NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

NOTICE 2007-55 AND POSSIBLE ADMINISTRATIVE GUIDANCE ADDRESSING SECTIONS 897(h)(1) and 1445(e)(6)

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New York State Bar Association Tax Section

Report on Notice 2007-55 and Possible Administrative Guidance Addressing Sections 897(h)(1) and 1445(e)(6)[1]

I. Introduction

Notice 2007-55[2] (the "Notice") announced that Treasury regulations would be issued clarifying how Sections 897(h)(1) and 1445(e)(6) of the Internal Revenue Code[3] apply to "distributions" made by a "qualified investment entity" (as defined below, a "QIE"). The Notice has been the subject of commentary and criticism,[4] including a number of recent requests that it be withdrawn.[5] We have been asked to address how the Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS") might implement through regulations the positions expressed in Section 2 of the Notice.[6]

II. Background

Section 897 generally imposes net-basis U.S. federal income tax on any gain derived by a non-U.S. person from the sale or exchange of a "United States real property interest" (a

[1] The principal author of this Report is Robert Cassanos. Substantial contributions were made by Brian Kniesly and Daniel Jacobson. Helpful comments were received from Richard Andersen, Kim Blanchard, Stephen Land, William McRae, Shane McGuire Milam, Michael Miller, Andrew Needham, Elliot Pisem, Michael Schler, David Sicular, Willard Taylor and Gordon Warnke.

[2] 2007-27 I.R.B. 13.

[3] All references to "Sections" herein are references to sections of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise expressly indicated herein, and references to regulations are to the Treasury Regulations issued under the Code.

[4] *See* Peter J. Genz, *Request for Guidance on Certain Tax Issues Arising in REIT Liquidations, Including Issues Relating to Notice 2007*-55, ABA Sec. Tax. Rep. (June 10, 2008) *available at* http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2008/080610realestate200755.authcheckdam.pdf ("ABA Report"); Kimberly S. Blanchard, *Notice 2007-55 Rules Liquidating Distributions from REITs Are Taxable Under §897(h)(1)*, 36 Tax Mgmt. Int'l J. No. 8, Aug. 10, 2007 *available at* http://www.weil.com/files/Publication/2c32a49d-f8a5-4823-ad92-f7ab9dbc0311/Presentation/PublicationAttachment/8ebc91be-f004-42cf-845b-faa7a8325bdc/36TMIJ_No8_08-10-07.pdf; Peter A. Glicklich and Abraham Leitner, *IRS Announces That Certain Distributions by U.S. REITs to Foreign Investors Will Be Taxable*, 36 Tax Mgmt. Int'l J. International Journal 376, 379 (Aug. 10, 2007); Semer and Alexander, 743 T.M., *Structuring Real Estate Joint Ventures with Private REITs*, at V.A.2.b.(1)(b)(ii).

[5] Letter from Jeffrey D. DeBoer, President and CEO, The Real Estate Roundtable, to Timothy Geithner, Secretary of the Treasury, U.S. Dep't. of the Treasury (Jan. 19, 2011), *available at* http://www.reit.com/Portals/0/RERLetterreNotice2007-55(1-19-11).pdf; Letter from 26 Members of Congress to Emily McMahon, Acting Assistant Secretary for Tax Policy, U.S. Dep't of the Treasury, and William J. Wilkins, Chief Counsel, IRS (June 24, 2011) *available at* http://www.reit.com/Portals/0/IRS2007-55notice.pdf ; Letter from Tony M. Edwards, Executive Vice President and General Counsel, NAREIT, to IRS (May 1, 2012); Letter from William M. Paul, Chair, Section of Taxation, ABA, to Emily McMahon and William J. Wilkins (May 16, 2012).

[6] The recommendations in this Report are intended to offer suggestions about future guidance in implementing the Notice through regulations.

"USRPI"). A USRPI includes an interest in real property located in the United States[7] and stock in a domestic corporation (other than a domestically-controlled QIE, as defined below) which is a United States real property holding corporation (such a domestic corporation, a "USRPHC").[8] This provision, together with the accompanying withholding tax rule in Section 1445, is commonly referred to as "FIRPTA."[9] Generally, FIRPTA tax applies only to gains derived from sales or other dispositions of USRPIs. For example, if a non-U.S. person owns rental real property located in the United States, rental payments from leasing that real property are not subject to FIRPTA tax, but gain from a sale of the real property would be. Similarly, if a non-U.S. person owns stock of a USRPHC, dividends paid by the USRPHC out of its earnings and profits generally are not subject to FIRPTA tax, but gain from the sale of the shares in the USRPHC would be.

A "real estate investment trust," as defined in Section 856 (a "REIT"), is a corporation for U.S. tax purposes, but is subject to a special modified pass-through regime under Sections 856 through 860. A REIT can, however, also be a USRPHC, and many REITs will in fact meet the asset test to qualify as USRPHCs.

Section 897(h)(1) contains a special rule that applies when a non-U.S. person owns shares in a QIE. A QIE is defined to include any REIT, whether or not it is a USRPHC.[10] In particular, Section 897(h)(1) provides as follows:

> LOOK-THROUGH OF DISTRIBUTIONS.—Any distribution by a qualified investment entity to a nonresident alien individual, a foreign corporation, or other qualified investment entity shall, to the extent attributable to gain from sales or exchanges by the qualified investment entity of United States real property interests, be treated as gain recognized by such nonresident alien individual, foreign corporation, or other qualified investment entity from the sale or exchange of a United States real property interest. Notwithstanding the preceding sentence, any distribution by a

[7] §897(c)(1)(A)(i).

[8] More precisely, a USRPI includes "any interest (other than an interest solely as a creditor) in any domestic corporation unless the taxpayer establishes…that such corporation was at no time a [USRPHC] during the shorter of the period after June 18, 1980, during which the taxpayer held such interest, or the 5-year period ending on the date of the disposition of such interest." §897(c)(1)(A)(ii).

[9] Initially enacted as part of the Foreign Investors in Real Property Tax Act of 1980, Pub. L. No. 96-499, known as "FIRPTA."

[10] §897(h)(4)(A). Prior to January 1, 2014, the definition of a QIE also includes any regulated investment company that either is a USRPHC or would be if not for §§897(c)(3) and (h)(2). §897(h)(4)(A)(i)(II). Currently, after December 31, 2013, a regulated investment company will be subject to QIE treatment only with respect to distributions it makes that are attributable to its direct or indirect interest in a REIT. §897(h)(4)(A)(ii). Note however that Congress has in the past repeatedly extended this phaseout and a tax extenders bill was introduced in the Senate on December 19, 2013 that would have extended this phaseout through 2014, although the bill failed on procedural grounds. Tax Extenders Act of 2013, S. 1859, 113th Cong. § 223 (2013). Accordingly, throughout this Report we will focus on QIEs that are REITs.

> qualified investment entity to a nonresident alien individual or a foreign corporation with respect to any class of stock which is regularly traded on an established securities market located in the United States shall not be treated as gain recognized from the sale or exchange of a United States real property interest if such individual or corporation did not own more than 5 percent of such class of stock at any time during the 1-year period ending on the date of such distribution.

Prior to the Notice there was only one private letter ruling interpreting Section 897(h)(1), and no published guidance.[11] In 2007, the IRS issued the Notice. Section 2 of the Notice addresses the meaning and scope of Section 897(h)(1) and reads as follows:

> Sections 897(h)(1) and 1445(e)(6) by their terms apply to all distributions to the extent attributable to gain from sales or exchanges by the qualified investment entity of a USRPI. Accordingly, the IRS will challenge under current statutory and regulatory provisions an assertion by any foreign taxpayer that section 897(h)(1) does not apply to distributions in complete liquidation under sections 331 and 332. In addition, regulations will clarify that the application of section 897(h)(1) and withholding under section 1445(e) is not limited to distributions by qualified investment entities that are subject to section 316. The regulations will clarify that the term "distribution," as used in sections 897(h)(1) and 1445(e)(6), includes any distribution included under sections 301, 302, 331, and 332, where the distribution is attributable, in whole or in part, to gain from the sale or exchange of a USRPI by a qualified investment entity or other pass-through entity.

As the following discussion indicates, the brevity of the Notice belies the complexity of the issue it addresses.

While the Notice tells us that Section 897(h)(1) applies to all distributions from a QIE, there are many questions about *how* that section applies to distributions that are not answered by the Notice. Determining how to answer these questions is difficult because Section 897(h)(1), as worded, does not fit together well with some other provisions of the Code, including other provisions of FIRPTA.[12]

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[11] In 1990, the IRS issued a private letter ruling holding that §897(h)(1) does not apply to liquidating distributions by a REIT. That ruling was revoked in 2004. PLR 9016021 (January 18, 1990), *revoked by* PLR 200453008 (September 27, 2004).

[12] For example, FIRPTA provides an exception from USRPHC status for QIEs which are "domestically controlled" (that is, more than 50% owned by U.S. persons). §897(h)(2). Any foreign investor can sell stock of a domestically controlled REIT (commonly referred to as a "DREIT") without incurring FIRPTA tax. Yet, according to the second

In particular, Section 897(h)(1) appears to require that the measure of FIRPTA tax imposed on the shareholder be based solely on the QIE's gains from the sales of USRPIs, rather than on the shareholder's income or gain from the distribution made by the QIE (as determined under the normal U.S. federal income tax rules). Specifically, the shareholder's income or gain may not match, in amount or in timing, the QIE's gain from the sale of its USRPIs. In addition, to implement the tax where the QIE has income and gains that are not from dispositions of USPRIs, the QIE's gain from the sale of its USRPIs must somehow be allocated or attributed to its distributions so that the shareholder's share of these gains could be determined and the FIRPTA taint inherent in these gains could be "passed through" to the QIE's shareholders.

This Report tries to determine the best way to craft regulations that implement the interpretation of Section 897(h)(1) adopted by the Notice, and reflects two guiding principles: First, statutory interpretations that result in a measure of taxable income that is closer to the taxpayer's economic income are favored over other interpretations. Second, any particular rule or interpretation should minimally disrupt the network of other rules that intersect with the rule in question. The alternative approaches we consider wind up either over- or under-taxing foreign shareholders to a greater degree than the approach we recommend. Accordingly, we believe the approach suggested is the best approach to implement Section 897(h)(1) in a manner consistent with the Notice.

III. Summary of Recommendations

1. A fair and relatively manageable way to implement the Notice would begin by first defining the amount of gain derived by a QIE that is referred to in Section 897(h)(1) to include all net gains and losses derived by the QIE from dispositions of USRPIs. Preferably the QIE's total net gains and losses from USRPI dispositions would be divided into two categories: (i) those net gains and losses which *could be* designated by the QIE as capital gain dividends ("Long-term FIRPTA Gains"), and (ii) all other net gains and losses ("Residual FIRPTA Gains") (Long-term FIRPTA Gains and Residual FIRPTA Gains, collectively "Total FIRPTA Gains").

