

**Office of Chief Counsel  
Internal Revenue Service**

**memorandum**

CC:LM:RFP:MIA:POSTF-N-147422-01  
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**date:** October 19, 2001  
**to:** Luis C. Linares, Team Coordinator, LMSB  
**from:** Associate Area Counsel (LMSB), Miami

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**subject:** [REDACTED]

**DISCLOSURE**

This memorandum may contain privileged information. Any unauthorized disclosure could have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

**COORDINATION**

The advice in this memorandum has not been coordinated with any Industry Counsel as the issues here involving international and corporate tax are not known to fall within any Industry Specialization Program. The undersigned is the Assistant Industry Counsel for the Pharmaceuticals ISP.

**EFFECTIVE DATE**

This opinion constitutes non-docketed significant legal advice subject to review in the National Office of Chief Counsel. It should not be relied upon until after the 10-day review period.

**SUMMARY**

This memorandum responds to your oral request for assistance on May 11, 2001, and confirms tentative informal guidance previously rendered. You asked us to determine if the provisions of I.R.C. § 897, addressing the income tax consequences to foreign persons of disposing of interests in United States real property, apply to the redemptions of [REDACTED] stock by the [REDACTED]

██████████ in ██████████ and ██████████.<sup>1</sup>

Those provisions would apply only if you were to determine that ██████████ was a USRPHC in ██████████ and ██████████,<sup>2</sup> something we doubt was the case.

We also explored whether the redemptions were equivalent to a dividend subject to the flat 30% tax of § 871(a)(1)(A). We concluded below they were not.<sup>3</sup>

#### FACTS

This opinion is not to be relied upon if our understanding of the facts is incorrect. During ██████████ and ██████████, ██████████ was an executive officer and a director of ██████████, a United States publicly traded ██████████. He was a non-resident alien who was a resident in the ██████████ during those years. In ██████████ ██████████ transferred his substantial holdings in ██████████ stock to the ██████████, a ██████████ foreign trust.<sup>4</sup> ██████████'s children might have been trust beneficiaries although ██████████ was not one.

The following three persons owned more than █% of ██████████'s outstanding stock during ██████████ and ██████████:

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<sup>1</sup> The following abbreviations are used in this memorandum:

██████████	████████████████████
USRPI	United States real property interest
USRPHC	United States Real Property Holding Company

<sup>2</sup> See n. 4 below as to the determination date.

<sup>3</sup> Given our conclusion, it was not necessary to consider the applicability of a reduced rate of tax withholding under the income tax treaty between the United States and the ██████████.

<sup>4</sup> The transfer of stock to the trust was a non-taxable exchange. See I.R.C. § 897(e)(1), Treas. Reg. § 1.897-6(T)(a)(1). However, the disposition of the interest in the trust on gain that is attributable to a United States real property interest (USRPI) is subject to United States taxation. See Notice 88-72, 1988-2 CB 383.

Description	Number of Shares	% of Class	Number of shares	% of Class
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED] %	[REDACTED]	[REDACTED] %
[REDACTED]	[REDACTED]	[REDACTED] %	[REDACTED]	[REDACTED] %
[REDACTED]	[REDACTED]	[REDACTED] %	[REDACTED]	[REDACTED] %

The reduction in the number of shares held by the [REDACTED] [REDACTED] resulted from a redemption of [REDACTED] shares at \$ [REDACTED] a share on [REDACTED] and the redemption of an additional [REDACTED] shares at \$ [REDACTED] a share on [REDACTED].

**ISSUES**

1. Whether the [REDACTED] stock redemptions by the [REDACTED] [REDACTED] are taxable under § 897.
2. Whether the redemptions are equivalent to a dividend and subject to income tax withholding under § 1445.

**ANALYSIS**

**1. Section 897**

The gain or loss realized by a nonresident alien individual upon the disposition of a USRPI is taxed "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." §897(a)(1)(A). See also, §871(b)(1) (income of foreign persons effectively connected with a U.S. trade or business generally taxed on a net basis).

The definition of a USRPI includes, in addition to a direct interest in domestic realty, §897(c)(1)(A)(i), an equity interest or stock in a USRPHC. §897(c)(1)(A)(ii).

A domestic corporation is presumed to be a USRPHC and

USRPI unless the taxpayer establishes taxpayer establishes it was not a USRPHC. §897(c)(1)(A)(ii).

An exception is recognized for stock interests of more than 5% of a USRPHC which is publicly traded.<sup>5</sup> §897(c)(3). The [REDACTED]'s stock interest in [REDACTED] exceeded the 5% statutory exception and thus the trust's [REDACTED] stock would be a USRPI if [REDACTED] were a USRPHC.

A USRPHC is defined as a corporation whose USRPIs are at least 50% of the fair market value of the sum of: (i) its USRPIs, (ii) its interests in real property located outside the United States, and (iii) its other assets used or held for use in a trade or business. §897(c)(2); Treas. Reg. §1.897-2(b)(1).

