

Nonrecognition Transactions Involving FIRPTA Companies

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David F. Levy is a partner at Skadden, Arps, Slate, Meagher & Flom LLP.

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FIRPTA played a significant role, that statement is likely to elicit a wry smile, particularly if the transaction was intended to qualify for nonrecognition treatment.² Whatever one thinks of the opening statement, it sets the tone for this article, the primary purpose of which is to explore some difficult FIRPTA issues associated with reorganization and liquidation transactions involving a foreign corporation that owns a subsidiary U.S. real property holding corporation (USRPHC).

FIRPTA created three code sections — sections 897, 1445, and 6039C. Those sections provide income tax, withholding tax, and information reporting rules, respectively, for foreign persons who acquire or dispose of U.S. real property interests (USRPIs).³ As originally enacted, FIRPTA embodied the basic principle that a foreign person should be subject to U.S. tax on the sale of a USRPI and should not be able to avoid that tax

“Nothing in FIRPTA is clear.” To a reader who is not experienced in the vagaries and nuances of the Foreign Investment in Real Property Tax Act of 1980,¹ that statement may sound a bit brash. To a reader who has struggled through a major transaction in which

²See, e.g., Blanchard, “FIRPTA in the 21st Century — Installment One: A Closer Look at Reg. § 1.897-5T(c),” 36 *Int’l Tax J.* 520 (BNA) (Oct. 12, 2007) [hereinafter Blanchard -5T Article] (“Huge M&A deals implicate FIRPTA. And more often than not, when the tax advisor consults the regulations and Notices for an answer to a FIRPTA question, she finds no answer, finds a partial answer that cannot be clearly applied to the facts at hand, or finds an answer that is clearly ridiculous under the circumstances.”).

³Unless otherwise noted, all section references are to the Internal Revenue Code of 1986 as amended.

¹P.L. 96-499, 96th Cong., 2d Sess. (1980), 1980-2 C.B. 509, 524.

through the use of either a U.S. holding entity structure or a nonrecognition transaction. Thus, the operative provisions of FIRPTA contain technical rules that define the scope of the term "USRPI," describe the circumstances under which a foreign person will be subject to U.S. tax on the sale of a USRPI, and impose additional requirements that must be satisfied each time a foreign person desires to transfer a USRPI in a transaction that would otherwise qualify for nonrecognition treatment.

The additional requirements imposed by the FIRPTA regime on nonrecognition transactions will provide the focal point of this article. In exploring the issues presented by those requirements, this article will focus on two themes and three policy issues.

The first theme of this article is that section 897 and the temporary regulations and other guidance thereunder are written in a way that makes it difficult, and sometimes impossible, for a taxpayer to predict with certainty (or an acceptable level of certainty) the tax results that will be produced by an otherwise routine nonrecognition transaction. Second, to the extent the FIRPTA provisions do produce results that a taxpayer can predict with certainty, those results often turn on minor differences in transaction structure, with economically similar (and sometimes economically identical) transactions producing dramatically different tax results.

Those two themes illustrate three fundamental policy issues. First, in the context of the transactions described in this article, the existing FIRPTA regime presents traps for the unwary that produce counterintuitive results that do not seem to advance any tax policy objective. Second, to the extent the IRS has attempted to remedy those traps, the remedies themselves can create other counterintuitive results and traps for the unwary. Third, the FIRPTA regime does not function rationally in a situation in which a foreign corporation that owns a USRPI desires to either migrate into the United States (for example, become a Delaware corporation) or be acquired by a U.S. corporation in a nonrecognition transaction. In situations in which a publicly traded foreign corporation desires to engage in one of those transactions, the existing FIRPTA nonrecognition regime will often prove impossible to navigate.

Although those policy issues may seem abstract, they can have a tremendous adverse effect on legitimate corporate transactions. For example, the FIRPTA nonrecognition regime can effectively prevent a foreign corporation or a potential U.S. acquirer from engaging in a tax-deferred reorganization that would move foreign-held USRPIs into U.S. corporate solution in a manner that preserves the built-in gain inherent in those USRPIs. In other cases, the FIRPTA regime may place U.S. corporate acquirers at a competitive disadvantage to foreign corporate acquirers in situations in which both acquirers are competing for the opportunity to acquire the same foreign corporation in a tax-

deferred reorganization. Although taxpayers have attempted to address those types of problems using some of the alternative structures described in this article, those alternative structures tend to be cumbersome, second-best solutions that do not adequately address the legitimate goals of the parties.

Section I of this article reviews the FIRPTA rules applicable to transfers of USRPHCs. Section II explores in detail the FIRPTA rules applicable to nonrecognition transactions involving foreign corporations that hold USRPHCs. Section II also explores some alternative transaction structures that might be considered by a foreign corporation that finds itself unable to engage in a FIRPTA nonrecognition transaction. Section III provides conclusions and a summary of the recommendations made throughout the article.

By the end of this article, the reader is guaranteed to appreciate the accuracy of the opening statement.

I. Transferring USRPHC Interests

A. General Rules

In general, foreign persons are not subject to U.S. federal income tax on the gain attributable to the sale or exchange of a capital asset unless the gain itself is effectively connected with the conduct of a trade or business in the United States.⁴ Section 897(a) provides an exception to that rule and requires a foreign person to take any gain recognized on the disposition of a USRPI into account as if the foreign person were engaged in a U.S. trade or business and that gain were effectively connected with that trade or business. Foreign persons are subject to U.S. tax at graduated rates on income or gain that is effectively connected with a U.S. trade or business.⁵

In general, section 897(c)(1)(A)(i) defines a USRPI as an interest, other than an interest solely as a creditor, in real property (for example, land and improvements) located in the United States or the U.S. Virgin

⁴See sections 871(b) and 881(a). See generally Dale, "Effectively Connected Income," 42 *Tax L. Rev.* 689 (1987); Isenberg, "The 'Trade or Business' of Foreign Taxpayers in the United States," 61 *Taxes* 972 (1983).

⁵Foreign corporations that earn effectively connected income are generally subject to a 30 percent branch profits tax on certain after-tax earnings. Section 884. The branch profits tax is designed to conform the taxation of a foreign corporation that operates a U.S. trade or business through a branch with a foreign corporation that operates a U.S. trade or business through a taxable U.S. subsidiary by subjecting ECI earned through a branch to a second level of tax. See Blessing, "The Branch Tax," 40 *Tax Law.* 587 (1987). The branch profits tax does not apply to income recognized by a foreign corporation under section 897(a) on the sale of a USRPHC interest. Section 884(d)(2)(C).

Islands.⁶ Section 897(c)(1)(A)(ii) provides that the term “USRPI” also includes any interest, other than an interest solely as a creditor, in any domestic corporation (USRPHC interest) unless the holder establishes that the corporation was at no time a USRPHC during the so-called USRPHC lookback period. The USRPHC lookback period means the shorter of the period after June 18, 1980, during which the taxpayer held the interest and the five-year period ending on the date of the disposition of the interest.⁷ A corporation will be treated as a USRPHC if the fair market value of its USRPIs equals or exceeds 50 percent of the aggregate FMV of its USRPIs, foreign real estate assets, and other trade or business assets.⁸

When the FIRPTA legislation was enacted, a foreign shareholder could sell the stock of a wholly

owned USRPHC to a purchaser in a transaction that provided the purchaser with an FMV tax basis in the assets of the USRPHC and resulted in no U.S. tax at either the foreign shareholder level or the USRPHC level. Because a U.S. seller would be subject to U.S. tax on the sale of stock in a USRPHC, the pre-FIRPTA regime was viewed as providing foreign sellers with a pricing advantage vis-à-vis comparably situated U.S. sellers; as a result of the U.S. tax exemption, foreign sellers could “afford” to transfer the stock of USRPHCs at a lower price than their U.S. counterparts. In that context, the FIRPTA legislation was adopted to provide for a single shareholder-level tax on the sale of USRPHC stock by a foreign seller and thereby eliminate that pricing advantage.⁹

⁶The term “United States real property interest” includes land, improvements, and personal property associated with the use of real property. Reg. section 1.897-1(b)(1). The term does not include an interest in United States real property solely as a creditor. Reg. section 1.897-1(d)(1). An interest will be treated as an interest other than solely as a creditor (that is, a USRPHC interest) if the interest is (i) stock in the USRPHC; (ii) an interest that is, in whole or in part, “a direct or indirect right to share in the appreciation in value of an interest” in that stock, or a “direct or indirect right to share in the appreciation in value of assets of, or gross or net proceeds derived by, the [USRPHC]”; or (iii) a right, whether or not currently exercisable, to directly or indirectly acquire, by purchase, conversion, exchange, or otherwise, any interest described in clause (i) or (ii). Reg. section 1.897-1(d)(3)(i). For a discussion of the rules concerning the classification of interests in entities as USRPIs, see Austrian and Schneider, “Tax Aspects of Foreign Investment in U.S. Real Estate,” 45 *Tax Law*. 385 (1992).

⁷Section 897(c)(1)(A)(ii).

⁸Section 897(c)(2); reg. section 1.897-2(b)(1). Reg. section 1.897-2 provides an intricate set of rules that are used to determine whether a U.S. corporation satisfies the 50 percent USRPI value test, a discussion of which is beyond the scope of this article. For a discussion of those rules, see Rubin and Hudson, 912 *T.M.* (BNA), *Federal Taxation of Foreign Investment in U.S. Real Estate*, at A-28 to A-35. Generally speaking, a corporation must determine its status as a USRPHC on the last day of its tax year or on one of the events listed in reg. section 1.897-2(c)(1). See generally Caliano, “The Impact of Sec. 897 on an NRA or Foreign Corporation’s Sale of Domestic Stock,” 11-07 *The Tax Adviser* 662 (Nov. 2007). Also, a corporation may elect to determine its status as a USRPHC as of the last day of each month. Reg. section 1.897-2(c)(3)(ii). Finally, a USRPHC may “voluntarily determine its status as of the date of any acquisition or disposition of its assets,” and “if the fair market value of its U.S. real property interests on such date no longer equals or exceeds 50 percent of the fair market value of all assets described in paragraphs (d) and (e) of [reg. section 1.897-2], such corporation shall cease to be a U.S. real property holding corporation as of such date.” Reg. section 1.897-2(f)(1). This article assumes that all USRPHCs will voluntarily determine their status as USRPHCs on the date of any transaction that affects the entity’s status as a USRPHC.

⁹FIRPTA was enacted before the 1986 legislative repeal of the holding in *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935). Before the enactment of FIRPTA, any person — foreign or domestic — could sell the stock of a U.S. corporation to a U.S. purchaser, who could then liquidate the corporation. Under the law then in effect, the U.S. corporation would enjoy nonrecognition treatment on the distribution of its assets in liquidation, and the purchaser would take an FMV tax basis in the distributed assets. See H.R. Rep. No. 96-1167, at 509-511 (1980). In other words, before the repeal of the *General Utilities* doctrine, an acquisition of the stock of a corporation, coupled with the liquidation of that same corporation, provided the purchaser with a stepped-up tax basis in the corporation’s assets without a corresponding corporate-level income tax. See generally Shores, “Repeal of *General Utilities* and the Triple Taxation of Corporate Income,” 45 *Tax Law*. 177 (1992). In that type of transaction, the only difference between a domestic seller of USRPHC stock and a foreign seller of USRPHC stock was that the domestic seller would be subject to U.S. tax on the sale of the stock while the foreign seller would not. In Congress’s view, that disparate tax treatment provided the foreign seller with an unfair pricing advantage when compared with a similarly situated domestic seller. H.R. Rep. No. 96-1167, at 509-511. To eliminate that pricing advantage, Congress chose to eliminate the tax disparity that gave rise to the advantage by subjecting a foreign seller to U.S. tax on the disposition of a USRPHC interest. Feingold and Glicklich, “An Analysis of the Temporary Regulations Under FIRPTA: Part I,” 69 *J. Tax’n* 262, (1988) (“FIRPTA was enacted to remove the competitive advantage that foreign investors in U.S. real estate were perceived to have as a result of their ability to avoid U.S. income tax on their real estate gains”); Feder and Parker, “The Foreign Investment in Real Property Tax Act of 1980,” 34 *Tax Law*. 545, 547-549 (discussing in detail the legislative history of FIRPTA).

Because FIRPTA was enacted before the 1986 repeal of the *General Utilities* doctrine, it seems clear that by imposing a tax on foreign sellers of USRPHC interests, Congress was *not* creating a second level of tax. Instead, Congress was placing foreign sellers of USRPHC stock in the same position as domestic sellers of USRPHC stock by imposing on foreign sellers a single level of tax that would not have otherwise been imposed. See Brown, “Whither FIRPTA?” 57 *Tax Law*. 295, 297-300 (2004) (providing a detailed discussion of the legislative background and policy goals underlying FIRPTA).

It is important to note that, on its face, section 897(c)(1)(A)(ii) applies on an “interest-by-interest basis,” implying that the same equity interest in a U.S. corporation may be a USRPI for one foreign shareholder and a non-USRPI for another foreign shareholder, and that for the same foreign shareholder, one interest (for example, a block of stock) in a U.S. corporation may be a USRPI and another interest in that same corporation may be a non-USRPI.¹⁰

Section 897 provides three exceptions to the rule that a USRPHC interest is treated as a USRPI: the “FIRPTA cleansing exception” in section 897(c)(1)(B), the “publicly traded exception” in section 897(c)(3), and the “domestically controlled QIE exception” in section 897(h)(2). Each is discussed below.

B. The FIRPTA Cleansing Exception

Section 897(c)(1)(B) provides that a USRPHC interest shall not be treated as a USRPI if the issuing USRPHC does not own *any* USRPIs and *all* USRPIs held by the USRPHC were disposed of in transactions in which the full amount of gain (if any) inherent therein was recognized.¹¹ The FIRPTA cleansing exception reflects that the FIRPTA legislation was de-

signed to eliminate the pricing advantage formerly enjoyed by foreign sellers of USRPHC interests by ensuring that the gain realized by a foreign person on the sale of such an interest would be subject to one level of U.S. tax.¹² Thus, if a USRPHC disposes of all of its USRPIs in taxable transactions, the goal of FIRPTA has been satisfied — the USRPHC will either pay U.S. tax on the gain inherent in its USRPIs or use existing corporate-level tax attributes (for example, net operating losses or loss carryforwards) to offset that gain — and the foreign holder of the USRPHC interest need not pay a second U.S. tax on the sale of that interest.¹³

C. The Publicly Traded Exception

Section 897(c)(3) provides that if a class of stock in a USRPHC is “regularly traded” on an “established securities market,” a share of stock in that class will not be treated as a USRPI in the hands of a foreign person that owned no more than 5 percent of the FMV of the equity interests in that class during the shorter of the period during which the foreign person held the stock or the five-year period ending on the date on which the stock is sold (a non-5 percent holder).¹⁴ Accordingly, a foreign person that held 5 percent or more

¹⁰This concept can be illustrated through two fact patterns:

Fact Pattern 1. At all times between the first day of year 1 and the last day of year 5, foreign corporation X owned all 100 of the outstanding shares of XYZ, a U.S. corporation. At all times during that period, XYZ was a USRPHC. On day 1 of year 6, XYZ sold a portion of its USRPIs and ceased to be a USRPHC. On day 2 of year 6, foreign corporation Y contributed cash to XYZ in exchange for 75 newly issued shares of XYZ. On these facts, the 75 shares of stock issued by XYZ to Y would not be treated as a USRPI, because XYZ was not a USRPHC during the USRPHC look-back period applicable to Y's interest.

Fact Pattern 2. On day 1 of year 8, Y sells 50 of its 75 shares of XYZ to X in exchange for cash. XYZ has been a non-USRPHC throughout Y's holding period. Because the shares sold by Y were not USRPIs for Y, Y will not be subject to tax under section 897 on the sale of those shares to X. Assuming that the 50 shares that X acquired from Y represent a separate interest in XYZ for purposes of section 897(c)(1)(A)(ii), those 50 shares would not constitute a USRPI in X's hands either, because XYZ was not a USRPHC during the USRPHC look-back period applicable to X's ownership of *those shares*. Although the regulations are less than clear on that point, other IRS pronouncements support that interpretation. See *infra* notes 36 to 40 and accompanying text (discussing the implications of Notice 99-43 on the interest-by-interest application of section 897(c)(1)(A)(ii)); cf. temp. reg. section 1.897-5T(b)(3)(iv) (permitting a U.S. corporation to distribute a USRPI to its foreign parent corporation in a tax-free section 332 liquidation and providing that the stock in a “former” USRPHC shall not be treated as a USRPI).

¹¹If an entity is treated as a USRPHC because it owns interests in lower-tier corporations that themselves are USRPHCs, the entity can satisfy the FIRPTA cleansing exception if the lower-tier USRPHCs dispose of their own USRPIs in fully taxable transactions. Section 897(c)(1)(B)(i)(II).

¹²See *supra* note 9 and accompanying text (discussing the policy goals underlying the FIRPTA legislation in the context of a sale of a USRPHC interest).

¹³It is important to note that a foreign person cannot take advantage of the FIRPTA cleansing exception by making an election under either section 338(g) or section 338(h)(10) in connection with the sale of a USRPHC. The former election will not enable the foreign person to satisfy the FIRPTA cleansing exception, because the deemed corporate-level asset sale that occurs in connection with a section 338(g) election does not take place until *after* the sale of stock by the foreign person. Section 338(a) (the corporation for which a section 338(g) election is made “shall be treated as having sold all of its assets *at the close of the acquisition date*”) (emphasis added). The latter election is not available when the seller is a foreign corporation. See reg. section 1.338(h)(10)-1(b) (for the seller and the buyer to make a section 338(h)(10) election for the sale of stock in a target C corporation, several requirements must be satisfied, one of which is that the target C corporation must be a member of a consolidated group of corporations within the meaning of reg. section 1.1504-1(h), and the seller must be either a member of that consolidated group or a *domestic* corporation that owns stock of the target sufficient to permit the filing of a consolidated return); and section 1504(b)(3) (a foreign corporation is not eligible for inclusion in a consolidated group of corporations and cannot join in the filing of a consolidated tax return). Although the section 338 regulations permit a section 338(h)(10) election in situations in which the target is an S corporation, that rule is of no use in the context of the FIRPTA cleansing exception because an S corporation is not permitted to have a corporate or foreign shareholder. See section 1361(b)(1)(B), (C).

¹⁴Section 897(c)(3); see also reg. section 1.897-1(c)(2)(iii). The temporary regulations extend the publicly traded exception to certain other interests issued by a publicly traded USRPHC (for example, a class of nonlisted stock) if, on the date the interest

(Footnote continued on next page.)

of a class of publicly traded USRPHC stock (a 5 percent holder) and then sold enough stock to fall below the 5 percent threshold must enter a five-year “cooling-off period” before the foreign person can sell the balance of its stock tax free under the publicly traded exception.¹⁵

In determining the amount of USRPHC stock that it owns, a foreign shareholder, under section 897(c)(6)(C), must apply the constructive ownership rules of section 318(a), modified by substituting “5%” for “50%” in section 318(a)(2)(C) and (a)(3)(C).¹⁶

Reg. section 1.897-1(m) provides that the term “established securities market” includes: a national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (the Exchange Act); a foreign national securities exchange that is officially recognized, sanctioned, or supervised by any governmental authority; and any over-the-counter market.

Reg. section 1.897-9T(d)(1) treats stock as “regularly traded” if specific trading volume and reporting requirements are satisfied.¹⁷ Temp. reg. section 1.897-9T(d)(2) provides that stock of a USRPHC that is traded on a U.S. securities market is considered to be

was acquired, it had an FMV less than the FMV of 5 percent of the regularly traded class of the USRPHC’s stock with the lowest FMV. Temp. reg. section 1.897-9T(b). This rule is subject to numerous limitations. First, if a non-regularly traded class of interests is convertible into a regularly traded class of interests, an interest in the non-regularly traded class shall be treated as a USRPI if, on its acquisition date, the non-regularly traded interest had an FMV greater than 5 percent of the value of the regularly traded class into which it is convertible. Also, if a person acquires multiple interests in the same non-publicly traded class of stock, those interests must be aggregated and revalued on each acquisition date and, if a person exceeds the 5 percent value limitation on any such acquisition date, each interest in that class shall be treated as a USRPI. Finally, if a person acquires interests in multiple classes of non-publicly traded stock of the same USRPHC with a principal purpose of avoiding the 5 percent limitation set forth in the regulation, those interests generally will be aggregated for purposes of applying that limitation.

¹⁵See Blanchard, “FIRPTA in the 21st Century — Installment Two: The 5% Public Shareholder Exception,” 37 *Int’l Tax J.* 44 (BNA) (Jan. 11, 2008) [hereinafter Blanchard 5% Holder Article] (discussing the publicly traded exception, the circumstances under which a literal application of the exception can produce unexpected results, and potential arguments that could be relied on to mitigate those results).

¹⁶Section 897(c)(6)(C).

¹⁷Specifically, temp. reg. section 1.897-9T(d)(1) treats stock as regularly traded if the following requirements are satisfied: trades in the particular class of stock are effected, other than in de minimis quantities, on at least 15 days during the calendar quarter for which the determination is made; the aggregate number of interests in the class traded is at least 7.5 percent (2.5 percent for classes of stock held by more than 2,500 record holders) or more of the average number of interests in that class outstanding during the calendar quarter; and the issuing corporation satisfies the reporting requirements of temp. reg. section 1.897-9T(d).

“regularly traded” for any calendar quarter during which it is regularly quoted by brokers or dealers making a market in those interests.¹⁸

Reg. section 1.897-9T(d)(3) provides more stringent requirements (collectively, the foreign exchange reporting requirements) that must be satisfied for stock of a USRPHC that is traded on a foreign securities market to be considered “regularly traded.” To satisfy the foreign exchange reporting requirements, the USRPHC that issued the stock must either register the class of stock under section 12 of the Exchange Act or attach a statement to its tax return each year that identifies each 5 percent holder of the USRPHC’s stock and the amount of stock held by each such 5 percent holder. The regulation indicates that the foreign exchange reporting requirements apply on a year-by-year basis, meaning that if a USRPHC fails to satisfy those requirements in a particular tax year, its stock will not qualify for the publicly traded exception for that year.¹⁹

The differences between the requirements applicable to shares of stock that are listed on U.S. markets and those that are listed on foreign markets are rarely relevant to domestic U.S. corporate issuers, which typically list their shares on U.S. markets. In an odd twist, however, that distinction may become critically important to a *foreign* corporate issuer that desires to either engage in an inbound reorganization or liquidation transaction or file an election under section 897(i). Those scenarios are discussed in greater detail below.²⁰

D. The Domestically Controlled QIE Exception

Section 897(h)(2) provides that a USRPI does not include any “interest,” regardless of its size, held by a foreign person in a “domestically controlled qualified investment entity,” referred to as a “QIE.” Section 897(h)(4) states that a real estate investment trust will be treated as a domestically controlled QIE for a disposition of an interest therein if less than 50 percent of the REIT’s stock was owned, directly or indirectly, by foreign persons at all times during the shorter of the five-year period ending on the date of that disposition or the period of time during which the entity was in

¹⁸A broker or dealer is treated as making a market in a class of stock only if the broker or dealer holds himself out to buy or sell stock in that class at the quoted price.

¹⁹Reg. section 1.897-9T(d)(3)(ii) (flush language) (“Interests in a domestic corporation which has filed a report pursuant to this paragraph (d)(3)(ii) shall be considered to be regularly traded on an established securities market *only* for the taxable year of the corporation with respect to which such a report is filed.”) (emphasis added).

²⁰See *infra* notes 116 to 142 and accompanying text (discussing the FIRPTA toll charge that must be paid by certain foreign corporations that engage in certain inbound reorganization and liquidation transactions).

existence (the domestically controlled lookback period).²¹ Unlike the interest-by-interest analysis that one must perform to determine whether an interest in a U.S. corporation is a USRPI,²² section 897(h)(4) appears to require a taxpayer to conduct the domestically controlled QIE analysis on an entitywide basis, which could produce unexpected results for an unwary foreign purchaser.²³

Section 897(h)(4) does not define the term “directly or indirectly,” nor does the provision contain constructive ownership rules or incorporate by reference the constructive ownership rules of section 318. The legislative history to section 897(h)(4) provides no guidance on the scope of the phrase “directly or indirectly,” nor does it provide any insight into the policy underlying the domestically controlled QIE exception.²⁴

The regulations do, however, indicate that the phrase “directly or indirectly” does not contemplate the use of constructive ownership rules. Reg. section

1.897-1(c)(2)(i) states that a “domestically-controlled REIT is one in which less than 50 percent of the fair market value of the outstanding stock was directly or indirectly held by foreign persons. . . . For purposes of this determination the actual owners of stock, as determined under section 1.857-8, *must be taken into account.*”²⁵ Reg. section 1.857-8(b), in turn, provides that the “actual owner of stock of a real estate investment trust is the person who is required to include in gross income in his return the dividends received on the stock.” Because those provisions require a potential domestically controlled QIE to take into account those persons who are required to include in gross income *on their tax returns* the dividends paid by the QIE, and that category of persons includes *only* those persons who are treated as the owners of the QIE’s stock without regard to constructive ownership or attribution rules, the regulations stand for the proposition that section 897(h)(4) does not require the parties to undertake a constructive ownership analysis to identify those persons who directly or indirectly own QIE shares.

That interpretation of section 897(h)(4) and the regulations is consistent with both the long-established principle that the constructive ownership rules of section 318 do not apply unless another code provision specifically incorporates them by reference,²⁶ as well as the various provisions of the code and regulations that

²¹Before the enactment of the American Jobs Creation Act of 2004, P.L. 108-357 (the Jobs Act), section 897(h)(2) applied only to domestically controlled REITs. The Jobs Act extended the application of section 897(h)(2) to certain regulated investment companies that were domestically controlled USRPHCs, and it adopted the term “qualified investment entity” to describe both REITs and those RICs that were covered by the new legislation. Generally speaking, the changes made by the Jobs Act regarding RICs were effective only through December 31, 2007. Section 897(h)(4)(A)(ii). Following that sunset date, the term “QIE” generally refers only to a REIT.

²²See *supra* note 10 and accompanying text.

²³For example, assume the following: At all times between the beginning of year 1 and the end of year 5, foreign corporation X was the sole foreign owner of REIT 1 and owned 51 percent of the outstanding stock of REIT 1; REIT 1 was a USRPHC throughout that period and remains a USRPHC; on day 1 of year 6, X sold its entire interest in REIT 1 to a U.S. person; on day 2 of year 6, when REIT 1 was wholly owned by U.S. persons, foreign corporation Y contributed cash to REIT 1 in exchange for 10 percent of the outstanding stock of REIT 1; and immediately after Y’s acquisition of REIT 1 stock, 90 percent of REIT 1’s stock was owned by U.S. persons. If one were to interpret section 897(h)(4) literally and apply the domestically controlled QIE standard on an entitywide basis, the REIT 1 stock issued to Y would be a USRPI as of its acquisition date because: (i) REIT 1 was a USRPHC on the day Y acquired the stock, and (ii) REIT 1 is not under a literal interpretation of section 897(h)(4) a domestically controlled QIE, because during the domestically controlled look-back period, REIT 1 was controlled by foreign corporation X. This result, which is inexplicable from a policy perspective and perhaps unintended, could prove surprising to a foreign person who anticipated using the interest-by-interest approach described in footnote 10.

²⁴The conference report that accompanied the FIRPTA legislation provides no insight on the policy underlying section 897(h)(2) and simply states, “In the case of REITs which are controlled by U.S. persons, sales of the REIT shares by foreign shareholders would not be subject to tax (other than in the case of distribution by the REIT).” H. Rept. No. 96-1479, 96th Cong., 2d Sess. (Nov. 26, 1980).

²⁵*Id.* (emphasis added).

²⁶Section 318(a) provides constructive ownership rules “for purposes of those provisions . . . to which the rules contained in [section 318] are expressly made applicable.” *Id.* (emphasis added). That language has been interpreted strictly by both the courts and the IRS, which have refused to apply constructive ownership principles in situations in which those principles were not expressly incorporated into the relevant statute or regulation. For example, in *Yamamoto v. Commissioner*, T.C. Memo. 1986-316, 51 T.C.M. (CCH) 1560 (1986), the court held that a taxpayer could not rely on the attribution rules of section 318 to satisfy the control requirement imposed by section 351(a) in a situation in which the taxpayer transferred appreciated assets to an indirect wholly owned subsidiary. The court stated: “Section 318 attributes a proportionate share of the stock held by a corporation to its shareholders who hold 50 percent or more of its stock. Section 318 applies, however, *only* [f]or purposes of those provisions of [subchapter C] to which the rules contained in this section are expressly made applicable.’ . . . Neither section 368(c) nor section 351 state that the attribution rules of section 318 apply.” *Id.* at 1565 (emphasis added and citations omitted); see also *Berghash v. Commissioner*, 43 T.C. 743 (1965), *aff’d*, 361 F.2d 257 (2d Cir. 1966) (refusing to apply the option attribution rule of section 318 to determine whether a taxpayer was in control of a corporation within the meaning of section 368(c), because section 368(c) did not specifically incorporate the attribution rules of section 318; “Section 318 is not expressly made applicable to part III of subchapter C. . . . Consequently, the stock attribution rule of section 318(a)(4) relating to the ownership of stock subject to an option is not applicable to the stock ownership requirement regarding corporate control as defined by section 368(c).”); Rev. Rul. 56-613, 1956-2 C.B. 212 (the acquiring corporation in a purported B reorganization did not possess control of the target

(Footnote continued on next page.)

treat “indirect” ownership as something different than either constructive ownership or ownership by attribution.²⁷ That interpretation of section 897(h)(4) is also consistent with the negative inference that arises from the fact that section 897(c)(6)(C), which applies *only* to the determination of USRPHC status under section 897(c)(2), incorporates by reference (and then modifies) the constructive ownership rules of section 318. Under this line of reasoning, it is obvious that Congress knows how to incorporate constructive ownership rules into parts of the section 897 analysis and affirmatively chose to incorporate those rules into section 897(c)(2) but *not* section 897(h)(4).²⁸

Although a taxpayer may conclude with a high level of confidence that domestically controlled QIE status is determined without regard to constructive ownership

corporation through direct stock ownership, but would have possessed control if it were allowed to include stock owned by its subsidiary corporation; it was ruled, that the acquiring corporation is not treated as owning target stock held by its subsidiaries, because section 368(c) does not incorporate constructive ownership rules); Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 9.02 at 9-13 (7th ed. 2006) (“Section 318(a) applies to transactions governed by subchapter C (i.e., sections 301 through 385, covering most, but not all, of the transactions discussed in this work) but *only* if expressly made applicable by the relevant statutory provision.”) (emphasis in original).

