting '10 percent' for '50 percent', and

"(II) in any case where such paragraph would not apply but for subclause (I), by considering a corporation as owning the stock (other than stock in such corporation) owned by or for any shareholder of such corporation in that proportion which the value of the stock which such shareholder owns in such corporation bears to the value of all stock in such corporation.

"(3) Treatment of stock held by certain partnerships.–

"(A) In general.–For purposes of this section, if–

"(i) a partnership is a 10-percent shareholder in any domestic corporation, and

"(ii) 10 percent or more of the capital or profits interests in such partnership is held (directly or indirectly) by nonresident alien individuals or foreign corporations,

each partner in such partnership who is not otherwise a 10-percent shareholder in such corporation shall, with respect to the stock in such corporation held by the partnership, be treated as a 10-percent shareholder in such corporation.

"(B) Exception.–

"(i) In general.–Subparagraph (A) shall not apply with respect to stock in a domestic corporation held by any partnership if, at all times during the 5-year period ending on the date of the disposition involved–

"(I) the aggregate bases of the stock and securities in such domestic corporation held by such partnership was less than 25 percent of the partnership's net adjusted asset cost, and

"(II) the partnership did not own 50 percent or more (by vote or value) of the stock in such domestic corporation.

The Secretary may by regulations disregard any failure to meet the requirements of subclause (I) where the partnership normally met such requirements during such 5-year period.

"(ii) Net adjusted asset cost.–For purposes of clause (i), the term 'net adjusted asset cost' means–

"(I) the aggregate bases of all of the assets of the partnership other than cash and cash items, reduced by

"(II) the portion of the liabilities of the partnership not allocable (on a proportionate basis) to assets excluded under subclause (I).

"(C) Exception not to apply to 50-percent partners.–Subparagraph (B) shall not apply in the case of any partner owning (directly or indirectly) more than 50 percent of the capital or profits interests in the partnership at any time during the 5-year period ending on the date of the disposition.

"(D) Special rules.–For purposes of subparagraph (B) and (C)–

"(i) Treatment of predecessors.–Any reference to a partnership or corporation shall be treated as including a reference to any predecessor thereof.

"(ii) Partnership not in existence.–If any partnership was not in existence throughout the entire 5-year period ending on the date of the disposition, only the portion of such period during which the partnership (or any predecessor) was in existence shall be taken into account.

"(E) Other pass-thru entities; tiered entities.–Rules similar to the rules of the preceding provisions of this paragraph shall also apply in the case of any pass-thru entity other than a partnership and in the case of tiered partnerships and other entities.

"(c) Coordination With Nonrecognition Provisions; Etc.–

"(1) Coordination with nonrecognition provisions.–

"(A) In general.–Except as provided in subparagraph (B), any nonrecognition provision shall apply for purposes of this section to a transaction only in the case of–

"(i) an exchange of stock in a domestic corporation for other property the sale of which would be subject to taxation under this chapter, or "(ii) a distribution with respect to which gain or loss would not be recognized under section 336 if the sale of the distributed property by the distributee would be subject to tax under this chapter.

"(B) Regulations.–The Secretary shall prescribe regulations (which are necessary or appropriate to prevent the avoidance of Federal income taxes) providing–

"(i) the extent to which nonrecognition provisions shall, and shall not, apply for purposes of this section, and

"(ii) the extent to which–

"(I) transfers of property in a reorganization, and

"(II) changes in interests in, or distributions from, a partnership, trust, or estate,

shall be treated as sales of property at fair market value.

"(C) Nonrecognition provision.–For purposes of this paragraph, the term 'nonrecognition provision' means any provision of this title for not recognizing gain or loss.

"(2) Certain other rules made applicable.–For purposes of this section, rules similar to the rules of subsections (g) and (j) of section 897 shall apply.

"(d) Certain Interest Treated as Stock.–For purposes of this section–

"(1) any option or other right to acquire stock in a domestic corporation,

"(2) the conversion feature of any debt instrument issued by a domestic corporation, and

"(3) to the extent provided in regulations, any other interest in a domestic corporation other than an interest solely as creditor, shall be treated as stock in such corporation.

