P.A.T.H. ACT LEADS TO WIDESPREAD TAX CHANGES

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In the spirit of giving of the recent holiday season, Congressional Democrats and Republicans and the President joined together to enact into law the Protecting Americans from Tax Hikes Act of 2015 (the "P.A.T.H. Act") on December 18, 2015.

The P.A.T.H. Act includes more than $85 billion in tax breaks, which will affect a wide-range of taxpayers, including foreign investors in U.S. real estate.

RELIEF FOR FOREIGN INVESTMENT IN U.S. REAL ESTATE AT THE COST OF INCREASED WITHHOLDING

U.S. tax law creates preferential tax treatment for two types of collective investment vehicles marketed to investors: (i) Real Estate Investment Trusts ("R.E.I.T.'s"), and (ii) Regulated Investment Companies ("R.I.C.'s").[1]

R.E.I.T.'s must invest in real estate and real estate mortgages, while R.I.C.'s may invest in the stock and securities of nearly any company. Unlike a corporation, which is subject to corporate-level tax, a R.E.I.T. or R.I.C. can escape paying corporate-level tax if it distributes all of its income to its shareholders as dividends. As with many tax benefits, there are conditions that must be met in order to receive the favorable tax treatment. A R.E.I.T. or R.I.C. must meet certain income and asset tests, and it must not be a closely-held entity. That is, the R.E.I.T. or R.I.C. must be an investment vehicle for many, not a disguised family holding company.

The P.A.T.H. Act makes several taxpayer-favorable changes to the tax treatment of investments in R.E.I.T.'s and R.I.C.'s., as discussed below.

The P.A.T.H. Act makes several changes to sections of the Internal Revenue Code (the "Code") known collectively as the Foreign Investment in Real Property Tax Act ("F.I.R.P.T.A."), which imposes a withholding tax on a foreign investor who sells U.S. real estate or an interest in a company whose predominant asset is U.S. real estate.

The P.A.T.H. Act eliminates tax liability under F.I.R.P.T.A. for certain investments in R.E.I.T.'s. The legislation also eliminates taxation of investments made by foreign pension plans in R.E.I.T.'s and U.S. real estate. For certain foreign collective investment vehicles investing in R.E.I.T.'s, F.I.R.P.T.A. tax liability is eliminated as well. However, the legislation includes a unfavorable change that generally increased the withholding burden on a sale of U.S. real estate from 10% to 15%.

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[1] R.I.C.'s are commonly called mutual funds.

Background

F.I.R.P.T.A. is set forth in Code §§897 and 1445. Code §897 imposes U.S. tax on a foreign person's sale of a U.S. real property interest ("U.S.R.P.I."), with limited exceptions. Code §1445 generally requires a person who purchases a U.S.R.P.I. from a foreign seller to withhold 10% of the amount realized on the sale. If the tax withheld exceeds the actual tax liability, the seller has two options: (i) the seller and the buyer can ask the I.R.S. for permission to lower the tax withheld to the actual tax liability, if such request is made before the sale; or (ii) the seller can file a U.S. income tax return after the sale and request a refund of the excess tax withheld over the actual tax liability. Since the income tax return cannot be filed until the following year, the seller must wait to receive the refund under the latter option.

A U.S.R.P.I. includes direct ownership of U.S. real estate, such as land or a building located in the United States, as well as stock owned in a U.S. corporation that is classified as a U.S. real property holding corporation ("U.S.R.P.H.C.").

A U.S.R.P.H.C. may include stock owned in a R.E.I.T. For a foreign investor, the purchase of stock of a publicly traded R.E.I.T. is an easy way to indirectly invest in U.S. real estate.

Dividends paid to foreign investors also pose U.S. tax issues. R.E.I.T.'s can make two types of dividends: (i) an ordinary dividend, which is a distribution of a R.E.I.T.'s income from rent, interest, and other passive investments (but not sales of assets); and (ii) a capital gain dividend, which is a distribution of proceeds from a sale of real estate. For U.S. individual investors, a capital gain dividend is preferable since it is subject to lower long-term capital gains tax rates (maximum rate of 20%) rather than the regular tax rates (maximum rate of 39.6%). However, foreign investors face a major concern with capital gains dividends due to F.I.R.P.T.A. Capital gains dividends subject the foreign investor to U.S. tax, and the added requirement to file U.S. income tax returns. Foreign corporate investors may be subject to both the regular corporate tax (maximum rate of 35%) and the 30% branch profits tax. By contrast, an ordinary dividend paid to a foreign investor is generally only subject to a 30% withholding tax (subject to reduction by tax treaty) and no obligation to file U.S. tax returns. As a result, a foreign investor generally prefers ordinary dividends over capital gains dividends.