²⁷ See, e.g., section 958(a)(2) (requiring a shareholder of a corporation to treat himself as constructively owning the stock held “directly or indirectly” by a foreign corporation in which he owns shares); reg. section 1.871-14(g)(2)(ii) (for purposes of determining whether a recipient of interest is related to the payer for purposes of the portfolio interest exemption, “stock owned means stock directly or indirectly owned *and* stock owned by reason of the attribution rules of Section 318(a)”) (emphasis added). In each case, the attribution of subsidiary stock from a corporation to its shareholders, whether by cross reference to section 318(a) or otherwise, would be unnecessary if the words “directly or indirectly” were sufficient, standing alone, to cause that attribution to occur. See TAM 200733024, *Doc 2007-19133*, or 2007 TNT 161-15 (“‘Direct or indirect’ ownership rules do not include constructive ownership. When Congress intends constructive ownership rules to apply, it will expressly so state”). Indeed, in distinguishing between “actual ownership” and “constructive ownership,” section 318 itself uses the terminology “directly and indirectly” to refer only to stock that is actually owned by a person, either directly or (indirectly) through a nominee or fiduciary. See Bittker and Eustice, *supra* note 26, at para. 9.02 at 9-13 (“‘Actual stock ownership’ is referred to in various provisions of section 318 as stock owned ‘directly or indirectly,’ i.e., stock titled in the name of the owner (direct ownership) or held by an agent (indirect ownership). ‘Indirect ownership,’ therefore, does not mean ownership by attribution”).

²⁸ See Phillips, “REIT Structures: Problems/Solutions” (2008), at 23 (publication pending, on file with the author) (discussing the “inexplicable ambiguities” inherent in the domestically controlled QIE rule, and concluding that the complexity of FIRPTA and the presence of constructive ownership rules in section 897(c)(6)(C) “undercuts any excuse that the [constructive ownership] issue has been overlooked”).

rules, the conclusion is not free from doubt. That is because reg. section 1.897-1(c)(2)(i) does not state that the actual owners of QIE stock are the *only* persons that the QIE must “take into account,” and the language of section 897(h)(4)(B) can be read as contemplating a look-through analysis for QIE shareholders that are entities.²⁹ Consider whether a “high” level of certainty is sufficient in a situation in which a foreign person would sell QIE stock only if the QIE were domestically controlled, but would otherwise retain the stock or engage in a different transaction if the QIE were not domestically controlled.³⁰

²⁹ See Staffaroni, “Foreign Investors in RICs and REITs,” 56 *Tax Law* 511, 563 n.319 (2003) (“The statutory reference to ‘indirect’ ownership seems to indicate that Congress had in mind more than simply identifying the beneficial owner of the REIT shares.”).

³⁰ The direct and indirect ownership analysis becomes extremely difficult in the context of a publicly traded REIT. *Id.* (“It is unclear how a foreign investor itself could determine whether a REIT is domestically controlled if the REIT is widely held. Indeed, it would seem difficult for a widely held REIT itself to make this determination.”); Ponda, “Foreign Pension Plans Investing in Shares of a U.S. REIT,” *Tax Notes*, Mar. 24, 1997, p. 1593, *Doc 97-8309*, or 97 TNT 56-55 (“Although most publicly traded REITs are doubtless domestically controlled (and sale gain on such REITs’ shares thus do not subject to FIRPTA), foreign shareholders may find it difficult to establish domestically controlled status”); see generally Einhorn, Emmerich, and Panovka, “REIT M&A Transactions — Peculiarities and Complications,” 55 *Bus. Law* 693 (2000); State Bar of California Taxation Section, International Tax Committee, “Who Are ‘Direct and Indirect’ Shareholders of ‘Domestically-Controlled REITs?’” (May 2002) (on file with the author).

To illustrate the problem, assume that foreign person X has held 45 percent of the common stock of a publicly traded REIT at all times during the domestically controlled look-back period. X’s interest is too large to qualify for the publicly traded exception, but if the REIT was domestically controlled at all times during the domestically controlled look-back period, X could sell its common stock tax free under the domestically controlled QIE exception. How is X supposed to determine whether the REIT is domestically controlled? X could certainly review the SEC ownership filings (for example, Schedule 13D) made by the other shareholders of the REIT to see whether the REIT had any large foreign holders during the domestically controlled look-back period. See Bohrer, “When an Acquisition ‘Plan or Proposal’ Requires a Schedule 13D Amendment,” 19 *Insights* 8, at 17 (Aug. 2005) (discussing the SEC disclosure requirements applicable to persons who acquire 5 percent or more of the stock of a publicly traded company). Suppose those filings turn up no additional foreign ownership, but also show significant ownership by other REITs and RICs. Must X now investigate the shareholders of those REITs and RICs to determine whether there is any foreign ownership at that level? In the absence of constructive ownership rules, X should not have to look any further than the shareholders of the REIT in which it owns stock, but the ambiguity in the statute is troubling nonetheless.

Unfortunately, in the context of publicly traded REITs, even if one were to improve the facts significantly, the domestically controlled QIE analysis may not become any easier. Building on the prior example, assume that no person other than X has ever

(Footnote continued on next page.)

II. Application of FIRPTA Nonrecognition Rules

A. Introduction

Subsections (d) and (e) of section 897 restrict a foreign person's ability to rely on a nonrecognition provision in connection with a transfer of a USRPI. Section 897(d) applies to distributions of USRPIs by foreign corporations, while section 897(e) applies to transactions in which a foreign person exchanges a USRPI for another asset.

Section 897(d)(1) provides the general rule that a foreign corporation must recognize the gain (if any) inherent in a USRPI on the distribution of that USRPI, even if the distribution is otherwise described in a nonrecognition provision such as section 337(a)³¹ or section 361(c).³² Section 897(d)(2) provides two exceptions to that gain recognition rule. First, section 897(d)(2)(A) provides that a foreign corporation shall not be required to recognize gain under section 897(d)(1) on the distribution of a USRPI if the distributee would be subject to tax on a subsequent disposition of the property and the basis of the property in the hands of the distributee is not greater than the basis of the property in the hands of the distributor, increased by the amount of gain (if any) recognized by the distributor in connection with the distribution. Second, section 897(d)(2)(B) provides that gain recognition shall not be required under section 897(d)(1) to the extent provided in the regulations promulgated under section 897(e)(2).

Section 897(e)(1) states that, except to the extent provided in section 897(d) and (e)(2), a nonrecognition provision shall not apply to a transfer of a USRPI in an exchange transaction unless the property received in the exchange (the replacement property) would, on a subsequent disposition, be subject to U.S. tax under sections 1 through 1400T of the code. Section 897(e)(2) directs Treasury to issue regulations that describe the extent to which a nonrecognition provision shall or

filed an SEC ownership report regarding the REIT. Does that mean that the REIT has no other foreign owners that might prevent it from qualifying as domestically controlled? One would hope so, but the statute is not that forgiving — it requires X to assess the REIT's status as domestically controlled by looking to *all* of the REIT's shareholders throughout the entire domestically controlled look-back period, not just those who filed ownership reports with the SEC. In light of that, it is difficult to see how X can determine with certainty that the publicly traded REIT in which it owns stock is domestically controlled.

³¹Section 337(a) provides that no gain or loss shall be recognized to a liquidating corporation on the distribution of property to its 80 percent corporate shareholder in a liquidation described in section 332.

³²Section 361(c) provides that no gain or loss shall be recognized on the distribution of certain property by a corporation that is a party to a reorganization.

shall not apply to an exchange of a USRPI by a foreign person. Section 897(e)(3) provides that the term “nonrecognition provision” means any code provision that provides for the nonrecognition of gain or loss.

The regulations promulgated under section 897(d) and (e) were issued in temporary form in 1988 — temp. reg. section 1.897-5T and 1.897-6T, respectively — and have been modified or supplemented to one degree or another by seven different notices, some of which modify other notices in the series.³³ In the end, significant portions of the original regulatory language are no longer applicable, and many of the other rules set forth in the regulations come with exceptions and with exceptions to exceptions that appear only in the notices or notices that modify other notices.

The following sections of this article will discuss the current section 897(d) and (e) rules in the context of a foreign corporation that desires to transfer a USRPHC interest in some types of reorganization and liquidation transactions that, in the absence of section 897(d) and (e), would qualify *in their entirety* for nonrecognition treatment. In describing reorganization transactions, this article uses the customary parlance of A, B, C, D, E, F, (a)(2)(D), and (a)(2)(E) reorganizations to refer to reorganization transactions that are described in subsections (a)(1)(A) through (a)(1)(F), (a)(2)(D), and (a)(2)(E) of section 368, respectively. Consistent with the terminology used in the FIRPTA area, the terms “parenthetical B reorganization” and “parenthetical C reorganization” refer to B and C reorganization transactions in which the parent of the acquiring corporation issues stock to the target corporation or its shareholders, as described in the parenthetical language in subsections (a)(1)(B) and (a)(1)(C) of section 368. Similarly, this article uses the terms “332 liquidation” and “351 transaction” to refer to subsidiary liquidations described in section 332 and contribution transactions described in section 351, respectively. The structure

³³Notice 2006-46, 2006-1 C.B. 1044, *Doc 2006-9901*, or *2006 TNT 100-9* (providing rules relating to inbound merger transactions, foreign-to-foreign nonrecognition transactions, and the FIRPTA toll charge); Notice 99-43, 1999-2 C.B. 344, *Doc 1999-27115*, *1999 TNT 158-15* (providing rules relating to single-entity reorganization transactions involving a “former” USRPHC); Notice 89-85, 1989-2 C.B. 403 (providing rules relating to certain distributions of USRPHC interests by foreign corporations and section 897(i) elections); Notice 89-64, 1989-1 C.B. 270 (providing rules relating to the application of Article XIII(9) of the Canada-U.S. Income Tax Convention to certain nonrecognition exchanges involving USRPIs); Notice 89-57, 1989-1 C.B. 698 (providing rules relating to the filing requirements that must be satisfied by a foreign person that transfers a USRPI in a nonrecognition transaction); Notice 88-72, 1988-2 C.B. 383 (providing rules applicable to the disposition of interests in partnerships that own USRPIs); Notice 88-50, 1988-1 C.B. 535 (announcing the IRS's intention to treat a domestication of a foreign corporation as an inbound F reorganization that involves a deemed transfer of assets (including USRPIs) owned by the foreign corporation).

charts included in the Appendix illustrate those transactions in both the “foreign-to-foreign” and “inbound” contexts.

Before proceeding, the reader should note that when a foreign corporation that is a party to a reorganization transfers a USRPHC interest to another corporation that is a party to the reorganization, the rules of section 897(e) and temp. reg. section 1.897-6T apply before the rules of section 897(d) and temp. reg. section 1.897-5T. For example, assume that foreign corporation X desires to engage in an inbound F reorganization transaction in connection with which, as illustrated in Figure 15 of the Appendix, X will transfer its assets to New X (a U.S. corporation) and distribute the stock of New X to its shareholders in full liquidation. To obtain nonrecognition treatment for the first leg of the transaction, X must rely on section 361(a) and satisfy the requirements of section 897(e) and temp. reg. section 1.897-6T. To obtain nonrecognition treatment for the second leg of the transaction, X must rely on section 361(c) and satisfy the rules of section 897(d) and temp. reg. section 1.897-5T. Obviously, X would not concern itself with the tax treatment of the second leg of the transaction unless it could obtain nonrecognition treatment for the first leg of the transaction. For that reason, this article will discuss section 897(e) and temp. reg. section 1.897-6T before discussing section 897(d) and temp. reg. section 1.897-5T.

B. The Section 897(e) Temporary Regulations

The temporary regulations promulgated under section 897(e)(2) are set forth in temp. reg. section 1.897-6T, which has been supplemented and modified by portions of temp. reg. section 1.897-5T and a variety of notices, including Notice 89-57, Notice 89-85, Notice 99-43, and Notice 2006-46.

For a foreign person to enjoy nonrecognition treatment on the transfer of a USRPI in exchange for replacement property, the following requirements must be satisfied:

- the replacement property must be a USRPI (the hot-to-hot requirement);
- the foreign person must be subject to tax on a disposition of that USRPI within the meaning of temp. reg. section 1.897-5T(d)(1)(i) (the subject-to-tax requirement);
- the foreign person must comply with the filing requirement in temp. reg. section 1.897-5T(d)(1)(iii) (the FIRPTA filing requirement); and
- the transaction must not run afoul of the anti-abuse rules in temp. reg. section 1.897-6T(c).³⁴

³⁴See *infra* notes 98 to 115 and accompanying text and notes for a discussion of the subject-to-tax requirement and the FIRPTA filing requirement, respectively.

Temp. reg. section 1.897-6T(b), as modified by Notice 2006-46, provides exceptions to the hot-to-hot requirement for some foreign-to-foreign exchange transactions in which a foreign person transfers a USRPI to a foreign corporation in transactions that would otherwise qualify for nonrecognition treatment.

1. The Hot-to-Hot Requirement

Temp. reg. section 1.897-6T(a)(1), which contains the hot-to-hot requirement, provides in pertinent part:

Except as otherwise provided in this section and in [section] 1.897-5T, for purposes of section 897(e) any nonrecognition provision shall apply to a transfer by a foreign person of a U.S. real property interest on which gain is realized *only to the extent that the transferred U.S. real property interest is exchanged for a U.S. real property interest which, immediately following the exchange, would be subject to U.S. taxation upon its disposition, and the transferor complies with the filing requirements of paragraph (d)(1)(iii) of [section] 1.897-5T. . . .* In the case of an exchange of a U.S. real property interest for stock in a domestic corporation (that is otherwise treated as a U.S. real property interest), *such stock shall not be considered a U.S. real property interest unless the domestic corporation is a U.S. real property holding corporation immediately after the exchange.* Whether an interest would be subject to U.S. taxation in the hands of the transferor upon its disposition shall be determined in accordance with the rules of [section] 1.897-5T(d)(1).³⁵

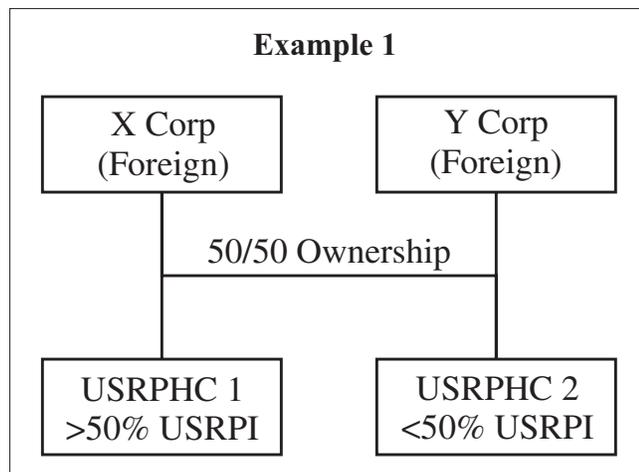
The hot-to-hot requirement may produce some unexpected results that, depending on the circumstances, may be mitigated through careful planning.³⁶ For example, if a foreign person transfers a USRPI to a

³⁵*Id.* (emphasis added).

³⁶As the New York State Bar Association (NYSBA) Tax Section made clear in its report on the temporary section 897 regulations [hereinafter the NYSBA Report], the hot-to-hot requirement contravenes the clear language of section 897(e)(1): The statutory language requires that the replacement property received by a foreign person in a nonrecognition exchange be subject to U.S. tax under Chapter 1 of subtitle A of title 26 — sections 1 through 1400T of the code — on a future disposition, while the hot-to-hot requirement prohibits a foreign person from enjoying nonrecognition treatment unless the replacement property would be subject to tax under *section 897* on a future disposition. New York State Bar Association, “Report on the Temporary and Proposed Regulations Under Sections 897(d) and (e) and Certain Related Provisions,” *Doc 89-936*, or *89 TNT 30-57* at 5 (pagination reflects electronic numbering by Lexis system; original on file with the author). The inconsistency between the statutory language and the hot-to-hot requirement becomes readily apparent in situations where a foreign person decides to contribute a USRPI to a partnership that is engaged in a U.S. trade or business that does *not* involve U.S. real property. In that case, although the partnership interest received by the foreign person would be subject to U.S. tax on a subsequent disposition because

(Footnote continued on next page.)

“former” USRPHC in exchange for an interest that is not a USRPI immediately after the exchange, the foreign person will recognize gain in connection with that transfer.



Example 1. As illustrated on this page, foreign corporation X and foreign corporation Y each own 50 percent of the stock of USRPHC 1 and 50 percent of the stock of USRPHC 2. For valid business reasons, X and Y decide to consolidate their ownership of the two corporations beneath a single entity by contributing the stock of USRPHC 1 to USRPHC 2 in a section 351 transaction. Until December 31, 2007, more than 50 percent of the value of USRPHC 2's assets was attributable to USRPIs. On that date, USRPHC 2 acquired a non-USRPI asset whose value was sufficient to reduce the USRPI percentage of USRPHC 2 below 50 percent and begin the USRPHC cooling-off period for the USRPHC 2 shares held by X and Y. The contribution of the USRPHC 1 stock to USRPHC 2 would not cause USRPHC 2 to return to USRPHC status.

In this case, X and Y will recognize gain on the contribution of the USRPHC 1 stock to USRPHC 2, because USRPHC 2 would not be a USRPHC immediately after the contribution and, presumably, the newly issued shares of USRPHC 2 would not be USRPIs in the hands of X and Y. That conclusion is consistent with the analysis described in Section I.C above concerning the application of section 897(c)(1)(A)(ii) on an “interest-by-interest” basis. That conclusion is also consistent with the analysis adopted by the IRS in Notice 99-43, which was issued to mitigate the harsh results

the partnership itself is engaged in a U.S. trade or business, the foreign person would recognize gain on the contribution to the extent that the value of the partnership interest received by the foreign person is attributable to non-USRPIs. *Id.* at 12.

that would be produced by a literal application of the hot-to-hot requirement and the interest-by-interest analysis in the case of a single-entity reorganization involving a “former” USRPHC.

Example 2. The facts are the same as in Example 1 except that instead of combining USRPHC 1 and USRPHC 2, the parties decide to migrate USRPHC 2 from Maryland to Delaware in a transaction in which: (i) USRPHC 2 forms a wholly owned Delaware subsidiary (Delco) and merges downstream into Delco; and (ii) X and Y exchange their USRPHC 2 shares for Delco shares that provide substantially identical economic and voting rights. But for section 897(e), that transaction would be treated as an F reorganization.

Under the interest-by-interest interpretation of section 897(c)(1)(A)(ii), the Delco shares issued to X and Y would not be USRPIs immediately after the merger, because Delco would not have been a USRPHC at any time during the USRPHC lookback period for the newly issued Delco shares.³⁷ Accordingly, in the absence of an exception, the migratory merger of USRPHC 2 into Delco would be fully taxable to X and Y. In Notice 99-43, the IRS provided such an exception for single-entity E and F reorganizations in which the new interests received by the foreign shareholders in the reorganization are substantially identical³⁸ to the old interests that were surrendered. In the process, the IRS supported the notion that section 897(c)(1)(A)(ii) applies on an interest-by-interest basis and that the status of an “interest” as a USRPI does not, in the absence of a special rule, tack onto the replacement property received for that interest:

When the final regulations under section 897(e) are issued, the regulations will include an exception that will provide that a foreign taxpayer will not recognize gain under section 1.897-6T(a)(1) (as finalized) for a stock exchange under section 354(a) in certain reorganizations described in section 368(a)(1)(E) or (F). The exception will apply where the taxpayer receives stock in the corporation that is substantially identical to the shares exchanged

³⁷Section 897(c)(1)(A)(ii) provides that the Delco shares issued to X and Y are treated as USRPIs unless Delco was at no time a USRPHC during the USRPHC look-back period for those shares. In this case, the USRPHC look-back period would include only the day of the merger.

³⁸To satisfy the “substantially identical” standard of Notice 99-43, the interests issued by Delco to X and Y in the migratory merger must “possess (in the aggregate and with respect to any other outstanding securities of the corporation) the same dividend rights, voting power, liquidation preference (if any), convertibility and other legal and economic entitlements as the shares exchanged, and do not contain any additional rights or obligations.” Notice 99-43, Section II.

The final regulations will provide, for purposes of section 897(a) and (e), that stock received in a section 368(a)(1)(E) or (F) reorganization qualifying for nonrecognition pursuant to section 354(a) under the examples described above, constitutes the same interest in the corporation whose stock was exchanged for purposes of determining whether the interest received is a U.S. real property interest under section 897(c)(1)(A)(ii). *Thus, the determination of whether the interest received in such an exchange is a U.S. real property interest under section 897(c)(1)(A)(ii) will include the period prior to the exchange.*³⁹

Notice 99-43 would be helpful to X and Y in Example 2 but not in Example 1. Nonetheless, in Example 1, X and Y may be able to combine the assets and operations of USRPHC 1 and USRPHC 2 without triggering gain under section 897. For example, the parties could cause USRPHC 1 and USRPHC 2 to contribute all of their assets to a new member-managed joint venture. Depending on the relative values of the contributed assets, the interests taken by each party, and the extent to which the joint venture deploys its assets in a trade or business, the movement of assets by USRPHC 1 to the joint venture might cause the USRPI percentage of USRPHC 1 to fall below 50 percent, which in turn would cause the USRPHC 1 stock held by X and Y to enter the USRPHC cooling-off period.⁴⁰

2. Special Rules for Foreign-to-Foreign Exchanges

There are countless situations in which a foreign corporation (the transferor foreign corporation) might wish to transfer a USRPHC interest to another foreign corporation (the transferee foreign corporation) in exchange for stock of the transferee foreign corporation in either a section 351 transaction or a reorganization described in section 368 (such transfers are collectively referred to as foreign-to-foreign exchanges). In a foreign-to-foreign exchange, the stock of the transferee foreign corporation would not be a USRPI. Consequently, without an exception, the transaction would not satisfy the hot-to-hot requirement and the transferor foreign corporation would not be entitled to nonrecognition treatment in connection with the foreign-to-foreign exchange.

³⁹*Id.* (emphasis added).

⁴⁰See reg. section 1.897-2(e)(2) (“For purposes of determining whether a corporation is a U.S. real property holding corporation, a holder of an interest in a partnership . . . shall be treated pursuant to section 897(c)(4)(B) as holding a proportionate share of the assets of the entity. . . . Any asset treated as held by a holder of an interest by reason of this paragraph (e)(2) which is used or held for use in a trade or business by the partnership . . . shall be treated as so used or held for used by the holder of the interest.”).

As discussed below, temp. reg. section 1.897-6T(b), as modified by Notice 2006-46, contains five relatively narrow exceptions to the hot-to-hot requirement that permit some transferor foreign corporations to enjoy nonrecognition treatment in some types of foreign-to-foreign exchanges. The rules applicable to foreign-to-foreign exchanges are scattered among sections 3(a) and (b) of Notice 2006-46 and parts of temp. reg. section 1.897-6T(b)(1). In all cases, to achieve nonrecognition treatment, the transferee foreign corporation must satisfy the subject-to-tax requirement for any USRPI received in the foreign-to-foreign exchange, and the FIRPTA filing requirement also must be satisfied.⁴¹

Before proceeding, it is important to note that if a transferor foreign corporation transfers a USRPHC interest to the transferee foreign corporation in exchange for stock of the transferee foreign corporation and then distributes that transferee foreign corporation stock to its shareholders, the transferor foreign corporation needs to achieve nonrecognition treatment under section 897 only for the first leg of the transaction. The second leg of the transaction falls outside U.S. taxing jurisdiction, because the United States does not impose a tax on the transfer by a foreign person of stock in a foreign corporation.⁴²

a. Foreign-to-foreign mergers involving foreign corporations with ‘low USRPI percentages.’ The first exception set forth in section 3(b) of Notice 2006-46 permits a transferor foreign corporation to enjoy nonrecognition treatment under section 361 on the transfer of a USRPI to a transferee foreign corporation that occurs in connection with an A, C, (a)(2)(D), or (a)(2)(E) reorganization (collectively, foreign-to-foreign mergers),⁴³ provided that the transferor foreign corporation would not have been a USRPHC at any time during the previous five years if the transferor foreign corporation were a domestic corporation.⁴⁴

This rule, which in many respects is a significant extension of the now-repealed temp. reg. section 1.897-6T(b)(2)(i), may represent an acknowledgement by the IRS that in the foreign-to-foreign exchange context, the

⁴¹Temp. reg. section 1.897-6T(b)(1); see *infra* notes 105 to 115 and accompanying text (discussing the filing requirements set forth in temp. reg. section 1.897-5T(d)(1)(iii)); *infra* notes 98 to 104 and accompanying text (discussing the subject-to-tax requirement of temp. reg. section 1.897-5T(d)(1)(i)).

⁴²This conclusion assumes that the transferee foreign corporation has not elected to be treated as a U.S. corporation under section 897(i). See *infra* Section II.E (discussing the section 897(i) election and its effects). If the transferee foreign corporation has made such an election, the transaction would be treated as an inbound reorganization described in Section II.C below.

⁴³See the Appendix for structure charts illustrating these transactions.

⁴⁴Notice 2006-46, section 3(b) (first bullet).

government's interests are preserved in any nonrecognition transaction in which the transferee foreign corporation takes a carryover basis in a transferred USRPI and would be subject to U.S. tax on a subsequent disposition of that USRPI. If that is the direction in which the IRS is heading, it would be an extremely welcome development. As discussed below, the reasoning behind the "low USRPI percentage" rule should be extended to all foreign-to-foreign exchange transactions.

b. Public foreign-to-foreign mergers. Under the second exception set forth in section 3(b) of Notice 2006-46, a transferor foreign corporation may enjoy nonrecognition treatment under section 361 on the transfer of a USRPI that occurs in connection with a foreign-to-foreign merger under the following conditions: (i) the stock of the transferor foreign corporation and the stock of the transferee foreign corporation are both regularly traded on an established securities market within the meaning of reg. section 1.897-1(m) and (n) and temp. reg. section 1.897-9T(d)(1) and (2) immediately before the exchange; (ii) the stock of the transferee foreign corporation satisfies those standards immediately after the exchange; and (iii) in situations in which the transferor foreign corporation would have been a USRPHC at any time during the previous five years if the transferor foreign corporation were a domestic corporation, and no foreign shareholder of the transferor foreign corporation owned a greater than 5 percent interest in that corporation at such time under the rules of temp. reg. section 1.897-1(c)(2)(iii) and 1.897-9T.⁴⁵ For a parenthetical C or (a)(2)(D) reorganization, the requirement in clause (ii) must be satisfied by the parent of the transferee foreign corporation, not the transferee foreign corporation itself.⁴⁶ For an (a)(2)(E) reorganization, it is the parent corporation of the foreign merger subsidiary that must satisfy that requirement.⁴⁷

As discussed below, it is not clear whether the public foreign-to-foreign merger rule requires the stock of both the transferor and transferee foreign corporations to be traded on a U.S. securities market.⁴⁸ Also, the public foreign-to-foreign (a)(2)(E) rule is much narrower than most taxpayers might realize, and that might catch some taxpayers by surprise.⁴⁹

c. Nonpublic foreign-to-foreign mergers. The third exception in Notice 2006-46 represents a modification

of temp. reg. section 1.897-6T(b)(1)(ii) and applies to foreign-to-foreign mergers that do not satisfy the requirements of the first two exceptions described above. Under this exception, the transferor foreign corporation will enjoy nonrecognition treatment under section 361 on the transfer of a USRPI to the transferee foreign corporation only if, immediately after the merger, the shareholders of the transferor foreign corporation own more than 50 percent of the voting stock of the transferee foreign corporation. For a parenthetical C or (a)(2)(D) reorganization, the shareholders of the transferor foreign corporation must own more than 50 percent of the voting stock of the parent of the transferee foreign corporation.⁵⁰ For an (a)(2)(E) reorganization, the shareholders of the parent corporation that controlled the foreign merger subsidiary before the merger must own more than 50 percent of the voting stock of the parent corporation after the merger.⁵¹

For purposes of determining whether the 50 percent voting requirement is satisfied in an upstream foreign-to-foreign merger — that is, a foreign-to-foreign merger in which the transferee foreign corporation already owns more than 50 percent of the voting stock of the transferor foreign corporation — the shareholders of the transferee foreign corporation will be treated as shareholders of the transferor foreign corporation on a look-through basis.⁵²

Notice 2006-46 states that the nonpublic foreign-to-foreign merger rule was intended to facilitate internal restructuring transactions. The rule, however, applies on its face to any transaction in which the transferor foreign corporation is larger than the transferee foreign corporation and, as a result of that fact, the shareholders of the transferor foreign corporation end up owning more than half of the combined entity immediately after the transaction. Even if the transferor foreign corporation is smaller than the transferee foreign corporation, the parties may be able to satisfy the voting control requirement by having the transferee foreign corporation issue supervoting stock that provides the shareholders of the transferor foreign corporation with voting control over the transferee foreign corporation.

As was the case in the public merger context, the narrowness of the nonpublic foreign-to-foreign (a)(2)(E) rule might catch some taxpayers by surprise.⁵³

d. Foreign-to-foreign D and F reorganizations. The fourth exception is in temp. reg. section 1.897-6T(b)(1)(i) and applies to foreign-to-foreign D and F

⁴⁵Notice 2006-46, section 3(b) (second bullet). If interpreted literally, the 5 percent holder limitation applies only if the transferor foreign corporation would have been a USRPHC when it had a 5 percent holder.

⁴⁶Notice 2006-46, section 3(b) (two paragraphs following the second bullet).

⁴⁷See *infra* notes 65 to 68 and accompanying text.

⁴⁸See *infra* notes 62 to 64 and accompanying text.

⁴⁹See *infra* notes 65 to 68 and accompanying text.

⁵⁰Notice 2006-46, section 3(a) (third full paragraph); see also temp. reg. section 1.897-6T(b)(1)(ii) (incorporated by reference into section 3(a) of Notice 2006-46).

⁵¹Notice 2006-46, section 3(a) (final paragraph).

⁵²Notice 2006-46, section 3(a) (third full paragraph).

⁵³See *infra* notes 65 to 68 and accompanying text.

reorganizations.⁵⁴ The transferor foreign corporation can enjoy nonrecognition treatment under section 361 for these exchanges without having to satisfy the additional rules that were in temp. reg. section 1.897-6T(b)(2) and subsequently revoked by Notice 2006-46.⁵⁵

It is important to note that the foreign-to-foreign D reorganization rule requires the transferor foreign corporation to distribute the stock of the transferee foreign corporation in a distribution that, at the shareholder level, qualifies for nonrecognition treatment under section 354(a). Accordingly, the foreign-to-foreign D reorganization rule applies exclusively to acquisitive D reorganizations (that is, reorganizations described in sections 368(a)(1)(D) and 354(b)(1)) and has no application to divisive D reorganizations (that is, reorganizations described in sections 368(a)(1)(D) and 355).⁵⁶

e. Foreign-to-foreign B reorganizations and section 351 transactions. The fifth exception in Notice 2006-46

⁵⁴ See the Appendix for structure charts illustrating these transactions.