2. There are various methodologies by which the QIE's Total FIRTA Gains could be "attributed" to distributions made by the QIE, none of which is perfect. The method we suggest would first allocate Long-term FIRPTA Gains to distributions designated as capital gain dividends (or distributions which could have been so designated) and allocate Residual FIRPTA Gains to other distributions, in each case until the Total FIRPTA Gains had been deemed distributed. Non-FIRPTA income and gain would each only be

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part of the Notice, a distribution which is treated as a sale (such as a liquidating distribution) is subject to tax under §897(h)(1), even though an actual sale would not be subject to any FIRPTA tax due to the special DREIT rule.

allocated to ordinary and capital gain dividends after the Residual FIRPTA Gains and Long-term FIRPTA Gains had been used up pursuant to the allocation described in the preceding sentence. There would be no ability to specially allocate distributions and the treatment of a distribution as a FIRPTA distribution under this point would be controlling.[13]

3. At the close of a taxable year, any Total FIRPTA Gains (of either type) that had not been allocated to distributions made by the QIE would be carried forward and potentially applied against distributions of the same type in subsequent years. During any year, we refer to the amounts that have been carried forward into the year together with the undistributed amounts of Total FIRPTA Gains from the current year as the "Not Previously Distributed FIRPTA Gains" or "NPDFG" accounts.

4. If at the time of a non-Section 301 distribution there were any unallocated NPDFGs, those gains would be allocated to the distribution in a manner similar to the manner in which earnings and profits would be allocated. In the case of liquidations, the unallocated NPDFGs would simply be matched against the first dollars of distributions.

5. A QIE would be required to withhold pursuant to Section 1445(e)(6) in accordance with the amount of Total FIRPTA Gains treated as distributed (pursuant to the methodology described in points 2, 3 and 4).

6. However, shareholders could apply for and receive certificates of reduced withholding to the extent their tax was limited by the principles of point 7. It would be a condition of such a certificate that the QIE withhold from subsequent distributions, and that the shareholder pay tax with respect to such subsequent payments, in the manner described in point 7. If a shareholder did not request a reduced withholding certificate, it could still apply the principles of point 7 to determine the net amount of FIRPTA tax and seek a refund of any withholding in excess of that amount, but only if it entered into an agreement on a timely filed return and agreed to pay tax in the manner described in point 7 below, and the QIE entered into the appropriate withholding agreements.

7. At the shareholder level, the Section 897(h)(1) tax would apply to the lesser of (i) the amounts treated as distributed Total FIRTPA Gains under point 2, 3 and 4 above, and (ii) the amount of the shareholder's taxable income or gain (under the normal U.S. tax rules) as a result of the distribution in question. In other words, Section 897(h)(1) would be interpreted as characterizing the income or gain recognized by a shareholder upon his receipt of a distribution from a QIE as subject to FIRPTA (or not), but not as converting what would otherwise be a recovery of basis into income or gain. To the extent the QIE

[13] Thus, in some cases distributions that might have been treated as a regular dividend subject to FDAP withholding tax would instead be subject to tax under FIRPTA. However, both taxes would not be imposed on the same dollar of income.

level allocation of Total FIRPTA Gains (of either type) was greater than the amount of income or gain recognized by the shareholder, the balance would be carried over by the shareholder and applied against the next distribution that was taxable to the shareholder (whether or not that distribution itself was attributable at the QIE level to FIRPTA gain). Thus, there would in effect be two running tallies, one at the QIE level and one at the shareholder level. At the QIE level, FIRPTA gain which had not been attributed to a distribution would be added to the QIE's NPDFG account and attributed to subsequent distributions under the rules set forth in points 2, 3 and 4 above. At the shareholder level, FIRPTA gain which was allocated to a distribution but which exceeded the shareholder's income or gain with respect to that distribution would be carried forward by the shareholder and would taint subsequent taxable distributions (i.e., cause the Section 897(h)(1) tax to apply to them).

8. Once the balance of the NPDFG account had been distributed and the shareholder level FIRPTA gain carryforward, if any, had been applied to subsequent distributions, the balance of any distribution not covered by any of the foregoing recommendations would be taxed under the general rules applicable under the Code, including the balance of Section 897.[14]

9. There will be cases in which the foreign shareholder sells the stock of the QIE before the FIRPTA gain carryforward at the shareholder level has been applied to a subsequent distribution. The question then arises whether such an unused carryforward should taint gain derived by the foreign shareholder on a subsequent sale of stock of a QIE if, for whatever reason, the gain on the sale of that stock would not otherwise have been subject to FIRPTA. This could occur for example if at the time of sale the QIE was domestically controlled, the shareholder was eligible for the benefits of Section 892, the so-called "cleansing exception" (as defined below) applied, or the QIE was not a USRPHC. In each of these cases, the shareholder of the QIE has been permitted to shelter gain recognized by the QIE from a disposition of a USRPI with non-USRPI tax attributes (that is, basis recovery from a non-FIRPTA asset has been applied to shelter FIRPTA gain). Because these attributes have been "imported" into the FIRPTA base we think it is appropriate to level a FIRPTA tax on a subsequent sale of the QIE stock to the extent of the lesser of (x) the shareholder's actual gain on such sale (computed as it would be for a U.S. shareholder) or (y) the shareholder's FIRPTA gain carryforward amount.

10. While there is logic for the tainting concept discussed in point 9, if there is concern (which we do not share) that the IRS lacks the authority to impose this taint absent a statutory change, we believe this concern has been addressed by the mechanisms outlined

[14] So, for example, if the QIE was domestically controlled, after taking into account its share of FIRPTA gain in accordance with the foregoing rules, a foreign shareholder would not be subject to FIRPTA tax with respect to the balance of its gain.

in points 5 through 7 above, which make the shareholder's agreement to the principles of point 7 a prerequisite to net basis, rather than gross basis, tax and withholding. In effect, this approach makes the ability to defer current tax of FIRPTA gain on dispositions by QIEs elective, but in a way which is even-handed. We note that electivity has been suggested by other commentators who have discussed similar approaches, although not perhaps for this reason. Thus, QIE shareholders could either pay FIRPTA tax currently on a gross basis, or in effect elect to pay FIRPTA tax on a net basis as discussed above. Electing QIE shareholders would agree to treat gains from the subsequent sale of QIE stock as ECI to the extent this was a requirement for being taxed on a net basis.

11. Under the prevailing interpretation of current law, a QIE which has sold all of its USRPIs is technically no longer a USRPHC even if it has not yet distributed the gain from those USRPIs. This rule is referred to as the "cleansing exception." While the cleansing exception makes sense when applied to taxpaying C corporations, this interpretation of the cleansing exception does not make sense when applied to QIEs which can permanently avoid corporate level tax by making appropriate distributions. For this reason, we think the regulations implementing Section 897(h)(1) should make clear that a QIE cannot purge itself of its taint as a USRPHC until it has fully distributed its entire NPDFG account.

12. To deal with cases in which FIRPTA tax would not apply to the sale of stock of a QIE that is sold while the QIE has an NPDFG account (for reasons other than the cleansing election), consideration should be given to adopting an anti-abuse rule which could for example take the form of treating the stock sale as a constructive distribution if, e.g., a plan of liquidation had previously been adopted or the QIE's NPDFG account exceeded a specified percentage of the QIE's assets (perhaps one-third). Alternatively, consideration could be given to imposing the FIRPTA toll charge on distributions out of the QIE's NPDFG account that are received by a transferee of a QIE (which could be limited to NPDFG accounts that are over a threshold amount).

13. The application of Section 897(h)(1) to shareholders who own 5% or less of any class of stock ("5% or less shareholders") of a QIE which is publicly traded on a U.S. exchange should be clarified to confirm that those shareholders who are 5% or less shareholders for the relevant period are not subject to Section 897(h)(1) or the Notice and that they will not be subject to tax under Sections 871(a) and 881 ("FDAP withholding") on distributions not otherwise subject to FDAP withholding (in other words, liquidating distributions, redemptions not essentially equivalent to a dividend, etc.).[15] Those shareholders who became 5% or less shareholders after the QIE recognized FIRPTA level gains but before they sold their shares would however be subject to the carryover

[15] The IRS has confirmed this in a non-binding memorandum. Memorandum from Office of Chief Counsel (International), AM2008-003 (Feb. 15, 2008) *available at* http://www.irs.gov/pub/irs-utl/am2008003.pdf.

regime discussed above in point 9 if they were taxed on a net basis with respect to their prior Section 897(h)(1) distributions.

IV. Discussion

The relevant portions of the Code and the Notice read as follows:

Section 897(h)(1):

> LOOK-THROUGH OF DISTRIBUTIONS.—Any distribution by a qualified investment entity to a nonresident alien individual, a foreign corporation, or other qualified investment entity shall, to the extent attributable to gain from sales or exchanges by the qualified investment entity of United States real property interests, be treated as gain recognized by such nonresident alien individual, foreign corporation, or other qualified investment entity from the sale or exchange of a United States real property interest.

Section 1445(e)(6):

> DISTRIBUTIONS BY REGULATED INVESTMENT COMPANIES AND REAL ESTATE INVESTMENT TRUSTS.—If any portion of a distribution from a qualified investment entity (as defined in section 897(h)(4)) to a nonresident alien individual or a foreign corporation is treated under section 897(h)(1) as gain realized by such individual or corporation from the sale or exchange of a United States real property interest, the qualified investment entity shall deduct and withhold under subsection (a) a tax equal to 35 percent (or, to the extent provided in regulations, 20 percent) of the amount so treated.

Notice 2007-55:

> In addition, regulations will clarify that the application of section 897(h)(1) and withholding under section 1445(e) is not limited to distributions by qualified investment entities that are subject to section 316. The regulations will clarify that the term "distribution," as used in sections 897(h)(1) and 1445(e)(6), includes any distribution included under sections 301, 302, 331, and 332, where the distribution is attributable, in whole or in part, to gain from the sale or exchange of a USRPI by a qualified investment entity or other pass-through entity.

The key questions that the regulations therefore need to answer are:

1. What does the phrase "any distribution" in Section 897(h)(1) mean?

2. What is the correct way to determine the amount of each distribution that is "attributable to gain" from sales or exchanges by the QIE of USRPIs? And

3. Should Section 897(h)(1) be interpreted to impose FIRPTA tax on distributions that would not otherwise be treated as taxable income under general U.S. tax rules?