Foreign Investors Investing in Public R.E.I.T.'s

Prior to the P.A.T.H. Act, F.I.R.P.T.A. provided for an exemption from tax for a sale of stock in a publicly traded R.E.I.T., provided that the seller owned 5% or less of the stock of the R.E.I.T. (the "5% maximum ownership restriction").

If a R.E.I.T. sold U.S. real estate and then made a capital gain distribution to its non-U.S. shareholders, the R.E.I.T. could treat the capital gain dividend as an ordinary dividend subject to 30% U.S. withholding tax (or less under an applicable income tax treaty), provided that the 5% maximum ownership restriction was met.

The P.A.T.H. Act increased the 5% maximum ownership restriction to 10%. This allows a foreign investor to increase his ownership of R.E.I.T. stock to 10% and still be exempt from F.I.R.P.T.A. on a sale of that stock.

In the case of a capital gain dividend received from a R.E.I.T. by a foreign shareholder, the P.A.T.H. Act increased the 5% maximum ownership restriction for ordinary dividend treatment to 10%.

These changes should encourage greater investment in R.E.I.T.'s. They are effective for sales or distributions made on or after December 18, 2015.

Investment in Domestically Controlled R.E.I.T.'s

If a foreign investor holds stock in a domestically-controlled R.E.I.T., the stock is not considered a U.S.R.P.I. and gain from the sale of the stock is not subject to tax under F.I.R.P.T.A. A domestically-controlled R.E.I.T. is a R.E.I.T. in which less than 50% of the stock is owned by foreign persons for the five-year period preceding the sale of the stock. This exception applies to a publicly-traded R.E.I.T., as well as a privately-held R.E.I.T. It applies with no limitation on the percentage of ownership the investor may have in the R.E.I.T. (*i.e.*, the foreign investor can even own more than 10% of the R.E.I.T.).

The P.A.T.H. Act added certain presumptions that a R.E.I.T. can make in determining whether it is domestically controlled. A helpful presumption is that if a R.E.I.T. is publicly traded, then the R.E.I.T. can presume that any shareholder who owns less than 5% is a U.S. person, unless the R.E.I.T. has actual knowledge to the contrary.

Since (i) publicly-traded R.E.I.T.'s are generally widely held (and thus may have many shareholders who own less than a 5% interest), and (ii) such stock is often held in the name of a brokerage company (such as Merrill Lynch or Goldman Sachs) that holds the stock on behalf of a customer (but does not tell the R.E.I.T. the name of the customer), then this presumption should be helpful in qualifying for the F.I.R.P.T.A. exemption.

Foreign Collective Investment Vehicles as Qualified Shareholders Investing in Any R.E.I.T.

The P.A.T.H. Act adds a new exception to tax under F.I.R.P.T.A. for an investment by a qualified shareholder in a R.E.I.T. that is either a publicly-traded R.E.I.T. or a private R.E.I.T. A qualified shareholder is a collective investment vehicle (*i.e.*, an investment fund with many investors) that can obtain tax treaty benefits for dividends under an applicable tax treaty with the United States and that is generally a publicly-traded entity on a foreign stock exchange.

A qualified shareholder is not subject to any limitation on how much R.E.I.T. stock it may own, *provided that* any investor in the qualified shareholder does not own, through application of the constructive ownership rules, more than 10% of the R.E.I.T. For example, if a qualified shareholder owns 90% of a R.E.I.T., but each investor in the qualified shareholder owns 10%, then each investor owns (by application of the constructive ownership rules) only 9% of the R.E.I.T. (*i.e.*, 10% of 90%). Thus, the qualified shareholder can receive full exemption from tax under F.I.R.P.T.A.

This is a difficult exception to meet, so it is uncertain how useful it will be.

Qualified Foreign Pension Funds Investing in Any U.S.R.P.I.

The U.S. tax law provides an exemption from tax for U.S. pension funds investing in real property, subject to certain conditions. However, there is generally no similar relief for foreign pension funds.