⁵⁵ Temp. reg. section 1.897-6T(b)(2) states that the nonrecognition treatment applicable to the foreign-to-foreign reorganization transactions described in temp. reg. section 1.897-6T(b)(1) will apply only if one of the five conditions set forth in that paragraph are satisfied. Those conditions are as follows: (i) each of the interests exchanged or received in a transferor corporation or transferee corporation would not be a U.S. real property interest as defined in section 1.897-1(c)(1) if those corporations were domestic corporations; (ii) the transferee corporation (and the transferee corporation's parent in the case of a parenthetical B or C reorganization) is incorporated in a foreign country that maintains an income tax treaty with the United States that contains an information exchange provision, the transfer occurs after May 5, 1988, and the transferee corporation (and the transferee corporation's parent in the case of a parenthetical B or C reorganization) submits a binding waiver of all benefits of the respective income tax treaty (including the opportunity to make an election under section 897(i)), which must be attached to each of the transferor and transferee corporation's income tax returns for the year of the transfer; (iii) the transferee foreign corporation (and the transferee corporation's parent in the case of a parenthetical B or C reorganization) is a qualified resident as defined in section 884(e) and any regulations thereunder of the foreign country in which it is incorporated; (iv) the transferee foreign corporation (and the transferee corporation's parent in the case of a parenthetical B or C reorganization) is incorporated in the same foreign country as the transferor foreign corporation, and there is an income tax treaty in force between that foreign country and the United States at the time of the transfer that contains an exchange of information provision; or (v) the transferee foreign corporation is incorporated in the same foreign country as the transferor foreign corporation and the transfer is incident to a mere change in identity, form, or place of organization of one corporation under section 368(a)(1)(F). Aside from the condition set forth in clause (i), which has been expanded and converted into the "low USRPI percentage rule" by section 3 of Notice 2006-46, the conditions required by temp. reg. section 1.897-6T(b)(2) have been eliminated in their entirety by section 3(d) of Notice 2006-46.

⁵⁶ Compare section 354(b)(1) with section 355(b)(2)(B).

represents a modification of temp. reg. section 1.897-6T(b)(1)(iii) and applies to section 351 transactions and foreign-to-foreign B reorganizations in which nonrecognition treatment is sought under section 354.⁵⁷ In each case, the transferor foreign corporation will enjoy nonrecognition treatment on the transfer of a USRPI to the transferee foreign corporation only if the USRPI being transferred is stock of a USRPHC and substantially all of the outstanding stock of the transferee foreign corporation is owned by the transferor foreign corporation.⁵⁸ Also, if the transferor foreign corporation disposes of the stock of the transferee foreign corporation within one year from the date of its receipt, the transferor foreign corporation shall recognize a proportionate share of the gain inherent in the stock of the USRPHC that was transferred in the exchange.⁵⁹

It is not clear why the foreign-to-foreign section 351 contribution exception is limited to transactions in which a foreign person contributes USRPHC stock to a foreign corporation. It is difficult to discern why, from a policy perspective, a foreign corporation is required to recognize gain on the contribution of a parcel of U.S. real estate to another foreign corporation in a section 351 transaction, but is entitled to nonrecognition treatment on the contribution of stock in a USRPHC whose sole asset consists of a parcel of U.S. real estate. Moreover, the exception does not apply to a transfer of an option to acquire USRPHC stock. Thus, for example, a foreign option holder who desires to contribute that option to a foreign corporation in a section 351 transaction would actually have to exercise the option, acquire the underlying USRPHC stock, and contribute that stock to the transferee foreign corporation in the section 351 transaction. An option holder who is unable to exercise an option because of financial or contractual constraints would not be entitled to rely on the exception at all. The same holds true for a foreign person who holds a nonstock USRPHC interest such as a shared appreciation mortgage.⁶⁰ This limitation on the foreign-to-foreign 351 rule should be eliminated.

Even more puzzling is the requirement that the USRPHC shareholders own substantially all of the stock of the transferee foreign corporation immediately after the exchange. The IRS has offered no insight on

⁵⁷ See the Appendix for structure charts illustrating those transactions.

⁵⁸ Temp. reg. section 1.897-6T(b)(1)(iii) as modified by Notice 2006-46, section 3(c). Although this article focuses on transfers of USRPHC interests by foreign corporations, it is important to note that the foreign-to-foreign B reorganization and section 351 rules are not restricted to corporate transferors. Thus, for example, a foreign individual or partnership could transfer USRPHC interests to a foreign corporation under those rules.

⁵⁹ *Id.*

⁶⁰ See reg. section 1.897-1(d)(3)(i)(D), 1.897-1(d)(2)(i).

the policy concern that motivated that rule, and it should be eliminated as unnecessary.

f. Additional concerns. In some respects, the modified foreign-to-foreign exchange rules represent a welcome attempt by the IRS to soften the much-maligned rules adopted by temp. reg. section 1.897-6T(b).⁶¹ In other respects, however, the modified rules raise a number of difficult concerns in addition to those noted above.

First, it is not clear whether, to take advantage of the public foreign-to-foreign merger rule, the stock of both the transferor foreign corporation and the transferee foreign corporation must be regularly traded on a U.S. securities market.⁶² A requirement that both for-

⁶¹See NYSBA Report, *supra* note 36 (criticizing in several respects the rules set forth in temp. reg. section 1.897-6T); "Florida Bar Tax Section Opposes Complexity and Double Taxation Under Section 897 Regulations," *Tax Notes*, Aug. 1, 1988, p. 472, *Doc 88-6460*, or *88 TNT 155-34* (Florida Bar Tax Section letter criticizing multiple portions of temp. reg. sections 1.897-5T and 1.897-6T); "Peat Marwick Decries Double Taxation as to Corporate Distributions and Nonrecognition Transactions Involving Foreign Investment in Realty," *Tax Notes*, Aug. 29, 1988, p. 910, *Doc 88-7212*, or *88 TNT 175-32* (comment letter by accounting firm Peat Marwick criticizing multiple portions of temp. reg. section 1.897-5T and 1.897-6T); Matthews, "FIRPTA Regulations Come Under Fire," *Tax Notes*, May 16, 1988, p. 801; Matthews, "FIRPTA Regulations Unfairly Subject Shareholders to Double Taxation on Inbound Reorganizations," *Tax Notes*, Mar. 6, 1989, p. 1166.

⁶²The public foreign-to-foreign merger rule requires that the stock of both the transferor foreign corporation and the transferee foreign corporation be "regularly traded under reg. section 1.897-1(n) and temp. reg. section 1.897-9T(d)(1) and (2)." In describing the rules under which the regularly traded determination is made, Notice 2006-46 does not refer to temp. reg. section 1.897-9T(d)(3).

Temp. reg. section 1.897-9T(d)(1) states that for a class of stock to be "regularly traded," the trading volume requirements set forth in that provision must be satisfied, and the issuer must satisfy the reporting requirements of temp. reg. section 1.897-9T(d)(3). Temp. reg. section 1.897-9T(d)(2) states that a class of stock that is traded on a *domestic* established securities market shall be treated as regularly traded for any calendar quarter during which that stock is regularly quoted by brokers or dealers making a market in the stock. Temp. reg. section 1.897-9T(d)(3), which is referenced in temp. reg. section 1.897-9T(d)(1) but *not* in Notice 2006-46, provides rules that a domestic issuer must satisfy for a class of stock that is listed on a *foreign* securities market to be treated as regularly traded.

Because Notice 2006-46 refers to the domestic exchange rule of temp. reg. section 1.897-9T(d)(2) but omits any reference to the foreign exchange rule of temp. reg. section 1.897-9T(d)(3), Notice 2006-46 could be interpreted as requiring the stock of both the transferor and transferee foreign corporations to be traded on a *domestic* securities market for those corporations to take advantage of the public foreign-to-foreign merger rule.

There are at least two reasonable counterarguments to that interpretation. First, a foreign corporation could argue that (i) the requirements set forth in temp. reg. section 1.897-9T(d)(1)

(Footnote continued in next column.)

eign corporations be traded on a U.S. securities market would make the public foreign-to-foreign merger rule unavailable to most potential transferor foreign corporations. It is conceivable that both foreign corporations could list their shares through an American depository receipt (ADR) arrangement⁶³ before the transaction and that the transferee foreign corporation could maintain the ADR arrangement following the transaction. It is not clear, however, whether an ADR arrangement would satisfy the public foreign-to-foreign merger rule or, if it could, how long such an ADR arrangement must remain in place following the merger.

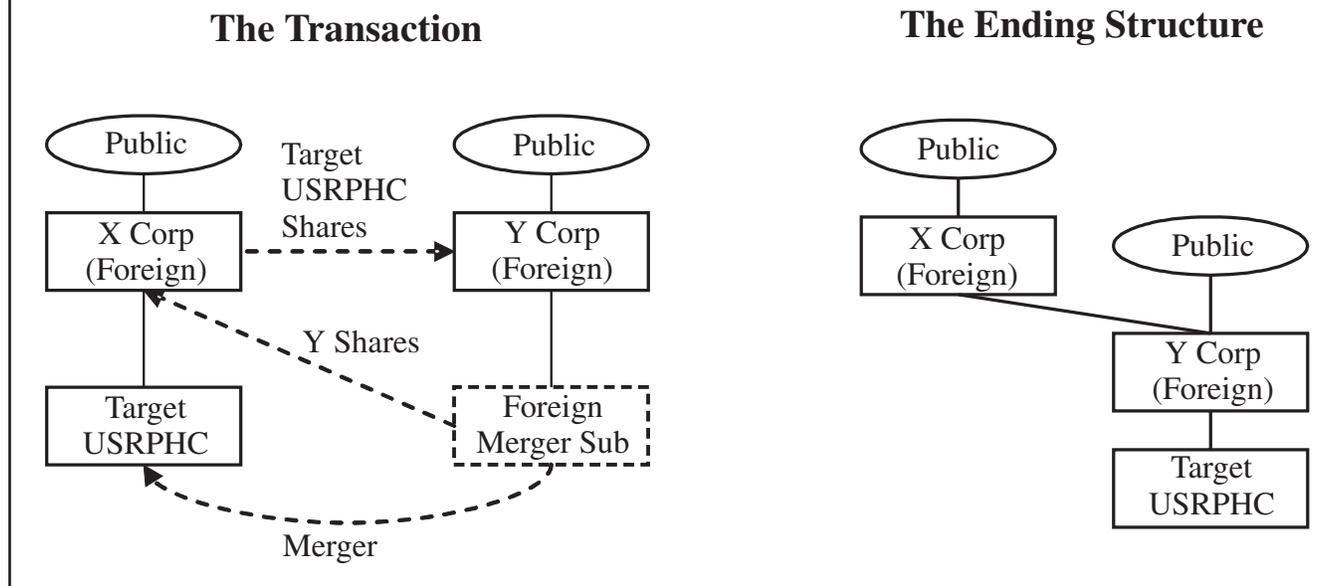
Second, a transferor foreign corporation cannot take advantage of the public foreign-to-foreign merger rule if it would have been a USRPHC at any time during the five-year period preceding the transaction if it were a domestic corporation, and if it had a 5 percent holder at that time. It is difficult to discern a policy objective for the 5 percent holder restriction. First, because the United States has chosen not to exercise taxing jurisdiction over foreign persons who transfer stock in foreign corporations that hold USRPIs, it is difficult to see why the government would find it necessary to restrict the ability of a transferor foreign corporation to engage in a foreign-to-foreign exchange simply because it had a 5 percent holder during the five-year period preceding the exchange. Perhaps more important, because the transferee foreign corporation will take a

apply with equal force to shares traded on both domestic and foreign securities markets; (ii) the requirements of temp. reg. section 1.897-9T(d)(3) apply only to *domestic* corporations whose shares are traded on foreign securities markets and are therefore inapplicable to foreign issuers; and (iii) consequently, shares of a foreign corporation that are traded on a foreign securities market should satisfy the "regularly traded" standard so long as the trading volume requirements of temp. reg. section 1.897-9T(d)(1) are satisfied.

Second, the foreign corporation could argue that because temp. reg. section 1.897-9T(d)(1)(i)(C) contains a cross reference to temp. reg. section 1.897-9T(d)(3), a foreign corporation whose shares satisfy the trading volume requirements of temp. reg. section 1.897-9T(d)(1) will satisfy the regularly traded standard so long as the requirements of temp. reg. section 1.897-9T(d)(3) are satisfied. Practically speaking, even if that argument were successful, a foreign corporation whose shares were listed on a foreign securities market would not be able to satisfy the regularly traded standard unless its shares were registered under section 12 of the Exchange Act. See temp. reg. section 1.897-9T(d)(3)(i); *infra* notes 130 to 134 and accompanying text (discussing the application of temp. reg. section 1.897-9T(d)(3) to a publicly traded foreign corporation).

⁶³Under an ADR arrangement, U.S. persons hold negotiable interests that represent a beneficial ownership interest in a share (or a fraction of a share) of stock in a foreign company, together with any dividends paid thereon. The shares of a foreign company that are part of an ADR arrangement may be listed on a U.S. stock exchange. For a general description of ADR arrangements and the securities law requirements applicable to them, see Young, "Using American Depository Receipts To Access The U.S. Capital Markets," 8 *Insights* 3, at 15 (Mar. 1994).

Example 4



carryover basis in the USRPIs it receives from the transferor foreign corporation, any historic FIRPTA gain inside the transferor foreign corporation will be preserved for future taxation under section 897. Thus, to the extent the government has any interest in the existence of a 5 percent holder of a transferor foreign corporation, the government's interests are adequately addressed by the existing rules. Unless there is some other motivation behind the 5 percent holder restriction, the restriction would seem unnecessary. That conclusion seems particularly striking in situations in which the 5 percent holder restriction can be avoided entirely if the parties were to reverse the direction of a transaction.

Example 3. Widely held, publicly traded foreign corporation X owns 100 percent of the stock of USRPHC 1. Foreign corporation Y is also widely held and publicly traded and owns 100 percent of the stock of USRPHC 2. X and Y agree to engage in a foreign-to-foreign A reorganization. Both X and Y would have been USRPHCs during the past five years if they had been domestic entities. X has always had a 5 percent holder, but Y has never had a 5 percent holder.

In this case, if X were to merge into Y with Y surviving, the transaction would not satisfy the public foreign-to-foreign merger rule, and X would recognize the gain inherent in its USRPHC 1 stock unless it could satisfy one of the other foreign-to-foreign exchange exceptions. If, however, Y were to merge into X with X surviving, the transaction would satisfy the public foreign-to-foreign merger rule. Although reversing

the direction of a transaction is a basic tax planning technique, doing so may create significant corporate, securities law, and employee benefits issues, not to mention significant business and financing issues, all of which could jeopardize a transaction. Given those potential problems, combined with the above-described protections accorded the fisc, the 5 percent holder restriction should be eliminated as both counterintuitive and unnecessary.⁶⁴

The third concern with the new rules contained in Notice 2006-46 is that the operation of the foreign-to-foreign (a)(2)(E) rules might catch some taxpayers by surprise. That is because those rules are only designed to provide nonrecognition protection under section 361 to a foreign merger subsidiary that merges with and

⁶⁴It is also important to bear in mind that the definition of 5 percent holder in Notice 2006-46 conforms to the definition of 5 percent holder in reg. section 1.897-1(c)(2)(iii) and temp. reg. section 1.897-9T. This means that, to identify its 5 percent holders, a foreign corporation would have to undertake the constructive ownership analysis required by section 897(c)(6)(C). See temp. reg. section 1.897-9T(b). ("For purposes of paragraph (c)(2)(iii) of [section] 1.897-1, section 318(a) shall apply (except that section 318(a)(2)(C) and (3)(C) shall each be applied by substituting '5 percent' for '50 percent').") As a practical matter, it would likely be impossible for any publicly traded foreign corporation to identify its 5 percent holders. Query whether that would prevent most foreign corporations from satisfying the requirements of the public foreign-to-foreign merger rule. See *infra* notes 133 to 134 and accompanying text (discussing, in the context of the FIRPTA toll charge, the inability of a publicly traded foreign corporation to identify its 5 percent holders).

into a foreign target corporation; thus, if a foreign person (corporate or otherwise) participates as a shareholder in an (a)(2)(E) reorganization, Notice 2006-46 will not provide that person with nonrecognition treatment under section 354.⁶⁵ To illustrate the potential for surprise, assume that, in Example 4, acquiring foreign corporation Y forms a wholly owned, special purpose foreign merger subsidiary, issues its own stock to the merger subsidiary, and causes the merger subsidiary to merge with and into the target USRPHC. In that transaction, the target USRPHC would survive as a subsidiary of Y and the shareholders of the target USRPHC (X, in this case) would become shareholders of Y.⁶⁶

Under the IRS's view, the transaction illustrated in Example 4 would not qualify as a foreign-to-foreign (a)(2)(E) reorganization, because the transferor foreign corporation — the foreign merger subsidiary — would transfer its assets to the target USRPHC, which is not a foreign corporation. Instead, the IRS would view the transaction as an *inbound* (a)(2)(E) reorganization in which the foreign merger subsidiary merges with and into the target USRPHC.⁶⁷ That result is likely to surprise those taxpayers who are inclined to think of a foreign-to-foreign (a)(2)(E) reorganization as a transaction that, like a foreign-to-foreign B reorganization, involves foreign shareholders of a target USRPHC surrendering their target USRPHC shares in exchange for shares of a foreign acquiring corporation.⁶⁸ Perhaps the oddest aspect of the foreign-to-foreign (a)(2)(E) rules is

that in most cases, the rules will provide FIRPTA nonrecognition relief to the one entity that might never need it — the foreign merger subsidiary, which is usually a newly formed, single-purpose vehicle that owns no assets other than the merger consideration.

g. Summary. It is difficult to reconcile the IRS's practical approach toward low USRPI percentage mergers with the various concerns presented by the other foreign-to-foreign exchange rules, most of which will prove unworkable in many situations. The low USRPI percentage rule is easy to understand and apply in practice, and it protects the interests of the government by ensuring that nonrecognition treatment is provided only in those foreign-to-foreign exchanges in which the transferee foreign corporation remains subject to tax on the gain inherent in any USRPI it receives in the exchange. That same principle should be extended to all foreign-to-foreign exchanges, whatever their form. Thus, any foreign person should be permitted to rely on any nonrecognition provision in connection with the transfer of any USRPI to a foreign corporation, as long as the foreign corporation remains subject to tax on the gain inherent in any USRPI it receives in the exchange. The adoption of that recommendation would protect the interests of the government and at the same time alleviate a multitude of unnecessary obstacles to legitimate transaction planning.

3. Antiabuse Rules

Temp. reg. section 1.897-6T(c) contains antiabuse rules, one of which is particularly relevant to the foreign-to-foreign exchange transactions described above. Temp. reg. section 1.897-6T(c)(4) provides:

A foreign person who directly or indirectly owns a U.S. real property interest may not directly or indirectly rearrange the incidents of ownership of the U.S. real property interest through the use of nonrecognition provisions in order to gain the benefit of a treaty exemption from taxation. Such nonrecognition will not apply to the transferor.

Despite its obvious importance, that provision does not contain any additional detail on the meaning of the phrase “in order to” and thereby subjects many foreign-to-foreign reorganization and liquidation transactions to a level of uncertainty that would not otherwise exist. For example, assume that a Country Y corporation that owns 100 percent of the stock of a USRPHC migrates to the United Kingdom and, in the process, becomes eligible for a lower U.S. withholding tax rate on dividends paid by the USRPHC. Is the Country Y corporation required to recognize the gain inherent in the USRPHC stock simply because it becomes entitled to the lower U.S. withholding tax rate on dividends?

once again find itself one corporation short of a full deck, because X has no parent corporation with which to satisfy that requirement.

⁶⁵Depending on the circumstances, a foreign shareholder of a USRPHC might be able to achieve nonrecognition treatment by testing an (a)(2)(E) reorganization as a foreign-to-foreign B reorganization or section 351 transaction. Cf. Rev. Rul. 67-448, 1967-2 C.B. 144.

⁶⁶Section 368(a)(2)(E); reg. section 1.368-2(j)(2).

⁶⁷If the foreign merger subsidiary were to own a USRPI at the time of its merger into the target USRPHC, that transaction would be subject to the inbound reorganization rules of temp. reg. section 1.897-5T and 1.897-6T. See *infra* Section II.C. To qualify the transaction as a foreign-to-foreign (a)(2)(E) reorganization, the foreign merger subsidiary would have to merge with and into foreign corporation X. See Figure 8 of the Appendix.

⁶⁸Cf. Rev. Rul. 67-448, 1967-2 C.B. 144. Even if X were to somehow receive nonrecognition treatment under section 361 as the “transferor foreign corporation,” the transaction would still not satisfy the foreign-to-foreign (a)(2)(E) rules. For example, the public foreign-to-foreign (a)(2)(E) rule requires that, before the exchange, “stock of the corporation in control of the transferor corporation . . . must be regularly traded.” Notice 2006-46, section 3(b) (final paragraph). In this case, if X were the transferor foreign corporation, it would find that it has no publicly traded controlling shareholder with which to satisfy that requirement. The same result holds true in the nonpublic foreign-to-foreign (a)(2)(E) context. In that context, the parties would be required to demonstrate that “the shareholders of the corporation that controls the transferor corporation before the reorganization own more than fifty percent of the voting stock of the controlling corporation after the reorganization.” Notice 2006-46, section 3(a) (final paragraph). If X were the transferor corporation, it would

(Footnote continued in next column.)

It is impossible to answer that question without additional facts, but the existence of additional facts does not necessarily provide clarity. For example, suppose that in addition to the USRPHC stock, the Country Y corporation owns a number of foreign assets, and the migration from Country Y to the U.K. provides significant foreign tax savings for those foreign assets. That fact would tend to shield the Country Y corporation from gain recognition under the antiabuse rule. A slight change in the facts, however, will inject significant uncertainty into the analysis. Thus, assume that the Country Y corporation could have achieved similar foreign tax savings by migrating to Guernsey; a migration to Guernsey would not have provided any additional U.S. tax benefits; and the Country Y corporation chose to migrate to the United Kingdom to achieve both foreign tax savings and a reduction in the U.S. withholding tax rate on USRPHC dividends. That set of facts would certainly seem to inject additional risk into the FIRPTA analysis, but it is difficult to tell just how much.

To make the analysis even more difficult, there exists some confusion as to the scope of the phrase “benefit of a treaty exemption.” On its face, the gain recognition rule of temp. reg. section 1.897-6T(c)(4) applies any time a foreign person rearranges its ownership of USRPIs to obtain the benefit of any treaty exemption. Nonetheless, at least one commentator has indicated that the regulation was intended to cover only transactions that permit the taxpayer to obtain treaty benefits for the FIRPTA capital gains tax, as opposed to other treaty benefits, such as reduced rates of withholding tax.⁶⁹

The notion that temp. reg. section 1.897-6T(c)(4) is concerned only with FIRPTA capital-gains-related treaty benefits would seem to be at odds with the language of that provision. Nonetheless, when viewed in the context of the section 897(e) nonrecognition requirements, the argument that temp. reg. section 1.897-6T(c)(4) requires gain recognition only in situations in which the transaction was done to secure such a benefit is not without merit.⁷⁰

⁶⁹See Levey, *U.S. Taxation of Foreign-Controlled Businesses*, section 14.03[4][d] at 14-57 (2006). The author states that temp. reg. section 1.897-6T(c)(4):

den[ies] nonrecognition to any transfer of a USRPI to a company that can take advantage of a treaty exemption from tax on the gain. Only two treaties might offer that opportunity after December 31, 1984 — those with Canada and the Netherlands, which offer a partial gain reduction for interests that were held on certain dates or that have a tacked holding period that extends before those dates. For the rest of the world, this provision ceased to have current applicability on January 1, 1985.

Id. (emphasis added).

⁷⁰In TAM 9214003, the IRS addressed the application of section 1125(c) of FIRPTA, which was not codified in the code.

(Footnote continued in next column.)

C. The Section 897(d) Temporary Regulations

Temp. reg. section 1.897-5T provides rules for determining the circumstances under which a foreign corporation will be entitled to nonrecognition treatment on the distribution of USRPHC stock in connection with either a reorganization or section 332 liquidation of a foreign corporation with or into a U.S. corporation (an inbound reorganization or inbound 332 liquidation, respectively), or a section 332 liquidation of one foreign corporation into another foreign corporation (a foreign-to-foreign 332 liquidation).⁷¹ Temp. reg. section 1.897-5T(c)(1) provides the general rule that unless otherwise provided by the exceptions set forth in subparagraphs (2), (3), or (4) of that provision, a foreign corporation shall recognize gain, but not loss, on the distribution of USRPHC stock in connection with an inbound reorganization, inbound 332 liquidation, or foreign-to-foreign 332 liquidation. The following subsections of this article will discuss the exceptions set forth in those subparagraphs, some of which have been modified by one or more notices. All of the rules in temp. reg. section 1.897-5T are subject to the antiabuse rules in temp. reg. section 1.897-6T(c).⁷² The transactions discussed below are illustrated on the structure charts included in the Appendix.

1. ‘Inbound’ Reorganizations and 332 Liquidations of Foreign Corporations That Own USRPHC Interests

a. Inbound A, C, F, and (a)(2)(D) reorganizations. Temp. reg. section 1.897-5T(c)(4), as modified by portions of Notice 89-85 and Notice 2006-46, provides rules applicable to a foreign corporation that distributes USRPHC stock in connection with an inbound A, C, F, or (a)(2)(D) reorganization in which the foreign corporation (i) transfers a USRPHC interest to a U.S. corporation in exchange for stock of the U.S. corporation (or stock of the parent of the U.S. corporation, in the case of a parenthetical C or (a)(2)(D) reorganization),

Section 1125(c) of FIRPTA contained a “treaty override” provision that allowed some foreign persons to enjoy existing treaty exemptions from the U.S. CGT until January 1, 1985. Thus, until January 1, 1985, those persons could sell a USRPI and rely on a treaty exemption to eliminate the tax that would have otherwise been triggered by section 897(a). The TAM contains language suggesting that the antiabuse rule of temp. reg. section 1.897-6T(c)(4) was aimed at a situation in which a foreign person who did not enjoy such a treaty exemption attempted to transfer a USRPI to a foreign entity that did enjoy such an exemption. In that situation, in the absence of an antiabuse rule, the transferor could enjoy nonrecognition treatment on the transfer of the USRPI, while the transferee could rely on section 1125(c) of FIRPTA to sell that USRPI free of U.S. tax.

⁷¹Reg. section 1.897-5T also provides rules for “outbound” transactions in which a USRPHC makes a liquidating distribution to a foreign corporation.

⁷²Temp. reg. section 1.897-5T(a).

and (ii) distributes that stock to its shareholders.⁷³ Those rules permit a foreign corporation to enjoy nonrecognition treatment under section 361(c) for the second leg of the transaction⁷⁴ if the following three requirements, each of which is discussed below, are satisfied:

- at the time of the distribution, the distributee of the USRPHC stock would satisfy the subject-to-tax requirement for that stock;⁷⁵
- the transferor foreign corporation and its shareholders comply with the FIRPTA filing requirements;⁷⁶ and
- the transferor foreign corporation pays a special tax (the FIRPTA toll charge) equal to any taxes that section 897 would have imposed on all persons who disposed of interests in the transferor foreign corporation during the 10-year lookback period described below, determined as if the transferor foreign corporation were a U.S. corporation on the date of each such disposition.⁷⁷

b. Inbound (a)(2)(E) reorganizations. As discussed above in connection with Example 4,⁷⁸ the IRS views an inbound (a)(2)(E) reorganization as one in which a *foreign* merger subsidiary that owns a USRPI merges with and into a U.S. corporation. In that case, as illustrated at Figure 17 of the Appendix, the foreign merger subsidiary would transfer a USRPI to the U.S. corporation in a transaction in which the foreign merger subsidiary goes out of existence, and the parent corporation of the foreign merger subsidiary becomes a shareholder of the U.S. corporation. The foreign merger subsidiary will enjoy nonrecognition treatment in connection with that transaction if the subject-to-tax requirement, the FIRPTA filing requirement, and the FIRPTA toll charge requirement are satisfied. Presum-

⁷³If a transaction is structured as a transfer of a USRPI by a foreign corporation to a domestic corporation in exchange for stock of a domestic corporation, and that stock is *not* distributed to the shareholders of the foreign corporation, then the transaction is not an inbound reorganization and is not governed by the *distribution* provisions of temp. reg. section 1.897-5T. Instead, the transaction represents an exchange of a USRPI for replacement property, which is governed by temp. reg. section 1.897-6T, as supplemented by the subject-to-tax requirement and the FIRPTA filing requirement, both of which are contained in temp. reg. section 1.897-5T. See *supra* Section II.B.

⁷⁴As discussed in note 73 *supra*, the foreign corporation must satisfy the requirements of temp. reg. section 1.897-6T, including the hot-to-hot requirement, to secure nonrecognition treatment under section 361(a) for the first leg of the transaction.

⁷⁵Temp. reg. section 1.897-5T(c)(4)(ii)(A) as modified by Notice 89-85, as modified by Notice 2006-46, section 1.

⁷⁶Temp. reg. section 1.897-5T(c)(4)(ii)(C) as modified by Notice 89-85, as modified by Notice 2006-46, section 1.

⁷⁷Notice 89-85, as modified by Notice 2006-46, section 2.

⁷⁸See *supra* notes 65 to 68 and accompanying text.

ably, the distribution rules of temp. reg. section 1.897-5T would not be relevant in a “typical” (a)(2)(E) reorganization in which a *domestic* merger subsidiary of a domestic acquiring corporation is used to acquire a target USRPHC the shares of which are held by foreign persons.⁷⁹

c. Inbound D reorganizations. Temp. reg. section 1.897-5T provides nonrecognition rules for distributions of USRPHC stock that occur in connection with inbound D reorganizations, but those rules differ depending on whether the reorganization is acquisitive or divisive. In an acquisitive D reorganization, a foreign corporation holding a USRPI will transfer substantially all of its assets to a USRPHC in exchange for USRPHC stock in a transaction described in sections 368(a)(1)(D) and 354(b)(1) and will distribute that USRPHC stock to its shareholders in full liquidation.⁸⁰ Temp. reg. section 1.897-5T(c)(4), as modified by Notice 89-85 and Notice 2006-46, permits the foreign corporation to enjoy nonrecognition treatment under section 361(c) for the second leg of the transaction if the subject-to-tax requirement, the FIRPTA filing requirement, and the FIRPTA toll charge requirement are satisfied.