A. Analysis of Key Questions

1. What Does the Phrase "Any Distribution" in Section 897(h)(1) Mean?

(a) Types of Distributions

Section 897(h)(1) uses the phrase "any distribution." The term "distribution" is used in the Code to refer to payments made by a corporation to a shareholder in his capacity as such. But there are different types of distributions under the Code, and each has different tax consequences to the shareholder receiving the distribution. The principal types of distributions and their treatment for tax purposes are as follows:

Section 301 distributions are distributions made with respect to stock, where the stock remains outstanding. These distributions are treated as:

(i) first, a taxable dividend to the extent paid out of the corporation's earnings and profits;[16]

(ii) then, a tax-free recovery of basis;[17] and

(iii) finally, taxable gain from the sale or exchange of stock of the corporation making the distribution.[18]

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[16] §§301(c)(1) and 316. These distributions are often referred to by reference to §316, which defines a "dividend."
[17] §301(c)(2).
[18] §301(c)(3). §301(c)(3) literally refers to gain from the sale or exchange of "property." The Supreme Court has interpreted "property" in this context to mean "stock." *Boulware v. U.S.*, 552 U.S. 421 (2008) ("Under §301(c), the portion of the distribution that is a "dividend," as defined by §316(a), must be included in the recipient's gross income; and the portion that is not a dividend is, depending on the shareholder's basis for his stock, either a nontaxable return of capital or a gain on the sale or exchange of stock, ordinarily taxable to the shareholder as a capital gain"). The temporary regulations under FIRPTA confirm that such distributions from USRPHCs are considered to give rise to gain from a "sale or exchange of stock" which constitutes a USRPI. §1.897-5T(b)(2)(i). The legislative history to the Small Business Job Protection Act of 1996 (Pub. L. 104-188) summarized this Regulation as follows: "[A]mounts received by a foreign shareholder in a USRPHC, in a section 301 distribution from the USRPHC that exceeds the available earnings and profits of the USRPHC, are treated as gain from the sale or exchange of the shareholder's USRPHC stock to the extent that they exceed the shareholder's adjusted basis in the stock; such amounts are therefore also subject to tax under FIRPTA (sec. 301(c)(3); Treas. Reg. sec. 1.897-

Section 331 distributions are made with respect to stock, where the corporation is liquidating and therefore will cease to exist and the stock will cease to be outstanding. These distributions are treated as consideration received in a Section 1001 taxable exchange of the stock.[19] Basis is recovered differently than in Section 301—namely, basis is recovered first, and the amount of the corporation's earnings and profits is not relevant.[20]

Section 302 distributions are distributions made with respect to stock, where the shareholder gives up specific shares of stock in exchange for the distribution (i.e., the stock is redeemed), but the corporation remains in existence and the other shares of stock remain outstanding. These distributions are treated either as:

(i) a Section 301 distribution;[21] or

(ii) a taxable exchange.[22]

There are some additional special rules that apply to distributions from QIEs.[23] A QIE is entitled to claim a dividends-paid deduction[24] and most QIEs use this deduction to eliminate their corporate-level tax. The dividends-paid deduction applies to distributions described in Section 316 (that is, Section 301 distributions out of earnings and profits) and most Section 331 liquidating distributions and Section 302 redemptions. In addition, QIEs, unlike regular C corporations, have the ability to designate certain of their distributions as being "capital gain dividends," that is, as distributions which are attributable to the net capital gains realized by the QIE.[25] Net capital gain is defined as the excess of the net long-term capital gain for the taxable

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5T(b)(2)(i))." H.R. Rep. No. 104-586, at 166-67 (1996). *See also* §1.367(a)-8 (gain recognition agreement triggered by §301(c)(3) distribution); §1.1248-1(b); Rev. Rul. 95-5, 1995-1 C.B. 100 (construing identical language in §1368(b)(2) by reference to §301(c)(3)); B. Bittker & J. Eustice, Federal Income Taxation of Corporations & Shareholders ¶ 8.02 (Thomson Reuters/WG&L, 7th ed. 2006 with updates through July 2013).

[19] §331(a); §1.331-1(b).

[20] Rev. Rul. 85-48, 1985-1 C.B. 126.

[21] §302(d).

[22] §302(a). This is similar to a §331 transaction, except that basis is recovered as it would be in a normal sale of shares. §302(a) and (d) read as follows:

(a) General rule. If a corporation redeems its stock (within the meaning of §317(b)), and if paragraph (1), (2), (3), (4), or (5) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

…

(d) Redemptions treated as distributions of property. Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of §317(b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which §301 applies.

[23] Whether to a U.S. or non-U.S. shareholder.

[24] §857(b)(2)(B).

[25] §857(b)(3)(C); §1.857-6(e)(1)(i).

year over the net short-term capital loss for such year.[26] One benefit of this designation is that the distributions so designated are taxed to the shareholders at the rates applicable to long-term capital gains.[27] By contrast, other distributions from QIEs are taxed at ordinary income rates.[28]

(b) Tax Treatment of REIT Distributions to Non-U.S. Shareholders

If a non-U.S. person owns shares in a REIT, the shareholder is subject to a combination of the REIT rules and the FIRPTA rules, as follows:

Dividends paid by the REIT that are ordinary dividends are generally subject to the 30% dividend withholding tax under Sections 871 and 881, unless reduced by treaty or a Code provision, for example, Section 892. The degree to which Section 897(h)(1) may apply to treat such a dividend as income effectively connected with a U.S. trade or business to the extent attributable to gain from the sale of USRPIs by the REIT is one of the subjects addressed in this paper.

Dividend distributions that are designated as capital gain dividends do not appear to be treated as gain from the sale of the REIT shares. Rather, under Section 857(b)(3)(B), the dividend is "gain from the sale or exchange of a capital asset held for more than 1 year." In this case, the "capital asset" is not deemed to be the stock of the REIT.[29] Thus, if not for Section 897(h)(1), a foreign shareholder would not be subject to net tax on such capital gain dividends, nor would it be subject to the withholding tax normally imposed on taxable dividend payments.[30]

The above rules apply whether or not the REIT is a domestically controlled REIT (a "DREIT").

If the non-U.S. person sells shares of the REIT, which shares are USRPIs, the gain or loss from the disposition would be treated as effectively connected with a U.S. trade or business, unless the seller is entitled to an exemption, under Section 892, for example.

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[26] §1222(11). Net short-term capital loss, in turn, is defined as the excess of short-term capital losses over short-term capital gains. §1222(6). Thus, net short-term capital gains and gains which are ordinary in character are excluded from net capital gain.

[27] §857(b)(3)(B).

[28] The capital gain dividend designation is not available to liquidating distributions and redemptions even though under §562(b) these may qualify as "dividends" for purposes of computing the QIE's dividends paid deduction. §562(a) and (b). §562(b) is expressly limited "for purposes of computing the dividends paid deduction."

[29] *See* ABA Report, *supra* note 4, at fn. 21.

[30] This assumes that the foreign shareholder does not hold the REIT shares in connection with the conduct of a U.S. trade or business, a very unusual case.

If the non-U.S. person sells shares of a REIT whose stock is not a USRPI, for example because the REIT is a DREIT or the REIT is otherwise not a USRPHC, then the gain would not be subject to U.S. taxation.

(c) Defining What Section 897(h)(1) Means By "Any Distribution"

The issue in defining the term "any distribution" as interpreted by the Notice is how to reconcile the rules for measuring gain at the QIE and shareholder levels, considering that there is no necessary correlation between the two sets of rules.

Some commentators believe that the legislative history establishes (or strongly supports the view) that "any distribution" in Section 897(h)(1) was meant to refer only to distributions designated as capital gain dividends.[31] For the reasons discussed below, we do not agree with this view. Before discussing what the legislative history says and why we do not believe it supports this view, we think it is important to address why a QIE's capital gain dividends are not necessarily an accurate measure of the FIRPTA gains recognized by the QIE.

First, a QIE is not required to distribute all of its net capital gains, so a QIE could have gain from sales of USRPIs that it does not distribute. (A QIE that does not distribute its capital gains would be subject to corporate level tax on its undistributed gains, but it could offset them with the QIE's tax attributes, such as capital loss carryovers, which may be derived from non-USRPI losses).[32]

Second, a REIT is not obligated to designate a distribution as a capital gain dividend.[33] Thus, the REIT could distribute an amount equal to its net capital gain thereby obtaining a

[31] ABA Report, *supra* note 4, at 24-33.
[32] Rev. Rul. 76-299, 1976-2 C.B. 211 and Federal Tax Coordinator 2d ¶ E-6617 (capital loss carryovers); PLR 200534013 (May 12, 2005) and P. Fass, M. Shaff & D. Zief, Real Estate Investment Trust Handbook §5:78 (West 2012-2013 ed.) ("REIT Handbook") (net operating losses).
[33] This option is not available for a RIC which is a QIE since a RIC can only receive the dividends paid deduction with respect to its net capital gain if it distributes the requisite amount and labels the distribution in question a "capital gain dividend." This is because §852 (which applies to RICs) and §857 (which applies to REITs) are fundamentally different in the manner in which they treat net capital gain. Net capital gain is explicitly deducted from investment company taxable income under §852(b)(2)(A) and is then separately taxed under §852(b)(3) (after reduction for net capital gain dividends). On the other hand, REIT taxable income does include net capital gain, and §857(b)(3)(A)(i), which requires the deduction for dividends paid to be computed without regard to capital gain dividends, only applies to the extent it results in less tax. §857(b)(3)(A) is meant to be a taxpayer-friendly rule and is a holdover from when corporations received a capital gain rate preference. There does not appear to be any requirement that a capital gain dividend be identified as such to receive a deduction from REIT taxable income under §857(b)(2)(B). *See* Johnston & Brown, Taxation of Regulated Investment Companies and Their Shareholders, ¶ 4.02.

dividends paid deduction, but not designate any portion of such dividend as a capital gain dividend.[34]

Third, capital gain dividends do not need to be derived solely from FIRPTA gains and in fact must include all net long-term gains and losses derived from sales of assets held by the QIE, regardless of whether the assets sold are USRPIs. So the total can include both FIRPTA gains and losses and non-FIRPTA gains and losses, which could arise, for example, when an equity REIT disposed of investments in non-U.S. real property. Gains and losses from such property may constitute long-term capital gains and losses but do not constitute gain or loss from the disposition of a USRPI.[35, 36]

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[34] The FIRPTA withholding rules under §1445, which are both over- and under-inclusive, attempt to deal with this difficulty by imposing FIRPTA withholding on all capital gain dividends and any ordinary dividends that could have been so designated. §1.1445-8(c)(2)(ii)(A). §1.1445-8(c)(2)(ii) reads as follows:

> (A) In general. Except as otherwise provided in paragraph (c)(2)(ii)(C) of this section, the amount subject to withholding is the amount of any distribution, determined with respect to each share or certificate of beneficial interest, designated by a REIT as a capital gain dividend, multiplied by the number of shares or certificates of beneficial interest owned by the foreign person. Solely for purposes of this paragraph, the largest amount of any distribution occurring after March 7, 1991 that could be designated as a capital gain dividend under section 857(b)(3)(C) shall be deemed to have been designated by a REIT as a capital gain dividend regardless of the amount actually designated.
>
> (B) Distribution attributable to net short-term capital gain from the disposition of a U.S. real property interest. [Reserved]
>
> (C) Designation of prior distribution as capital gain dividend. If a REIT makes an actual designation of a prior distribution, in whole or in part, as a capital gain dividend, such prior distribution shall not be subject to withholding under this section. Rather, a REIT must characterize and treat as a capital gain dividend distribution (solely for purposes of section 1445(e)(1)) each distribution, determined with respect to each share or certificate of beneficial interest, made on the day of, or any time subsequent to, such designation as a capital gain dividend until such characterized amounts equal the amount of the prior distribution designated as a capital gain dividend. The provisions of this paragraph shall not be applicable in any taxable year in which the REIT adopts a formal or informal resolution or plan of complete liquidation.