The P.A.T.H. Act added a new exemption to tax under F.I.R.P.T.A. for an investment by a qualified foreign pension fund, as defined below, in *any* U.S.R.P.I., not just

R.E.I.T. stock. This exemption also applies to a capital gain dividend received by a qualified foreign pension fund from a R.E.I.T.

A qualified foreign pension fund means any trust, corporation, or other organization (i) which is created or organized under the laws of a non-U.S. country, (ii) which is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees, (iii) which does not have a single participant or beneficiary with a right to more than 5% of its assets or income, (iv) which is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities, and (v) with respect to which, under the laws of the country in which it is established or operates, (a) contributions to such fund that would otherwise be subject to tax are deductible or excluded from the gross income of such fund or taxed at a reduced rate, or (b) taxation of any investment income of such fund is deferred or such income is taxed at a reduced rate.

This new exemption should be very useful to foreign pension funds and should encourage their investment in U.S. real property.

F.I.R.P.T.A. Withholding Tax Increased from 10% to 15%

There is an old expression that "no good deed goes unpunished." In the case of the changes to F.I.R.P.T.A. created by the P.A.T.H. Act, there may be some truth to that sentiment because the new law increases the 10% withholding tax rate under F.I.R.P.T.A. to 15%.

The effective date for this change was listed in Congressional summaries of the P.A.T.H. Act as applying to dispositions 60 days after the new law's date of enactment. Since the P.A.T.H. Act was enacted on December 18, 2015, the 60th day after the date of enactment would be February 16, 2016. However, P.A.T.H. Act §324(c) is worded differently and actually states that this change is effective for "dispositions after the date which is 60 days *after* date of enactment." This statutory language means that the change applies one day later than the 60th day and thus would apply to dispositions made on or after February 17, 2016. It is expected that the I.R.S. will clarify which date applies before then.

This change may be a trap for the unwary, especially since I.R.S. forms may not be updated in time to reflect this and other changes to F.I.R.P.T.A.

OTHER CHANGES TO F.I.R.P.T.A.

Interests in R.E.I.T.'s and R.I.C.'s Not Excluded from U.S.R.P.I. Definition

The so-called F.I.R.P.T.A. cleansing rule provides that the term United States real property interest or U.S.R.P.I., discussed above, does not include any interest in a corporation if as of the date of the disposition of such interest, such corporation did not hold any U.S.R.P.I.'s, and all of the U.S.R.P.I.'s held by such corporation were disposed of (within a certain period of time) in transactions in which the full amount of the gain was recognized.[2]

The P.A.T.H. Act modifies the cleansing rule by excluding stock of a corporation if such corporation, or any predecessor of such corporation, was a R.E.I.T. or a R.I.C.

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[2] Code §897(c)(1)(B).

at any time during the shorter of either (i) the period after June 18, 1980 during which the taxpayer held such stock, or (ii) the five-year period ending on the date of the disposition of such stock.

Dividends Derived from R.E.I.T.'s and R.I.C.'s Ineligible for Deduction for U.S.-Source Portion of Dividends from Certain Foreign Corporations

A corporation is allowed to deduct a portion of the dividend it receives from a domestic corporation. The deduction, known as the "dividends received deduction," depends on the percentage of ownership. A corporation can deduct

- 70% of the dividend, if it owns less than 20% of the other corporation;
- 80% of the dividend, if it owns at least 20% of the other corporation but less than 80%; or
- 100% of the dividend, if it owns more than 80% of the other corporation.[3]

"The P.A.T.H. Act made significan corrections and clarifications to th new unified syste of audit rules for partnerships."

Generally, a corporation is not allowed a dividends received deduction from a foreign corporation, unless the corporation owns at least 10% of the vote or value of the foreign corporation. In that case, the foreign corporation is called a qualified 10% owned foreign corporation. The deduction allowed is computed by determining the U.S.-source portion of the dividend received from the qualified 10% owned foreign corporation.

The deduction is available only if the foreign corporation distributing the dividend has post-1986 undistributed earnings and profits ("E&P") attributable either to income that is (i) effectively connected with a U.S. trade or business, or (ii) dividends received from an 80% owned domestic corporation (with post-1986 undistributed E&P).

For the purposes of determining whether dividends from a qualified 10% foreign corporation attributable to dividends from an 80% owned domestic corporation are eligible for the dividend received deduction,[4] the P.A.T.H. Act provides that a dividend received from a R.E.I.T. or a R.I.C. is not treated as a dividend from a domestic corporation and is therefore not eligible for the dividends received deduction.