"(e) Treatment of Certain Gain as a Dividend.–In the case of any gain which would be subject to tax by reason of this section but for a treaty and which results from any distribution in liquidation or redemption, for purposes of this subtitle, such gain shall be treated as a dividend to the extent of the earnings and profits of the domestic corporation attributable to the stock. Rules similar to the rules of section 1248(c) (determined without regard to paragraph (2)(D) thereof) shall apply for purposes of the preceding sentence.

"(f) Regulations.–The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this section, including–

"(1) regulations coordinating the provisions of this section with the provisions of section 897, and

"(2) regulations aggregating stock held by a group of persons acting together."

(b) Withholding of Tax.–Subchapter A of chapter 3 is amended by adding at the end the following new section:

"Section 1447. Withholding of Tax on Certain Stock Dispositions.

"(a) General Rule.–Except as otherwise provided in this section, in the case of any disposition of stock in a domestic corporation by a foreign person who is a 10-percent shareholder in such corporation, the withholding agent shall deduct and withhold a tax equal to 10 percent of the amount realized on the disposition.

"(b) Exceptions.–

"(1) Stock which is not regularly traded.–In the case of a disposition of stock which is not regularly traded, a withholding agent shall not be required to deduct and withhold any amount under subsection (a) if–

"(A) the transferor furnishes to such withholding agent an affidavit by such transferor stating, under penalty of perjury, that section 899 does not apply to such disposition because–

"(i) the transferor is not a foreign person, or

"(ii) the transferor is not a 10-percent shareholder, and

"(B) such withholding agent does not know (or have reason to know) that such affidavit is not correct.

"(2) Stock which is regularly traded.–

"(A) In general.–Except as provided in subparagraph (B), a withholding agent shall not be required to deduct and withhold any amount under subsection (a) with respect to any disposition of regularly traded stock if such withholding agent does not know (or have reason to know) that section 899 applies to such disposition.

"(B) Special rule where substantial disposition.–If–

"(i) there is a disposition of regularly traded stock in a corporation, and

"(ii) the amount of stock involved in such disposition constitutes 1 percent or more (by vote or value) of the stock in such corporation,

subparagraph (A) shall not apply but paragraph (1) shall apply as if the disposition involved stock which was not regularly traded.

"(C) Notification by foreign person.–If section 899 applies to any disposition by a foreign person of regularly traded stock, such foreign person shall notify the withholding agent that section 899 applies to such disposition.

"(3) Nonrecognition transactions.–A withholding agent shall not be required to deduct and withhold any amount under subsection (a) in any case where gain or loss is not recognized by reason of section 899(c) (or the regulations prescribed under such section).

"(c) Special Rule Where No Withholding.–If

"(1) there is no amount deducted and withheld under this section with respect to any disposition to which section 899 applies, and

"(2) the foreign person does not pay the tax imposed by this subtitle to the extent attributable to such disposition on the date prescribed therefor,

for purposes of determining the amount of such tax, the foreign person's basis in the stock disposed of shall be treated as zero or such other amount as the Secretary may determine (and, for purposes of section 6501, the underpayment of such tax shall be treated as due to a willful attempt to evade such tax).

"(d) Definitions and Special Rules.–For purposes of this section–

"(1) Withholding agent.–The term 'withholding agent' means–

"(A) the last United States person to have the control, receipt, custody, disposal, or payment of the amount realized on the disposition, or

"(B) if there is no such United States person, the person prescribed in regulations.

"(2) Foreign person.–The term 'foreign person' means any person other than a United States person.

"(3) Regularly traded stock.–The term 'regularly traded stock' means any stock of a class which is regularly traded on an established securities market.

"(4) Authority to prescribe reduced amount.–At the request of the person making the disposition or the withholding agent, the Secretary may prescribe a reduced amount to be withheld under this section if the Secretary determines that to substitute such reduced amount will not jeopardize the collection of the tax imposed by section 871(b)(1) or 882(a)(1).

"(5) Other terms.–Except as provided in this section, terms used in this section shall have the same respective meanings as when used in section 899.

"(6) Certain rules made applicable.–Rules similar to the rules of section 1445(e) shall apply for purposes of this section.

"(e) Regulations.–The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this section, including regulations coordinating the provisions of this section with the provisions of sections 1445 and 1446."