In a divisive D reorganization, a foreign corporation will transfer a USRPI to a USRPHC in exchange for stock of the USRPHC⁸¹ and then distribute that USRPHC stock to its shareholders in a transaction described in sections 368(a)(1)(D) and 355. A foreign corporation may also distribute the stock of a USRPHC

⁷⁹A “typical” (a)(2)(E) reorganization in which a U.S. acquirer uses a domestic merger subsidiary to acquire either the stock of a target USRPHC that is owned by a foreign corporation or the stock of a target foreign corporation that owns a USRPHC would produce one of two results: (i) the foreign corporation would exchange its target USRPHC stock for stock of the U.S. acquirer, and the target USRPHC would become a subsidiary of the U.S. acquirer; or (ii) the shareholders of the target foreign corporation would exchange their target foreign corporation stock for stock of the U.S. acquirer, and the target foreign corporation itself would become a subsidiary of the U.S. acquirer. In a transaction described in (i), the foreign corporation would not distribute any U.S. acquirer stock to its shareholders. Thus, the transaction should be treated as an exchange of target USRPHC stock by the transferor foreign corporation in a transaction that is governed exclusively by the USRPI exchange rules of temp. reg. section 1.897-6T(a). A transaction described in (ii) is not subject to U.S. taxing jurisdiction. Despite the lack of clarity on this point, the remainder of this article will assume that the definition of an inbound (a)(2)(E) reorganization includes only those (a)(2)(E) reorganizations in which a *foreign* merger subsidiary that owns a USRPI merges with and into a U.S. corporation.

⁸⁰Temp. reg. section 1.897-5T(c)(4).

⁸¹For this leg of the transaction to qualify for nonrecognition treatment under temp. reg. section 1.897-6T, the transferee U.S. corporation in the inbound reorganization must be a USRPHC. See *supra* Section II.B.1.

in a stand-alone section 355 transaction. In either case, temp. reg. section 1.897-5T(c)(1) and (c)(3)(i) requires the foreign corporation to recognize gain in connection with the section 355 distribution.⁸² Temp. reg. section 1.897-5T(c)(3)(i) does, however, limit the amount of gain recognized by the distributing foreign corporation “to the amount by which the aggregate basis of the distributed stock in the hands of the distributees exceeds the aggregate adjusted basis of the distributed stock in the hands of the distributing corporation.”⁸³ To take advantage of the inside/outside basis disparity limitation, the tax on which is sometimes referred to as the “inside/outside basis disparity tax,” the distributing foreign corporation must satisfy the FIRPTA filing requirement and the distributee shareholders must satisfy the subject-to-tax requirement, both of which are described below.⁸⁴

d. Inbound 332 liquidations. For an inbound 332 liquidation, the foreign corporation may enjoy nonrecognition treatment under section 337(a) if the subject-to-tax requirement, the FIRPTA filing requirement, and the FIRPTA toll charge requirement are satisfied and if, immediately after the transaction, the domestic corporation takes a tax basis in the distributed USRPHC interest that is not greater than the adjusted basis of that interest in the hands of the foreign corporation, increased by the amount of gain (if any) recognized by the foreign corporation in connection with the distribution.⁸⁵

Temp. reg. section 1.897-5T(b)(3)(v) states that if a U.S. corporation acquires the stock of a foreign corporation that owns a USRPI in a B reorganization or section 351 transaction and then causes that foreign corporation to engage in an inbound 332 liquidation within five years, the initial acquisition transaction and the liquidation transaction, generally speaking, will be integrated and treated as an inbound C or D reorganization. In that deemed reorganization transaction, the foreign corporation will be treated as having transferred its assets to the U.S. corporation in exchange for stock of the U.S. corporation and as having distributed that stock to its shareholders.⁸⁶ In that case, as discussed above, the foreign corporation would have to satisfy the rules of temp. reg. section 1.897-6T in connection with the first leg of the deemed transaction and the rules of temp. reg. section 1.897-5T in connection with the second leg of the deemed transaction.⁸⁷ Temp. reg. section

1.897-5T(b)(3)(v) states that the recharacterization rule will not apply “if the transfer of the foreign corporation stock and the liquidation . . . are separate and independent transactions justified by substantial and verifiable business purposes.”⁸⁸ It is not entirely clear whether the recharacterization rule of temp. reg. section 1.897-5T(b)(3)(v) survived the issuance of Notice 89-85.⁸⁹

2. Foreign-to-Foreign 332 Liquidations

Temp. reg. section 1.897-5T(c)(2) provides an exception to the general rule that a foreign corporation must recognize gain in connection with a foreign-to-foreign 332 liquidation.⁹⁰ That provision permits the transferor foreign corporation to enjoy nonrecognition treatment on the distribution of a USRPI that occurs in connection with such a liquidation if:

- the transferee foreign corporation satisfies the subject-to-tax requirement⁹¹ for the distributed USRPI;
- the basis of the USRPI in the hands of the transferee foreign corporation is not greater than the basis of the USRPI in the hands of the transferor foreign corporation, increased by the amount of gain (if any) recognized by the transferor foreign corporation in connection with the distribution; and
- the transferee foreign corporation satisfies the FIRPTA filing requirements.⁹²

Some might argue that this interpretation of the regulation is not entirely free from doubt, because the extent to which temp. reg. section 1.897-5T(c)(2) has been modified by Notice 89-85 and Notice 2006-46 is

⁸⁸*Id.*

⁸⁹As discussed in note 93 *infra*, Notice 89-85 states that the section 332 liquidation rules of temp. reg. section 1.897-5T(c)(2) will be replaced by a new inbound liquidation rule. Notice 89-85 then states that the new rule shall apply to liquidations occurring after July 31, 1989, but that a liquidating foreign corporation “may choose instead to apply the rules of the current temporary regulations, including sections 1.897-5T(b)(3)(v) and (c)(2)(ii)(B)” if certain requirements are satisfied. That language could be interpreted to mean that the recharacterization rule of temp. reg. section 1.897-5T(b)(3)(v) applies only to liquidating foreign corporations that affirmatively choose to apply the current rules of temp. reg. section 1.897-5T in lieu of the new rule set forth in Notice 89-85. That interpretation makes some sense in light of the fact that the FIRPTA toll charge requirement, incorporated into the inbound 332 liquidation context by Notice 89-85, would seem to obviate the recharacterization rule of temp. reg. section 1.897-5T(b)(3)(v). Nonetheless, Notice 89-85 provides no clear guidance on the continuing application of the recharacterization rule of temp. reg. section 1.897-5T(b)(3)(v).

⁹⁰See the Appendix for structure charts illustrating this transaction.

⁹¹See *infra* notes 97 to 104 and accompanying text.

⁹²See *infra* notes 105 to 115 and accompanying text.

⁸²Temp. reg. section 1.897-5T(c)(1).

⁸³Temp. reg. section 1.897-5T(c)(3)(i).

⁸⁴See temp. reg. section 1.897-5T(c)(3)(ii) (Example, paragraph (iii)).

⁸⁵Temp. reg. section 1.897-5T(c)(2)(i) and (ii), as modified by Notice 89-85, as modified by Notice 2006-46, section 2.

⁸⁶Temp. reg. section 1.897-5T(b)(3)(v).

⁸⁷*Id.*

unclear.⁹³ On balance, however, that reading of the regulation and the notices that have modified it pro-

⁹³Temp. reg. section 1.897-5T(c)(2)(i) and (ii) provide rules concerning both inbound 332 liquidations and foreign-to-foreign 332 liquidations. Notice 89-85 and Notice 2006-46 purport to replace those provisions with a new rule that applies to inbound 332 liquidations. Some might argue that the language in those two notices cast doubt as to the continuing applicability of temp. reg. section 1.897-5T(c)(2)(i) and (ii) to foreign-to-foreign 332 liquidations.

For example, Notice 89-85 states that temp. reg. section 1.897-5T(c)(2)(i) and (ii) “will be revised to provide that gain shall be recognized under section 1.897-5T(c)(1) upon the distribution of a USRPI by a foreign corporation to a domestic corporation . . . in a liquidation under section 332(a). Thus, gain will be recognized by the foreign corporation even if the requirements of current section 1.897-5T(c)(2)(i) are met.” Notice 89-85 goes on to provide an exception that applies *only to inbound liquidations* of a foreign corporation into a domestic corporation and states that “the revisions of section 1.897-5T(c)(2) of the temporary regulations shall apply to *all* distributions of USRPIs by foreign corporations *in liquidations under section 332(a)* of the Code occurring after July 31, 1989.” *Id.* (emphasis added). The quoted language from Notice 89-85 can be interpreted in two ways. In the author’s view, the better interpretation of the language is that the modifications made by Notice 89-85 apply only to distributions made by foreign corporations to domestic corporations, meaning that the portions of temp. reg. section 1.897-5T(c)(2) applicable to foreign-to-foreign 332 liquidations remain in effect as written. The more adverse reading would be that because the new gain recognition rule of Notice 89-85 applies to *all* section 332 distributions of USRPIs, and because the only exception to that rule applies to *inbound* 332 liquidations, the language in temp. reg. section 1.897-5T(c)(2)(i) and (ii) relating to foreign-to-foreign 332 liquidations no longer exists.

Notice 2006-46 does not provide clear guidance on this topic. In the “Background” section, Notice 2006-46 states that “Notice 89-85 announced rules that would *revise* the application of” temp. reg. section 1.897-5T(c)(2), providing some support for what the author believes is the better view of the law (emphasis added). In another place, however, Notice 2006-46 is a little more vague in its description of the effect of Notice 89-85 on the application of temp. reg. section 1.897-5T(c)(2): “In Notice 89-85, the IRS and Treasury announced that the exceptions set forth in temp. reg. section 1.897-5T(c)(2)(i) and (ii) would *be replaced by a new exception*. The new exception . . . provides that recognition of gain shall not be required on the liquidating distribution of a USRPI by a foreign corporation to a domestic corporation.” *Id.* (emphasis added). By implying that the language currently contained in temp. reg. section 1.897-5T(c)(2)(i) and (ii) will be replaced in its entirety by a new exception that applies *only to inbound 332 liquidations* of foreign corporations into domestic corporations, Notice 2006-46 could be interpreted as supporting the notion that Notice 89-85 eliminated the language in temp. reg. section 1.897-5T(c)(2)(i) and (ii) relating to foreign-to-foreign 332 liquidations.

In the author’s view, notices 89-85 and 2006-46 should be read as modifying only those portions of temp. reg. section 1.897-5T(c)(2)(i) and (ii) that deal with inbound 332 liquidations and as leaving untouched the language relating to foreign-to-foreign 332 liquidations. Although both notices are unclear on this point, there would not seem to be any policy justification for

vides the better view of the law, and would appear to be consistent with the IRS’s post-Notice 89-85 ruling policy on foreign-to-foreign 332 liquidations.⁹⁴

Even if notices 89-85 and 2006-46 did adversely affect the foreign-to-foreign 332 liquidation exception set forth in temp. reg. section 1.897-5T(c)(2), a transferor foreign corporation should still be entitled to nonrecognition treatment for such a transaction under one of two theories. First, even in the absence of regulations, the transferor foreign corporation should be entitled to rely on the statutory exception in section 897(d)(2)(A), which has not been altered by the notices. Under the statutory exception, a transferor foreign corporation would not recognize gain on the distribution of a USRPI in a foreign-to-foreign 332 liquidation as long as the transferee foreign corporation would be subject to tax on a disposition of that USRPI and the transferee does not take a tax basis in that USRPI that is higher than the basis of the USRPI in the hands of the transferor, increased by the amount of gain (if any) recognized by the transferor in connection with the distribution.

Second, the parties should be able to accomplish the same result as a foreign-to-foreign 332 liquidation by using an upstream merger of the transferor foreign corporation into the transferee foreign corporation.⁹⁵ If an

taxing a transferor foreign corporation on a section 332 distribution of a USRPHC interest to a transferee foreign corporation, provided that the transferee foreign corporation takes a carryover basis in that interest and will be subject to a FIRPTA tax on a future taxable disposition of that interest.

⁹⁴See LTR 9716016, *Doc 97-10916*, or *97 TNT 76-31* (ruling that a distribution of a USRPHC interest in a foreign-to-foreign 332 liquidation qualified for nonrecognition treatment under reg. section 1.897-5T(c)(2)(i) and (ii); the ruling does not mention Notice 89-85); LTR 9103028 (same).

⁹⁵See, e.g., Rev. Rul. 69-617, 1969-2 C.B. 57. In that ruling, the parent corporation owned more than 80 percent of the stock of its publicly traded subsidiary corporation. To transfer the assets of the subsidiary into a wholly owned corporation, the parent caused the subsidiary to merge into the parent in a transaction in which the shareholders of the subsidiary became shareholders of the parent. Following that merger, the parent contributed the assets of the merged subsidiary to a newly formed, wholly owned subsidiary. The IRS acknowledged that the upstream merger, although falling within the literal language of section 332, did not effect a “complete liquidation” of the subsidiary, because the merged subsidiary’s assets were contributed to the new subsidiary. Although the transaction failed to qualify as a section 332 liquidation, the Service did accord nonrecognition treatment by classifying the transaction as an upstream A reorganization of the merged subsidiary into the parent, followed by a contribution of the merged subsidiary’s assets into the new subsidiary as described in section 368(a)(2)(C). See also Rev. Rul. 58-93, 1958-1 C.B. 188 (subsidiary corporation merged into its 79 percent corporate shareholder in a transaction in which the 80 percent ownership requirement of section 332 was not satisfied; the transaction constituted as an A reorganization); LTR 200727001, *Doc 2007-15935*, or *2007 TNT 131-18* (upstream merger of subsidiary

(Footnote continued in next column.)

(Footnote continued on next page.)

upstream merger is unavailable, the administrative repeal of the *Bausch & Lomb* doctrine should enable the parties to engage in an upstream C reorganization in which the transferor foreign corporation transfers substantially all of its assets to its parent corporation in exchange for stock of the parent corporation, and distributes that parent stock in full liquidation.⁹⁶ In either case, the transferor foreign corporation would be entitled to nonrecognition treatment on the transfer of a USRPI to the transferee foreign corporation under the nonpublic foreign-to-foreign merger rule, as long as the transfer does not occur before some other transaction that results in a change of control in the transferee foreign corporation (for example, a greater than 50 percent shift in voting power of the transferee foreign corporation).⁹⁷

3. The Subject-to-Tax Requirement

Temp. reg. section 1.897-5T(d)(1)(i) provides the general rule used to determine whether the transferee of property in a transaction to which temp. reg. section 1.897-6T applies, or the distributee of property in a transaction to which temp. reg. section 1.897-5T applies, satisfies the subject-to-tax requirement:

Pursuant to the otherwise applicable rules of this section and [section] 1.897-6T, nonrecognition of

into parent treated an A reorganization); LTR 200250024, *Doc 2002-27234*, or *2002 TNT 241-39* (same); LTR 8851076 (same); LTR 8741010 (same).

⁹⁶In *Bausch & Lomb Optical Co. v. Commissioner*, 267 F.2d 75 (2d Cir. 1959), the court held that a transaction could not qualify as a C reorganization in a situation in which the acquiring corporation owned stock in the target corporation before the transaction because the acquiring corporation's prior ownership of target stock would prevent the transaction from satisfying the "solely for voting stock" requirement of section 368(a)(1)(C). The IRS repealed the *Bausch & Lomb* doctrine with the promulgation of current reg. section 1.368-2(d)(4). In the preamble to prop. reg. section 1.368-2(d)(4), the Service stated that "the 'upstream' reorganization under section 368(a)(1)(C) (i.e., the *Bausch & Lomb* transaction) should not be treated differently than the 'upstream' 'A' reorganization solely because the acquiring corporation already owns stock in the target corporation." 64 *Fed. Reg.* 31770. The IRS has also indicated in the proposed "no net value" regulations that an upstream transfer of assets from a wholly owned subsidiary to its parent corporation may qualify as a C reorganization in situations where section 332 treatment is unavailable. Prop. reg. section 1.332-2(e) (Example 2); see generally Matthias, "Tax-Free Reorganizations Among Related Corporations," 722 *PLI/Tax* 297 (2006); Wilcox, "The Elusive D Reorganization and Other Related Party Transactions," 722 *PLI/Tax* 655 (2006).

⁹⁷See Notice 2006-46, section 3(a) (foreign-to-foreign A reorganizations that do not qualify for the first two exceptions discussed in Section II.B.2 above "will be limited to restructurings where the 50 percent control requirement is satisfied"); temp. reg. section 1.897-6T(b)(1)(ii) (for a foreign-to-foreign C reorganization to qualify for nonrecognition treatment, the "transferor corporation's shareholders [must] own fifty percent of the voting stock of the transferee corporation . . . immediately after the reorganization); see also *supra* notes 43 to 49 and accompanying text (describing the rules applicable to foreign-to-foreign merger transactions).

gain or loss may apply with respect to certain distributions or exchanges of U.S. real property interests if *any gain from a subsequent disposition of the interests that are distributed or received by the transferor in the exchange would be included in the gross income of the distributee or transferor and be subject to U.S. taxation*. Gain is considered subject to U.S. taxation if the gain is included on the income tax return of a U.S. tax paying entity even if there is no U.S. tax liability (for example, because of net operating losses or an investment tax credit). *Gain is not considered subject to U.S. taxation if the gain is derived by a tax exempt entity. A real estate investment trust is considered to be a pass-through entity for purposes of the rule of taxability of this paragraph (d)(1)(i). Thus, for example, a tax exempt entity holding an interest in a real estate investment trust is not subject to tax.*⁹⁸

A foreign person generally will not satisfy the subject-to-tax requirement for a USRPI if on a subsequent disposition of that USRPI the person would be entitled "pursuant to the provisions of a U.S. income tax treaty to an exemption from U.S. taxation upon a disposition of the interest."⁹⁹ If a treaty exemption applies only to a portion of the gain that would be realized on such a disposition, the foreign person would be treated as having satisfied the subject-to-tax requirement for the portion of the interest that would not be entitled to the treaty exemption.¹⁰⁰ In either case, a foreign person may satisfy the subject-to-tax requirement for its entire interest in a USRPI if the person agrees to waive its right to any applicable treaty benefits.¹⁰¹

The language in the first three sentences of temp. reg. section 1.897-5T(d)(1)(i) may seem simple and straightforward at first blush, but the provision can often prove extremely unclear and difficult to apply in practice. In many cases, a literal application of the language produces unexpected results.

Example 5. Foreign corporation X, which owns 100 percent of the stock of USRPHC 1, engages in an inbound C reorganization in which X transfers all of its assets and liabilities to USRPHC 2 (a C corporation) solely in exchange for widely

⁹⁸*Id.* (emphasis added).

⁹⁹Temp. reg. section 1.897-5T(d)(1)(ii)(A).

¹⁰⁰Temp. reg. section 1.897-5T(d)(1)(ii)(B). The regulation states that the portion of a USRPI that is treated as subject to tax within the meaning of temp. reg. section 1.897-5T(d)(1)(i), and therefore eligible for nonrecognition treatment, is determined by multiplying the FMV of the USRPI by a fraction, the numerator of which is the amount of U.S. tax that would be due on an immediate disposition of the USRPI (taking the treaty benefits into account), and the denominator of which is the amount of U.S. tax that would be due on such a disposition but for the provisions of the treaty.

¹⁰¹Temp. reg. section 1.897-5T(d)(1)(ii)(C).

held, publicly traded stock of USRPHC 2 and then distributes that publicly traded stock in complete liquidation.

On these facts, it seems clear that if all of the shareholders of X are U.S. individuals or corporations, the subject-to-tax requirement will be satisfied. It also seems clear that if all of the shareholders of X are foreign persons who are not 5 percent holders of USRPHC 2, the subject-to-tax requirement arguably would *not* be satisfied because, under the publicly traded exception, those persons would not be required to report gain, or otherwise pay tax, on the sale of the USRPHC 2 stock they will receive in the distribution.

The clarity seems to stop with those two fact patterns. For example, how is X treated if half of its shareholders are U.S. individuals who are subject to tax on a subsequent disposition of the stock of USRPHC 2 and the other half of its shareholders are foreign non-5-percent holders who are entitled to rely on the publicly traded exception? Temp. reg. section 1.897-5T(d)(1)(i), even as modified by notices 89-85 and 2006-46, is worded in an all-or-nothing fashion — for X to enjoy nonrecognition treatment on the distribution of the stock of USRPHC 2, “the distributee” must satisfy the subject-to-tax requirement. The rule is silent on its application to foreign corporations with multiple shareholders and provides no guidance whatsoever on situations in which some shareholders satisfy the subject-to-tax requirement and some do not.

In this situation, it would seem appropriate to apply the regulation in a manner that requires X to recognize gain on the distribution of the stock of USRPHC 2 only to the extent that X’s shareholders would not be subject to tax on a subsequent disposition of that stock, but the regulation does not provide a clear path to that result. The lack of guidance on this issue might not be as troubling were it not for the fact that, as discussed above, temp. reg. section 1.897-5T(d)(1)(ii)(B) provides a specific set of rules concerning the application of the subject-to-tax requirement in situations in which, due to a treaty exemption, a foreign distributee or transferee of a USRPI is subject to tax on only a *portion* of the gain that would be recognized on a sale of USRPI.¹⁰² Given that the treaty exemption rule is part of the subject-to-tax requirement itself, one wonders whether the IRS deliberately drafted the general subject to tax rule of temp. reg. section 1.897-5T(d)(1)(i) in an all-or-nothing fashion.

The subject-to-tax requirement is even more unclear in cases in which a shareholder of X is a passthrough entity. A careful reading of the regulation brings out two points. First, passthrough entities do not seem to be subject to tax within the meaning of the regulation, and a foreign corporation apparently must look

through its passthrough shareholders to determine whether the subject-to-tax requirement has been satisfied. Second, the regulation provides no guidance as to what types of entities are passthrough entities (other than the passing reference to REITs), how passthrough entities are supposed to be “looked through,” particularly when members possess different economic rights, and how the other FIRPTA rules interface with the look-through rule in the subject-to-tax requirement.

Building on the facts of Example 5, assume that foreign corporation X is wholly owned by foreign partnership Y; immediately after the C reorganization, foreign partnership Y owned more than 5 percent of USRPHC 2; and units in foreign partnership Y are regularly traded on an established securities market and widely held by foreign individuals, with no single individual owning more than 5 percent of Y. In this case, if Y is viewed as a 5 percent holder of USRPHC 2, the subject-to-tax requirement would be satisfied.¹⁰³ However, Y is a passthrough entity and the regulations seemingly require X to look through Y to determine whether the subject-to-tax requirement has been satisfied at the partner level. If that look-through analysis requires X to attribute the stock of USRPHC 2 to the foreign owners of Y, none of those owners would satisfy the subject-to-tax requirement because each owner arguably would be a non-5-percent holder of USRPHC 2 and would be entitled to rely on the publicly traded exception. That result may seem entirely appropriate to the IRS, at least in a situation in which the Y units are regularly traded on an established securities market and the holders of those units are entitled to rely on the publicly traded exception on a sale of those units.¹⁰⁴

These types of issues are not limited to situations in which a foreign corporation with a passthrough shareholder desires to engage in an inbound transaction. If read literally, the subject-to-tax requirement can prevent some types of passthrough entities from engaging in basic nonrecognition transactions that do not involve the distribution of a USRPI. For example, assume that foreign partnership Y owns 100 percent of the stock of USRPHC 1, a Maryland corporation that desires to migrate to Delaware in an F reorganization to accommodate an initial public offering (IPO). As discussed

¹⁰³Temp. reg. section 1.897-1(c)(2)(iv) (although, for purposes of section 897(a), interests in a publicly traded partnership are treated similarly to interests in a publicly traded USRPHC, a foreign non-5-percent holder of a publicly traded partnership will recognize gain under section 897(a) if the partnership sells a USRPI); see also Blanchard 5% Holder Article, *supra* note 15, at 46 (indicating that a foreign partnership can be treated as a 5 percent holder for purposes of the publicly traded exception).

¹⁰⁴Reg. section 1.897-1(d)(2)(iv) (interests in a regularly traded class of units in a publicly traded partnership shall be eligible for the publicly traded exception); see *supra* notes 14 to 20 and accompanying text (discussing the publicly traded exception).

¹⁰²See *supra* note 100 and accompanying text.

above, to achieve nonrecognition treatment under temp. reg. section 1.897-6T for the exchange of USRPHC 1 shares that occurs in connection with that F reorganization, Y must satisfy the hot-to-hot requirement, the subject-to-tax requirement and the FIRPTA filing requirement. To satisfy the subject-to-tax requirement, Y must apparently look to its partners. If Y is a publicly traded partnership whose members include foreign persons who are non-5-percent holders, Y is presented with the same conundrum discussed above regarding Example 5. In that context, it might be difficult for Y to conclude that it satisfies the requirements for nonrecognition treatment.

Unfortunately, the subject-to-tax requirement, as articulated in temp. reg. section 1.897-5T(d)(1), is fundamentally unworkable in all but the most basic situations. At the very least, the requirement should be modified so that foreign persons who qualify for a U.S. tax exemption, such as the publicly traded exception or the domestically controlled QIE exception, are treated as satisfying the subject-to-tax requirement. Congress has chosen to relinquish U.S. taxing jurisdiction over foreign persons who qualify for those exceptions, and it is difficult to see why, in the context of an inbound reorganization or a basic nonrecognition exchange, the IRS would want to impose a tax on those persons or an entity in which they own interests.

Also, the look-through rule in the subject-to-tax requirement should be discarded. First, the rule is completely unworkable in situations involving REITs and partnerships in which the owners have differing economic rights, tiered structures that consist of REITs, partnerships and trusts, and publicly traded REITs, partnerships, and trusts. Second, in a situation in which a passthrough entity exchanges a USRPI for a replacement USRPI in a transaction that is governed exclusively by temp. reg. section 1.897-6T, the direct and indirect holders of the passthrough entity will always be subject to tax on a sale of the replacement USRPI to the same extent as the relinquished USRPI. In that context, it does not seem either necessary or appropriate to apply the subject-to-tax requirement on a look-through basis. That same basic logic applies to a situation in which a foreign corporation that is owned by a passthrough entity migrates into the United States or merges into a U.S. corporation.

4. The FIRPTA Filing Requirement

As discussed above, the filing requirement in temp. reg. section 1.897-5T(d)(1)(iii) must be satisfied for the transferor or distributor of a USRPI to obtain nonrecognition treatment under temp. reg. section 1.897-6T or temp. reg. section 1.897-5T in connection with an exchange or distribution of that USRPI. In a transaction to which temp. reg. section 1.897-6T(a) applies, the

filing requirement must be satisfied by the transferor.¹⁰⁵ In a transaction to which temp. reg. section 1.897-5T(c) applies, the filing requirement must be satisfied by the distributor and, to some extent, the shareholders of the distributor.¹⁰⁶ Temp. reg. section 1.897-5T(d)(1)(iii) provides in pertinent part:

If a U.S. real property interest is distributed or transferred after December 31, 1987, the transferor or distributor (that is a nonresident alien individual or a foreign corporation) shall file an income tax return for the taxable year of the distribution or transfer. The person filing the return must attach thereto a document setting forth the following:

* * *

(H) A declaration, signed by the distributee or transferor or its authorized legal representative, that the distributee or transferor shall treat any subsequent sale, exchange, or other disposition of the U.S. real property interest as a disposition that is subject to U.S. taxation, notwithstanding the provisions of any U.S. income tax treaty or intervening change in circumstances.

The so-called declaration requirement in paragraph (H) has troubled practitioners since the issuance of the temporary regulations.¹⁰⁷ Read literally, the requirement may, in some instances, force a foreign person to disregard the law and pay a tax that is not due.¹⁰⁸

Example 6. Foreign corporation X owns a 6 percent interest in publicly traded USRPHC 1 and

¹⁰⁵ See temp. reg. section 1.897-6T(a), 1.897-6T(b)(1), and 1.897-5T(d)(1)(iii).

¹⁰⁶ Compare temp. reg. section 1.897-5T(d)(1)(iii) (lead-in language) (“If a U.S. real property interest is distributed or transferred after December 31, 1987, the . . . distributor . . . shall file an income tax return”) with temp. reg. section 1.897-5T(d)(1)(iii)(H) (the tax return required by temp. reg. section 1.897-5T(d)(1)(iii) must include “a declaration, signed by the distributee . . . that the distributee . . . shall treat any subsequent sale, exchange, or other disposition of the U.S. real property interest as a disposition that is subject to U.S. taxation”) (emphasis added).

¹⁰⁷ See, e.g., “Klein Asserts Nonrecognition Exception Is Overreaching,” *Doc 88-7017*, or *88 TNT 170-18* (Aug. 18, 1988) (letter from Susan F. Klein to IRS Office of Associate Chief Counsel (International) criticizing the FIRPTA filing requirements); “Hood Says to Change Regulations as Applied to Domestications of Foreign Corporations,” *Doc 88-5061*, or *88 TNT 116-17* (June 2, 1988) [hereinafter Hood Letter] (letter from Bruce E. Hood to the IRS commissioner criticizing the FIRPTA filing requirements).

¹⁰⁸ See Hood Letter, *supra* note 107 (“Literally read [the declaration requirement] would require foreign shareholders of a U.S. corporation that had purged its status as a U.S. real property holding corporation under [section 897(c)(1)(B)] by disposing of all of its U.S. real property interests in recognition transactions

(Footnote continued on next page.)

exchanges that interest for a 10 percent interest in publicly traded USRPHC 2 (a C corporation) in a B reorganization in which the declaration requirement was satisfied. Over time, USRPHC 2 issues more stock to the public to fund acquisitions, in the process reducing X's ownership percentage in USRPHC 2 below 5 percent. Following the end of the five-year cooling-off period applicable to its USRPHC 2 interest, X sells its entire interest in USRPHC 2.

If the declaration requirement were interpreted literally, X would be required to pay tax on the sale of its interest in USRPHC 2 even though, at the time of the sale, that interest is not a USRPI under the publicly traded exception.¹⁰⁹ In this sense, the declaration requirement purports to function like a permanent gain recognition agreement.

The potential implications of the declaration requirement become even more severe if the "subsequent transfer" described in the declaration is another non-recognition exchange.

Example 7. On date 1, foreign person X transfers the stock of USRPHC 1 to USRPHC 2, a privately held Maryland REIT, in exchange for stock of USRPHC 2 in a transaction in which the declaration requirement was satisfied. Two years later, to accommodate an IPO, USRPHC 2 decides to change its state of incorporation from Maryland to Delaware in an F reorganization.

Will X be entitled to nonrecognition treatment for the migration of USRPHC 2 from Maryland to Delaware? A literal reading of the declaration requirement would suggest a negative answer to that question, but a negative answer proves too much.

Example 8. Foreign corporation X owns 100 percent of the stock of USRPHC 1. Foreign corporation X migrates to the United States in an inbound F reorganization in connection with which X transfers its assets to New X, a Delaware corporation that is a USRPHC, in exchange for stock of New X, and distributes the New X stock to its shareholders in complete liquidation. X satisfies the requirements of temp. reg. section 1.897-6T (including the FIRPTA filing requirement and the declaration requirement) for the first leg of the transaction, and the requirements of temp. reg. section 1.897-5T for the second leg of the transaction.

If the declaration requirement were applied literally to these facts, X would be required to recognize gain

to recognize gain on a liquidation or other disposition of the corporation's stock simply because they had acquired that stock in a [prior] domestication transaction."').