[35] Aside from foreign real estate, REITs may have investments in U.S. property which are properly classified as "real estate assets" for REIT purposes but whose classification as USRPIs is uncertain for FIRPTA purposes. For example, straight mortgages are "real estate assets" for REIT purposes, but do not constitute USRPIs for FIRPTA purposes. Because REITs can engage in active businesses, they may in some cases generate intangible assets, such as goodwill, whose status under the FIRPTA rules is uncertain. *See* PLR 200813009 (ruling that, on the facts presented, goodwill relating to the location and physical structure of the properties at issue and the value attributable to the hotel name portion of the real estate intangibles relating to such properties' uniqueness in history and heritage were "real estate assets" under §856(c)(5) and real estate assets for purposes of §856(c)(4)(A), and that rents attributable to such intangibles were rents from real property for purposes of §856(d)); PLR 9843020 (ruling that ski permits from the United States Forest Service were interests in real property for purposes of §856(c)(5)(C) and real estate assets for purposes of §856(c)(4)(A)).
REITs can also hold up to 25% of their gross assets in the form of stock of taxable REIT subsidiaries ("TRSs"). TRSs can be either foreign or domestic corporations. In the former case, they cannot constitute USRPIs. In the latter case, whether they constitute USRPIs will depend on the composition of their assets. RICs which are QIEs may encounter similar interpretive issues. For an examination of this issue as applied to toll road concessions, *see* NYSBA Tax Section Report No. 1195, November 16, 2009 (advocating greater consistency between REIT and FIRPTA definitions of real property assets).

Fourth, there may be FIRPTA gains and losses derived from sales of USRPIs that are not long-term capital gain or loss – that is, they may be short-term capital gains or losses or ordinary income or loss.[37]

Fifth, while redemptions and liquidating distributions can carry out capital gains of a QIE, these distributions cannot be designated as capital gain dividends. Thus, for example, a QIE which does not sell any USRPIs until it adopts a plan of liquidation would never be subject to Section 897(h)(1) on the distribution of these gains if the term "any distribution" was limited to capital gain dividends.

Section 897(h)(1)'s legislative history is not especially illuminating in regard to the foregoing issues. For example, the Conference Report accompanying the initial enactment of FIRPTA in 1980 (which included Section 897(h)(1)) notes that "[d]istributions by a real estate investment trust (REIT) to foreign shareholders would be treated as gain on the sale of U.S. real property to the extent of the shareholders' pro rata share of the *net capital gain* of the REIT."[38] This language is regarded as support for the view that Section 897(h)(1) was intended to be limited to capital gain dividends. But this language is ambiguous; it could mean that Congress intended that the Section 897(h)(1) tax would apply only to capital gain dividends (whether or not derived from the QIE's sale of USRPIs) or it could simply be describing the measure of an amount that would be subject to tax.

The legislative history to subsequent amendments to Section 897 make clear that capital gains distributions are subject to Section 897(h)(1).[39] However, this could be read either as implying that *only* capital gains dividends are subject to the Section 897(h)(1) tax *or* as implying no such thing and simply not addressing whether non-capital gains distributions are also subject

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[36] Under the current FIRPTA withholding regime, this issue is effectively ignored, because withholding is required on all such capital gain dividends whether or not attributable to gains from the disposition of USRPIs, thereby leading to the prospect of substantial over-withholding in many cases.

[37] While most REITs, for example, do not hold property for less than a year, they are entitled to do so. REITs may in fact also hold and sell property that is held primarily for sale to customers in the ordinary course of a trade or business ("dealer property"). Dealer property which does not come within a specified safe harbor is subject to a punitive 100% prohibited transactions tax. §857(b)(6)(A). However, there does not appear to be any rule which reclassifies safe-harbored dealer property as capital gain. It is merely exempt from the prohibited transactions tax. §857(b)(6)(C). Thus, such safe harbored dealer sales would not appear to be covered by a definition of capital gain dividends that is limited to net long-term capital gain. Note that the FIRPTA withholding regulations contain a reserved section for short-term gains. §1.1445-8(c)(2)(ii)(B).

[38] H.R. Conf. Rep. No. 96-1479, 1980-2 C.B. 575, 85.

[39] S. Rep. No. 192, 108th Cong., 1st Sess. 50 (2003) & H.R. Conf. Rep. No. 755, 108th Cong., 2d Sess. 413 (2004) (Description of "Present Law" with respect to the FIRPTA treatment of REIT distributions states that "[t]hese *capital gains* distributions from REITs generally are subject to withholding tax at a rate of 35 percent (or lower treaty rate)" and "the recipients of these *capital gains* distributions are required to file Federal income tax returns in the United States." The 2004 amendment "removes from treatment as effectively connected income for a foreign investor a *capital gain distribution* from a REIT" if the foreign investor owns 5% or less of a class of stock in the QIE that is publicly traded).

to the Section 897(h)(1) tax. The latter view would support applying Section 897(h)(1) to distributions by a REIT which sells its U.S. real estate and then adopts a plan of liquidation; that REIT will have net capital gain from the sale of its USRPIs but will not pay any distributions it can designate as capital gain dividends.[40] If the former view were taken, it would still leave uncertain whether Section 897(h)(1) would apply to a capital gain dividend not paid out of gains derived from sales of USRPIs.

Some of the other authority which is pointed to as supporting the view that Section 897(h)(1) applies only to capital gains dividends is, we believe, ambiguous. One such provision is Section 857(b)(3)(F), which requires that 5% or less shareholders of publicly-traded QIEs who are exempt from Section 897(h)(1) entirely by virtue of the second sentence thereof must include in income subject to withholding tax as ordinary dividends their share of distributions designated as capital gain dividends. At least one commentator concludes that this is evidence that Congress intended Section 897(h)(1) to apply only to capital gain dividends.[41] We believe that Section 857(b)(3)(F) actually supports the contrary interpretation. In Section 857(b)(3)(F) Congress clearly showed that it knew how to limit the scope of a provision to designated capital gain dividends when it wanted to. Yet the second sentence of Section 897(h)(1), which was added to the Code at the same time as Section 857(b)(3)(F), is not limited to capital gain dividends.[42] Rather, the second sentence of Section 897(h)(1) provides that "any distribution"

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[40] Since §562(a) limits dividends to those described in §316.
[41] ABA Report, *supra* note 4, at 52.
[42] To follow this argument it is useful to compare the language of the two sections. §897(h)(1) reads as follows:

> Any distribution by a qualified investment entity to a nonresident alien individual, a foreign corporation, or other qualified investment entity shall, to the extent attributable to gain from sales or exchanges by the qualified investment entity of United States real property interests, be treated as gain recognized by such nonresident alien individual, foreign corporation, or other qualified investment entity from the sale or exchange of a United States real property interest. Notwithstanding the preceding sentence, any distribution by a qualified investment entity to a nonresident alien individual or a foreign corporation with respect to any class of stock which is regularly traded on an established securities market located in the United States shall not be treated as gain recognized from the sale or exchange of a United States real property interest if such individual or corporation did not own more than 5 percent of such class of stock at any time during the 1-year period ending on the date of such distribution.

The second sentence quoted above was added to the Code in 2004. P.L. 108-357, §418(a). At the same time, §857(b)(3)(F) was also added. §418(b). It reads as follows:

> Certain distributions. In the case of a shareholder of a real estate investment trust to whom section 897 does not apply by reason of the second sentence of section 897(h)(1), the amount which would be included in computing long-term capital gains for such shareholder under subparagraph (B) or (D) (without regard to this subparagraph)—
>
> > (i) shall not be included in computing such shareholder's long-term capital gains, and
> > (ii) shall be included in such shareholder's gross income as a dividend from the real estate investment trust.

by a QIE to a 5% or less shareholder "shall not be treated as gain recognized from the sale or exchange of a [USPRI]." In other words, any distribution to such a shareholder will not be subject to the tax treatment provided for in the first sentence. The effect of Section 857(b)(3)(F) is to make certain distributions that would otherwise not be subject to U.S. tax as a result of the second sentence of Section 897(h)(1) subject to the withholding tax applicable to ordinary dividends. Unlike Section 897(h)(1), Section 857(b)(3)(F) only applies to distributions that are capital gain dividends. This difference in language between Section 897(h)(1) and Section 857(b)(3)(F) makes sense if the two sections were intended to have a different scope, which seems logical. There does not seem to be a good reason to exempt a foreign shareholder from withholding tax on a corporate law dividend merely because the QIE paying the dividend has made a designation which has no impact on such shareholder. But that is a much different question from whether or not the two concepts were intended to be co-extensive. Interpreting the two provisions not to be co-extensive is also consistent with the position discussed below that Section 857(b)(3)(F) should not subject such 5% or less shareholders to 30% withholding tax on liquidating distributions, which an Office of Chief Counsel Advice Memorandum has ruled is the correct interpretation.[43]

2. <u>What Is the Correct Way to Determine the Amount of a Distribution That Is "Attributable To Gain From The Sale Or Exchange" By the QIE of USRPIs?</u>

As noted above, Section 897(h)(1) contains an attribution concept: the portion of the distribution taxed as gain from the sale or exchange of a USRPI is limited to the portion of the distribution "attributable to gain from sales or exchanges by the qualified investment entity of United States real property interests." This concept requires delineation of at least two items. First, how is "gain from sales or exchanges" by the QIE of USRPIs calculated? Second, how should that gain be "attributed" to a particular distribution?

