Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Ron Rivelli, SE:S:CAS:SP:PP:P, Chief, Partnerships, Trusts and International Team
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from: Robert W. Lorence, Jr., Senior Counsel, CC:INTL:Br.4

subject: Deductions related to U.S. real property interests

This Chief Counsel Advice responds to your request for assistance concerning the deductibility of real estate tax, interest on a real estate mortgage, and other carrying charges paid during the taxable year when a U.S. real property interest (USRPI) is sold under the Foreign Investment in Real Property Tax Act (FIRPTA). This advice may not be used or cited as precedent.

ISSUES

1. Whether a nonresident alien or a foreign corporation may make an election under § § 871(d) or 882(d) of the Internal Revenue Code for a taxable year in which the taxpayer derives no income from U.S. real property other than gain from the sale of the USRPI?

2. Whether a nonresident alien or foreign corporation is entitled to claim deductions for real estate tax, interest on a real estate mortgage, and other carrying charges paid during the taxable year when a USRPI is sold under FIRPTA?

3. Should the Service use deficiency procedures or math error summary procedures to deny any deductions?

CONCLUSIONS

1. No, a nonresident alien or foreign corporation may not make an election under § § 871(d) or 882(d) for a taxable year in which the taxpayer derives no income from U.S. real property other than gain from the sale of the USRPI, because § 897 treats gain from the sale of a USRPI as effectively connected income.

2. Yes, a nonresident alien or foreign corporation is entitled to claim deductions that is attributable to income that is treated as effectively connected with the conduct of a trade or business within the United States under § 897.

3. Deficiency procedures should be used.

FACTS

According to your request for assistance, you conducted a random sample of six Forms 1120-F and discovered that several foreign corporations had filed initial and final U.S. income tax returns reporting the sale of USRPIs owned by the taxpayers. The only activities reported on these returns were sales of U.S. real property interests. On the two returns provided to us, deductions were taken for real estate taxes and state taxes incurred during the taxable year of the sale. Your research showed that no other income tax returns were filed under the foreign corporations' tax identification numbers. The foreign corporations had purchased the U.S. real property prior to the year of the sale, but reported no previous activity.

LAW AND ANALYSIS

Issue #1: Is a § 871(d) or § 881(d) election permitted for the tax year when no income other than gain from sale of USRPI is recognized?

Sections 871(a) and § 881(a) of the Internal Revenue Code (the Code) generally provide that nonresident alien individuals and foreign corporations are subject to a 30 percent tax on certain types of income, including interest, (other than original issue discount as defined in section 1273), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income to the extent income is from sources within the United States and is not effectively connected with the conduct of a trade or business within the United States.

Sections 871(b) and 882(a) provide, in part, that a nonresident alien individual or foreign corporation engaged in a trade or business within the United States during the taxable year shall be taxed at graduated rates as provided in section 1 or 11 of the Code on taxable income which is effectively connected with the conduct of a trade or business within the United States. Deductions are generally allowed to a nonresident alien individual or foreign corporation to the extent they are connected with income that is effectively connected with the conduct of a U.S. trade or business. Sections 873 and 882(c).

Sections 871(d) and 882(d) provide that a nonresident alien individual or foreign corporation which during the taxable year derives any income from real property held for the production of income and located in the United States, or from any interest in such real property, and which is not otherwise treated as income which is effectively connected with the conduct of a trade or business within the United States, may elect for such taxable year to treat all such income as income which is effectively connected with the conduct of a trade or business within the United States. In such a case, such income shall be taxable as provided in § § 871(b) and 882(a) whether or not such individual or corporation is engaged in a trade or business within the United States during the taxable year.

Elections under § § 871(d) and 882(d) apply only with respect to income that would not be treated as effectively connected income, but for this subsection. *See* § § 871(d)(1)(B) and 882(d)(1)(B) and Treas. Reg. § 1.871-10(a). Section 897(a) provides that gain or loss of a nonresident alien individual or a foreign corporation from the disposition of a USRPI shall be taken into account under § 871(b)(1), in the case of a nonresident alien individual, or under § 882(a)(1), in the case of a foreign corporation, as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with such trade or business. Because § 897(a) treats gain from sale of a USRPI as effectively connected income, the election cannot be made with regard to that income. In this case, because there appears to be only § 897 income, the election cannot be made.

If the taxpayers had other income (such as rental income) from the property for the year of the sale or for the prior tax years, the election could have been made for the taxable year of the income and would have remained in effect for all subsequent taxable years. For the taxpayers at hand, returns were not filed for prior years, so presumably income was not generated for those years. While taxpayers presumably had expenses (such as real estate tax and interest) for the prior taxable years, without income, the election could not be made.

Issue #2: Can deductions for real estate tax, interest on a real estate mortgage, and other carrying charges reduce income from the sale of a USRPI under §897(a)?

Sections 873 and 882(c) provide that in the case of a nonresident alien individual or foreign corporation, deductions shall be allowed for purposes of § § 871(b) and 882(a) only to the extent that they are connected with income which is effectively connected with the conduct of a trade or business within the United States.[1]

[1] Under § 873(b), the following deductions are allowed to a nonresident alien individual whether or not the income is effectively connected to a U.S. trade or business: (1) casualty or theft losses under § 165(c); (2) charitable deductions under § 170; and (3) personal exemptions under § 151. In the case of foreign

Because § 897 gain is treated as effectively connected income, expenses otherwise deductible that are connected to effectively connected income are permitted to be deducted by the taxpayer. For example, real estate taxes, interest, maintenance and repairs and insurance expenses incurred with respect to the USRPI would be deductible for the taxable year the § 897 gain was recognized.