¹⁰⁹See *supra* notes 14 to 20 and accompanying text (discussing the publicly traded exception).

on the second leg of the transaction simply because it satisfied the declaration requirement for the first leg of the transaction. It is difficult to envision a regulation producing such a result.¹¹⁰

The declaration requirement, like the subject-to-tax requirement, also presents difficulties in situations where a transferor foreign corporation has more than one foreign shareholder. For example, suppose that in Example 8, foreign corporation X has two shareholders, A and B, and A agrees to satisfy the FIRPTA filing requirement, but B refuses to do so. Can X satisfy the FIRPTA filing requirement for the transaction? Once again, temp. reg. section 1.897-5T(d)(1)(iii) refers only to "the distributee" and provides no guidance on X's ability to obtain non-recognition treatment for a distribution when one of its foreign shareholders agrees to satisfy the declaration requirement and one does not.

Another significant issue associated with the declaration requirement concerns the manner in which it applies to a foreign-to-foreign exchange transaction in which a transferor foreign corporation transfers a USRPI to a transferee foreign corporation in exchange for stock of the transferee foreign corporation. Read literally, temp. reg. section 1.897-5T(d)(1)(iii)(H) applies only to a transferor or distributee who *receives* a USRPI in a nonrecognition transaction. One could certainly make the case that the declaration requirement does not apply to either the transferor foreign corporation (because it would not receive a USRPI in the context of a foreign-to-foreign exchange) or the transferee foreign corporation (because it is neither a transferor nor a distributee of a USRPI). However, that argument might be difficult to sustain in light of the fact that temp. reg. section 1.897-6T(b), as modified by Notice 2006-46, clearly contemplates the application of the FIRPTA filing requirement, including the declaration requirement, to foreign-to-foreign exchange transactions.

In response to these and many other concerns about the declaration requirement, the IRS issued Notice 89-57,¹¹¹ in which it suspended the filing requirement of temp. reg. section 1.897-5T(d)(1)(iii) for transfers that satisfy three requirements. First, the transfer must otherwise qualify *in its entirety* for nonrecognition under the temporary regulations. Second, the transferor or distributor must not have any other income that is ECI during the tax year that includes the transfer. Finally,

¹¹⁰See NYSBA Report, *supra* note 36, at 32 ("The list of items to be set forth in the document attached to a return is presented conjunctively. This has apparently led some commentators on the Regulations to conclude that the waiver of treaty protection and irrevocable agreement to subsequent U.S. taxation, denoted as item (H) on that list, is a necessary requirement for any non-recognition treatment. We understand from a discussion with a draftsman of the Regulations that this was certainly not intended.").

¹¹¹1989-1 C.B. 698.

the foreign transferor must either obtain a withholding certificate under reg. section 1.1445-3(a) or submit a notice of nonrecognition to the IRS under reg. section 1.1445-1(d)(2).

Although Notice 89-57 represented an admirable and much-welcome attempt to mitigate the counterintuitive results presented by the declaration requirement, the notice itself created a new set of counterintuitive results. First, to rely on Notice 89-57, a foreign transferor or distributor may not earn a dollar of ECI from any source during the tax year in which the relevant transfer or distribution occurs. It is difficult to understand the concern behind that requirement. Because the requirement may result in similarly situated taxpayers experiencing dramatically different tax results from the same basic transaction, the requirement should be eliminated as unnecessary.¹¹²

The second unexpected result produced by Notice 89-57 is that a foreign person cannot rely on the notice for a transaction that involves boot. It is difficult to understand why, in determining how to structure a nonrecognition exchange of one USRPI for another, a foreign person must choose between forgoing the receipt of cash or other property that may be entirely appropriate and commercially reasonable in the context of the deal or agreeing to satisfy the declaration requirement and entering into what amounts to a permanent gain recognition agreement.¹¹³ The no-boot requirement should also be eliminated as unnecessary.

¹¹²For example, assume that foreign person X and foreign person Y each own 50 percent of the stock of USRPHC 1; each of X and Y plan to transfer the stock of USRPHC 1 to USRPHC 2 in a B reorganization that will satisfy the hot-to-hot requirement and the subject-to-tax requirement; X also owns 100 percent of the stock of a C corporation that operates a bottling plant in New York City, and X does not report any ECI during the tax year in which the B reorganization occurs; and Y owns 100 percent of the interests in a disregarded LLC that operates a different bottling plant in New York City, causing Y to report ECI for the operations of the bottling plant during the tax year in which the B reorganization occurs. On these facts, X would be able to rely on Notice 89-57 but Y would not. This means that X would not be required to satisfy any of the requirements set forth in temp. reg. section 1.897-5T(d)(1)(iii), while Y would either have to satisfy all of those requirements, including the declaration requirement, or recognize gain in connection with the B reorganization. X has an opportunity to both transfer his interest in USRPHC 1 to USRPHC 2 in a tax-free transaction today and transfer his interest in USRPHC 2 in a future transaction that is tax free. Y, however, must choose between recognizing gain today on the current exchange of USRPHC 1 stock for USRPHC 2 stock or agreeing to pay U.S. tax on a subsequent transfer of his USRPHC 2 stock even if there has been an intervening change in law or circumstance that would otherwise have exempted that sale from tax.

¹¹³Of course, the foreign transferor of a USRPI can always choose to enter into an exchange with boot and report the transaction as taxable in its entirety. This strategy would most likely

(Footnote continued in next column.)

It is important to note that although the results described above clearly follow from the language of Notice 89-57, it is not clear that the IRS intended to produce those results. For example, in LTR 9623028, the IRS addressed an inbound D reorganization in which a foreign corporation transferred a USRPI to a USRPHC in exchange for USRPHC stock and then distributed that USRPHC stock to its sole shareholder. Although the facts in the ruling are less than clear, the foreign corporation may have recognized gain under section 357(c) in connection with the transfer because the USRPI that it transferred to the USRPHC was subject to liabilities in excess of basis. The IRS acknowledged that this gain, if recognized, would be subject to U.S. tax under sections 897(a) and 882. Nonetheless, the Service otherwise accorded nonrecognition treatment to the transaction, “provided . . . that the filing requirements of section 1.897-5T(d)(1)(iii) of the temporary regulations, as modified by Notice 89-57, . . . are met.”¹¹⁴

In light of the disconnect between the language of the ruling, which contemplates the existence of both boot and ECI, and the language of Notice 89-57, which contemplates the nonexistence of both boot and ECI, it is unclear why the IRS referred to Notice 89-57 at all. Perhaps the Service concluded that the requirements of Notice 89-57 were satisfied, based on the theory that the assumption of the liability by the USRPHC did not represent boot and that the gain recognized by the transferor foreign corporation under section 357(c) did not represent ECI. If that interpretation is true, the language in the ruling and the language in Notice 89-57 would be completely consistent. Then again, it is entirely possible that the reference to Notice 89-57 is simply an acknowledgement that the FIRPTA filing requirement has been modified by another authority — Notice 89-57 — that may or may not be applicable to the transaction analyzed in the ruling. Without additional guidance, it is not possible to tell with certainty what, if anything, LTR 9623028 tells us about the requirements of Notice 89-57.¹¹⁵

prove palatable only to a foreign person with significant loss carryforwards or built-in loss assets that can offset the recognized gain.

¹¹⁴LTR 9623028, *Doc 96-16908*, or *96 TNT 113-28* (emphasis added).

¹¹⁵The Internal Revenue Manual provides no clear guidance on the relationship between temp. reg. section 1.897-5T(d)(1)(iii) and Notice 89-57. In fact, section 4.61.12.4 of the manual directs an examiner to “review the tax return for attachments required by reg. section 1.897-5T(d)(1)(iii) and Notice 89-57.” The IRM goes on to state that “these attachments *must* include . . . a declaration by the distributee that it will be subject to tax on a subsequent disposition of the USRPI.” *Id.* (emphasis added). Thus, the IRM suggests that the declaration requirement of temp. reg. section 1.897-5T(d)(1)(iii)(H) somehow survives alongside Notice 89-57, even though the latter authority was expressly designed to suspend the application of the former.

5. The FIRPTA Toll Charge

a. Background and fundamental issues. Under notices 89-85 and 2006-46, a foreign corporation that intends to distribute USRPHC stock in connection with an inbound 332 liquidation or inbound A, C, acquisitive D,¹¹⁶ F, (a)(2)(D), or (a)(2)(E) reorganization will be required to pay one of two taxes in connection with that distribution. First, the foreign corporation can choose to recognize all of the gain inherent in that USRPHC stock, in which case the rules of section 897(d) cease to be relevant. Alternatively, the foreign corporation can pay the FIRPTA toll charge and, assuming all other requirements discussed in this article are satisfied, enjoy nonrecognition treatment for that distribution.

The FIRPTA toll charge, as it applies to a particular foreign corporation, is equal to the aggregate amount of taxes that section 897 would have imposed on all foreign persons who disposed of stock in the foreign corporation during the “10-year look-back period,” determined as if the foreign corporation were a U.S. corporation on the date of each disposition, plus interest on those taxes at the underpayment rate beginning on the date on which the U.S. tax return would have been filed for each disposition.¹¹⁷

In the context of an inbound reorganization transaction, the 10-year look-back period means the earlier of (i) the period beginning on the date that is 10 years before the date on which the acquiring domestic corporation or a related person acquired control of the foreign corporation and ending on the date of the reorganization, or (ii) the period beginning on the date that is 10 years before the date of the reorganization and ending on the date of the reorganization.¹¹⁸ In the context of an inbound 332 liquidation, the 10-year look-back period means the period beginning on the date that is 10 years before the date on which the distributee domestic corporation or a related person acquired control of the distributing foreign corporation and ending on

the date of the liquidation.¹¹⁹ For these purposes, related-person status is determined under section 267(b) and control is determined under section 304(c).¹²⁰

Although the 10-year look-back period will be 10 years long for many of the transactions described in this article, it seems that the period can end up being much longer for “creeping” transactions. For example, assume that foreign corporation X owns all of the stock of USRPHC 1; Buyer, a U.S. corporation, acquired section 304(c) control of X in 1990; Buyer acquired the balance of X stock in 1995; and Buyer chooses to liquidate X in 2008. In this case, the 10-year look-back period would appear to begin in 1980 (the date that is 10 years before the date on which Buyer acquired section 304(c) control over X) and end on the 2008 liquidation date.¹²¹

The FIRPTA toll charge was first incorporated into the inbound reorganization regime of temp. reg. section 1.897-5T by Notice 89-85. Before the issuance of Notice 89-85, a foreign corporation that completed an inbound reorganization was required to recognize gain on the distribution of USRPHC stock to its shareholders, but the amount of gain was limited to the excess of the shareholders’ aggregate outside basis in the stock of the distributing foreign corporation over the foreign corporation’s inside basis in the distributed USRPHC stock.¹²² That same mechanism, the inside/outside basis disparity tax, still applies to inbound divisive D reorganizations and stand-alone section 355 distributions in which a foreign corporation distributes the stock of a USRPHC.¹²³

By requiring a distributing foreign corporation to recognize gain on the inside/outside basis disparity, the IRS was attempting to impose a retroactive FIRPTA tax on prior dispositions of stock in the distributing foreign corporation.¹²⁴ The attempt to impose that tax generated significant technical issues, as many commentators pointed out that an inside/outside basis disparity could result from depreciation deductions at the foreign corporation level rather than from sales of

¹¹⁶As discussed in Section II.C.1 *supra*, a foreign corporation will recognize gain on the distribution of USRPHC stock in connection with an inbound divisive D reorganization or stand-alone section 355 transaction. The amount of gain recognized by the distributing foreign corporation is, however, limited “to the amount by which the aggregate basis of the distributed stock in the hands of the distributees exceeds the aggregate adjusted basis of the distributed stock in the hands of the distributing corporation.” Temp. reg. section 1.897-5T(c)(3)(i). Also, the FIRPTA filing requirement and the subject-to-tax requirement must also be satisfied. Temp. reg. section 1.897-5T(c)(3)(ii) (Example, paragraph (iii)).

¹¹⁷See Notice 89-85, as modified by Notice 2006-46; section 6621. The FIRPTA toll charge also applies to dispositions of interests in predecessor foreign corporations. See Notice 89-85.

¹¹⁸Notice 2006-46, section 2.

¹¹⁹*Id.*

¹²⁰*Id.*

¹²¹See Notice 2006-46, section 2 (fifth paragraph).

¹²²See temp. reg. section 1.897-5T(c)(4)(ii)(B), (iii).

¹²³See temp. reg. section 1.897-5T(c)(1), (c)(3)(i); see also *supra* Section II.C.1. The regulation requires the distributing foreign corporation to recognize all of the gain inherent in the distributed USRPHC stock, but limits the amount of gain recognized to the amount of the inside/outside basis disparity. This is the same mechanism that was contained in temp. reg. section 1.897-5T(c)(4)(ii)(B) and 1.897-5T(c)(4)(iii) before the issuance of Notice 89-85 and the incorporation of the FIRPTA toll charge into the inbound reorganization and liquidation regime.

¹²⁴See NYSBA Report, *supra* note 36, at 16.

stock in the foreign corporation itself.¹²⁵ Moreover, it would have been nearly impossible to apply that regime in the context of a publicly traded foreign corporation. Apparently in response to that controversy, the IRS replaced the inside/outside basis disparity tax with the equally controversial FIRPTA toll charge.

From the IRS's perspective, the FIRPTA toll charge, like the inside/outside basis disparity tax that preceded it, prevents the foreign shareholders of a foreign corporation from somehow gaming the system by selling shares of the foreign corporation free of U.S. tax and then taking advantage of U.S. nonrecognition provisions at the corporate level when it becomes convenient to do so. By imposing a toll charge on prior dispositions of stock in the foreign corporation, the Service has attempted to force those foreign shareholders into an all-or-nothing situation — for a foreign corporation to enjoy the benefits of a U.S. nonrecognition provision in connection with an inbound reorganization or inbound 332 liquidation, the foreign corporation must be treated, at the shareholder level, as if it were a domestic corporation at all times during the 10-year look-back period.

From the taxpayers' perspective, the FIRPTA toll charge represents an attempt by the Service to impose a surrogate FIRPTA tax on inbound reorganizations and inbound 332 liquidations in violation of FIRPTA's original goal of imposing a single level of U.S. tax on dispositions of USRPIs by foreign persons. Taxpayers also view the FIRPTA toll charge as inappropriate because Congress chose to cede U.S. taxing jurisdiction over sales by foreign persons of stock in foreign corporations, even those that hold USRPIs, and the FIRPTA toll charge purports to circumvent that congressional mandate. Finally, following the repeal of the *General Utilities* doctrine, taxpayers view the FIRPTA toll charge as surplusage.¹²⁶

¹²⁵See NYSBA Report, *supra* note 36, at 16; Hudson, "Florida Bar Tax Section Opposes Complexity and Double Taxation Under Section 897 Regulations," *Doc 88-6460*, or *88 TNT 155-34* (July 28, 1988).

¹²⁶See NYSBA Report, *supra* note 36, at 15-18; Hudson, *supra* note 125 (criticizing the inside/outside basis disparity tax); Matthews, "FIRPTA Regulations Unfairly Subject Shareholders to Double Taxation on Inbound Reorganizations," *Tax Notes*, Mar. 6, 1989, p. 1166 (discussing a debate between commentators and government officials concerning the imposition of a second level of tax on foreign corporations that desire to migrate USRPHC interests into the United States); Feingold and Glicklich, *supra* note 9, at 263-264 (discussing the extent to which the repeal of the *General Utilities* doctrine has obviated the need for a FIRPTA tax on certain dispositions of USRPHC interests by foreign persons); "Failure to Make Section 897(i) Election Should Not Result in Taxation of Liquidation Distribution, Says Karlin," *Tax Notes*, Sept. 26, 1988, p. 1539 (discussing a letter written by Michael Karlin in which the author objects to the imposition of

(Footnote continued in next column.)

In addition to those rather fundamental policy issues, taxpayers view the FIRPTA toll charge as grossly unfair because it imposes a tax on the wrong group of taxpayers.

Example 9. Foreign corporation X was formed in 2004 by foreign persons A, B, and C, each of whom contributed \$100 to X in exchange for a one-third interest. X used the \$300 contributed by A, B, and C to purchase 100 percent of the stock of USRPHC 1, its sole asset. In 2006, A sold his entire interest in X to D in exchange for \$500. In 2007, when the USRPHC 1 stock owned by X was worth \$2,000, X migrated into Delaware in an inbound F reorganization as illustrated in Figure 15 of Appendix A.

On those facts, to complete an inbound migration to Delaware without recognizing the \$1,700 of FIRPTA gain inherent in its USRPHC 1 stock (\$2,000 minus \$300), X would be required to pay a FIRPTA toll charge equal to \$60 (\$400 gain recognized by A in 2006 x 15 percent tax rate), plus interest. That toll charge, however, has nothing to do with any transaction that was undertaken by X or its *current shareholders*. In fact, the government is penalizing X (and, indirectly, shareholders B, C, and D) simply because shareholder A engaged in a sale transaction that was not subject to U.S. tax.¹²⁷

As discussed below, perhaps the most severe problems with the FIRPTA toll charge calculation arise in the public company context.

b. The FIRPTA toll charge and publicly traded corporations. The NYSBA Report criticizes the section 897(d) and (e) temporary regulations for being "devised with a mind almost exclusively to closely held

the inside/outside basis disparity tax); *supra* note 9 (discussing the original policy goals of the FIRPTA legislation).

The NYSBA Report contained a particularly forceful criticism of the inside/outside basis disparity tax:

We find it difficult to understand how a foreign person's sale of the stock of a foreign corporation, which is explicitly outside the scope of FIRPTA, can be regarded as an "avoidance" of U.S. Federal income tax. The U.S. has explicitly limited its taxing jurisdiction under FIRPTA to USRPIs, including the stock of certain U.S. corporations and certain electing foreign corporations. . . . This explicit limitation of the scope of FIRPTA both cedes sole taxing jurisdiction with respect to such sales of foreign corporation stock to the country of residence of the shareholder. . . . We think it questionable to attempt to impose by regulation an indirect, surrogate, tax with respect to such prior stock sales that FIRPTA would not tax directly, to be borne by subsequent owners of the stock (and, possibly, by many shareholders who have long held their stock without sale or exchange).

Id. at 16.

¹²⁷See NYSBA Report, *supra* note 36, at 16 (block quote in immediately preceding footnote).

entities.”¹²⁸ In no area does that criticism ring more true than in the calculation of the FIRPTA toll charge for a publicly traded foreign corporation.

When analyzing the technical and policy issues presented by the FIRPTA toll charge concept, the world of publicly traded foreign corporations can be divided into three categories: foreign corporations that definitely would not have been USRPHCs at any time during the 10-year look-back period if they had been domestic; foreign corporations that definitely would have been USRPHCs at some point during the 10-year look-back period if they had been domestic; and foreign corporations that may have been USRPHCs at some point during the 10-year look-back period if they had been domestic.

i. Publicly traded foreign corporations that definitely would not have been USRPHCs during the 10-year look-back period. When it comes to the FIRPTA toll charge calculation, foreign corporations that would definitely not have been USRPHCs at any time during the 10-year look-back period if they had been domestic are both the most fortunate and (seemingly) the most rare. These corporations include entities that hold foreign real estate assets, as well as entities that hold significant U.S.-real-estate-related assets that are *not* USRPIs (for example, mortgages on USRPIs). The FIRPTA toll charge amount for such a corporation is zero because even if the corporation had been organized in the United States, no prior transfer of its stock by a foreign person would have been taxable under section 897. That is not to say, however, that such a corporation will not encounter difficulty engaging in an inbound reorganization — the corporation will still have to grapple with the hot-to-hot requirement, the subject-to-tax requirement, and the FIRPTA filing requirement, any one of which could prevent it from achieving nonrecognition treatment for such a transaction.¹²⁹

ii. Publicly traded foreign corporations that definitely would have been USRPHCs during the 10-year look-back period. A publicly traded foreign corporation that definitely would have been a USRPHC at some point during the 10-year look-back period if it had been domestic must confront some very difficult questions before proceeding with an inbound reorganization or inbound 332 liquidation transaction. The following discussion focuses on some of the more pressing questions.

Question 1: Can the foreign corporation rely on the publicly traded exception when calculating its FIRPTA toll charge liability? For a foreign corporation to rely on the publicly traded exception when calculating its FIRPTA toll charge liability, the stock of that

corporation must have been “regularly traded” on an “established securities market” within the meaning of temp. reg. section 1.897-9T(d)(2) and reg. section 1.897-1(m), respectively. If the corporation’s stock satisfies that standard, the FIRPTA toll charge would take into account only gains recognized by 5 percent holders during the 10-year look-back period. If the corporation’s stock does not satisfy that standard, the FIRPTA toll charge would take into account *all gains* recognized by *all* holders on *all* transfers that occurred during the 10-year look-back period. If the corporation’s stock is subject to the trading volatility typically associated with public company stock, the FIRPTA toll charge could conceivably exceed the amount of FIRPTA tax the corporation would incur in connection with a fully taxable sale of its USRPIs.

The status of a foreign corporation’s stock as “regularly traded” may seem like a basic question, but the analysis is fraught with uncertainty for any foreign corporation whose shares were, at any point during the 10-year look-back period, *neither* traded on a U.S. securities market *nor* registered under section 12 of the Exchange Act. For the stock of such a corporation to satisfy the regularly traded standard for a tax year during the 10-year look-back period, it seems that the foreign corporation would have had to have satisfied the foreign exchange reporting requirements set forth in temp. reg. section 1.897-9T(d)(3)(ii) for that year.¹³⁰

Example 10. For the last 10 years, the shares of foreign corporation X have been listed on the London Stock Exchange. No class of X corporation stock has been registered under section 12 of the Exchange Act. For the last 10 years, X’s sole asset has been the stock of USRPHC 1, a Delaware C corporation. During the last 10 years, X has not filed a U.S. tax return in which the foreign exchange reporting requirements were satisfied. X agrees to be acquired by USRPHC 2, a publicly traded Delaware C corporation, in an inbound C reorganization as illustrated in Figure 11 of the Appendix. Assume that X can satisfy the other requirements imposed by temp. reg. section 1.897-5T and 1.897-6T, and the only open issue concerns the calculation of the FIRPTA toll charge.

On those facts, the stock issued by X and listed on the London Stock Exchange is not, under a literal interpretation of the regulations, regularly traded within the meaning of temp. reg. section 1.897-9T(d)(3)(ii) because X did not file a U.S. tax return that satisfies the foreign exchange reporting requirements. That X

¹²⁸*Id.* at 4.

¹²⁹*See, e.g.,* examples 11 through 13 *infra*.

¹³⁰*See supra* notes 17 to 19 and accompanying text (discussing the foreign exchange reporting requirements).

did not satisfy those requirements is not surprising because those requirements, on their face, apply exclusively to *domestic corporations* whose shares are traded on a foreign securities market and not registered under section 12 of the Exchange Act.¹³¹

Assuming the parties adopt the literal interpretation of the publicly traded exception and the foreign exchange reporting requirements, they could address the application of the publicly traded exception to the calculation of X's FIRPTA toll charge liability in two ways. First, X could seek a private letter ruling that, throughout the 10-year look-back period, its stock was regularly traded for purposes of the FIRPTA toll charge calculation. It goes without saying that a private letter ruling, even if issued, could significantly delay the closing of the transaction. More importantly, the parties would have to consider whether the transaction would proceed if the IRS refuses to issue the ruling and, if so, on what terms.

Second, X could file (or amend any previously filed) U.S. tax returns and attach to those returns the statements required by temp. reg. section 1.897-9T(d)(3)(ii). Given the uncertain state of the law concerning a taxpayer's ability to amend a tax return or file a late tax return,¹³² USRPHC 2 is not likely to accept the tax return filing strategy if it will assume a significant FIRPTA exposure with respect to the USRPHC 1 stock held by X.

Question 2: Can the foreign corporation identify its 5 percent holders? Continuing with Example 10, even if the parties can conclude that X's stock was regularly traded on an established securities market throughout the 10-year look-back period, the FIRPTA toll charge challenges do not end. In fact, those challenges only become more difficult.

For example, to compute the FIRPTA toll charge, the parties would have to identify each 5 percent holder of X stock. Although that task may seem simple, the parties will face two major obstacles in identifying X's 5 percent holders. First, foreign securities laws may not require a person who holds 5 percent of X stock to disclose that ownership.¹³³ Second, and more importantly, even if foreign securities laws require ownership disclosure by significant shareholders,

it is unlikely that those laws adopt constructive ownership rules similar to those found in section 897(c)(6)(C). In light of that fact as well as the breadth of those constructive ownership rules, it seems logical to assume that even if its shares are regularly traded on an established securities market, X may be unable to calculate the FIRPTA toll charge with a high degree of accuracy because of its inability to identify its 5 percent holders.¹³⁴

In light of that, USRPHC 2 might require X to obtain a private letter ruling that permits it to rely on any applicable foreign securities law filings to identify its 5 percent holders. One would assume that the IRS would not accept those filings as reliable evidence of X's 5 percent holders unless the foreign securities law requirements are at least as extensive as their U.S. counterparts. Even in that situation, however, the ruling process would have to address the potential disconnect between the standards for addressing ownership for purposes of the relevant securities laws and the constructive ownership standards set forth in section 897(c)(6)(C).

Question 3: Can the foreign corporation identify each instance in which a 5 percent holder would have recognized gain on its foreign corporation stock if the foreign corporation had been domestic? Once X and USRPHC 2 address the issues concerning the status of X's stock as regularly traded and the identification of X's 5 percent holders, they would have to turn to the calculation of the FIRPTA toll charge itself. As one might expect by this point, that process raises significant issues for which there is no guidance.

For example, in calculating the FIRPTA toll charge, X would have to take into account the fact that, once a person becomes a 5 percent holder of X stock, that person remains a 5 percent holder for at least five years.¹³⁵ Thus, if a foreign person acquires 5.5 percent of X stock in year 1 and sells 0.6 percent of that stock in a taxable transaction in year 2, that person will remain a 5 percent holder of X stock for purposes of the publicly traded exception for the five-year period following that sale. That five-year cooling-off period will complicate X's toll charge calculation process in situations in which the securities law disclosure obligations of a significant shareholder terminate when the shareholder's ownership level falls below 5 percent.

¹³¹See Blanchard, "FIRPTA in the 21st Century, Installment Three: FIRPTA and Foreign PTPs," 37 *Int'l Tax J'n'l* 176, 177 (Mar. 4, 2008) (discussing the application of the publicly traded exception to a foreign PTP the units of which are listed on a non-U.S. securities market).

¹³²See Jendraszek, "An Analysis of the Status of Amended Tax Returns and the Effects of their Use," 23 *Hous. L. Rev.* 769 (1986) (describing the uncertain status of amended returns under the code and the circumstances under which the courts and the IRS have both accepted and refused to accept amendments to tax returns).

¹³³See Blanchard -5T Article, *supra* note 2, at 522.

¹³⁴See Annie Jeong, "Applying Attribution to FIRPTA: Some Constructive Criticism," *Tax Notes Int'l*, Nov. 6, 2006, p. 465, *Doc 2006-19478*, or *2006 WTD 217-10* (discussing in detail the application of the constructive ownership rules in the context of the publicly traded exception).

¹³⁵Section 897(c)(3); *supra* notes 14 to 20 and accompanying text (discussing the requirements that must be satisfied for shares of stock in a USRPHC to satisfy the publicly traded exception).

To make matters even more complicated, the cooling-off period for 5 percent holders effectively extends the FIRPTA toll charge due diligence inquiry period by as much as 5 years because it is possible that a foreign person who was a 5 percent holder of X stock *before* the start of the 10-year look-back period may have sold X stock at a time that falls within both the 10-year look-back period and that person's 5-year cooling-off period. To address this situation, X would have to adopt a gain calculation convention that estimates the FIRPTA toll charge amount associated with a 5 percent holder whose cooling-off period coincides with the 10-year look-back period.

Another difficult question in the FIRPTA toll charge calculation concerns distributions to 5 percent holders that would have caused the holders to recognize gain under section 301(c)(3) if the distributing foreign corporation had been a U.S. corporation. Although gain that arises under section 301(c)(3) is not, technically speaking, attributable to a sale of the related stock, the IRS is likely to treat that gain, for purposes of the FIRPTA toll charge calculation, as resulting from a sale of that stock.¹³⁶ Thus, to accurately calculate its FIRPTA toll charge liability, a foreign corporation would be required to compute its U.S. earnings and profits and track its distributions throughout the 10-year look-back period.

An even more difficult toll charge calculation issue concerns prior nonrecognition transactions involving 5 percent holders of X. For example, assume that A, a 5 percent holder of X, contributed some of his X shares to a partnership whose assets (other than the X stock) were not USRPIs. If X had been a U.S. corporation, that contribution would have been, at the very least, partially taxable because of the failure to satisfy the hot-to-hot requirement and, potentially, fully taxable because of a failure to satisfy the FIRPTA filing requirement.¹³⁷ Consider whether X will be able to se-

cure that type of information from its 5 percent holders — if it's able to identify all of them.

iii. Publicly traded foreign corporations that may have been USRPHCs during the 10-year look-back period. A foreign corporation that may have been a USRPHC at some point during the past 10 years if it had been domestic must resolve some difficult questions of its own before proceeding with an inbound reorganization or inbound 332 liquidation. The corporation must analyze its asset composition during the 10-year look-back period to determine whether its USRPI percentage exceeded 50 percent at any point during that period. Because public companies rarely revalue their "hard assets" on an ongoing basis, this type of analysis will be extremely difficult for any foreign corporation whose USRPIs have, or have had in the past, a value that is anywhere close to 50 percent of the value of its assets. In the end, unless a publicly traded foreign corporation is highly confident that it would not have been a USRPHC at any time during the 10-year look-back period, the corporation will likely be discouraged from engaging in an inbound reorganization or inbound 332 liquidation unless the corporation undergoes the same process and performs the same analysis as a publicly traded foreign corporation that definitely would have been a USRPHC during the 10-year look-back period.

c. Summary. It is obvious that the FIRPTA toll charge presents tremendous obstacles to any publicly traded foreign corporation that wants to engage in an inbound transaction, owns USRPIs with significant built-in gain, and would have been, or could have been,

as actually owning the X stock held by F, the ruling would shed no light on the application of the FIRPTA toll charge because the transfer of X stock by F to B would have been ignored for tax purposes even if X had been a domestic corporation. If, however, foreign entity F was a foreign partnership, the ruling might be relevant. Ultimately, it is not possible to glean from that ruling any meaningful guidance concerning the application of the FIRPTA toll charge to prior nonrecognition transactions involving the stock of a foreign corporation.