(a) <u>"Gain From Sales or Exchanges" by the QIE of USRPIs</u>

One question that arises is whether the amount of the QIE's gain or loss from the sales or exchanges of USRPIs, should be measured on a net or gross basis. To take the simplest example,

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§857(b)(3)(B) refers to capital gain dividends. §857(b)(3)(D) refers to deemed distributions arising from undistributed capital gains. These are very specific cross references and clearly much narrower than the ordinary meaning of the term "any distribution" used in the first and second sentences of §897(h)(1). If one is prepared to believe that Congress spotted a flaw in the drafting of §897(h)(1) in 2004 and, rather than correcting it, repeated the drafting flaw in the next sentence of the same section and then corrected it via an oblique cross reference in another section, then the theory that §857(b)(3)(F) is evidence of a narrow interpretation makes sense. However the more straightforward interpretation would seem to be that Congress recognized the potentially broad scope of §897(h)(1), created an equally broad carve out for 5% or less shareholders, and then drafted a much narrower "rifle shot" recharacterization provision in §857 where recharacterization was appropriate. Having said that, as pointed out above, the legislative history if anything seems to point (although inferentially) in the other direction.

[43] Office of Chief Counsel Advice Memorandum AM 2008-003 (February 15, 2008), *supra* note 15.

suppose REIT sells two USRPIs during the year, one for a loss of $100, and one for a gain of $100. The net gain of the REIT attributable to sales of USRPIs is $0; the gross gain is $100. If a foreign person held the REIT's assets directly and had engaged in the same transactions in which the REIT had engaged, it would not have owed FIRPTA tax. Although perfect conformity with direct ownership is not possible, this example seems to weigh strongly in favor of interpreting "gain" to mean net gains (but taking into account only gains and losses derived by the QIE from sales of USRPIs).

However, at least one commentator has interpreted the language in Section 897(h)(1) to prohibit netting of this sort stating that the tax appears to be levied on an asset-by-asset basis.[44] While the statute uses the single word "gain" and thus is susceptible to being interpreted as meaning "gross gain," it seems equally capable of being interpreted as referring to net gain. The latter is certainly more consistent with general tax principles and with the other provisions of the Code governing the measurement of gain derived by a corporation and available to be distributed to its shareholders. We believe the gain should be measured on a net basis.

(b) How Should the Amount of Gain "Attributable to" A Distribution Be Determined?

In order to apply Section 897(h)(1), it is necessary to attribute the QIE's FIRPTA gains to distributions made by the QIE. As a matter of general REIT tax law, a QIE will marshal all of its items into two buckets, one consisting of all of the items that are taken into account in determining the amount it can designate as a capital gain dividend (basically, the excess of net long-term capital gains over net short-term capital losses) and the other consisting of everything else.[45] As we discuss later in more detail, we recommend that this approach also be used for purposes of Section 897(h)(1). Thus, a QIE would need to allocate all of its gains (and losses) from the dispositions of USRPIs into two buckets—one consisting of all of those gains and losses from USRPIs which would be included in the computation of the amount that could be designated as a capital gains dividend (whether or not any such amount was actually so designated) (referred to herein as "Long-term FIRPTA Gains"), and the other consisting of all

[44] Blanchard, "Is There a FIRPTA Tax on REIT Distributions?" 44 Tax Notes Int'l 223 at 225.

[45] Note that because different components of long-term capital gains from dispositions of real estate can be taxed under different rate schedules for different non-corporate shareholders, REITs are permitted to sub-allocate the long-term capital gain dividend between, say, the unrecaptured section 1250 gains and the residual capital gain bucket. *See* Notice 97-64, 1997-2 C.B. 323; Notice 2004-39, 2004 I.R.B. 22. While such sub-designations are not required, failure to so designate generally results in the entire capital gain dividend being taxed at the highest applicable rate. For example, this would be 25% in the case of unrecaptured section 1250 gains, compared to 20% for the residual capital gain. Id.; REIT Handbook, *supra* note 32, at §5:114. Consistent with the Notices, to the extent the QIE's long-term capital gains include, for example, unrecaptured section 1250 gains, the QIE's Long-Term FIRPTA Gains computation would need to keep track of these elements and any NPDFG account maintained by the QIE would include separate sub-accounts for each item. Consideration should be given to allowing QIEs to dispense with this added layer of complexity by treating all such components other than the residual 20% capital gain bucket as ordinary income items, similar to the treatment of other recapture items, provided this treatment applied uniformly to all REIT shareholders.

other gains and losses from sales of USRPIs (referred to herein as "Residual FIRPTA Gains"). While there are many other netting or classification schemes that could be constructed, the proposed scheme has the virtue of having some relationship with the manner in which those items are generally classified for purposes of determining the character of distributions from QIEs in the ordinary course.[46]

> Example: REIT has four items of income or gain in the current year: $100 short-term capital gain from the disposition of a USRPI; $100 of ordinary losses from its rental real estate activities; $100 of long-term capital loss from the disposition of a USRPI, and $200 of long-term capital gain from the disposition of an asset which is not a USRPI. The REIT makes one distribution of $100 for the year and designates it a long-term capital gain dividend.

<u>Illustration A</u>

	Ordinary	Short-term	Long-term
Gain		100	200
Loss	(100)		(100)

■ = FIRPTA gain/loss

Under the rules applicable to REITs, REIT has $100 of long-term capital gain and zero ordinary income.

At the shareholder level, how does Section 897(h)(1) treat this distribution? There is no net economic income from USRPIs—$100 of short-term gain is offset in economic terms by $100 of long-term loss. None of the net capital gain is attributable to USRPIs, yet the capital gain dividend would be subject to FIRPTA withholding under the current withholding regime.[47]

Now let us assume that the long-term loss was only $50 and the REIT paid a distribution of $150, designating all of the distribution as a capital gain dividend.

[46] Neither of these suggested categories would be identical to categories that would be subject to FIRPTA tax if, say, the QIE had been a partnership and the items in question had flowed through to a foreign partner. For example, a partnership template would permit netting of short-term FIRPTA gains against long-term FIRPTA losses, the way that such gains and losses would be netted if recognized by the taxpayer directly. But that is not the way the rules applicable to QIE distributions work as a general matter and to try to replicate partnership treatment would lead to a greatly elevated level of complexity.
[47] §1.1445-8(c)(2)(ii). These regulations impose FIRPTA withholding on all capital gain dividends paid by a REIT (as well as all dividends not so designated but which could have been so designated).

Illustration B

	Ordinary	Short-term	Long-term
Gain		100	200
Loss	(100)		(50)

= FIRPTA gain/loss

At this point there is a net FIRPTA gain of $50, but none of it actually contributed to the designation of the distribution as a capital gain dividend. We see two main options: treat $50 of the distribution as FIRPTA gain (even though the $50 of FIRPTA gain was not net long-term capital gain which could have supported the designation of the distribution as a capital gain dividend); or, treat the distribution as not including any FIRPTA gain and instead wait until a subsequent period when the REIT makes a regular dividend distribution or non-301 distribution to which the FIRPTA tax could be applied. If the "wait and see" approach were to be adopted, one would presumably want to keep track of the different character of the FIRPTA items: thus, the REIT would have a $50 long-term FIRPTA loss it could use to offset future long-term FIRPTA gain (offset for Section 897(h)(1) purposes only), and a $100 short-term gain that could be attributed to a future non-capital gain dividend distribution.

3. Should Section 897(h)(1) Be Interpreted to Impose FIRPTA Tax on Distributions That Would Not Otherwise Be Treated as Taxable Income Under U.S. Tax Rules?

Perhaps the most troubling and cryptic phrase in Section 897(h)(1) is "any distribution …shall…be treated as gain." It is capable of multiple interpretations**,** none of them entirely satisfactory.

One interpretation, which perhaps sits most easily with the literal language, is that the import of Section 897(h)(1) is to turn all distributions from a QIE that are attributable to QIE-level FIRPTA gains into taxable gain subject to the Section 897(h)(1) tax, regardless of whether or not they would otherwise be included in the taxable income of the shareholder receiving them. In other words, if a non-U.S. shareholder received a distribution from a QIE that was not a Section 316 dividend and was entirely a return of capital to that shareholder, the distribution would be treated as gain subject to the Section 897(h)(1) tax to the extent the QIE's gains from USRPI dispositions was attributable to that distribution.

To see what this interpretation would mean, we look first at a simple fact pattern.

Example 1. A newly formed REIT issues stock for $100 and buys a USRPI for $100. The value of the USRPI increases to $1,100, and the founding shareholders sell their stock for $1,100 to new shareholders and pay tax on $1,000 of gain. Assume that X, a nonresident alien or foreign corporation, is one of those new shareholders and purchases 10% of the REIT for $110. Then the REIT sells the USRPI for $1,100 and liquidates, distributing $110 to X. If $100 of that distribution to X is considered a distribution that is "treated as gain" pursuant to Section 897(h)(1) (because it is attributable to $100 of the REIT's inside gain from the sale of a USRPI), then X is being taxed on a "gain" of $100 in a transaction in which no gain has been realized by X. Moreover, the people who actually reaped the economic benefit of the appreciation of the USRPI—the founding shareholders of the REIT—have already recognized the very same gain and to the extent they are taxable persons, have presumably paid tax on that gain. Because of the cleansing exception, X presumably would not have an offsetting taxable loss. In addition, unless one in effect bifurcates the transaction into two separate transactions, it is not even clear that there is any loss to take (since the distribution is in exchange for the stock surrendered). Thus it would appear that X is being over-taxed in this example. By contrast, if X had been a U.S. person, X would have paid no tax on the receipt of the $110 because X would be treated as having sold its stock for $110, which is the amount of X's basis.

Note that we have simplified the example by assuming no further appreciation in the USPRI after X bought the shares because the point we are illustrating is that inside gain may be greater than outside gain. Essentially, this may happen any time a REIT's shares have been purchased in a secondary transaction.[48]

Example 2. Same facts as Example 1, except that the REIT does not liquidate and instead distributes $1,000 as a capital gain dividend. X takes into account $100 of capital gain dividend income, all of which is subject to tax under Section 897(h)(1). In this example, X still holds his REIT shares with a basis of $110. This means that X can sell those REIT shares (for $10, that being their fair market value), and X would recognize a $100 loss. To the extent that loss would be from a USRPI X could in theory use the loss to offset X's $100 of FIRPTA gains. Of course, that loss cannot be triggered until X sells the REIT shares, which may be years later. And unless X has other ECI gains in that period, or can carryback the loss, the loss may not be usable at all, even if it is treated as effectively connected.

This Example 2 presents a fact pattern where a literal interpretation of Section 897(h)(1) could lead to a result that matches the shareholder's economics, at least where X disposes of the REIT shares in the same period in which the capital gain dividend is paid. But this example is the ideal. In many cases shareholders will not be able to offset the gain they received from the

[48] This is a common occurrence. Indeed, the statute requires that the shares be "transferable." §856(a)(2).