CLARIFICATIONS TO THE NEW PARTNERSHIP AUDIT RULES

As discussed in the December edition of *Insights*, the Bipartisan Budget Act of 2015 amended the existing three different regimes for auditing partnerships and replaced them with a unified system of audit rules for smaller and larger partnerships.[5] The P.A.T.H. Act made significant corrections and clarifications to the new unified system of audit rules for partnerships.

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3 Code §243.

4 See Code §245. A domestic corporation is allowed a dividends received deduction for distributions from a 10% owned foreign corporation, however, to the extent that the dividend is derived from the earnings and profits attributable to the U.S.-source portion of such dividends.

5 Philip R. Hirschfeld and Nina Krauthamer, "Congress Enacts Sweeping New Partnership Audit Rules," Insights Vol. 2 No. 10 (2015): 40.

Amendments to Chapter 63 provided for a unified system for audit, adjustments, and collections of tax for partnerships starting after 2017, unless a partnership elected to not have the rules apply.

To examine a partnership, the I.R.S. may issue a notice of administrative proceeding to the partnership or its representative. Generally, the adjustments are made at the partnership level.[6] The I.R.S. has to notify the partnership or the representative about any proposed partnership adjustment before issuing a notice of final partnership adjustment.[7] The notice must identify all the adjustments issued to the partnership and provide the information on underpayment.

The partnership may seek modification if it disagrees with the underpayment made during an administrative proceeding. The partnership is permitted to (i) take into account amounts paid with amended returns filed by partners for a reviewed year, (ii) disregard the portion allocable to a tax-exempt partner, and (iii) take into account a rate of tax lower than the highest tax rate for individuals or corporations for the reviewed year. A partnership can also seek to modify the imputed underpayment amount by demonstrating a lower tax rate.[8] The statutory language only refers to "ordinary income" without making reference to income that may have a lower tax rate, such as that of a corporation, which may be subject to a lower rate than that of an individual. The P.A.T.H. Act removed the reference to "ordinary income," thus permitting application of a lower tax rate in some cases.

"The amount of the specified passiv activity loss is concomitantly decreased, and the partnership takes the decrease into account in the adjustment year with respect to the specified partners t which the decrease relates."

In addition, the P.A.T.H. Act added procedures to reduce the amount of imputed underpayment for publicly-traded partnerships. The imputed underpayment can be determined without regard to the portion of the underpayment that the partnership demonstrates is attributable to specified passive activity losses attributable to a specified partner. The amount of the specified passive activity loss is concomitantly decreased, and the partnership takes the decrease into account in the adjustment year with respect to the specified partners to which the decrease relates.

The partnership tax return can be audited within three years after

- the date the partnership tax return was filed;
- the date the return was due, if it was not filed; or
- the date an administrative adjustment request is made.

The three years can be extended if the I.R.S. issues a notice of proposed adjustment.[9] Once the proposed adjustment is issued, a partnership has 270 days in which it may seek a modification of the imputed underpayment. The partnership may request additional time. During this time, the I.R.S. is not allowed to issue a notice of final partnership adjustment. When a proposed adjustment is issued within the three-year period and results in an imputed underpayment, the final partnership notice may be issued no later than either

- the date that is 270 days after the partnership has completed its response

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[6] Code §6221.

[7] Code §6231(a)(1)&(2).

[8] Code §6225(c)(4).

[9] Code §6231.

seeking a revision of an imputed underpayment; or

- if the partnership provides an incomplete or no response, no later than 270 days after the date of a notice of proposed adjustment.

The P.A.T.H. Act clarifies the conflict between Code §6231, which restricts the filing of the final partnership adjustment before 270 days after the notice of proposed adjustment has been filed, and Code §6235, which requires the I.R.S. to issue the notice of final partnership adjustment within 270 days after the proposed notice of adjustment is issued. The P.A.T.H. Act provides 330 days to the I.R.S. to issue a notice of final partnership adjustment to a partnership.

The P.A.T.H. Act also clarifies that one of the forums for judicial review is the Court of Federal Claims.

THE EXTENDERS

The P.A.T.H. Act retroactively extends approximately 50 tax provisions that are favorable to individuals and businesses. These tax "extenders" were temporary tax provisions, which were regularly extended by Congress but had expired at the end of 2014.