In other inbound reorganization rulings, the IRS either accepted a taxpayer representation that there had been no prior toll charge transactions or issued the ruling contingent on the payment of the appropriate FIRPTA toll charge. *See* LTR 200803005, *Doc 2008-1113*, or *2008 TNT 14-22* (favorable ruling on inbound reorganization contingent on the payment of the FIRPTA toll charge by the transferor foreign corporation); LTR 9523020, or *95 TNT 113-14* (inbound 332 liquidation; taxpayer represented that there had been no prior dispositions of stock of the transferor foreign corporation); LTR 9316016, *93 TNT 90-25* (favorable ruling on inbound reorganization contingent on the payment of the FIRPTA toll charge by the transferor foreign corporation); LTR 9129010 (taxpayer represented that there had been no prior transfers of stock of the transferor foreign corporation). In one case, the IRS issued a private letter ruling concerning an inbound F reorganization of a foreign corporation that owned a USRPI without mentioning the FIRPTA toll charge at all. *See* LTR 9213025.

¹³⁶*See* temp. reg. section 1.897-5T(d)(2)(i) (a foreign shareholder that receives a distribution of property with respect to a USRPHC interest shall be treated as having sold that interest to the extent the distribution is treated "pursuant to section 301(c)(3)(A) as a sale or exchange of stock").

¹³⁷The author could find only one ruling that comes even remotely close to addressing the application of the FIRPTA toll charge to prior nonrecognition transactions. In LTR 9213025, the IRS addressed the inbound migration of foreign corporation X. At the time of the migration, X was wholly owned by foreign individual B. Before the migration, B owned his X stock through foreign entity F. Apparently, F distributed to B its entire interest in X before the migration. In addressing the effect of that distribution on the FIRPTA toll charge calculation, the Service simply stated that "the transfer of X . . . stock by F to B was not a transfer upon which taxation under section 897 would have been imposed had X been a domestic corporation." The ruling does not provide enough facts to indicate the basis for that conclusion. If foreign entity F was a foreign grantor trust and B was treated

(Footnote continued in next column.)

a USRPHC during the 10-year look-back period if the corporation had been domestic. In most cases, the parties will find those obstacles insurmountable in the absence of a favorable private letter ruling.¹³⁸

Perhaps the one bright spot in the FIRPTA toll charge area is that by shortening the FIRPTA toll charge look-back period to 10 years, the IRS seems to have acknowledged that the FIRPTA toll charge concept has some major shortcomings. The Service also seems to have adopted the same “rough justice” approach applied by Congress in connection with the 10-year built-in gains tax that applies to a C corporation that either converts to REIT, regulated investment company, or S corporation status, or transfers assets to a REIT, RIC, or S corporation in a carryover basis transaction.¹³⁹ As discussed below, the IRS should abandon the FIRPTA toll charge in its entirety and rely instead on either the built-in gains tax, in the case of an inbound reorganization or liquidation of a foreign corporation into a REIT, RIC, or S corporation, or the section 11 tax, in the case of an inbound reorganization or liquidation of a foreign corporation into a domestic C corporation, to achieve the objectives of the FIRPTA toll charge.

In many respects, the FIRPTA toll charge and the built-in gains tax are cousins. First, both taxes were designed to prevent tax avoidance by imposing a corporate-level income tax that would not otherwise exist on certain transactions occurring within 10 years of the relevant testing date. The FIRPTA toll charge purports to prevent avoidance of the FIRPTA tax by imposing that tax on a foreign corporation whose shares were sold during the 10-year look-back period. The built-in gains tax prevents avoidance of the section 11 tax and the repeal of the *General Utilities* doctrine by imposing a corporate-level tax on sales of built-in gain assets that occur within 10 years after the date on which a C corporation either converts to REIT, RIC,

or S corporation status or transfers assets to a REIT, RIC, or S corporation in a carryover basis transaction.¹⁴⁰

Second, the FIRPTA toll charge and the built-in gains tax both operate on a bright-line, 10-year basis, and both taxes are easily managed by any taxpayer with enough patience to wait out the 10-year period. Thus, suppose that, in Example 10, USRPHC 2 were to acquire all of the outstanding stock of X in exchange for cash. If USRPHC 2 were to liquidate X within 10 years of that acquisition, X would owe a FIRPTA toll charge on (at the very least) all of the gain recognized by its former shareholders in connection with that acquisition. If, however, USRPHC 2 were to wait 10 years and a day to liquidate X, the liquidation would not generate a FIRPTA toll charge or any other FIRPTA tax. A similar analysis would apply if USRPHC 2 itself were to convert from C corporation status to REIT status. In that case, if USRPHC 2 were to sell a built-in gain asset during the 10-year period following the REIT conversion, USRPHC 2 would be subject to the corporate-level built-in gains tax on that sale. If, however, USRPHC 2 were to wait 10 years and a day to sell that asset, the built-in gains tax would not apply.

Conceptually, the main difference between the FIRPTA toll charge and the built-in gains tax is that the FIRPTA toll charge is virtually impossible to apply outside the context of a closely held corporation, while the built-in gains tax is easy to apply in any context.

With those points in mind, the IRS should abandon the FIRPTA toll charge altogether and rely instead on the built-in gains tax or the section 11 tax, whichever is applicable, to achieve the objectives of the FIRPTA toll charge. That approach makes sense on many levels.

First, abandoning the FIRPTA toll charge should not reduce the amount of FIRPTA tax collected by the government because, in a typical inbound transaction, the transferor foreign corporation will not pay a material FIRPTA toll charge. In other words, if the FIRPTA toll charge amount associated with an inbound transaction is zero or immaterial, the inbound transaction would occur as planned; if the FIRPTA toll charge amount is material, the parties will typically engage in one of the (second-best) alternative transactions discussed in Section II.D.3.b below, or defer the inbound transaction until a point at which the FIRPTA

¹³⁸See Blanchard -5T Article, *supra* note 2, at 522 (“But [foreign corporation] is a publicly traded corporation; looking back even 10 years to examine the gain recognized on sales of its stock, even if it could pry that information from its shareholders, and even if it could ascertain which of its shareholders were foreign and which were not, will be a daunting if not impossible task.”).

¹³⁹See reg. section 1.337(d)-7 (application of 10-year built-in gains tax to REITs and RICs that were formerly C corporations or received assets from a C corporation in a carryover basis transaction); section 1374 (similar tax applicable to S corporations). Both of those provisions impose a corporate-level tax on a REIT, RIC, or S corporation that either was a C corporation with built-in gain assets before electing REIT, RIC, or S corporation status, or received built-in gain assets from a C corporation in a carryover basis transaction and sold those built-in gain assets in a taxable transaction that occurred within 10 years after the conversion or acquisition.

¹⁴⁰See T.D. 9047, *Doc 2003-6660*, or *2003 TNT 50-6* (Mar. 14, 2003); Notice 88-19, 1988-1 C.B. 486. In the absence of the built-in gains tax, a C corporation could convert to REIT or RIC status, sell built-in gain assets, and eliminate its corporate-level tax liability by making a distribution that is eligible for the dividends paid deduction. See sections 857 and 852.

toll charge amount would be either zero or immaterial,¹⁴¹ or abandon the inbound transaction altogether.

Second, abandoning the FIRPTA toll charge is likely to facilitate inbound transactions that might actually increase the amount of taxes collected by the government. For example, the built-in gains tax and the section 11 tax apply at a 35 percent rate to all of the historic gain inherent in all of the assets of the transferor foreign corporation. In contrast, the FIRPTA toll charge applies at capital gains rates to gains recognized during the 10-year look-back period, even if the amount of those gains was reduced by transactions that occurred before the start of that look-back period. Accordingly, the parties will often find that the potential built-in gains tax or section 11 tax exposure of a successor U.S. corporation is far greater than the actual FIRPTA toll charge exposure of the related transferor foreign corporation.¹⁴² A foreign corporation that is unwilling to complete an inbound transaction because of a current FIRPTA toll charge may be willing to live with a larger exposure to the built-in gains tax or the section 11 tax. That is because those taxes would not apply at the time of an inbound transaction and there-

fore would not represent an upfront transaction cost, the corporation that is exposed to the tax can control the circumstances under which the built-in gain is recognized, and the payment of the corporate-level built-in gains tax or section 11 tax would typically be associated with a sale that generates the cash needed to pay the tax.

Third, because a forward-looking rule such as the built-in gains tax or the section 11 tax is inherently easier to apply than a backward-looking rule that is unadministrable in most contexts, a forward-looking rule represents a more practical approach than the FIRPTA toll charge. After all, many foreign corporations would not anticipate completing an inbound transaction 10 years in advance and would therefore never think to continually keep track of the information necessary to calculate the FIRPTA toll charge (assuming they could obtain the information in the first place). Typically, there is at most a 6-month to 1-year lead time on such transactions. When the time comes to complete the U.S. tax planning process, the officers of the foreign corporation or its U.S. successor are typically stunned to learn of the FIRPTA toll charge and the issues it presents. A forward-looking tax exposure, however, is something that all parties could address in a straightforward way when planning for an inbound transaction.

Finally, abandoning the FIRPTA toll charge would help bring the inbound nonrecognition regime back into conformity with the initial policy underlying the USRPHC component of the FIRPTA legislation. Thus, that approach would ensure that only one level of tax is imposed in connection with the sale of a USRPHC interest by a foreign person. Moreover, the approach would prevent the inappropriate policy results that stem from the facts that the FIRPTA toll charge imposes a tax on persons who have held, and wish to continue holding, their USRPI investment, and violates congressional intent by subjecting to U.S. tax a type of transaction — the sale of stock in a foreign corporation — over which Congress relinquished taxing jurisdiction.

D. The FIRPTA Nonrecognition Rules in Practice

Where a foreign corporation desires to transfer a USRPHC interest in one of the nondivisive reorganization or liquidation transactions that are the focal point of this article, the rules promulgated under section 897(d) and (e) can, in theory, be boiled down to a few basic elements that together comprise five basic rules. Things get tricky only when one has to apply those basic elements and rules to an actual transaction.

1. The Basic Elements

For a transaction that involves a transfer of a USRPHC interest by a foreign corporation to another corporation (whether domestic or foreign) in exchange for stock of the transferee corporation, the basic elements set forth in temp. reg. section 1.897-6T and 1.897-5T

¹⁴¹ See the example at note 142 *infra*.

¹⁴² The following fact pattern illustrates this point: Privately held foreign corporation X has owned all of the stock of USRPHC 1 since 1981; the USRPHC 1 stock has a tax basis of \$10 and an FMV of \$1,000; X is owned by two foreign persons, A and C; A has held his X stock since 1981 and has never recognized gain on the stock; C acquired his X stock from another shareholder three years ago in a transaction in which \$500 of gain was recognized; and other than as described above, there have been no taxable transfers of X stock.

On those facts, the FIRPTA toll charge on the \$500 of gain recognized three years ago, even at individual capital gains rates, might be enough to discourage X from migrating into the United States today. Assuming that A and C retain their X stock, the parties might be inclined to defer the inbound transaction for seven years. At the end of that 7-year period, the FIRPTA toll charge would be zero because there would not have been any sales of X stock during the 10-year look-back period, determined at that time. Accordingly, X could complete the inbound transaction without triggering a FIRPTA tax or FIRPTA toll charge. If, however, X were allowed to migrate into the United States tax free today, X's U.S. successor corporation would be either a C corporation or a REIT. In either case, the U.S. successor corporation would be exposed to a U.S. corporate-level income tax, at a 35 percent rate, on \$990 of inside gain. In the best-case scenario, in which the successor corporation is a REIT, that exposure would last for 10 years following the migration. Even following the end of that 10-year period, shareholders A and C would be subject to FIRPTA tax under section 897(h)(1) if the REIT were to sell a USRPI. Also, shareholders A and C could no longer exit their investments free of U.S. tax simply by selling the stock of foreign corporation X. Instead, both shareholders would take carryover bases in their U.S. corporation stock and would recognize gain under section 897 if they were to sell that stock. Accordingly, in this case, an immediate inbound migration would increase, rather than decrease, potential U.S. tax exposure.

are the hot-to-hot requirement, the subject-to-tax requirement, and the FIRPTA filing requirement;¹⁴³ if the transfer involves a foreign-to-foreign exchange, the transaction must fall within the relatively narrow class of transactions described in temp. reg. section 1.897-6T(b), as modified by Notice 2006-46.¹⁴⁴

For a transaction that involves the distribution of USRPHC stock by a foreign corporation to its shareholders, the basic elements set forth in temp. reg. section 1.897-5T are the subject-to-tax requirement, the FIRPTA filing requirement,¹⁴⁵ and the FIRPTA toll charge.¹⁴⁶

2. The Basic Rules

Those three basic elements give rise to five basic rules that, subject to the antiabuse rules of temp. reg. section 1.897-6T(c)(4), apply to most foreign corporations that would desire to transfer a USRPHC interest in one of the transactions that are the focal point of this article.

Rule 1: Transactions that involve a transfer of a USRPHC interest to a domestic corporation. A foreign corporation that transfers a USRPHC interest to a domestic corporation in exchange for stock in the domestic corporation will not qualify for nonrecognition treatment under the code unless the domestic corporation is a USRPHC and the stock received in the exchange is a USRPI, the foreign corporation satisfies the subject-to-tax requirement with respect to the stock of the domestic corporation, and the foreign corporation satisfies the FIRPTA filing requirement.

Rule 2: Transactions that involve a transfer of a USRPHC interest by one foreign corporation to another foreign corporation in a foreign-to-foreign reorganization. A foreign corporation that transfers a USRPHC interest to another foreign corporation in a foreign-to-foreign reorganization transaction will not qualify for nonrecognition treatment under the code unless the transferee foreign corporation satisfies the subject-to-tax requirement with respect to that USRPHC interest, the parties satisfy the FIRPTA filing requirement, and the transaction falls within one of the five exceptions set forth in temp. reg. section 1.897-6T(b), as modified by Notice 2006-46.¹⁴⁷

Rule 3: Transactions that involve a transfer of a USRPHC interest by a foreign subsidiary corporation to its foreign parent corporation in a foreign-to-foreign 332 liquidation. Although the analysis is not entirely free from doubt, a foreign corporation that transfers a USRPHC interest to another foreign corpo-

ration in a foreign-to-foreign 332 liquidation will not qualify for nonrecognition treatment under the code unless the transferee foreign corporation satisfies the subject-to-tax requirement for that USRPHC interest; the basis of the USRPHC interest in the hands of the transferee foreign corporation is not greater than the basis of that interest in the hands of the transferor foreign corporation, increased by the amount of gain (if any) recognized by the transferor in connection with the distribution; and the parties satisfy the FIRPTA filing requirement.¹⁴⁸

Rule 4: Inbound nondivisive reorganization transactions that involve a transfer of USRPHC interests by a foreign corporation to a U.S. corporation. For an inbound A, C, acquisitive D,¹⁴⁹ F, (a)(2)(D), or (a)(2)(E)¹⁵⁰ reorganization in which a foreign corporation transfers (or is deemed to transfer) a USRPHC interest to a domestic corporation in exchange for stock in a domestic corporation and then distributes (or is deemed to distribute) that stock to its shareholders, the foreign corporation will not qualify for nonrecognition treatment under the code unless the domestic corporation is a USRPHC and the stock received by the foreign corporation in the first leg of the transaction is a USRPI; the foreign corporation and its shareholders satisfy the subject-to-tax requirement for that stock; the foreign corporation satisfies the FIRPTA filing requirement for the first leg of the transaction, and the foreign corporation and its shareholders satisfy the FIRPTA filing requirement for the second leg of the transaction; and the foreign corporation pays the FIRPTA toll charge.¹⁵¹

Rule 5: Transactions in which a foreign subsidiary corporation distributes a USRPHC interest to its domestic parent corporation in a 332 liquidation. For an inbound 332 liquidation in which a foreign corporation transfers a USRPHC interest to its domestic parent corporation, the foreign corporation will not qualify for nonrecognition treatment under the code unless the domestic parent corporation satisfies the subject-to-tax

¹⁴⁸See *supra* Section II.C.2.

¹⁴⁹As discussed at Section II.C.1 above, a divisive D reorganization would be subject to Rule 4, except that the FIRPTA toll charge would be replaced by the inside/outside basis disparity tax. This article generally focuses on nondivisive transactions.

¹⁵⁰As discussed at note 79 *supra*, an (a)(2)(E) reorganization that involves a domestic merger subsidiary and a foreign corporation as either the transferor of a USRPHC interest or the target corporation should be: (i) subject to Rule 1 if the foreign corporation is the transferor of a USRPHC interest and the parent of the domestic merger subsidiary is a domestic corporation; (ii) subject to Rule 2 if the foreign corporation is the transferor of a USRPHC interest and the parent of the domestic merger subsidiary is also foreign; and (iii) exempt from section 897 altogether if the foreign corporation is the target corporation that survives the merger.

¹⁵¹See *supra* Section II.C.1.

¹⁴³See *supra* Section II.B and Section II.C.

¹⁴⁴See *supra* Section II.B.2.

¹⁴⁵See *supra* notes 105 to 115 and accompanying text.

¹⁴⁶See *supra* notes 116 to 142 and accompanying text.

¹⁴⁷See *supra* Section II.B.2.

requirement and the FIRPTA filing requirement for that USRPHC interest; the domestic parent corporation takes a tax basis in the distributed USRPHC interest that is not greater than the adjusted basis of such interest in the hands of the foreign corporation, increased by the amount of gain (if any) recognized by the foreign corporation in connection with the distribution; and the foreign corporation pays the FIRPTA toll charge.¹⁵² If the domestic parent corporation acquired the stock of the foreign corporation in a B reorganization or section 351 transaction within the five-year period preceding the inbound 332 liquidation, the parties would have to consider whether the recharacterization rule of temp. reg. section 1.897-5T(b)(3)(v) applies.¹⁵³

Overlap. In applying these basic rules, it is important to bear in mind that more than one rule may apply to different components of the same nonrecognition transaction. For example, assume that an acquiring corporation (either foreign or domestic) owns an old and cold foreign subsidiary that holds USRPIs, and that the foreign subsidiary merges with and into a target USRPHC in an (a)(2)(E) reorganization in which the foreign subsidiary goes out of existence. From the perspective of the foreign shareholders of the target USRPHC, the transaction represents an exchange of USRPHC stock for acquiring corporation stock. That component of the transaction would be subject to Rule 1 or Rule 2, depending on whether the acquiring corporation is domestic or foreign.¹⁵⁴ From the perspective of the foreign subsidiary, the transaction represents an inbound reorganization that is subject to Rule 4.

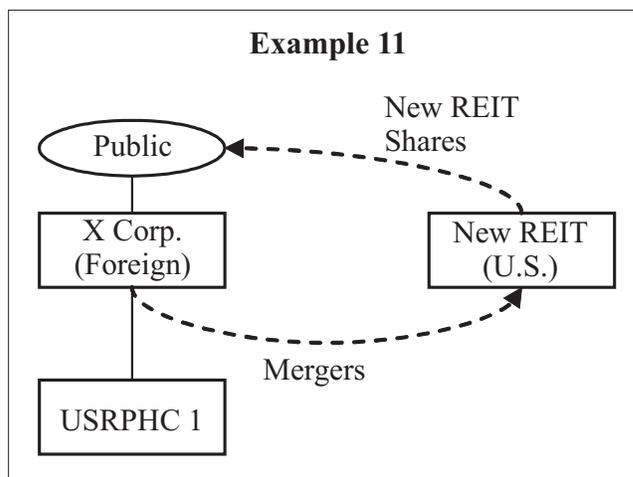
3. The Basic Elements and Rules in Action

a. Some basic problems. With a few basic principles giving rise to five basic rules, one might think that a foreign corporation would be able to navigate with ease the additional FIRPTA requirements that it must satisfy to enjoy nonrecognition treatment of one of the transactions described above. Unfortunately, the FIRPTA rules are written in a way that sometimes makes it impossible for a taxpayer to predict with an acceptable level of certainty the U.S. tax analysis applicable to, and the U.S. tax consequences generated by, the most basic nonrecognition transactions.

While many of the rules discussed in this article contain a level of ambiguity to which taxpayers have become accustomed, there are three major rules in the FIRPTA nonrecognition regime that share two onerous traits: They are extremely difficult to apply in practice, and, if misinterpreted, they can expose a foreign cor-

poration, as well as its acquirers or successors, to a potentially devastating tax liability. Those three rules are the subject-to-tax requirement, the FIRPTA filing requirement, and the FIRPTA toll charge.

Starting with the subject-to-tax requirement, it is extremely difficult to determine how a publicly traded foreign corporation is supposed to satisfy the requirement, especially in situations in which some of its holders would be subject to tax on a disposition of a distributed USRPHC interest while some would not. This problem can arise in the most basic reorganization imaginable.



Example 11. As illustrated on this page, foreign corporation X, which is the foreign equivalent of a REIT, is a widely held, publicly traded entity listed on the London Stock Exchange. Substantially all of X's shareholders are foreign persons, none of whom are 5 percent holders. X would have been a USRPHC during the 10-year look-back period if it were domestic. X's sole asset consists of substantially all of the stock of USRPHC 1, which is a self-managed REIT. The fair market value of the USRPHC 1 stock is \$5 billion, and the tax basis of that stock is \$1 billion. To expand its business and attract additional U.S. investors, X desires to migrate into the United States in an F reorganization and become a publicly traded REIT (New REIT). Although X is publicly traded, it did not satisfy the foreign exchange reporting requirements.

On these facts, if X were to migrate into the United States and become New REIT, it is not possible to determine with certainty whether X would satisfy the subject-to-tax requirement because substantially all of X's holders would be foreign persons that would be entitled to rely on the publicly traded exception on the sale of their New REIT shares. Some might argue that the subject-to-tax requirement is satisfied because the United States has asserted taxing jurisdiction over the

¹⁵² See *Id.*

¹⁵³ See *supra* notes 86 to 89 and accompanying text.

¹⁵⁴ It is important to note that if Rule 2 is relevant, an (a)(2)(E) reorganization may be tested as a B reorganization or section 351 transaction from the perspective of a foreign shareholder of the target USRPHC.

New REIT stock but has affirmatively chosen not to impose a tax on non-5-percent holders of that stock. That is a difficult argument to advance, however, because one cannot easily escape the fact that no shareholder of X would pay U.S. tax if he were to sell the stock of New REIT after the migration.

Even if X were to get comfortable that the subject-to-tax requirement is satisfied, it would then move on to the FIRPTA filing requirement. For a distribution made by a foreign corporation in connection with an inbound reorganization, the filing requirement apparently must be satisfied by *both* X and its shareholders.¹⁵⁵ Query whether it is realistic to expect that every foreign shareholder of X will submit the declaration required by temp. reg. section 1.897-5T(d)(1)(iii)(H) or, alternatively, whether the requirements of Notice 89-57 can be satisfied.

Assuming that X could overcome the issues associated with the subject-to-tax requirement and the FIRPTA filing requirement, it would face some stark choices concerning the FIRPTA toll charge, many of which were discussed above.¹⁵⁶ Those issues, coupled with the securities law and financial statement disclosure issues that would arise from the fact that New REIT would succeed to any unpaid FIRPTA tax of X, would likely encourage X to either abandon the migration altogether or complete the migration only on receipt of a favorable private letter ruling. In a real-life situation, the due diligence process required by that type of ruling would be staggering.

Example 11 involved a simple F reorganization in which X desired to migrate into the United States as New REIT. In that context, the worst outcome for X is that it will remain a foreign corporation listed on the London Stock Exchange — that is, no transaction will occur.¹⁵⁷ The negative consequences associated with the FIRPTA nonrecognition regime become much more severe when X is trying to choose between two different transactions.

Example 12. The facts are the same as in Example 11, except that X is contemplating a

merger with one of two companies — foreign corporation Y and a U.S. REIT that is a USRPHC (USRPHC 2). Both Y and USRPHC 2 are slightly smaller than X, meaning that the shareholders of X will own slightly more than 50 percent of the combined entity following the merger. Under foreign tax law, X can merge into either Y or USRPHC 2 in a transaction that is tax free to X and its shareholders. If the shareholders of X sell their X stock in exchange for cash, they will be subject to capital gains taxes in their home jurisdictions.

On those facts, X should be able to transfer its interest in USRPHC 1 to foreign corporation Y in a transaction that satisfies the FIRPTA requirements imposed on foreign-to-foreign exchange transactions.¹⁵⁸ That transaction would be tax free to both X and its shareholders under both foreign law and section 897.

A merger of X into USRPHC 2, however, implicates the same three issues — the subject-to-tax requirement, the FIRPTA filing requirement, and the FIRPTA toll charge — that arose with Example 11. Those issues, which go directly to the FIRPTA tax liability that USRPHC 2 would assume in connection with the merger, might lead USRPHC 2 to either offer a lower merger price to X's shareholders, or, perhaps even

¹⁵⁸See *supra* Section II.B.2 (discussing the “non-public foreign-to-foreign merger rule,” which allows a transferor foreign corporation to engage in a foreign-to-foreign A, C, or (a)(2)(D) reorganization in which the shareholders of the transferor foreign corporation own a controlling interest in the transferee foreign corporation after the transaction). Admittedly, if the shareholders of X would not own a controlling interest in Y immediately after the transaction, the parties would have to rely on another foreign-to-foreign exchange rule and address one or more of the concerns discussed at Section II.B.2 above. Even in that context, however, the parties could structure a transaction in which Y acquires all of the outstanding stock of X in exchange for newly issued Y stock. That transaction would not be subject to section 897 because X is a foreign corporation. If X and Y were organized in different countries, the parties might be able to adopt a postacquisition capital structure at the X level that minimizes any foreign tax leakage that might otherwise result from Y's ownership of X. That leakage might also be addressed through a foreign-to-foreign F reorganization in which X migrates into Y's jurisdiction. Alternatively, the parties might consider liquidating X into Y in a future foreign-to-foreign 332 liquidation or upstream A or C reorganization; the parties could also cause Y to merge downstream into X in a foreign-to-foreign downstream A, C, or D reorganization. Any one of those structures would enable X and Y to rely on the foreign-to-foreign nonrecognition provisions discussed in Section II.B.2 above to rationalize their postacquisition corporate structure. As discussed in Section II.D.3.b below, however, it would be very difficult for USRPHC 2 to implement those types of postacquisition restructuring transactions in a situation in which USRPHC 2 acquires the stock of X in exchange for newly issued USRPHC 2 stock. Accordingly, it is not unfair to assume that it will be far easier for Y to acquire X in a tax-free transaction than it would be for USRPHC 2 to acquire X in a tax-free transaction.

¹⁵⁵Temp. reg. section 1.897-5T(d)(1)(iii)(H).

¹⁵⁶See *supra* notes 116 to 142 and accompanying text.

¹⁵⁷The reader might wonder whether X could accomplish the same result as an inbound migration simply by distributing the stock of USRPHC 1 to its shareholders in a section 355 transaction in which X remains in existence. Assuming that such a transaction could satisfy the requirements of section 355, X would be subject to the inside/outside basis disparity tax discussed in Section II.C.1 above. It is logical to assume that, similar to the FIRPTA toll charge calculation process, X would encounter significant difficulty in determining the aggregate outside tax basis that its shareholders would take in the distributed USRPHC 1 stock. If X cannot determine with accuracy the inside/outside basis disparity, it would presumably be required to recognize all of the gain inherent in its USRPHC 1 stock at the time of the distribution.

worse, to demand a private letter ruling as a condition to the closing of the merger. Either alternative would obviously place USRPHC 2 at a competitive disadvantage to its competitor, foreign corporation Y.

It is important to note that the obstacles to a merger between X and USRPHC 2 would not vanish if one were to “assume away” the issues regarding the subject-to-tax requirement and the FIRPTA filing requirement and modify the facts so that the FIRPTA toll charge would be zero.

Example 13. The facts are the same as in Example 12, except that during the 10-year look-back period, more than half of X’s assets consisted of European real estate assets that were used in X’s business, X has retained those assets, and those assets will transfer to the entity that acquires X in connection with the merger. Assume that the subject-to-tax requirement and the FIRPTA filing requirement may be satisfied.

On those facts, a merger of X into USRPHC 2 might still present a formidable tax exposure because X might not be able to satisfy the hot-to-hot requirement in connection with the transfer of its USRPHC 1 stock to USRPHC 2 on the first leg of the inbound reorganization. To illustrate the point, if X were to merge with and into USRPHC 2 in an A reorganization, X would be deemed to transfer all of its assets (including its European real estate assets) to USRPHC 2 in exchange for stock of USRPHC 2, and distribute that stock to its shareholders in complete liquidation. If X’s European assets, together with any other non-USRPI trade or business assets of X and USRPHC 2, represent more than half the value of USRPHC 2 after the first leg of the transaction, USRPHC 2 would not be a USRPHC immediately after the first leg of the transaction. In that situation, X would recognize gain on the transfer of USRPHC 1 stock to USRPHC 2 because of a failure to satisfy the hot-to-hot requirement.¹⁵⁹

b. Some (second-best) solutions. In situations such as examples 12 and 13, the parties might consider side-stepping the FIRPTA inbound reorganization regime by using one of two basic structures — a foreign corporation acquisition structure and a reverse acquisition structure. These basic structures and their common variants present second-best solutions to the formidable obstacles standing in the way of a “straight” tax-deferred acquisition of a foreign corporation by a USRPHC. Unfortunately, in many instances, these second-best solutions may present the only acceptable tax-deferred acquisition structure available to the parties.

i. The foreign corporation acquisition structure. In the foreign corporation acquisition structure, the share-

holders of foreign corporation X, which owns substantially all of USRPHC 1, a REIT, would transfer their X shares to USRPHC 2 in exchange for USRPHC 2 shares. Because a foreign person is not subject to U.S. tax on any disposition of stock in a foreign corporation, the transaction would not trigger any U.S. tax to X’s shareholders.¹⁶⁰ Because X will not transfer a USRPI, the transaction will not trigger a U.S. tax at the X level. If X owns assets that USRPHC 2 does not wish to acquire, X could distribute those assets to its own shareholders, who could then engage in the stock-for-stock exchange.¹⁶¹

Although it satisfies the parties’ desire for an immediate tax-free transaction, the foreign corporation acquisition structure presents several major shortcomings, the largest of which is that USRPHC 2 will own 100 percent of USRPHC 1 through a foreign corporation — the dreaded “international sandwich” structure.¹⁶² USRPHC 2 can mitigate the impact of that structure by holding the stock of X for at least 10 years after the acquisition and then either liquidating X in an inbound 332 liquidation, migrating X into the United States (either through a continuation transaction or an inbound merger), or causing X to merge downstream into USRPHC 1.¹⁶³ In any of those transactions, the movement of USRPHC 1 stock from foreign corporate solution to U.S. corporate solution could be accomplished without the imposition of tax under section 897.¹⁶⁴ During that 10-year holding period, the parties

¹⁶⁰See *supra* notes 4 to 5 and accompanying text (capital gains of foreign persons are generally exempt from U.S. tax, except in the case of a sale of a USRPI).

¹⁶¹Depending on the circumstances, USRPHC 2 could recognize subpart F income on that distribution, even though the distribution occurred before the time at which USRPHC 2 acquired the stock of X. See section 951(a)(2); Leitner, “Subpart F Prop. Regs. Target New Abuses Involving Structured Investments in CFCs,” 101 *Jn’l of Tax’n* 5 (2004).