A foreign corporation or nonresident alien individual is permitted to claim otherwise allowable deductions only if a timely and accurate U.S. income tax return is filed. *See* § § 882(c)(2) and 874(a). If the current taxable year is the first taxable year that a return is required to be filed, the return must be filed within 16 months of the due date for filing the return in the case of a nonresident alien, or within 18 months of the due date for filing the return in the case of a foreign corporation. *See* Treas. Reg. § 1.874-1(b)(1) and § 1.882-4(a)(3)(i). These deadlines can be waived by the Commissioner in rare and unusual circumstances upon a showing of good cause by the taxpayer.

If a foreign corporation recognizes effectively connected income from the sale of a USRPI under § 897, the foreign corporation may be subject to the branch profits tax under § 884 on such income. *See* § 1.884-1(f)(1). The branch profits tax imposes an additional 30% rate of tax (unless reduced by treaty) on effectively connected income that is deemed repatriated from the United States. However, there is an exception to the branch profits tax for the taxable year when the foreign corporation completely terminates its U.S. trade or business. *See* Treas. Reg. § 1.884-2T(a).

On the two returns provided to us, the taxpayers reported a complete termination of their U.S. trade or business by virtue of the disposition of their USRPIs. *See* Form 1120-F, section III. As a result, the branch profits tax would not apply.

Issue #3: Whether deficiency proceedings or math error summary proceeding should be used to deny any deductions.

We coordinated this issue with the Office of Associate Chief Counsel (Procedure and Administration) and it has advised that deficiency proceedings should be used.

Section 6213 imposes certain restrictions on the assessment of deficiencies. Section 6213(b)(1) provides, in relevant part, "that if the taxpayer is notified that, on account of a mathematical or clerical error appearing on the return, an amount of tax in excess of that shown on the return is due, and that an assessment of the tax has been or will be made on the basis of what would have been the correct amount of tax but for the mathematical or clerical error, such notice shall not be considered as a notice of deficiency . . . and the taxpayer shall have no right to file a petition with the Tax Court

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operations, charitable deductions under § 170 are allowed whether or not the income is effectively connected with a U.S. trade or business. *See* § 882(c)(1).

based on such notice, nor shall such assessment or collection be prohibited . . . Each notice under this paragraph shall set forth the error alleged and an explanation thereof."

Section 6213(g)(2) defines "mathematical or clerical error" and enumerates 13 exceptions to the general rule where deficiency procedures need not be used before assessment of the tax.[2] Unless one of those specific situations applies, deficiency procedures must be followed. If the Service were to challenge a deduction as not otherwise being allowable under the Code, or of a type that is not attributable to effectively connected income from the disposition of the USRPI, then none of these thirteen scenarios would apply. Therefore, the Service would need to use deficiency procedures.

In each of the scenarios provided, the questions about the deductions pertain to specifics about the deductions being claimed and their relation to gain from the disposition of a USRPI. When there are questions like that, summary assessment proceedings cannot be used. The rule of thumb for math error is whether the error can

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[2] The thirteen exceptions are:
(A) an error in addition, subtraction, multiplication, or division shown on any return;
(B) an incorrect use of any table . . . if the incorrect use is apparent from the existence of other information on the return;
(C) an entry on a return of an item which is inconsistent with another entry of the same or another item on the return;
(D) an omission of information which is required to be supplied on the return to substantiate an entry on the return;
(E) an entry on a return of a deduction or credit in an amount that exceeds a statutory limit, if the limit is expressed as (i) a specified monetary amount, or (ii) as a percentage, ratio, or fraction, and if the items entering into the application of such limit appear on such return;
(F) an omission of a correct taxpayer identification number (TIN) required under section 32 (relating to earned income credit) to be included on a return;
(G) an entry on a return claiming the credit under section 32 with respect to net earnings from self-employment described in section 32(c)(2)(A) to the extent self-employment tax on the earnings has not been paid;
(H) an omission of a correct TIN required under section 21 (relating to expenses for household and dependent care necessary for gainful employment) or section 151 (relating to allowance of deductions for personal exemptions);
(I) an omission of a correct TIN required under section 24(e) (relating to child tax credit) to be included on a return;
(J) an omission of a correct TIN required under section 25A(g)(1) relating to higher education tuition and related expenses) to be included on a return;
(K) an omission of information required by section 32(k)(2) (relating to taxpayers making improper prior claims of earned income credit);
(L) the inclusion on a return of a TIN required to be included on the return . . . if (i) such TIN is of an individual whose age affects the amount of the credit under such section, and (ii) the computation of the credit on the return reflects the treatment of such individual as being of an age different from the individual's age based on such TIN; and
(M) the entry on the return claiming the credit under section 32 with respect to a child if, according to the Federal Case Registry of Child Support Orders established under section 453(h) of the Social Security Act, the taxpayer is a noncustodial parent of such child.

be determined from the face of the return only. If there is any question about the intent of the taxpayer, deficiency proceedings must be used.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Tracy Perry at (202) 622-5397 if you have any further questions.