The following discussion is focused on the permanent extensions of certain business tax provisions, specifically the following:

- Reduction in the S corporation recognition period for built-in gains tax
- Subpart F exception for active financing income
- Qualified investment entity treatment for R.I.C.'s under F.I.R.P.T.A.

Extension of Reduction in S Corporation Recognition Period for Built-in Gains Tax

The P.A.T.H. Act retroactively extends to tax years beginning after December 31, 2014, and makes permanent the provision that an S corporation has a period of five years to recognize its net built-in gain, which is reduced from the 10-year recognition period under prior law.[10]

Background

A small business corporation may elect to be treated as an S corporation.[11] A "small business corporation" is defined in Code §1361(b) and is generally as a domestic corporation that does not have

1. more than 100 shareholders,
2. corporate shareholders (*i.e.*, its shareholders are individuals, trusts, estates, qualified pensions, or certain non-profit organizations),

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[10] Code §1374(d)(7), as amended by P.A.T.H. Act §127(a).

[11] *Technical Explanation of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029* (Rules Committee Print 114-40), JCX-114-15 (Dec. 17, 2015), p. 41.

3. non-U.S. resident shareholders, and

4. more than one class of stock.[12]

Except as discussed below, an S corporation is not subject to tax at the corporate level, unlike a C corporation, because an S corporation's income and loss passes through to its shareholders. Thus, each shareholder separately accounts for and pays tax on its share of the S corporation's income or loss.[13]

"The P.A.T.H. Act retroactively extends approximately 50 tax provisions that are favorable to individuals and businesses."

A corporate-level tax is triggered under Code §1374 on the net recognized built-in gain[14] of an S corporation at the time a C corporation elects to become an S corporation, or at the time an S corporation receives an asset with a carryover basis from a C corporation in a nontaxable transfer. The S corporation is taxed at the highest marginal corporate rate (currently 35%) on all gains that were built-in at the time of the election or asset transfer, if the gain is recognized during a recognition period.

The general recognition period under the prior law was ten years. Under the P.A.T.H. Act, the recognition period has been permanently amended to five years.

Under the prior and current law, the recognition period for converting into an S corporation begins with the first day of the first tax year for which the S election was in effect.[15] The recognition period for any asset transferred by the C corporation starts on the date the asset is acquired by the S corporation in lieu of the beginning of the first tax year for which the corporation was an S corporation.[16]

For a C corporation that converts into an S corporation, if the S corporation's taxable income is less than the amount of net recognized built-in gain in the year such built-in gain is recognized (*i.e.*, because of losses after the C corporation converts into an S corporation), no tax under Code §1374 is imposed on the excess of the built-in gain over the taxable income for that year. Under Code §1374(d)(2) however, this excess of recognized built-in gain, which was untaxed in one year, is treated as recognized built-in gain in the next tax year.[17] Furthermore, Treas. Reg. §1.1374-4(h) dictates that the built-in gain tax applies to income when a corporation sells an asset before or during the recognition period and the income from such sale is reported using the installment method of Code §453 during or after the recognition period.[18]

If the S corporation acquires an asset from a C corporation in a transaction in which the S corporation's basis in such asset is determined (in whole or in part) by reference to the basis of such asset (or other property) in the hands of a C corporation, the tax of Code §1374 applies to any net recognized built-in gain attributable to any such assets for any tax year beginning in the recognition period.[19]

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12 Code §1361(b).

13 Code §1366.

14 See Code §1374(d)(5). Certain built-in income items are treated as recognized built-in gain for this purpose.

15 Code §1374(d)(7)(A).

16 Code §1374(d)(8)(B).

17 *Technical Explanation*, p. 41-42.

18 *Id.*

19 Code §1374(d)(8)(A).

The amount of any built-in gain tax imposed under Code §1374 for any tax year of an S corporation is treated as a loss sustained by the S corporation during such tax year. The character of such loss shall be determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax.[20]

Rules for Years 2009, 2010, and 2011 (Prior to P.A.T.H. Act)

Before the P.A.T.H. Act, an S corporation with tax years beginning in 2009 and 2010 did not have tax imposed on the net recognized built-in gain under Code §1374 if the seventh tax year in the corporation's recognition period proceeded such tax year.[21]

For an S corporation with a tax year beginning in 2011, no tax was imposed on the net recognized built-in gain of an S corporation under Code §1374 if the fifth year in the corporation's recognition period proceeded such tax year.[22]

Rules for Years 2012, 2013, and 2014 (Prior to P.A.T.H. Act)

"The P.A.T.H. Act permanently and retroactively extends, to tax years beginning after December 31, 2014, the temporary exclusion for 'active financing income from the definition o Subpart F income."