¹⁶²See generally Gail Taylor and Pete Belanger, “Minimizing Tax Costs for a Sandwich Structure,” *Tax Notes*, July 7, 2003, p. 85, *Doc 2003-16005*, or *2003 TNT 130-41*.

¹⁶³See, e.g., Rev. Rul. 85-197, 1985-2 C.B. 120 (downstream merger of holding company into its wholly owned operating subsidiary); Rev. Rul. 57-465, 1957-2 C.B. 250 (downstream D reorganization of one foreign corporation into another); LTR 9316016 (downstream D reorganization of a foreign corporation into a USRPHC); see also LTR 200747006, *Doc 2007-25964*, or *2007 TNT 227-12* (downstream C reorganization of upper-tier corporation into lower-tier corporation).

¹⁶⁴See *supra* Section II.C (discussing the FIRPTA nonrecognition rules applicable to inbound reorganizations of foreign corporations that hold USRPHC interests). The basic inbound transactions described in the text would not generate a FIRPTA toll charge because, on these facts, there would be no sales of X stock during the 10-year look-back period preceding the inbound transaction. See *supra* notes 116 to 142 and accompanying text (discussing the FIRPTA toll charge and the manner in which it is calculated). If X was organized in a jurisdiction that would

(Footnote continued on next page.)

¹⁵⁹See *supra* notes 34 to 40 and accompanying text (discussing the hot-to-hot requirement).

could adopt structures that enable X to manage any tax liability that it may incur on the receipt of distributions from USRPHC 1 or on the migration of X into the United States.¹⁶⁵

The parties would face additional obstacles in situations where USRPHC 2 is a REIT. For example, the stock of X would not be treated as a real estate asset for purposes of the REIT 75 percent asset test.¹⁶⁶ Accordingly, USRPHC 2 would need to treat X as a taxable REIT subsidiary (TRS)¹⁶⁷ and would have to ensure that the value of the stock of X, together with the value of all other TRS stock owned by USRPHC 2, does not exceed 20 percent of the gross value of all of USRPHC 2's assets.¹⁶⁸ USRPHC 2 would also have to take steps to ensure that the recognition of subpart F income (if any) attributable to its ownership of X stock does not violate the REIT income tests.

More importantly, if USRPHC 2 is a REIT, a future liquidation or inbound reorganization of X might prove problematic for two reasons. First, USRPHC 2 would apparently be treated as a passthrough entity for purposes of the subject-to-tax requirement, meaning that the requirement would have to be satisfied at the USRPHC 2 shareholder level.¹⁶⁹ As discussed above, that process could prove quite difficult. USRPHC 2

impose a tax on a U.S.-bound reorganization, the reorganization could be accomplished through either a dual incorporation structure in which X becomes an entity organized under both foreign law and U.S. law or an election to treat X as a disregarded subsidiary of USRPHC 2. *See* reg. section 301.7701-5(a) ("A business entity that is created or organized both in the United States and in a foreign jurisdiction is a domestic entity."); Rev. Rul. 88-25, 1988-1 C.B. 116 (domestication of foreign corporation treated as an inbound F reorganization for purposes of sections 897(d) and (e)); reg. section 301.7701-3(g)(1)(iii), (g)(2)(ii) (election to treat a corporate subsidiary as a disregarded entity of its parent is treated as a liquidation of the subsidiary); *see generally* Westin, "International Dual Incorporation: Welcoming Another Frankenstein," 15 *J. Int'l Tax'n* 18 (2004). In either case, the parties would have to put in place a structure that manages any future foreign tax exposure at the X level. A discussion of foreign tax planning techniques is beyond the scope of this article.

¹⁶⁵ *See supra* note 164 (discussing dual-incorporated entities). If a migration of X into the United States poses foreign tax planning issues, the parties may be able to achieve benefits similar to a migration either through an entity election that results in X being treated as a disregarded entity of USRPHC 2 or through a transaction in which X becomes a dual incorporated entity (that is, an entity that is incorporated in both the United States and a foreign jurisdiction).

¹⁶⁶ *See* section 856(c)(5)(A).

¹⁶⁷ *See* section 856(c)(4)(B)(iii)(II), (III) (a REIT may not own securities of an issuer representing more than 10 percent of the voting power or value of all of the issuer's outstanding securities; the 10 percent rule does not apply to securities issued by a TRS).

¹⁶⁸ *See* section 856(c)(4)(B)(ii).

¹⁶⁹ *See supra* notes 97 to 104 and accompanying text (discussing the subject-to-tax requirement).

may be able to manage those difficulties, however, by making a section 897(i) election for X immediately before the liquidation.¹⁷⁰ Second, if USRPHC 2 ultimately liquidates X, the stock of USRPHC 1 formerly held by X would become a built-in gain asset in the hands of USRPHC 2, meaning that USRPHC 2 would be subject to a corporate-level tax on any gain recognized on the disposition of that USRPHC 1 stock during the 10-year period following the liquidation of X.¹⁷¹ A similar analysis applies if X migrates into the United States as a REIT. In that case, although the stock of the REIT would not be a built-in gain asset in the hands of USRPHC 2, the stock of USRPHC 1 would be a built-in gain asset in the hands of the REIT.

As an aside, if the parties are unable to accept the shortcomings associated with the foreign corporation acquisition structure, they could consider having USRPHC 1 and USRPHC 2 combine their assets in a joint venture. Depending on the circumstances, that corporate structure may prove too cumbersome, as it would leave X in existence as a passive entity whose sole purpose is holding an indirect interest in a joint venture, a structure that could present securities law issues in situations in which X is publicly traded. This type of structure also could create potentially undesirable securities trading arbitrage opportunities because X and USRPHC 2 would own the same exact asset — an indirect interest in the joint venture assets — but their shares would trade independently of one another. Finally, the parties would also be hard pressed to find a strategy that enables X to exit the joint venture interest without triggering a FIRPTA tax.

ii. The reverse acquisition structure. In a reverse acquisition structure, USRPHC 1 (the subsidiary REIT of foreign corporation X) would acquire USRPHC 2 in a reorganization transaction in which the shareholders of USRPHC 2 become shareholders of USRPHC 1. That structure, while helpful in many respects, may present additional tax and business complexities that the parties may not have expected. For example, because USRPHC 2 is a publicly traded company, the reverse acquisition structure would essentially require the parties to undertake an IPO of USRPHC 1 and a simultaneous public acquisition of USRPHC 2 by USRPHC 1. Furthermore, depending on the size and location of USRPHC 2's real estate assets, an acquisition of USRPHC 2 by USRPHC 1 may give rise to state transfer and property tax issues that would not have arisen had the transaction been structured as an inbound merger of X into USRPHC 2.

¹⁷⁰ *See Id.*

¹⁷¹ *See* reg. section 1.337(d)-7 (applying the built-in gains tax under the principles of section 1374 to certain transactions in which the assets of a C corporation become the assets of REIT).

Finally, and perhaps most importantly, if USRPHC 1 is able to obtain domestically controlled QIE status for an uninterrupted period of five years following the transaction date, the USRPHC 1 stock held by X on the transaction date will cease to be a USRPI.¹⁷² At that point, X could sell its USRPHC 1 stock or distribute such stock in liquidation, in each case without incurring tax under section 897.

If X requests that the combined entity adopt charter-based restrictions that prevent the entity from becoming a non-domestically-controlled QIE,¹⁷³ X would have to consider whether the changes made to the USRPHC 1 charter or X's rights as a shareholder of USRPHC 1 constitute a deemed recapitalization of the USRPHC 1 stock held by X.¹⁷⁴ If those amendments were treated as a recapitalization, X would have to satisfy the requirements described in temp. reg. section 1.897-6T, including the hot-to-hot requirement and the FIRPTA filing requirement, to prevent the immediate recognition of the FIRPTA gain inherent in the USRPHC 1 stock at the time of the deemed recapitalization.¹⁷⁵ In this case, because USRPHC 1 would be a USRPHC, X should be able to satisfy the hot-to-hot requirement in connection with a deemed recapitalization of that entity. If X is not eligible to rely on Notice 89-57, however, it would have to satisfy the

¹⁷²If the acquisition of USRPHC 2 by USRPHC 1 was done for bona fide business reasons and not for the principal purpose of tax avoidance, the IRS should not be able to rely on section 269 to impose gain recognition on any subsequent liquidation of X or sale of USRPHC 1 stock by X that would otherwise be tax free. See, e.g., *D'Arcy MacManus & Massius, Inc. v. Commissioner*, 63 T.C. 440 (1975) (section 269 does not apply to an acquiring corporation that structured its acquisition of a target as a C reorganization instead of a B reorganization to avoid the application of the separate return loss year rules for the target's net operating losses); *Arwood Corp. v. Commissioner*, T.C. Memo. 1971-2, 30 T.C.M. (CCH) 6 (section 269 does not apply to a situation in which the taxpayer enters into a transaction that was motivated by a valid business purpose but was structured with a view toward minimizing taxes; "We think that arranging the merger in a manner that produces the most favorable tax results is simply intelligent business planning. It must be remembered that section 269 addresses itself to a situation where the principal purpose of the acquisition is tax avoidance; in the present case only the method selected for effecting the acquisition was motivated to some extent by tax considerations.") (second emphasis added).

¹⁷³See LTR 9630016, *Doc 96-21246*, or *96 TNT 147-40* (charter-based stock transfer restrictions designed to maintain the status of an entity as a domestically controlled REIT do not violate the requirement that a REIT's stock must be freely transferable).

¹⁷⁴Rev. Rul. 56-654, 1956-2 C.B. 216 (modification of the terms of stock issued by a corporation treated as a deemed E reorganization); LTR 200326032, *Doc 2003-15432*, or *2003 TNT 125-45* (amendment to the certificate of incorporation of a USRPHC treated as an E reorganization that was subject to the rules of sections 897(d) and (e)); LTR 200339054, *Doc 2003-21184*, or *2003 TNT 188-34* (same).

¹⁷⁵See *supra* Section II.B.

FIRPTA filing requirement set forth in temp. reg. section 1.897-5T(d)(1)(iii), including the declaration requirement.¹⁷⁶ As discussed above, if X were to satisfy the declaration requirement, it would be required (literally) to pay a FIRPTA tax on *any* subsequent disposition of its USRPHC 1 stock, even if the disposition occurs when USRPHC 1 is a domestically controlled QIE. Thus, unless X either satisfies the Notice 89-57 requirements or gets comfortable that the declaration requirement will not subject it to tax under section 897 on a future disposition of USRPHC 1 stock, a deemed recapitalization might frustrate X's ability to exit its investment in USRPHC 1 on a tax-free basis.

In addition to navigating those issues, X would have to confront the basic question discussed in Section I.D above: How is X supposed to determine whether USRPHC 1 is a domestically controlled QIE?¹⁷⁷ Although it might be impossible to determine domestically controlled QIE status with complete certainty, the parties can maximize their chances of obtaining domestically controlled QIE status for USRPHC 1 by adopting a structure in which X's initial interest in USRPHC 1 is set at substantially less than 50 percent, and if USRPHC 1 adopts a domestically controlled QIE monitoring system that either enables X to sell down its interest in USRPHC 1 or forces USRPHC 1 to redeem stock held directly or indirectly by other foreign persons, in each case to the extent necessary to maintain domestically controlled QIE status.¹⁷⁸ The apportionment of the tax cost associated with any sell down by X would be an obvious focus of the negotiations between X and USRPHC 2.

c. Summary. On the very simple transactions outlined in examples 12 and 13, the FIRPTA nonrecognition rules have managed to bring us full circle: The FIRPTA legislation was originally enacted to eliminate the pricing advantage that foreign persons enjoyed when they were able to sell USRPIs free of U.S. tax. In cases such as examples 12 and 13, the FIRPTA nonrecognition rules provide foreign acquirers with a different type of advantage, in that a U.S. acquirer might be unable to compete effectively with a foreign

¹⁷⁶The declaration requirement, if interpreted literally, would force X to pay a FIRPTA tax for *any* subsequent disposition of its USRPHC 1 stock, regardless of a change in fact or circumstance. Thus, if X were to satisfy the declaration requirement in connection with a deemed recapitalization of USRPHC 1, X would have to recognize gain on a subsequent disposition of its USRPHC 1 stock even if, at the time of that disposition, that stock is not a USRPI. See *supra* notes 107 to 110 and accompanying text.

¹⁷⁷See *supra* notes 28 to 30 and accompanying text.

¹⁷⁸If USRPHC 1 undergoes a deemed recapitalization as described above, the parties would need to ensure that any sell down of X's interest, or any other transaction that generates ECI at the X level, does not occur in the same tax year as the recapitalization.

acquirer when both acquirers are competing for the opportunity to acquire the same foreign target corporation in a tax-deferred reorganization. Example 13 also illustrates the truly ironic point that in addition to undercutting the policy goals that motivated the FIRPTA legislation, the FIRPTA nonrecognition rules can discourage foreign corporations from bringing *into* U.S. corporate solution foreign assets and operations that would not otherwise be subject to U.S. tax.

In response to the difficulties presented by the FIRPTA nonrecognition regime, many parties have resorted to one of the basic alternative structures outlined above, the features of which have been tweaked, combined with other structures, and enhanced with so many different features that it is impossible to describe them all. All of the alternative structures in this area, however, are, by definition, second-best solutions in that the parties do not immediately achieve their desired results and often have to live with an undesirable structure for a substantial period of time. Such a structure may give rise to increased tax costs (both foreign and U.S.), increased financing costs, and administrative burdens that may significantly reduce the parties' desire to enter into a transaction in the first place. Nonetheless, if the parties are faced with the choice of either abandoning a transaction altogether or incurring a significant FIRPTA tax to complete a transaction, one of the second-best solutions outlined above (or a variation thereon) might provide a more palatable result.

Finally, in thinking about the problems presented by the FIRPTA nonrecognition regime, it is important to note that although this article has focused heavily on the plight of publicly traded foreign corporations that desire to transfer a USRPHC interest in a nonrecognition transaction, they are not the only entities that encounter trouble with the FIRPTA nonrecognition rules. For example, a privately held foreign corporation would struggle with the subject-to-tax requirement and the FIRPTA filing requirement in situations in which the foreign corporation is owned by a U.S. pension fund, or one or more passthrough entities, including, for example, a U.S. REIT. Even if all of the stock of a foreign corporation is held by individuals and corporations, the parties might find themselves unable to satisfy the subject-to-tax requirement in connection with an inbound reorganization of the foreign corporation into a USRPHC whose stock qualifies for the publicly traded exception or the domestically controlled QIE exception.

E. The 897(i) Election

After dedicating more than 30,000 words to analysis and criticism of the FIRPTA nonrecognition regime, this article would be incomplete without a discussion of section 897(i), one of the most obscure provisions in all of FIRPTA.

Section 897(i) was enacted to prevent a conflict among the FIRPTA provisions, which arguably impose discriminatory treatment on foreign corporations that

own USRPIs, and the nondiscrimination provisions contained in various treaties to which the United States is a party. Boiled down to its most basic elements, section 897(i), as interpreted and limited by the regulations and the various notices that have modified the regulations, permits a foreign corporation that would have been a USRPHC if it had been domestic to file an election (an 897(i) election) to be taxed as a U.S. corporation for purposes of the FIRPTA provisions.

An 897(i) election produces two basic results. First, the foreign shareholders of the corporation will be treated for purposes of section 897 as if the foreign corporation were domestic.¹⁷⁹ Second, because the foreign corporation would be treated as a U.S. corporation for purposes of FIRPTA, the foreign corporation could engage in inbound reorganization and liquidation transactions without having to satisfy the requirements of section 897(d) and (e) and the associated regulations.¹⁸⁰

While the potential benefits of an 897(i) election are clear, some of the key requirements that must be satisfied to make that election are far from clear. Thus, while an 897(i) election may hold promise for some foreign corporations, many others will find the election unavailable as a practical matter.

To make an 897(i) election, a foreign corporation must satisfy five requirements. First, the foreign corporation must be entitled to nondiscrimination treatment for its USRPIs under "any treaty obligation" of the United States.¹⁸¹ Second, the foreign corporation must show that at the time of the election it would have been a USRPHC

¹⁷⁹Reg. section 1.897-3(a) ("A foreign corporation that has made an election under section 897(i) is in effect is [sic] subject to all rules under sections 897 and 1445 that apply to domestic corporations").

¹⁸⁰*E.g.*, reg. sections 1.897-3(a) ("In addition, section 897(d) will not apply to any distribution of a U.S. real property interest by such corporation or to any sale or exchange of such interest pursuant to a plan of complete liquidation under section 337"); 1.897-5T(b)(4) ("Except as otherwise provided herein for purposes of this section and section 1.897-6T, a foreign corporation that has made a valid election under section 897(i) shall be treated as a domestic corporation and not as a foreign corporation in determining the application of section 897"). A foreign corporation that has an 897(i) election in place would also be treated as a domestic corporation for purposes of determining the tax treatment of a 332 liquidation of the foreign corporation into a foreign parent corporation. *Id.* In that context, an 897(i) election may cause the distributing foreign corporation to recognize gain in connection with certain distributions of property to its foreign parent. *See temp. reg. section 1.897-5T(b)(3)(iv)(B).*

¹⁸¹Section 897(i)(1)(B); reg. section 1.897-3(b)(2). Such a treaty obligation could arise under any treaty, including an income tax treaty and a "friendship, commerce, and navigation" treaty. *See* Notice 88-1, 1988-1 C.B. 471.

if it had been formed as a U.S. corporation.¹⁸² Third, the foreign corporation must submit a signed waiver by each person who holds an interest in the foreign corporation stating that the gain, if any, from the disposition of an interest in such corporation (other than an interest solely as a creditor), which would be taken into account under section 897(a), shall be taxable despite any provision to the contrary in a treaty to which the United States is a party.¹⁸³ For a foreign corporation whose shares qualify for the publicly traded exception, the waivers need be filed only by 5 percent holders.¹⁸⁴ Fourth, the foreign corporation itself must submit a binding agreement to be treated as though it were a domestic corporation for any gain or loss recognized on the disposition of a USRPI that occurs during the period in which the 897(i) election is in effect and on the disposition of any property (including a non-USRPI) that is acquired in exchange for a USRPI in a nonrecognition transaction as defined in section 897(e).¹⁸⁵ Finally, the foreign corporation must pay the FIRPTA toll charge for any transfers of stock of the foreign corporation that occurred during the 10-year look-back period.¹⁸⁶

¹⁸²Temp. reg. section 1.897-8T(b). This requirement is not consistent with section 897(i), which clearly states that *any* foreign corporation that owns a USRPI may make an 897(i) election. Presumably, Treasury decided that the statute was far too generous to a foreign corporation that owned USRPIs that represented less than 50 percent of the value of its assets. In that situation, an 897(i) election would have enabled the foreign corporation to enjoy nonrecognition treatment on the transfer of a USRPI without having to satisfy the requirements of section 897(d) and (e), and would have permitted the corporation's foreign shareholders to sell their foreign corporation stock free of U.S. tax because, even if the foreign corporation was domestic, it would not be a USRPHC.

¹⁸³Section 897(i)(3); reg. section 1.897-1(c)(2).

¹⁸⁴Section 897(i)(3) (flush language); reg. section 1.897-3(c)(4)(i).

¹⁸⁵Reg. section 1.897-3(c)(3). This requirement reflects the fact that as a result of the inapplicability of section 897(e) and temp. reg. section 1.897-6T, a foreign corporation can exchange a USRPI for a non-USRPI that, in the absence of an exception, would not be subject to tax in the hands of the foreign corporation on a future disposition. For example, assume that foreign corporation X owns 100 percent of the stock of USRPHC 1; in connection with a B reorganization, X transfers all of that stock to ABC Co., in exchange for ABC voting stock; and ABC is not a USRPHC. If X has an 897(i) election in effect, it will be entitled to nonrecognition treatment under section 354 for that exchange. In the absence of a special rule such as reg. section 1.897-3(c)(3), X would be able to sell the ABC stock tax free in the future under section 881 because an 897(i) election causes X to be treated as a U.S. corporation only for purposes of section 897.

¹⁸⁶Reg. section 1.897-3(d)(2)(i) as modified by Notice 89-85 as modified by section 2 of Notice 2006-46. The FIRPTA toll charge look-back period applicable to 897(i) elections will be the earliest of the period beginning on the date that is 10 years before the date on which one or more domestic shareholders or related persons acquire control of the electing foreign corporation and ending on the date of the election, or the period beginning on the

(Footnote continued in next column.)

A publicly traded foreign corporation that is contemplating an 897(i) election will have to confront many of the same difficulties that were discussed above regarding the FIRPTA toll charge. For example, a publicly traded foreign corporation that desires to make an 897(i) election must identify its 5 percent holders using the constructive ownership rules of section 897(c)(6)(C) and obtain treaty waivers from those holders.¹⁸⁷ As discussed in Section II.C.5.b above, it might be impossible for a publicly traded foreign corporation to accurately identify its 5 percent holders. More importantly, if such a foreign corporation desires to make an 897(i) election for a tax year after the year in which its shares have begun trading, it must grapple with the FIRPTA toll charge calculation issues discussed in Section II.C.5 above.

It would appear that if a publicly traded foreign corporation attempts to make an 897(i) election that proves to be invalid for failure to accurately identify or obtain waivers from its 5 percent holders, the foreign corporation would continue to be treated as a foreign corporation for purposes of section 897.¹⁸⁸ For that reason, a U.S. corporation considering whether to acquire such a foreign corporation in an inbound nonrecognition transaction may be reluctant to do so unless the acquirer either is absolutely certain that the 897(i) election is valid or requires the foreign corporation to satisfy all of the requirements set forth in section 897(d) and (e) and the associated regulations regarding the reorganization.

The lack of clarity described above is unfortunate, given that section 897(i) was designed to enhance the ability of a foreign corporation to engage in nonrecognition transactions and, according to the regulations, "is the exclusive remedy of any foreign person claiming discriminatory treatment under any treaty with respect to the application of sections 897, 1445, and 6039C to a foreign corporation."¹⁸⁹

III. Conclusions

For a variety of reasons, foreign investors often hold ECI-producing USRPIs through a chain of one or

date that is 10 years before the date of the election and ending on the date of the election. For these purposes, related-person status is determined under section 267(b) and control is determined under section 304(c). *Id.*

¹⁸⁷See *supra* notes 14 to 20 and accompanying text (discussing the publicly traded exception); notes 130 to 133 and accompanying text (discussing, in the FIRPTA toll charge context, the application of the publicly traded exception to a foreign corporation whose shares are listed on a foreign exchange).

¹⁸⁸Temp. reg. section 1.897-5T(b)(4) ("Except as otherwise provided herein for purposes of this section and section 1.897-6T, a foreign corporation that has made a *valid election* under section 897(i) shall be treated as a domestic corporation and not as a foreign corporation in determining the application of section 897") (emphasis added).

¹⁸⁹Reg. section 1.897-3(a).

more corporations.¹⁹⁰ Foreign investors, both individual and corporate, will often prefer to hold those USRPIs through a corporation (either a REIT or a C corporation) to minimize their exposure to the U.S. filing obligations and income tax and withholding tax consequences associated with ECI. If a foreign investor is a corporation, it may wish to conduct its U.S. real estate activities through a U.S. subsidiary REIT or C corporation to manage its exposure to the branch profits tax.

Given the extent of foreign investment in U.S. real estate, combined with the various tax rules that *encourage* many foreign investors to conduct their U.S. real estate activities through USRPHCs, one would expect the rules applicable to transfers of USRPHC interests, especially transfers that occur in connection with non-recognition transactions, to be both fair and clear. Unfortunately, it is difficult to use those terms to describe the FIRPTA nonrecognition regime.

From the perspective of fairness, the FIRPTA non-recognition regime presents different types of issues in the foreign-to-foreign and inbound contexts. In the foreign-to-foreign context, the FIRPTA nonrecognition regime produces dramatically different results for similarly situated foreign transferors, without any apparent policy justification. For example, a foreign corporation that has historically owned \$1 billion of U.S. real estate and \$1.01 billion of foreign real estate could rely on the low USRPI percentage rule to transfer its USRPIs to another foreign corporation in a foreign-to-foreign merger that is not subject to the regularly traded requirement, the 5 percent holder restriction, or the voting control requirement.¹⁹¹ If, however, the asset values were reversed, so that the corporation owned \$1.01 billion of U.S. real estate and \$1 billion of foreign real estate, the corporation could not engage in any foreign-to-foreign reorganization without either recognizing the

gain inherent in its USRPIs or grappling with the vagaries of the foreign-to-foreign exchange rules discussed above.

The issues only become more difficult in the inbound context, in which three components of the FIRPTA nonrecognition regime pose major obstacles to basic nonrecognition transactions that should provide clear, well-settled results — the FIRPTA toll charge, the FIRPTA filing requirement, and the subject-to-tax requirement. Those components are discussed in detail in Section II.C.3 through Section II.C.5 of this article. There are, however, some additional points concerning the FIRPTA toll charge that bear mentioning here.

First, in situations in which a foreign person desires to transfer a USRPHC interest, the FIRPTA legislation was designed to provide for a single level of tax.¹⁹² In enacting the FIRPTA legislation, Congress chose to cede U.S. taxing jurisdiction over sales by foreign persons of stock in foreign corporations, even those that hold USRPIs. The adoption of the FIRPTA toll charge violates those basic principles by imposing a surrogate tax on sales of foreign corporation stock made by foreign persons. That tax need not, and should not, exist. This point has been made before.¹⁹³

Second, many of the publicly traded foreign investment vehicles that make major investments in U.S. real estate will find themselves completely unable to calculate their FIRPTA toll charge exposure with any degree of accuracy, even for the most basic transactions, such as those discussed in examples 11 and 12. The inability to calculate the FIRPTA toll charge, in many cases, will inhibit transactions such as inbound migrations or mergers that might otherwise be beneficial to the U.S. fisc.

Third, and perhaps most important, the inability of an entity to calculate its own FIRPTA toll charge exposure can, under the circumstances outlined in Example 12, provide a foreign corporate acquirer with a competitive advantage over a U.S. corporate acquirer in

¹⁹⁰See NYSBA Report, *supra* note 36, at 12-13. (“The treatment in [the temporary regulations] of inbound C, D, and F Reorganizations of a foreign corporation (particularly reg. section 1.897-5T(c)(4) and examples thereunder) appears to have aroused more public comment than any other aspect of the Regulations (indeed probably more than all other aspects combined). These provisions are particularly important in light of the impetus given by Congress to domesticate a foreign corporation’s United States business, in enacting the Branch Profits Tax and related provisions”); see generally Segal, Fink, and Stern, “Foreign Investment in U.S. Real Estate: Structuring for Non-Treaty Country Foreign Investors,” 25 *J. Real Est. Tax’n* 211 (1998); Hudson, “The Tax Effects of Choice of Entities for Foreign Investment in U.S. Real Estate and U.S. Businesses,” 4 *Bus. Entities* 2 (Mar./Apr. 2002); Hudson, “Current Techniques for Foreign Investment in U.S. Real Estate,” *Tax Notes*, July 2, 2001, p. 99, *Doc 2001-18094*, or 2001 *TNT* 127-69; Hirschfeld and Grossman, “Opportunities for the Foreign Investor in U.S. Real Estate — If Planning Comes First,” 94 *Jn’l Taxation* 1 (Jan. 2001).

¹⁹¹See *supra* notes 61 to 64 and accompanying text.

¹⁹²See *supra* note 9 (discussing the policy goals underlying the FIRPTA legislation).

¹⁹³See Blanchard -5T Article, *supra* note 2, at 522 (“Like many of the rules under FIRPTA, Regs. [section] 1.897-5T(c) is a relic of the 20th century, and should be eliminated as dead-wood”); NYSBA Report, *supra* note 36, at 18 (“In our view, provided that the possibility of tax avoidance by means of a pre-G.U. Repeal domestication is precluded, an inbound reorganization allows no possibility of tax avoidance and the Regulations should, accordingly, permit full nonrecognition”); Feld, “Is FIRPTA (Partially) Obsolete?” *Tax Notes*, May 11, 1987, p. 607 (“Repeal of the *General Utilities* principle in the 1986 Act eliminates the need to tax shareholders in order to assure one tax on the gain”); *supra* notes 61 and 126 (discussing criticism of the inside/outside basis disparity tax, which was the predecessor to the FIRPTA toll charge); *supra* note 9 (discussing the policy goals underlying the FIRPTA legislation).

situations where both acquirers are competing for the opportunity to acquire the same foreign corporation in a nonrecognition transaction.

Putting the issue of fairness aside, it is no one's interest to have a FIRPTA nonrecognition regime that is so unclear that it precludes taxpayers from achieving tax certainty on the most basic transactions. Often, after struggling with a structure for months on end to achieve an acceptable level of certainty (or a manageable level of uncertainty, depending on one's perspective), a taxpayer will either abandon a good business opportunity or settle for a suboptimal structure that produces little (if any) additional revenue for the fisc and generates significant transaction costs and business issues for the participants.

It would seem obvious by this point that the FIRPTA nonrecognition regime, as it applies to the types of transactions described in this article, is in dire need of a drastic overhaul. In determining how to achieve that overhaul, one might, as a practical matter, have to look at the long term differently than the short term.

In the long term, there seems to be only one way to meaningfully address the problems of the FIRPTA nonrecognition regime as it applies to the transactions described in this article: Cut the Gordian knot and reduce the FIRPTA nonrecognition regime to a simple rule that permits any foreign corporation to rely on any nonrecognition provision in connection with the transfer of any USRPI to any other corporation (whether foreign or domestic) as long as the recipient corporation of the USRPI takes a carryover basis in the USRPI, and that the recipient would be subject to U.S. tax on an a disposition of the USRPI. In cases in which the recipient corporation is a REIT or a RIC, the subject-to-tax requirement would be satisfied by the built-in gains tax. All other transfers that occur in connection with a reorganization (for example, a distribution of stock by a foreign corporation in connection with an inbound reorganization) would be eligible for nonrecognition treatment. That rule, as simple as it might seem, would preserve intact FIRPTA's original goal of ensuring that the gain inherent in a foreign-held USRPI would be subject to one level of U.S. tax that could not be avoided through the use of nonrecognition provisions, respect that Congress has ceded U.S. taxing jurisdiction over sales by foreign persons of stock in foreign corporations, and prevent the tax law from unnecessarily inhibiting bona fide business transactions.

In the short term, if the IRS desires to sculpt the FIRPTA nonrecognition regime through the issuance of notices, it would seem appropriate for the Service to

consider guidance that addresses some of the more significant issues described above.