(c) Exception From Branch Profits Tax.–Subparagraph (C) of section 884(d)(2) is amended to read as follows:

"(C) gain treated as effectively connected with the conduct of a trade or business within the United States under–

"(i) section 897 in the case of the disposition of a United States real property interest described in section 897(c)(1)(A)(ii), or

"(ii) section 899,"

(d) Reports With Respect to Certain Distributions.–Paragraph (2) of section 6038B(a) (relating to notice of certain transfers to foreign person) is amended by striking "section 336" and inserting "section 302, 331, or 336".

(e) Clerical Amendments.–

(1) The table of sections for subpart D of part II of subchapter N of chapter 1 is amended by adding at the end the following new item:

"Section 899. Dispositions of stock in domestic corporations by 10-percent foreign shareholders."

(2) The table of sections for subchapter A of chapter 3 is amended by adding at the end the following new item:

"Section 1447. Withholding of tax on certain stock dispositions."

(f) Effective Date.–

(1) In general.–Except as otherwise provided in this subsection, the amendments made by this section shall apply to dispositions after December 31, 1995, except that section 1447 of the Internal Revenue Code of 1986 (as added by this section) shall not apply to any disposition before the date that is 6 months after the date of the enactment of this Act.

(2) Coordination with treaties.–Sections 899 (other than subsection (e) thereof) and 1447 of the Internal Revenue Code of 1986 (as added by this section) shall not apply to any disposition by any person if the application of such sections to such disposition would be contrary to any treaty between the United States and a foreign country which was in effect on the date of the enactment of this Act, and at the time of such disposition and if the person making such disposition is entitled to the benefits of such treaty determined after the application of section 894(c) of the Internal Revenue Code of 1986 (as added by section 12883).

Section 12883. Limitation on Treaty Benefits.

(a) General Rule.–Section 894 (relating to income affected by treaty) is amended by adding at the end the following new subsection:

"(c) Limitation on Treaty Benefits.–

"(1) Treaty shopping.–No foreign entity shall be entitled to any benefits granted by the United States under any treaty between the United States and a foreign country unless such entity is a qualified resident of such foreign country.

"(2) Tax favored income.–No person shall be entitled to any benefits granted by the United States under any treaty between the United States and a foreign country with respect to any income of such person if such income bears a significantly lower tax under the laws of such foreign country than similar income arising from sources within such foreign country derived by residents of such foreign country.

"(3) Qualified resident.–For purposes of this subsection–

"(A) In general.–Except as otherwise provided in this paragraph, the term 'qualified resident' means, with respect to any foreign country, any foreign entity which is a resident of such foreign country unless–

"(i) 50 percent or more (by value) of the stock or beneficial interests in such entity are owned (directly or indirectly) by individuals who are not residents of such foreign country and who are not United States citizens or resident aliens, or

"(ii) 50 percent or more of its income is used (directly or indirectly) to meet liabilities to persons who are not residents of such foreign country or citizens or residents of the United States.

"(B) Special rule for publicly traded entities.–A foreign entity which is a resident of a foreign country shall be treated as a qualified resident of such foreign country if–

"(i) interests in such entity are primarily and regularly traded on an established securities market in such country, or

"(ii) such entity is not described in subparagraph (A)(ii) and such entity is wholly owned by another foreign entity which is organized in such foreign country and the interests in which are so traded.

"(C) Entities owned by publicly traded domestic corporations.–A foreign entity which is a resident of a foreign country shall be treated as a qualified resident of such foreign country if–

"(i) such entity is not described in subparagraph (A)(ii) and such entity is wholly owned (directly or indirectly) by a domestic corporation, and "(ii) stock of such domestic corporation is primarily and regularly traded on an established securities market in the United States.

"(D) Secretarial authority.–The Secretary may, in his sole discretion, treat a foreign entity as being a qualified resident of a foreign country if such entity establishes to the satisfaction of the Secretary that such entity meets such requirements as the Secretary may establish to ensure that individuals who are not residents of such foreign country do not use the treaty between such foreign country and the United States in a manner consistent with the purposes of this subsection.

"(4) Foreign entity.–For purposes of this subsection, the term 'foreign entity' means any corporation, partnership, trust, estate, or other entity which is not a United States person."

(b) Conforming Amendment.–Paragraph (4) of section 884(e) is amended to read as follows:

"(4) Qualified resident.–For purposes of this subsection, the term 'qualified resident' has the meaning given to such term by section 894(c)(3)."

(c) Effective Date.–The amendments made by this section shall take effect on January 1, 1996, and shall apply to any treaty whether entered into before, on, or after such date.