FIRPTA distribution when they subsequently sell their QIE stock at a loss, even if the two events occur in the same taxable period.

First, if the REIT is a DREIT, its stock will not be a USRPI, and thus a loss from the sale of such stock will not be treated as ECI pursuant to FIRPTA (unless it is in fact ECI, an extremely rare circumstance).[49] Second, stock in a REIT will not be a USRPI if less than 50% of the REIT's assets consist of USRPIs.[50] Third, a QIE will no longer be a USRPI once the cleansing exception applies. So in the example above, if the REIT's remaining assets were not USRPIs, the cleansing exception would apply; if they were, it would not. Thus, in any of these cases, the offsetting loss on the sale of the QIE stock cannot be used by a foreign shareholder to offset his prior FIRPTA distribution which was treated as a taxable gain, even if the two events occur in the same taxable period. None of these exceptions is optional or elective; all are the product of per se rules whose application may be uncertain in some or many respects but cannot be waived or avoided by the taxpayer to the extent they apply.

Note that to the extent there is over-taxation of X in Example 2, there is nothing that can be done about it (other than a resort to self-help by X, for example, by selling his shares prior to payment of the capital gain dividend).[51] The question presented is whether or not the potential for over-taxation in the Example 2 fact pattern must be extended to the facts of Example 1. The problem illustrated by Example 1 may occur in any situation where as a general matter of tax law, X would be entitled to a full or partial recovery of his basis upon the distribution (this could be a liquidating distribution, a redemption not substantially equivalent to a dividend, or even an ordinary distribution which exceeded earnings and profits).

An alternative interpretation of Section 897(h)(1) would be that only distributions that are otherwise taxable to the shareholder can be taken into account as gain pursuant to Section 897(h)(1).

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[49] A similar issue arises if the QIE is not a DREIT and X is a sovereign wealth investor that is entitled to claim the benefits of §892.

[50] To be precise, a domestic corporation will not be a USRPI if upon the disposition of any interest in the corporation (other than an interest solely as a creditor) the disposing taxpayer demonstrates that the corporation was not a USRPHC at any time during the five-year period preceding the disposition or, if shorter, the period during which the taxpayer held his interest. A corporation will not be a USRPHC if the fair market value of its USRPIs is less than 50% of the sum of the fair market value of its USRPIs, its interests in real property located outside the U.S. and any other of its assets which are used or held for use in a trade or business. §897(c)(2). Note that a RIC has to meet this asset test to be a QIE; a REIT does not. §897(h)(4)(A)(i).

[51] It is also worth noting that a similar issue can arise if a non-U.S. person buys stock of a regular U.S. corporation which is neither a QIE nor a USRPHC. Suppose X (a non-U.S. person) buys 10% of corporation Z for $110, Z sells an asset for a $1,000 gain and pays a $1,000 dividend of which X gets $100, and then X sells the stock for $10 and has a $100 loss. X has received $100 of FDAP income (which could be subject to up to $30 of tax), yet X had no economic gain. This result is simply because a shareholder is taxed on a dividend to the extent it is out of the corporation's E&P, regardless of whether the shareholder held the stock in that corporation at a gain or a loss.

These two interpretations raise the question: was Section 897(h)(1) intended to change the measure of X's income or gain, or merely to characterize the actual gain at the shareholder level as either ECI or not, in a situation where changing the measure of income or gain is highly likely to permanently distort the foreign shareholder's taxable income?

To answer this question it is helpful to look how similar provisions in other parts of the Code have been interpreted. These are few because for the most part there are not many provisions which appear to characterize payments as income without regard to whether or not they really are income. However, the Passive Foreign Investment Company ("PFIC") rules[52] were faced with an arguably similar provision and chose to limit income to the shareholder's actual gain.

Section 1291(a)(1) states that if a U.S. person receives an "excess distribution" with respect to stock of a PFIC, that distribution is treated as ordinary income. An "excess distribution" is defined to mean any distribution received with respect to stock which exceeds a specified threshold amount.[53] Section 1291(a)(2) provides that:

> If the taxpayer disposes of stock in a passive foreign investment company, then the rules of paragraph (1) shall apply to any gain recognized on such disposition in the same manner as if such gain were an excess distribution.

The proposed regulations promulgated under this section had to deal with an overlap issue very similar to that addressed by the Notice. That is, what to do with a distribution which was also a disposition? Recall that the distribution rule required that the entire distribution be treated as ordinary income (without regard to earnings and profits or basis recovery) while the disposition rule limited ordinary income treatment to actual gain. Sensibly, the Proposed Regulations, after adopting a broad definition of distributions similar to that proposed by the Notice, then adopted a broad "tie-breaker" rule which stated that a distribution which was also a disposition would be treated solely as a disposition:

> *Prop. Reg. 1.1291-2(b)*
> Distribution. In general. For purposes of section 1291 and these regulations, unless otherwise provided in this paragraph (b), a distribution is any actual or constructive transfer of money or property by a section 1291 fund with respect to its stock. For example, a distribution includes a transfer of stock taxable pursuant to section 305(b) and (c), a transfer in redemption of stock taxable under section 301 pursuant to section 302(d), and an amount treated as a dividend under section 78. A distribution, however, does not include a transfer that qualifies under section 305(a) or 355(a). <u>Transfers with respect to stock that are treated as</u>

[52] §§1291-1298.
[53] §1291(b).

dispositions of the stock under §1.1291-3 are not treated as distributions under this section.

The regulations went on to define dispositions broadly as well:

Prop. Reg. 1.1291-3(b)
Disposition. In general. For purposes of this section, a disposition is any transaction or event that constitutes an actual or deemed transfer of property for any purpose of the Code and the regulations thereunder, including (but not limited to) a sale, exchange, gift, or transfer at death, an exchange pursuant to a liquidation or section 302(a) redemption, or a distribution described in section 311, 336, 337, 355(c) or 361(c).

One might suggest that a similar approach be adopted in Section 897. Section 897(a), for example, provides that gain or loss from a disposition of a USRPI shall be treated as ECI. Thus, one could imagine a system in which distributions from QIEs were governed by Section 897(h)(1), while dispositions of stock of USRPHCs were governed by Section 897(a). The test would then be whether a distribution was also a disposition; if it was, similar to the proposed PFIC rules above, the tie would be broken by deferring to the disposition rules and the FIRPTA tax by definition would be limited to gain. By contrast, if a distribution was not a disposition or treated as a disposition to any extent, the distribution rules would trump and the entire amount would be presumed to be gain.

This approach however suffers from at least two deficiencies when applied to Section 897(h)(1). The first is that, as pointed out above, a corporate dividend distribution may be treated as a return of basis to the extent it exceeds earnings and profits, even though it is not a "disposition" nor treated as such. In the PFIC context, this is not perhaps overly worrisome. The PFIC rules allow electing shareholders to make a so-called QEF election to avoid the adverse tax consequences created by receipt of excess distributions.[54] Thus, to the extent that the statute and the proposed regulations "over taxed" a U.S. shareholder by treating return of basis distributions as income, that shareholder had a way of opting out of over-taxation. Not all shareholders can make QEF elections, however, because making the election requires the cooperation of the PFIC in providing information or access to information.[55] But presumably a PFIC which is not providing information about its income would not be equipped to do an earnings and profits study either, so perhaps it was not unreasonable to adopt an effectively conclusive presumption that any distribution was out of earnings and profits. In fact, it is commonly understood that a corporate law distribution may be presumed to be out of earnings and profits unless the contrary can be proven by the taxpayer.[56]

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[54] §1295(b).
[55] §1295(a)(2); §1.1295-1(g).
[56] *See*, e.g., *DiZenzo v. Comm'r*, 348 F.2d 122 (2nd Cir. 1965); *Truesdell v. Comm'r*, 89 T.C. 1280 (1987); *U.S. v. Bok*, 156 F.3d 157 (2nd Cir. 1998); Comisky, Feld & Harris: Tax Fraud & Evasion Vol. 1, Offenses, Trials, Civil

By contrast, QIEs are all U.S. entities which do information reporting.[57] Public REITs, for example, often pay dividends that are a return of capital, as do many closed-end RICs. These basis recovery distributions are not dispositions nor are they treated as such. A regime which treated these amounts in excess of earnings and profits, but before basis was recovered, as gain would not comport with the principles listed above.

The second deficiency however is even more troubling. Unlike the PFIC rules, Sections 897(a) and 897(h)(1) are not coordinated. This appears to be by design. Section 897(a) applies to gain derived from the sale of stock of a corporation only if the corporation in question is a domestic corporation and meets a specified test such that it is a USRPI.[58] Stock of a domestic corporation which is a USRPHC (other than a domestically controlled QIE) is a USRPI. By contrast, Section 897(h)(1) applies to all QIEs which own USRPIs, whether or not they themselves are USRPHCs.[59] So distributions from a QIE can be subject to FIRPTA tax even if gain on the sale of the stock of the QIE is not. The issue arises in cases, for example, in which the distributions from the QIE are (or may be) attributable to gains derived from a USRPI, but either the QIE is not a USRPHC or the shareholder in question is entitled to exemption from FIRPTA tax on gains derived from sales of stock of USRPHCs, for example, by virtue of Section 892. Conversely, gain from the sale of a QIE can be subject to FIRPTA tax even if a distribution from the QIE (including a capital gain dividend) should not be subject to FIRPTA tax, such as when the QIE is a USRPHC, but the particular distribution is attributable to gain from property that is not a USRPI.

B. <u>Implementation of Section 897(h)(1) and the Notice</u>

1. <u>Alternative Approaches</u>

The following alternative approaches to implementation of Section 897(h)(1) and the Notice are presented in increasing levels of complexity. Attached as an appendix is a chart that summarizes these approaches in a tabular form.

1. Interpret Section 897(h)(1) to apply only to capital gain dividends (or distributions which could have been designated as capital gain dividends) and subject all such

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Penalties ¶ 2.03[5] and ¶ 8.02[6][c][ii]; *see also* §§1.1441-3(c)(1) and (2)(i)(C); Instructions to IRS Form 1099-DIV *available at* http://www.irs.gov/pub/irs-pdf/i1099div.pdf, last visited August 30, 2013 ("If you make a payment that may be a dividend but you are unable to determine whether any part of the payment is a dividend by the time you must file Form 1099-DIV, the entire payment must be reported as a dividend.").

[57] §856(a)(3).

[58] §§897(a)(1), (c)(1)(A)(ii) and (c)(2).