Before the P.A.T.H. Act, the recognition period of Code §1374 for tax years beginning in 2012, 2013, and 2014 implemented a five-year recognition period, instead of the general 10-year period, when determining the net recognized built-in gain.[23] The five-year recognition period began with the first day of the first tax year for which the corporation was an S corporation (or beginning with the date the S corporation acquired assets from a C corporation).[24] If (i) an S corporation disposed of assets subject to Code §1374 in a tax year beginning in 2012, 2013, or 2014 and (ii) the disposition occurred more than five years after the first day of the relevant recognition period, gain or loss on the disposition was not considered in determining the net recognized built-in gain.[25]

R.E.I.T.'s and R.I.C.'s under Code §1374

A R.E.I.T. or R.I.C., as defined above, that was formerly a C corporation (or that acquired assets from a C corporation) generally is subject to the rules of Code §1374 as if the R.E.I.T. or R.I.C. was an S corporation, unless the relevant C corporation elects "deemed sale" treatment. The regulations expressly refer to the 10-year period in Code §1374.[26] As discussed above, the P.A.T.H. Act permanently amends the recognition period for net recognized built-in gain of an S corporation to five years. The five-year recognition period also applies to R.E.I.T.'s and R.I.C.'s that do not elect the "deemed sale" treatment.[27]

Extension of Subpart F Exception for Active Financing Income

The P.A.T.H. Act permanently and retroactively extends, to tax years beginning after December 31, 2014, the temporary exclusion for "active financing income" from the

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20 Code §1366(f)(2).

21 Code §1374(d)(7)(B)(i).

22 Code §1374(d)(7)(B)(ii).

23 Code §1374(d)(7)(C).

24 *Technical Explanation*, p. 43.

25 *Id.*

26 *Id.*

27 P.A.T.H. Act §127(b).

definition of Subpart F income.[28] Active financing income includes income derived in the active conduct of a banking, financing, or similar business; as a securities dealer; or in the conduct of an insurance business.

Background

Under the Subpart F rules,[29] U.S. shareholders that own 10% or more of a controlled foreign corporation ("C.F.C.") are subject to U.S. tax on certain income earned by the C.F.C., regardless of whether such income is distributed to the shareholders. Insurance income and foreign base company income ("F.B.C.I.") were initially among the types of income subject to inclusion under the Subpart F rules, until the temporary exceptions (see below) became effective for tax years beginning in 1999 and after.[30]

Under Code §954, F.B.C.I. includes foreign personal holding company income ("F.P.H.C.I.") and foreign base company services income ("F.B.C. Services Income"). F.B.C. Services Income is income derived from services performed for or on behalf of a related person outside the country in which the C.F.C. is organized.[31]

Generally, F.P.H.C.I. consists of

- passive income such as dividends, interest, royalties, rents, and annuities;
- interests in trusts, partnerships, and real estate mortgage investment conduits ("R.E.M.I.C.'s");
- net gains from commodities or foreign currency transactions; and
- income from other similar transactions.[32]

Insurance income is treated as Subpart F income and consists of any income of a C.F.C. attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the C.F.C.'s country of organization.[33]

Active Financing Income Exception (Prior to P.A.T.H. Act)

There were temporary exceptions that prevented certain F.P.H.C.I., F.B.C. Services Income, and insurance income from being treated as Subpart F income.[34] This Subpart F exclusion applied to "active financing income," which is generally income derived in the active conduct of a banking, financing, or similar business; as a securities dealer; or in the conduct of an insurance business.[35]

Before the enactment of the P.A.T.H. Act, the temporary exceptions for active financing income applied to tax years of foreign corporations beginning after December

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28 Code §§953(e)(10) and 954(h)(9), as amended by P.A.T.H. Act §128.

29 Code §§951-64.

30 *Technical Explanation*, p. 44.

31 Code §954(e).

32 Code §954(c).

33 *Technical Explanation*, p. 44.