For example, in the inbound context, the adverse impact of the FIRPTA filing requirement could be mitigated by deleting the "no boot" and "no ECI" requirements in Notice 89-57, neither of which seems to advance any clear policy objective. Also, the subject-to-tax requirement could be modified so that foreign persons who qualify for the publicly traded exception or the domestically controlled QIE exception are treated as satisfying the requirement. The subject-to-tax look-through rule could be discarded in its entirety. Most importantly, the FIRPTA toll charge also could be discarded in its entirety, with the built-in gains tax or the section 11 tax being relied on to achieve the objectives of the FIRPTA toll charge. At the very least, the FIRPTA toll charge rules should be modified in a manner that enables a publicly traded foreign corporation to satisfy the publicly traded exception for prior stock sales and rely on foreign securities filings and some basic presumptions (including presumptions relating to E&P levels and transfers made by former 5 percent holders) to calculate its FIRPTA toll charge liability.

In the foreign-to-foreign context, the principle underlying the low USRPI percentage rule could be extended to all foreign-to-foreign exchanges. Under that approach, any foreign person would be able to transfer any USRPI to a transferee foreign corporation in a nonrecognition transaction as long as the transferee foreign corporation remains subject to tax under section 897 on all of the gain inherent in the USRPI at the time of the transaction. Thus, for example, the narrow rules applicable to foreign-to-foreign mergers, the strict ownership limitations on foreign-to-foreign B reorganizations and section 351 transactions, and the restrictions on the nature of property that may be contributed to a foreign corporation in a section 351 transaction would all be eliminated as unnecessary. Those modifications would help rationalize the hodgepodge of rules that currently comprise the foreign-to-foreign exchange regime while continuing to ensure that a foreign-to-foreign exchange will not allow the gain inherent in a USRPI to escape taxation under section 897.

Although those interim modifications would only begin to address the ambiguities and technical obstacles inherent in the FIRPTA nonrecognition regime, they would represent a big step in the direction of fairness and clarity and might enable taxpayers to engage in some basic, nonabusive transactions that, as a practical matter, are currently unavailable. ♦

Appendix

Figure 1.
Foreign-to-Foreign A Reorganization – Section 368(a)(1)(A)^a



^aNote: An A reorganization can also be carried out through a transaction in which the transferor foreign corporation merges into a disregarded subsidiary of the transferee foreign corporation. See reg. section 1.368-2(b)(1)(ii).

Figure 2.
Foreign-to-Foreign B Reorganization – Section 368(a)(1)(B)



Figure 3.
Foreign-to-Foreign C Reorganization – Section 368(a)(1)(C)

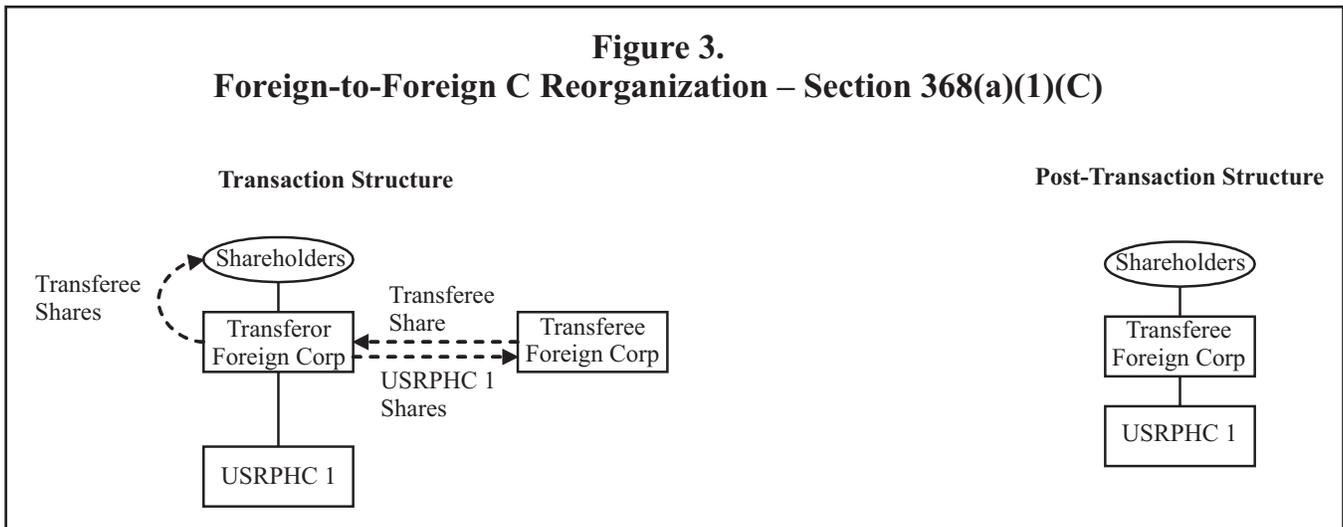


Figure 4.
Foreign-to-Foreign Parenthetical C Reorganization – Section 368(a)(1)(C)

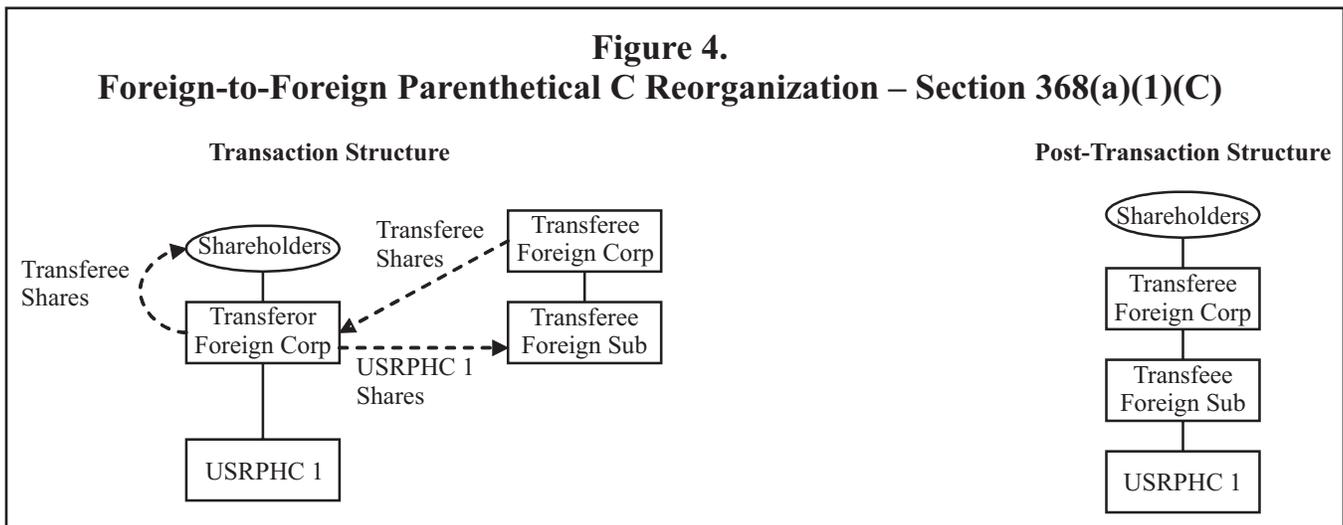


Figure 5.
Foreign-to-Foreign Acquisitive D Reorganization – Section 368(a)(1)(D)

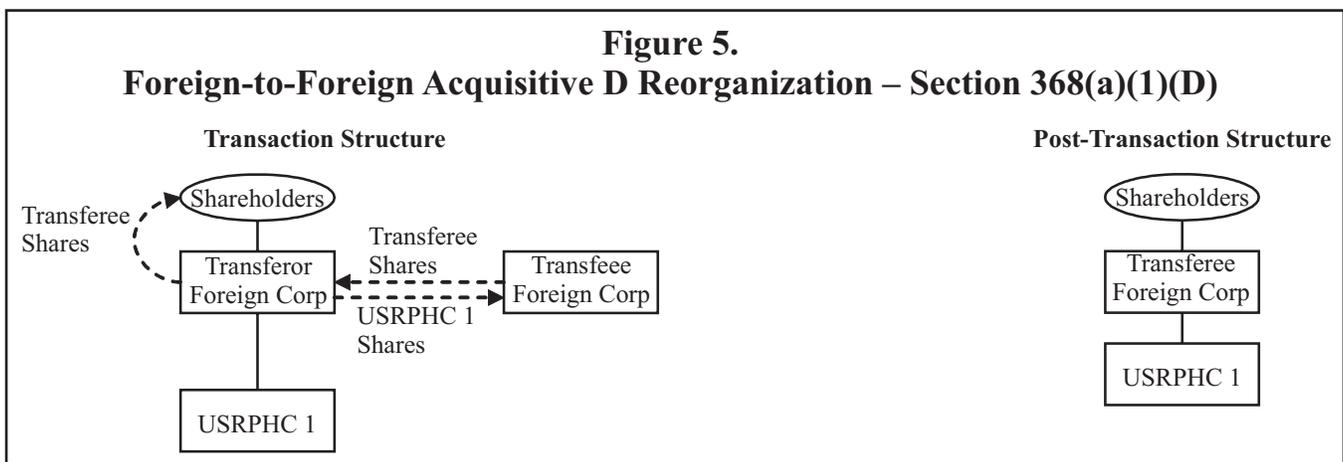
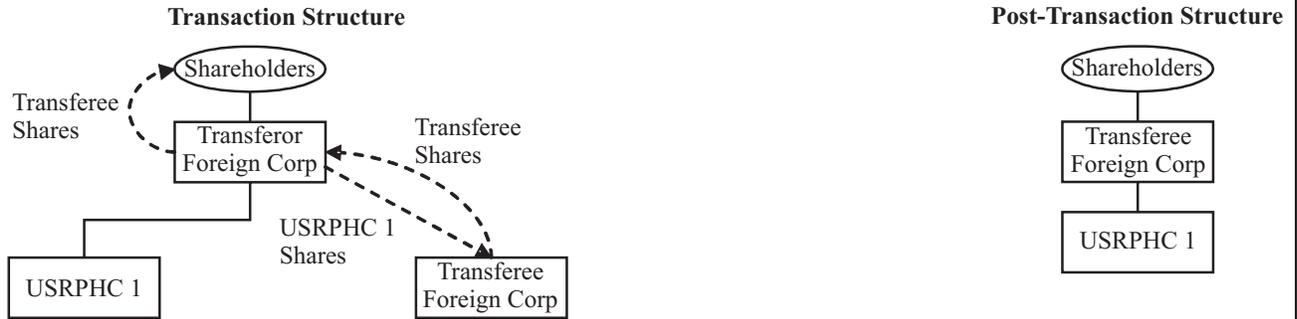


Figure 6.

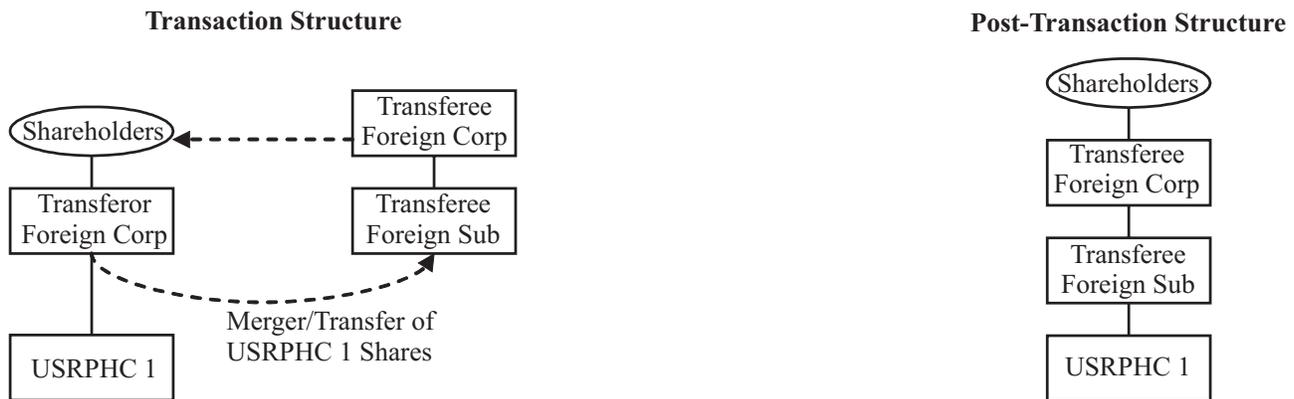
Foreign-to-Foreign F Reorganization – Section 368(a)(1)(F)^a



^aNote: An F reorganization can be accomplished through several different methods.

Figure 7.

Foreign-to-Foreign (a)(2)(D) Reorganizations – Section 368(a)(2)(D)



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Figure 8.
Foreign-to-Foreign (a)(2)(E) Reorganization – Section 368(a)(2)(E)

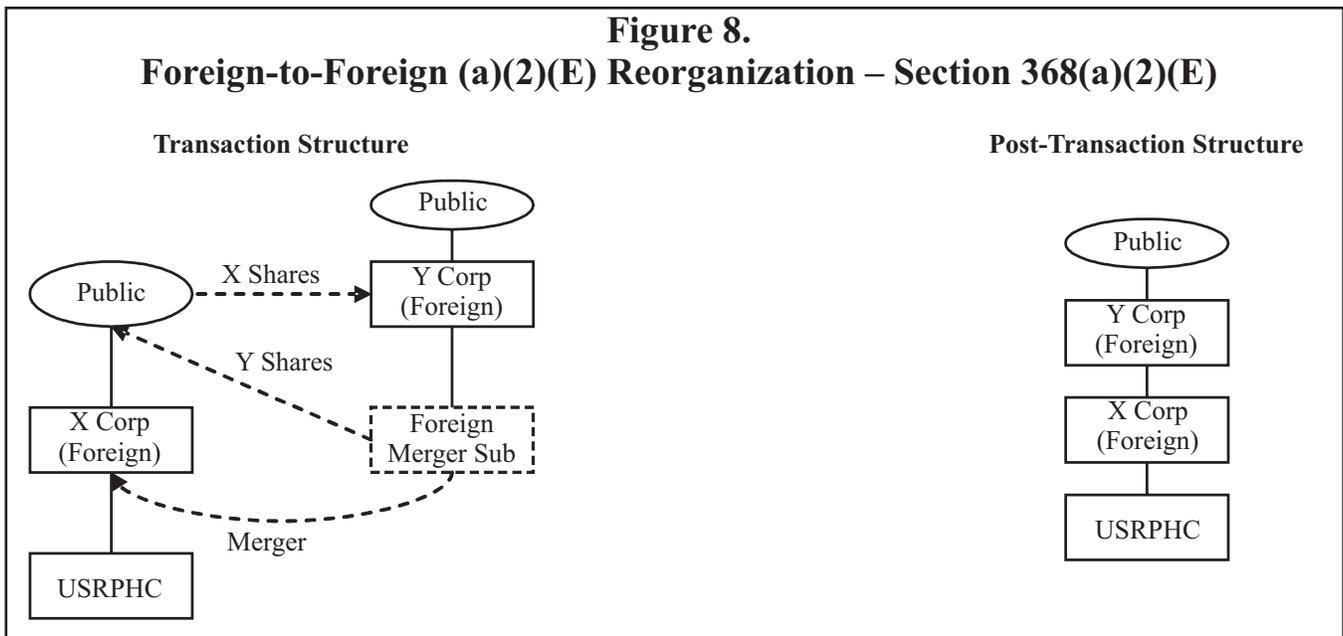
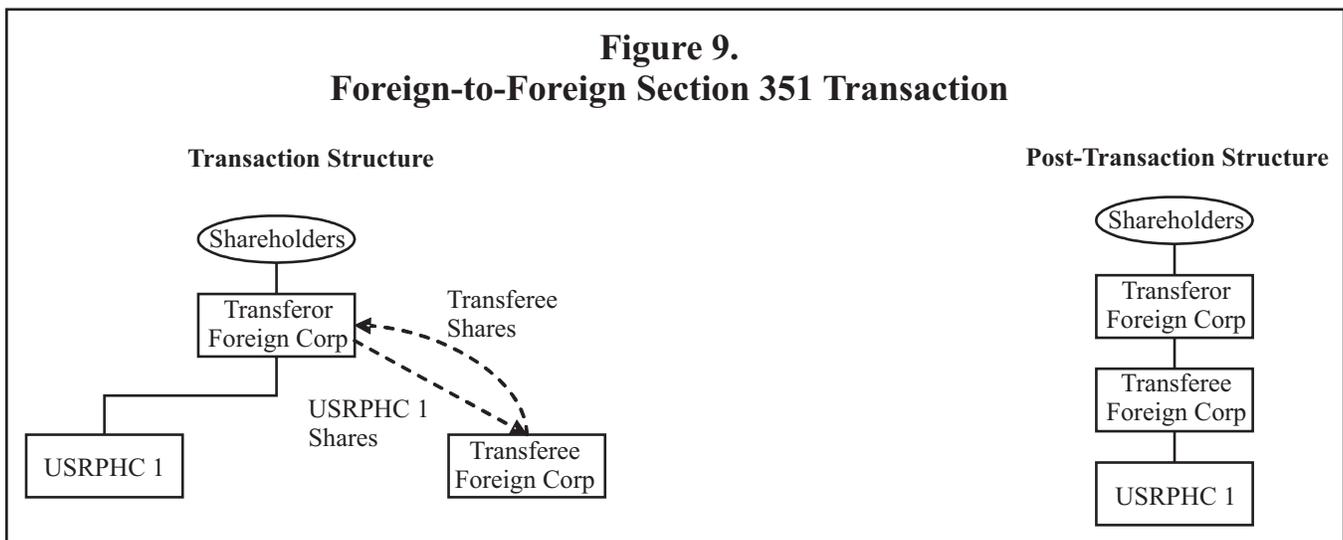


Figure 9.
Foreign-to-Foreign Section 351 Transaction



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Figure 10.
Inbound A Reorganization – Section 368(a)(1)(A)^a



^aNote: An A reorganization can also be carried out through a transaction in which foreign corporation X merges into disregarded subsidiary of USRPHC 2.

Figure 11.
Inbound C Reorganization – Section 368(a)(1)(C)

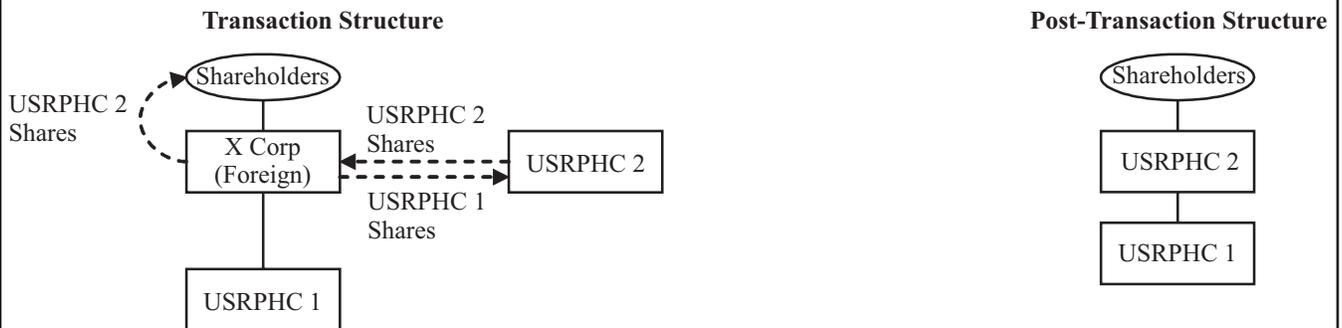


Figure 12.
Inbound Parenthetical C Reorganization – Section 368(a)(1)(C)

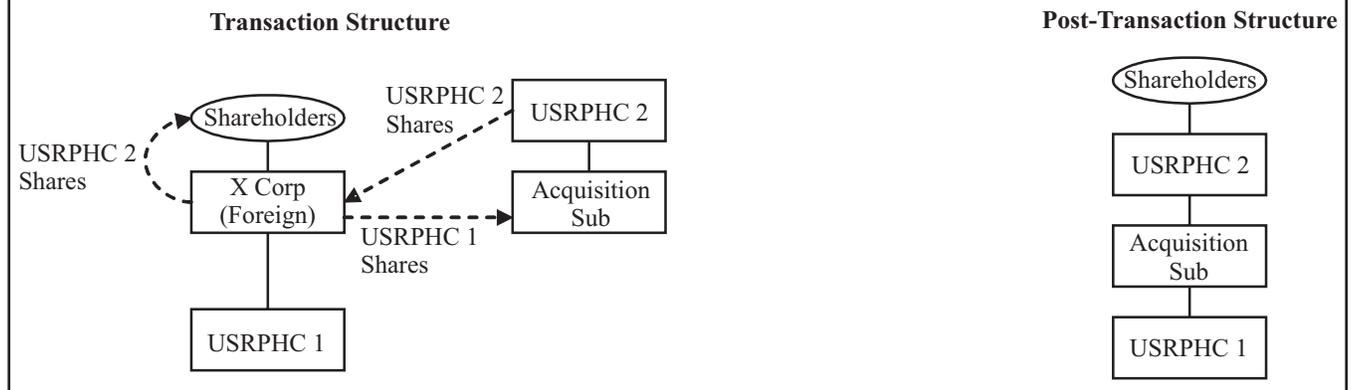


Figure 13.
Inbound Acquisitive D Reorganization – Section 368(a)(1)(D)



Figure 14.
Inbound Divisive D Reorganizations – Section 368(a)(1)(D)

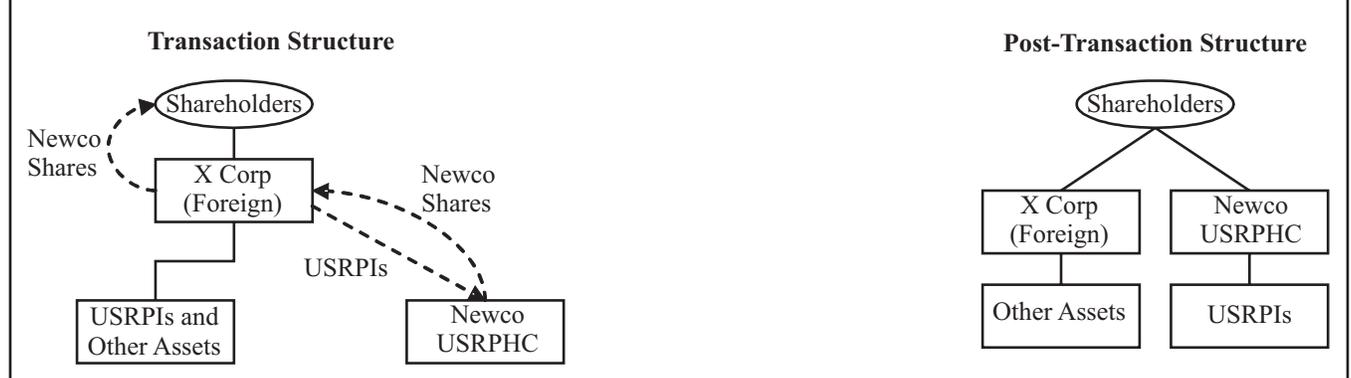
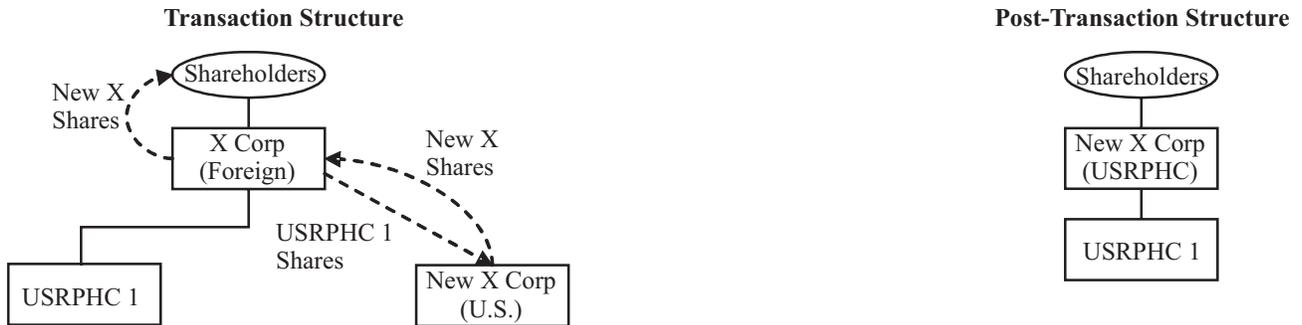


Figure 15.
Inbound F Reorganization – Section 368(a)(1)(F)^a



^aNote: An F reorganization can be accomplished through a number of different methods. The illustration at Figure 15 reflects the inbound F reorganization transaction steps that are deemed to occur for purposes of temp. reg. section 1.897-5T and 1.897-6T.

Figure 16.
Inbound (a)(2)(D) Reorganization – Section 368(a)(2)(D)

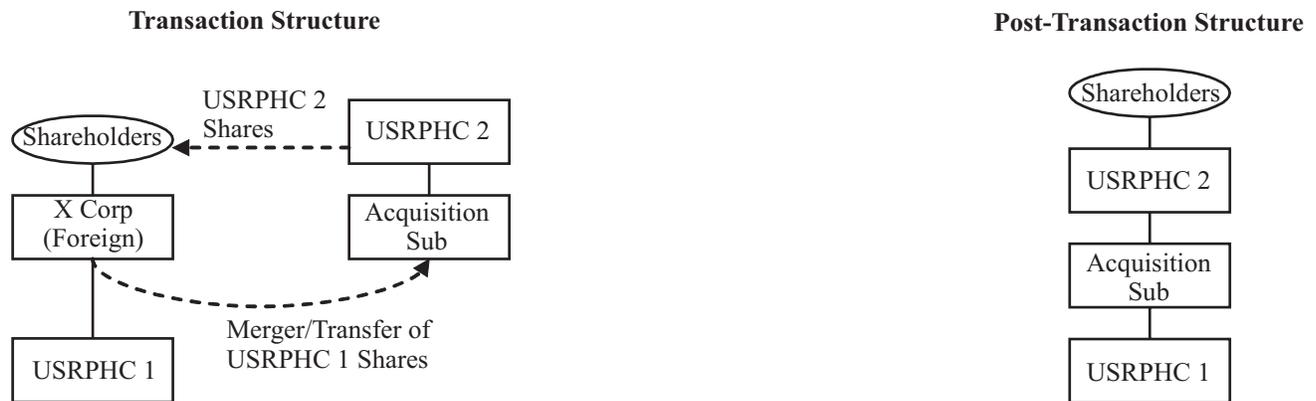


Figure 17.
Inbound (a)(2)(E) Reorganization – Section 368(a)(2)(E)

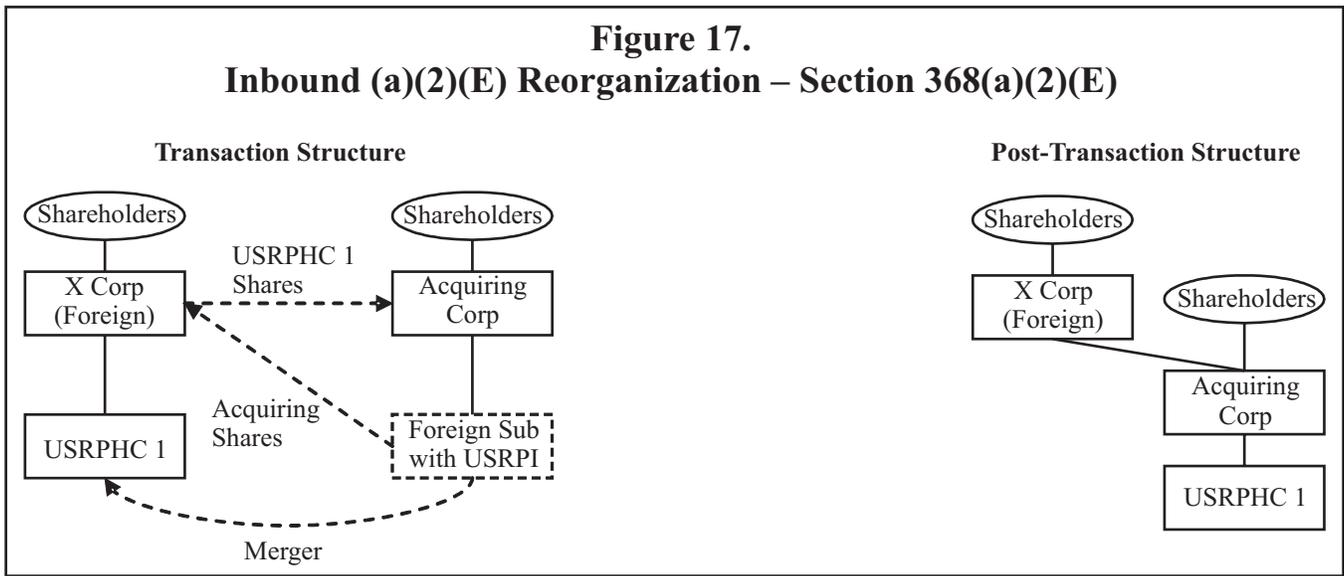


Figure 18.
Foreign-to-Foreign Section 332 Liquidation

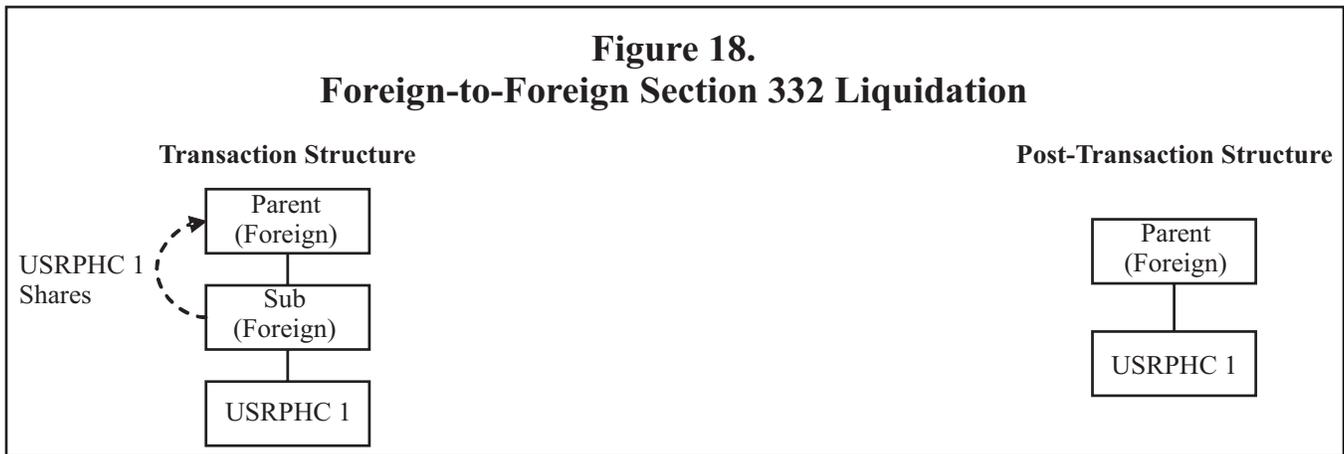


Figure 19.
Inbound Section 332 Liquidations