[59] This includes DREITs as well as REITs whose asset mix would preclude USRPHC status (i.e., mortgage REITs for example). Note that a RIC, unlike a REIT, can be a QIE only if it is a USRPHC (without regard to whether or not it is domestically controlled). §857(h)(4)(A)(i)(II).

distributions to the Section 897(h)(1) FIRPTA tax. This is essentially the approach adopted by the existing withholding regulations under Section 1445 for REITs.[60] Since this approach does not track the QIE's actual FIRPTA gains (and attribute them to distributions), it produces results that are both over- and under-inclusive. Over-inclusive because if the QIE had any long-term capital gains derived from dispositions of non-USRPIs, this approach applies the Section 897(h)(1) tax to dividends that are not attributable to FIRPTA gains. Under-inclusive because it does not purport to tax any short-term or ordinary gains that are from dispositions of USRPIs and because it does not tax any long-term gains except to the extent reflected in Section 301 distributions.

2. Same as the first approach except that FIRPTA tax would not be imposed on such capital gain dividends (or distributions that could have been designated as capital gain dividends) except to the extent of the QIE's actual FIRPTA gains.[61] It is less over-inclusive than the first approach because it limits FIRPTA tax to actual FIRPTA gains. However, it is as under-inclusive as the first approach.

3. The third approach that could be envisioned would be like the second except that it would also create a method of tracking and allocating FIRPTA gains, if any, not taken into account in the determination of long-term gains. These gains would then be allocated only with respect to distributions which are treated as "dividends" within the meaning of Section 562(a) and which were not actual or deemed capital gain dividends. This would be less under-inclusive than the second approach because it would attempt to capture any gains from sales of FIRPTA assets that did not result in long-term capital gain but it would still be under-inclusive (as compared to the Notice) in that it would not apply the tax to gains distributed as something other than a Section 316 dividend.

4. The fourth approach that could be envisioned would be like the third, except that instead of being limited to Section 301 distributions out of earning and profits as described in Section 562(a), it would apply to all Section 301 distributions. This approach would be less under-inclusive than the third approach because it would capture FIRPTA gains attributed to Section 301 distributions in excess of earnings and profits.[62] Since distributions in excess of earnings and profits are treated as a

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[60] §1.1445-8(c)(2)(ii)(A).

[61] *See* the ABA Report, *supra* note 4, at 34-36 for a similar recommendation.

[62] The first three approaches cannot be over-inclusive in this manner since they only impose a FIRPTA tax to the extent of earnings and profit that are in any event treated as income or gain to the shareholder. This is the first alternative that has to address the third question, because it is the first alternative which seeks to define "distributions" more broadly than "dividends."

return of basis and then as gain,[63] use of this approach would require a decision as to whether Section 897(h)(1) was intended to create gains where none existed or merely to characterize existing shareholder level income and gains as either subject to FIRPTA or not. If the former approach were taken (i.e., all distributions attributable to QIE-level FIRPTA gains are taxable at the shareholder level), this approach would be over-inclusive in the sense that it could result in taxation of a greater amount of gain than the shareholder of the QIE actually had with respect to the investment in question.

5. If instead, the fourth approach was followed but distributions would be subject to the Section 897(h)(1) tax only if they were otherwise taxable to the shareholder, this approach would be contrary to the Notice as to scope because it does not impose FIRPTA tax on non-dividend equivalent redemption distributions and liquidating distributions. However, in terms of regulatory complexity, it is, in principle, as complex as an approach which is consistent in scope with the Notice, since it would require (i) tracking FIRPTA gains at the QIE level, (ii) implementing a method of attributing such gains to distributions or deemed distributions made, and (iii) implementing a way of reconciling those distributions of FIRPTA gain with the gain recognized at the shareholder level. In other words, once one defines "distributions" to mean something broader than "dividends" (in other words, Section 301 distributions out of earnings and profits) the whole panoply of Section 897 complexity rightly feared by the many critics of the Notice is already upon us. For the most part, implementing the Notice only adds incremental complexity from here on in.

6. Full implementation of the Notice without an outside gain limitation. In other words, all distributions (of whatever type) would be subject to tax under Section 897(h)(1) without regard to whether the distributions in question were treated in whole or in part as a return of basis at the shareholder level. This would minimize under-inclusiveness but greatly increase the potential for over-inclusiveness since in contrast to the fifth alternative it would allow a return of basis to be reclassified as gain subject to FIRPTA.

7. Full implementation of the Notice with some method of outside gain limitation or offset. The methods adopted in the fifth alternative to track FIRPTA gain at the QIE level and to reconcile the attribution of that gain to shareholder level gain would also be applied to liquidating distributions and redemptions. This approach would be consistent with the scope of the Notice but would require incremental complexity to

[63] §§301(c)(2) and (3).

apply the methods of tracking, attributing and reconciling FIRPTA gain to non-Section 301 distributions as well as Section 301 distributions.

The basic issue presented in interpreting Section 897(h)(1) with which this Report is concerned is whether the term "any distribution" was intended to be limited to distributions treated as dividends under Section 562(a) or some subset thereof. As pointed out above, once the term is defined to mean anything broader than a dividend then the potential for conflict between the corporate measure of FIRPTA gain and the shareholder measure of FIRPTA gain is apparent, since the universe of distributions now includes some subset which requires basis recovery at the shareholder level.

If Section 897(h)(1) is interpreted to resolve that conflict by treating returns of capital as income, as suggested by alternatives four and six, then it will be relatively easy to implement, but very distortive in its effects on the shareholder's income.

Conversely, if Section 897(h)(1) is interpreted to permit the amount of FIRPTA distributions to be reconciled to the shareholder's actual income, as suggested by alternatives five and seven, then the complexity of the implementing regulations will be increased, perhaps substantially so, but the resulting tax base will be in closer conformity to the shareholder's actual economic income.

It is the first guiding principle of this Report to try to interpret Section 897(h)(1) so that it conforms to the taxpayer's actual economic income. Thus, we recommend the seventh approach. In contrast to the first five approaches, the seventh approach does not permit distributions attributable to gains derived from the sales of USRPIs to avoid FIRPTA tax merely because of the form chosen for the distribution. And unlike the fourth and sixth alternatives, it does not distort the taxpayer's income by seeking to tax distributions which are, under general tax principles, treated as a return of basis, rather than income or gain. We believe this is the correct approach because it carries out the intent of Section 897(h)(1) which is to ensure that when a foreign person invests in USRPIs through a QIE, the gain recognized by the shareholder should be subject to the FIRPTA tax to the extent derived from the sale of those USRPIs.

The remainder of this Report focuses on our detailed recommendations as to how to implement the seventh approach.

2. <u>How to Implement the Preferred Approach</u>

This section describes two different ways of applying the Section 897(h)(1) tax to all distributions (as the Notice provides) while also minimizing the extent to which the foreign shareholder of a QIE has to pay U.S. tax on a total amount of income and gain that exceeds the shareholder's actual economic income and gain. Our recommendation is that regulations adopt the second method, which we call the "FIRPTA Within Gain" method. We first describe the method we are not recommending and explain why we are not recommending it.

(a) Offsetting Loss Approach

The first method would impose the Section 897(h)(1) tax on the full amount of every distribution (to the extent the distribution is attributable to QIE-level FIRPTA gain), and then permit the shareholder to recognize an appropriate amount of "ECI" loss when the QIE stock is disposed of, so that the total amount of net ECI income recognized is no greater than the shareholder's actual economic gain from holding the QIE shares. In other words, this is essentially a "two wrongs do make a right" approach.

To illustrate how this would apply, consider the facts in Example 1 discussed earlier: X has a basis of $110 in the REIT shares, receives a liquidating distribution of $110, and $100 of this distribution is attributable to QIE-level USRPI gain. Under this first method, the Section 897(h)(1) tax would be imposed on $100 of the distribution received by X; the distribution of $110 would reduce X's basis in the shares from $110 to $100, and because the shares were redeemed as part of the liquidation, X could claim a $100 ECI taxable loss from disposing of the QIE shares having a basis of $100 in exchange for zero of consideration.[64]

There are a number of problems with this method. First, if the ECI loss is recognized in a later taxable year than the Section 897(h)(1) ECI gain, the shareholder will have a timing mismatch. This is similar to the timing detriment discussed in Example 2 above. If X is an individual, he cannot carry back the loss to the earlier period;[65] and, if X is a corporation, it cannot carry its losses back more than 3 years.[66] Thus, unless X has other, unrelated gains from the sale of effectively connected assets, allowing X to recognize an ECI loss in a later period may not enable X to limit its U.S. tax to an amount that matches X's net economic income. The timing detriment therefore often becomes a permanent detriment. While U.S. persons can also face this predicament in some cases, U.S. persons are taxable on their worldwide income and therefore are much more likely, all else being equal, to have offsetting items that allow them to use their capital losses. The schedular nature of FIRPTA would seem to mandate a method which allows the closest matching of non-economic gains and offsetting losses.

Second, the ECI loss might not match up appropriately in amount to the Section 897(h)(1) gain, so that the total amount taxed to the shareholder might be less than or more than

[64] As Example 1 illustrates, in some situations this method would require that the tax rules pretend there was a disposition of the QIE stock for zero consideration in order to create an opportunity for the shareholder to use the unused tax basis to generate an ECI loss.
[65] §1212(b)(1).
[66] §1212(a)(1)(A).

true economic gain. One of the peculiarities of Section 897(h)(1) is that it applies to REITs which are not USRPIs. If the "offset" rule simply works by treating the REIT as a USRPHC in all events so that the shareholder's loss on the disposition of his stock is ECI, then inevitably there will be cases in which the treatment of the QIE stock as a USRPI will result in over-inclusion of FIRPTA gain or over-inclusion of FIRPTA loss.

This issue could be avoided in turn not by reclassifying all of the REIT's stock in the hands of X as a USRPI but by reclassifying as a USRPI only the notional amount of unrecovered basis which was subject to over-taxation in the first place, on a dollar for dollar basis. Note that this would require computing (and keeping track of) the cumulative difference between the FIRPTA gain distributed and the shareholder level gain. Then that notional FIRPTA basis would have to be apportioned to the shares retained by X so that the offsetting gain or loss (as the case may be) would be triggered at the appropriate times. This would be necessary, for example, in the event that X disposed of his REIT shares in multiple transactions.