34 *Id.*

35 Code §954(h)(3).

31, 1998 and before January 1, 2015, and to tax years of U.S. shareholders with or within such tax years of such foreign corporation's end.[36]

In order to qualify for the active financing exceptions to Subpart F treatment, a C.F.C. is required to be predominantly engaged in the active conduct of a banking, financing, or similar business, and to conduct substantial activity with respect to such business.[37] Other exceptions apply to income derived from certain cross-border transactions as well as exceptions for certain F.P.H.C.I. derived by a securities dealer within the meaning of Code §475 and for gain from the sale of active financing assets.[38]

"The P.A.T.H. Act permanently and retroactively extends, to tax years beginning after December 31, 2014, the inclusion of a R.I.C. within the definition of a qualifie investment entity' under Code §897."

Extension of Qualified Investment Entity Treatment under F.I.R.P.T.A. to R.I.C.'s

The P.A.T.H. Act permanently and retroactively extends, to tax years beginning after December 31, 2014, the inclusion of a R.I.C. within the definition of a "qualified investment entity" under Code §897.[39]

However, this provision of the P.A.T.H. Act does not apply with respect to the withholding requirement under Code §1445 for any payment made before the enactment date of December 18, 2015. Thus, a R.I.C. that withheld and remitted tax under Code §1445 on distributions made after December 31, 2014 and before December 18, 2015 is not liable to the distributee with respect to such withheld and remitted amounts.[40]

There are special U.S. tax rules that apply to a foreign person's capital gains derived from dispositions of an interest in U.S. real property.[41] Under F.I.R.P.T.A., a foreign person who sells a U.S.R.P.I., as defined above, is subject to tax at the same rates as a U.S. person. Code §1445 also imposes a withholding tax on such income.

A U.S.R.P.I. includes stock or a beneficial interest in any domestic corporation unless such corporation has not been a U.S. real property holding corporation during the testing period.[42] A U.S.R.P.I. does not include an interest in a domestically controlled qualified investment entity.[43]

A qualified investment entity includes a real estate investment trust and also includes a R.I.C. that meets certain requirements.[44] However, before the P.A.T.H. Act, the inclusion of a R.I.C. in that definition did not apply for certain purposes after December 31, 2014.[45]

A distribution from a qualified investment entity that is attributable to the sale of

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36 *Technical Explanation*, p. 46.

37 See Code §954(h)(2).

38 See Code §954(h); *Technical Explanation*, p. 45.

39 Code §897(h)(4)(A), as amended by P.A.T.H. Act §133(a).

40 P.A.T.H. Act §133(b).

41 *Technical Explanation*, p. 49.

42 See Code §897; *Technical Explanation*, p. 49.

43 *Id.*

44 Code §897(h)(4)(A).

45 Code §897(h).

a U.S.R.P.I. is also subject to tax under F.I.R.P.T.A. unless the distribution is with respect to an interest that is regularly traded on an established securities market located in the U.S. and the recipient foreign corporation or nonresident alien individual does not hold more than 5% of that class of stock or beneficial interest within the one-year period ending on the date of distribution.[46] There are additional rules that apply to certain tiers of qualified investment entities.

NEW RULES FOR INDIVIDUAL TAXPAYER IDENTIFICATION NUMBERS

The P.A.T.H. Act modifies the individual taxpayer identification number ("I.T.I.N.") application procedures and establishes new rules on the use, renewal, and expiration of I.T.I.N.'s. These new provisions are effective for I.T.I.N. requests made after December 18, 2015.

General Rules for I.T.I.N.'s

An individual who files a U.S. tax return must provide his taxpayer identification number on the return.[47] A taxpayer identification number is generally the individual's Social Security number ("S.S.N.").[48] Individuals who are not eligible to have S.S.N.'s must obtain I.T.I.N.'s in order to properly file U.S. tax returns.[49] Examples of individuals who may need an I.T.I.N. in order to file a U.S. tax return include the following:

- Nonresident aliens filing a claim for a reduced withholding rate under treaty benefits
- Nonresident aliens required to file a U.S. tax return
- U.S. resident aliens filing a U.S. tax return
- Dependents or spouses of a U.S. citizen or resident alien
- Dependents or spouses of a nonresident alien visa holder[50]

"The P.A.T.H. Act modifies th I.T.I.N. application procedures and establishes new rules on the use, renewal, and expiration of I.T.I.N.'s."