Under an alternative test, a corporation is presumed not to be a USRPHC if the "book value" of its USRPIs, measured under generally accepted accounting principles, is 25% or less of the total accounting book values of the classes of assets considered in definition of a USRPHC (USRPIs, foreign realty and trade or business assets). Treas. Reg. §1.897-2(b)(2). You may wish to use this simpler method to determine if [REDACTED] was a USRPHC on the applicable dates.<sup>6</sup>

Evidently, it is necessary that the Examining Team determine if [REDACTED] was a USRPHC on the relevant determination dates. If that were the case, the redemption under consideration would appear to be subject to tax under §897. Please inform us of your determination.

## **2. Section 1441**

U.S. source dividends paid by a domestic person to a foreign person are usually subject to income tax withholding

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<sup>5</sup> Stock is considered to be regularly traded if it is regularly quoted by brokers or dealers making a market in such interests. A broker or dealer is considered to make a market only if the broker or dealer holds himself out to buy or sell interests in the stock at the quoted price. See Treas. Reg. §1.897-1(m)(1) and (3).

<sup>6</sup> Whether a corporation is a USRPHC is determined as of one of the dates listed in the regulations, including the last day of the corporation's taxable year. Treas. Reg. § 1.897-2(c).

at a flat 30% rate. § 871(a)(1)(A), § 1441(a), (b). The dividends subject to tax are "distributions," as defined in § 316, from a domestic corporation. Treas. Reg. § 1.861-3(a)(1), (2). Thus, redemptions that fail to qualify for "sale" treatment under § 302(a) would be considered dividends subject to withholding. Accordingly, even if █████ were not a USRPHC, if the redemptions under consideration were treated as dividends for failing to satisfy the requirements of § 302(b), then the distributions in redemption would be subject to withholding.<sup>7</sup>

The Court in United States v. Davis, 397 U.S. 301 (1970) held that for a redemption to be considered a "sale" (not equivalent to a dividend) under § 302(b)(1) a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation, taking into consideration the attribution rules of §318(a). See also, Rev. Rul. 75-502, 1975-2 C.B. 111 (factors considered in determining whether a reduction in a shareholder's proportionate interest results in a meaningful reduction within the meaning of Davis).

Redemptions by public companies involve minuscule reductions in the vote of common stock minority shareholders; nevertheless, since such minority shareholders exercise no control over the corporation either before or after the redemptions, the redemptions are considered "sales" rather than "dividends." Rev. Rul. 1976-385, 1976-2 C.B. 92 (reduction from tiny to tinier ruled a sale). The ruling noted that one purpose of § 302(b)(1) is to provide capital gain treatment for redemptions of stock held by minority shareholders who exercise no control over corporate affairs. See S. Rep. No. 1622, 83<sup>rd</sup> Cong., 2d Sess., 44-45 (1954).

In contrast, the Service in Rev. Rul. 81-289, 1981-2 C.B. 82 treated a redemption pursuant to a tender offer by a public corporation as a dividend to a shareholder who tendered 40 of 2000 shares, or the same two percent fraction of the corporation's outstanding shares redeemed, because there was no reduction whatsoever in the shareholder's proportionate interest in the corporation.

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<sup>7</sup> We do not consider the applicability of the income tax treaty between the United States and the █████ in light of our conclusion that the redemption was not equivalent to a dividend.

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More to the point, in Rev. Rul. 75-512, 1975-2 C.B. 112, a trust's ■% minority stock interest was reduced to ■% by a redemption. The Service ruled that the redemption qualified as a sale under § 302(b)(1), evidently because the trust remained a minority shareholder that took no part in the management of the company. Thus, the trust experienced a meaningful reduction of its rights to vote, to participate in current earnings and accumulated surplus, and to share in the net assets of the corporation in the event of a liquidation.

In light of these authorities, the redemptions by the ■ in ■ and ■ were not dividends subject to income tax withholding. They are considered sales that simply preserved the trust's minority shareholder position in ■. This result conforms with economic reality, as the trust could have obtained capital gains sale treatment simply by selling the ■ stock in the securities market. See also Treas. § 445(e)(3) and Treas. Reg. § 1.1445-5(e)(1) [No withholding tax if the taxpayer is not defined as a USRPI under §897(c)(1)(B)] and Treas. Reg. §1.897-5T(b)(2).

LMSB attorney James P. Dawson, (305) 982-5316, and the undersigned collaborated in this advisory opinion. Please call

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us if you have any question or would like additional assistance in this case.

DAVID R. SMITH  
Associate Area Counsel (LMSB)

By: \_\_\_\_\_  
SERGIO GARCIA-PAGES  
Special Litigation Assistant  
(LMSB)  
Tel. No. (305) 982-5315

cc:  
TSS 4510 Attn: Associate Chief Counsel (International) Branch  
4  
Area Counsel (Area 3- Downers Grove)  
Associate Area Counsel (Industry Programs) (Chicago Location)  
Senior Legal Counsel, Area 3 RFPH (Mint Building).