To apply for an I.T.I.N., the individual must complete a Form W-7, *Application for I.R.S. Individual Taxpayer Identification Number*, which requires a taxpayer to present original documents such as passports and birth certificates, or certified copies of such documents. Notarized or apostilled copies of such documents are not accepted by the I.R.S.[51]

The Form W-7 may be submitted by mail or in person.[52] For example, a taxpayer

[46] Code §§857(b)(3)(F), 852(b)(3)(E), and 871(k)(2)(E) require dividend treatment, rather than capital gain treatment, for certain distributions to which F.I.R.P.T.A. does not apply by reason of this exception. See also Code §881(e)(2).

[47] *Technical Explanation*, p.124.

[48] Code §6109(a).

[49] Treas. Reg. §301.6109-1(d)(3)(i).

[50] *Technical Explanation*, p.124.

[51] See Instructions for Form W-7 (Rev. December, 2014).

[52] *Id.*

may apply for an I.T.I.N. by bringing the completed documentation and forms to an I.R.S. Taxpayer Assistance Center in the United States or to an I.R.S. office abroad. An acceptance agent or certifying acceptance agent may also submit the Form W-7 application on behalf of the taxpayer along with the required documentation. A certifying acceptance agent is authorized by the I.R.S. to verify the taxpayer's identifying documentation and must attach a certificate of accuracy to the Form W-7 application that is filed on behalf of a taxpayer.[53]

"Under the P.A.T.H. Act, any I.T.I.N. issued after December 31, 2012 will expire if it is not used on a Federal income tax return for a period of three consecutive tax years."

Issuance of I.T.I.N.'s under the P.A.T.H. Act

The P.A.T.H. Act established that the I.R.S. may issue I.T.I.N.'s if the applicant provides the required documentation either (i) in person to an I.R.S. employee or to a community-based certified acceptance agent (authorized by the I.R.S.),[54] or (ii) by mail. Individuals who were issued I.T.I.N.'s before 2013 must renew those I.T.I.N.'s pursuant to a staggered schedule between years 2017 and 2020.

Individuals residing outside the United States may submit in-person applications to an employee or designee of the I.R.S. at a U.S. diplomatic mission or consular post. This new provision enables the I.R.S. to establish procedures on how to accept I.T.I.N. applications by mail.[55]

The I.R.S. must maintain a program for certifying and training community-based acceptance agents. The following persons may qualify as acceptance agents:

- Financial institutions
- Colleges and universities
- Federal agencies
- State and local governments (including state agencies responsible for vital records)
- Persons that provide assistance to taxpayers in the preparation of their tax returns
- Other persons or categories of persons as authorized by regulations or in other guidance by the I.R.S.[56]

The I.R.S. may determine what documents are acceptable for establishing an individual's identity, foreign status, and residency. However, only original documents or certified copies meeting the I.R.S. requirements will be acceptable.

The I.R.S. must also develop procedures that distinguish I.T.I.N.'s used by individuals solely for the purpose of obtaining treaty benefits to ensure they are only used for such benefits.[57]

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[53] *Technical Explanation*, p.125.

[54] The community-based certified acceptance agent program is intended to expand the existing I.R.S. acceptance agent program. See Rev. Proc. 2006-10, 2006-1 C.B. 293 (December 16, 2005).

[55] *Technical Explanation*, p.126.

[56] *Id.*

[57] *Id.*

Expiration of I.T.I.N.'s under the P.A.T.H. Act

Under the P.A.T.H. Act, any I.T.I.N. issued after December 31, 2012 will expire if it is not used on a Federal income tax return for a period of three consecutive tax years (expiring on December 31 of the third consecutive year).[58]

I.T.I.N.'s issued prior to 2013 are subject to the general rule that the I.T.I.N. will expire if it is not used for a period of three consecutive years. However, regardless of whether an I.T.I.N. has been used on a Federal income tax return or not, an I.T.I.N. issued prior to 2013 will no longer be valid as of the following applicable dates:

- An I.T.I.N. issued before 2008 will expire on January 1, 2017.
- An I.T.I.N. issued in 2008 will expire on January 1, 2018.
- An I.T.I.N. issued in 2009 or 2010 will expire on January 1, 2019.
- An I.T.I.N. issued in 2011 or 2012 will expire on January 1, 2020.[59]

The Treasury Office of the Inspector General must conduct an audit of the I.T.I.N. application process beginning two years after December 18, 2015 and every two years thereafter. The I.R.S. must also conduct a study on the effectiveness of the I.T.I.N. application process before amending these new provisions.[60]

[58] *Id.*

[59] *Id.*, p. 126-127.

[60] *Id.*, p. 127.

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