Finally note that even if all of these rules are complied with (in other words, the tainted basis is accurately computed and tracked) whether or not an effectively connected loss will result will depend on the value of the REIT stock at the time it is sold. This value can change however for many reasons, including intervening changes in value and distributions. Thus, there will not always be an offsetting loss. Conversely, there may be cases in which there is no loss at the time of the Section 897(h)(1) distribution but an offsetting loss is subsequently created by a later distribution from the REIT which is not subject to Section 897(h)(1), for example because it is not derived from the sale of USRPIs. In such case, it is possible that the subsequently created loss would be treated as effectively connected even though, for example, the REIT was not a USRPHC. The net result could be to convert what would have been FIRPTA tax into either FDAP tax or possibly no tax (for example, if the subsequent distribution is a capital gain distribution not derived from USRPIs). It may be possible to address this issue through a series of rules (akin to the extraordinary dividend rules of Section 1259) which would force a basis reduction (presumably first out of the tainted basis) or alternatively an "untainting" of the existing basis in appropriate cases but this would be very complex and difficult to administer.[67]

(b) <u>FIRPTA Within Gain Approach</u>

[67] By contrast, this particular issue would not arise under the "FIRPTA Within Gain" approach, discussed below, because that approach can never create a loss (although it could displace FDAP income with FIRPTA gain, as discussed below). Thus while the offsetting loss method might work relatively well in the straightforward case involving a single asset REIT which liquidates in a single period, it seems that in more complex cases it suffers from two defects. First, it is much more likely than the more direct "FIRPTA Within Gain" approach to result in permanent distortions of the taxpayer's actual economic income (as will arise for example in every case in which the foreign taxpayer is not a corporation, the QIE is his only source of FIRPTA gain, and the basis recovery gets postponed to a later taxable period). Second, in order to avoid at least some of the distortive effects set forth above, this approach requires a very complex implementation scheme, one in which the usual tax concepts of income, gain and basis recovery are dispensed with and replaced with purpose-built concepts unique to §897(h)(1). Thus it would seem to violate both of the fundamental constraints outlined at the beginning of this Report.

We refer to the second approach as the “FIRPTA Within Gain” approach. Under this approach, the amount taxable at the shareholder level under Section 897(h)(1) with respect to a distribution from a QIE would be the lesser of (i) the shareholder’s income or gain realized under general tax principles, and (ii) the shareholder’s share of the QIE’s FIRPTA gain.

In other words, in applying Section 897(h)(1) to a distribution, the shareholder would first look to see what its gain on the distribution would be under general U.S. tax principles. It would then compare this amount to the amount of QIE-level gain from the disposition of USRPIs allocated to the shareholder by reason of Section 897(h)(1). The shareholder would pay the Section 897(h)(1) tax on the lesser of the two amounts. To the extent that the amount of the QIE’s FIRPTA gain allocable to the shareholder exceeded the shareholder’s taxable income from the distribution, the shareholder would carryover the untaxed FIRPTA gain against subsequent non-FIRPTA distributions. To the extent that the taxpayer had income or gain from the distribution that was not treated as attributable to the QIE’s USRPI gain, the ordinary U.S. tax rules would apply to that income or gain (e.g., it might be subject to U.S. tax under Section 881 as FDAP).

To give an example of this method, suppose that foreign shareholder X owns 10% of a REIT which has assets consisting of both USRPIs and non-USRPIs. The REIT sells a long-term USRPI asset at a gain of $100 and sells a long-term non-USRPI asset at a loss of $200 and proceeds to distribute say $300 consisting of all of its proceeds from the two dispositions. Assume that the REIT has no earnings and profits. X receives a Section 301 distribution of $30 all of which is treated as a return of basis (to the extent thereof) and thereafter as capital gain. Assume that X’s basis in the REIT stock is $15. Under the suggested method, X would treat the distribution as follows: the first $15 would be treated as a recovery of X’s basis. The next $10 dollars would be treated as a distribution of X’s share of the REIT’s FIRPTA gain pursuant to Section 897(h)(1). The last $5 would be treated in accordance with normal principles as gain from the sale of X’s stock in REIT. So, for example, if the REIT is a DREIT, this $5 would not be subject to FIRPTA tax; if the REIT was not a DREIT and was a USRPHC, then the $5 would be subject to FIRPTA tax under Section 897(a) (unless X qualified for another exemption from that tax).

Conversely, let us suppose that X’s basis was $30; in this case, the entire distribution would be a return of basis under normal U.S. tax rules, so there would be no Section 897(h)(1) tax imposed. But the next distribution to X which would be taxable under normal U.S. rules would be treated by X as “attributable to” the $10 of gain from the sale of the USRPI in the prior period and would be taxable to that extent (regardless of the REIT's status as a DREIT or X's status as a Section 892 investor).[68]

If that next distribution was otherwise FDAP income, then the question would be raised whether it should be treated as a distribution taxable under Section 897(h)(1) (at the rate applicable to FIRPTA gains) or instead treated as a FDAP distribution taxable under Section 871(a) or 881 at the rate applicable to FDAP income (which could differ from the rate applicable to FIRPTA gain). The answer to this question may depend in part on whether or not one wants to maximize consistency between the manner in which the NPDFG account maintained at the REIT level is allocated to distributions and the manner in which the shareholder level FIRPTA gain carryforward is allocated. If consistency is preferred, to the extent the NPDFG system allocates a particular type of FIRPTA gain to a particular type of distribution, then presumably if the shareholder elects to defer that inclusion at the shareholder level, the FIRPTA gain carryforward should be matched against the next distribution of the same or similar type. Since in the example the FIRPTA gain carryforward came from the long-term FIRPTA gain portion of the NPDFG account, whether or not the FIRPTA gain carryforward was absorbed by an ordinary dividend would depend upon the rules used to allocate that particular account at the REIT level.[69]

On the other hand, one might wish to give precedence to wiping out X's untaxed Section 897(h)(1) FIRPTA gain carryforward as quickly as possible. So in this example, if a $20 non-capital gain dividend were later distributed, $10 of the $20 would be taxable as FIRPTA gain and the other $10 as ordinary dividend income.

On balance, we think the approach which maximizes consistency between the recovery of the two accounts is preferable, although it may result in slower recovery of deferred FIRPTA tax.

Withholding could be done on the gross amount of the distributions but with the proviso that shareholders could apply for reduced withholding certificates and/or apply for refunds based on the "FIRPTA Within Gain" method. The IRS may need to add more resources to enable requests for reduced withholding certificates to be processed promptly if this approach is followed. In the case in which the reduction in withholding was attributable to the shareholder's recovery of basis, receipt of a certificate could be conditioned on the QIE's undertaking to

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[68] This result may seem counterintuitive, but it is designed to align two concepts which the statute appears to require to be aligned, namely the shareholder's share of the QIE's FIRPTA gain (a corporate level concept) and the shareholder's gain which is presumably (relying on the first guiding principal above) what the statute is trying to tax. Aligning these two concepts which have no necessary relationship with each other requires such an adjustment.

[69] Under the preferred approach suggested below, because long-term FIRPTA gain would not generally be attributed to ordinary distributions out of E&P, there would not be displacement of FDAP tax by FIRPTA tax in this example. See discussion at pages 38-39 below. On the other hand, if the FIRPTA gain carryforward had arisen from a distribution out of the residual FIRPTA gain portion of the NPDFG account it would displace the dividend characterization in this case, thereby converting a FDAP tax into a FIRPTA tax.

withhold on subsequent distributions even if (at the corporate level) the QIE's distributions in respect of its FIRPTA gains had already exceeded its net gain. So, in the example presented, X would be subject to withholding on $10 in the first period unless X received a withholding certificate to the effect that the distribution was a recovery of basis as to him.[70] Alternatively, in the event that X did not apply for a reduced withholding certificate, X could file a return for that year and claim a refund of the tax withheld. However, receipt of the refund would be conditioned on receipt of the same certifications from the shareholder and the QIE to treat subsequent transactions consistently as would have been obtained in the withholding certificate process. Thus, in all events, withholding would be done on a "gross" basis unless the taxpayer and the QIE had agreed to follow the "FIRPTA Within Gain" method consistently.[71]

Under this approach, the shareholder always determines the amount of his income or loss at the shareholder level, just as he would in the absence of Section 897(h)(1). However, to the extent the distribution received is attributable to FIRPTA gains of the QIE, the shareholder's income or gain would be treated as ECI but only to that extent. To the extent that the shareholder level gain was less than the shareholder's share of the corporate level FIRPTA gain, the "taint" would carry over to his next distribution until the shareholder had paid tax on the lesser of his total economic income or gain from the investment in the QIE or his share of the QIE's FIRPTA gain.

To take another example, suppose the REIT is a DREIT and holds two assets, a USRPI with a value of $1,000 and a basis of zero, and a non-USRPI with a basis and value of $1,000. X is a 10% shareholder of this DREIT and has a basis of $100 in his shares. DREIT adopts a plan of liquidation and sells the USRPI. X's share of that distribution is $100 (10% of $1,000). Under the generally applicable rules relating to liquidating distributions, X is entitled to treat liquidating distributions first as a recovery of basis.[72] Accordingly, X would be able to get a certificate of reduced withholding allowing him to receive the first liquidating distribution of $100 free and clear provided that X and the DREIT agreed that he would be subject to withholding on the next distribution at the appropriate rate (assume 35%) until the "right" amount was withheld. Since the DREIT's remaining asset is not a USRPI in this example, this would mean that X would be subject to withholding and taxation at a 35% rate on all subsequent distributions until the entire $35 had been withheld and taxed. If, for example, the second asset was sold for $1,000, X would be subject to withholding and tax of $35 out of the second $100 distribution received. On the other hand, if the non-USRPI had in the interim become worthless

[70] To the extent there is a distribution in excess of earnings and profits there would be regular FIRPTA withholding at a 10% rate under §1.1445-5(e)(1).
[71] Note that this proposal would not require the QIE to give such an undertaking. It may be unwilling or unable to do so, for example, if it is not equipped to keep track of the NPDFG accounts. Less than 5% shareholders of public QIEs would not be subject to §897(h)(1) in any event, and investors in private QIEs, or greater than 5% investors in public QIEs, could presumably negotiate side letters or other agreements if application of §897(h)(1) was of concern to them. *Cf.* Office of Chief Counsel Advice Memorandum AM 2008-003 (February 15, 2008), *supra* note 15.
[72] Rev. Rul. 85-48, 1985-1 C.B. 126.

and was ultimately sold for nominal consideration or abandoned, there would be no withholding (or tax) as X would not have received any other distributions and would have had no gain at the shareholder level.

The virtues of this approach are that it attempts to square the first and third questions. It allows for the broadest possible scope for Section 897(h)(1) in a manner consistent with the Notice while minimizing the taxation of phantom or noneconomic gains. While not without complexity, it would seem to be a fair trade-off for the increased accuracy of this method as opposed to what might be called the literalist method of implementing the Notice, which would seek to tax gross gains and leave it to general principles of law and/or self-help to allow taxpayers to avoid over-taxation.[73]

Suppose, however, that there has been a distribution by the QIE of all of its FIRPTA gains (including its NPDFG account), but the gain was sheltered at the shareholder level because the distribution to which it was allocated was treated by that shareholder as a return of basis and the shareholder in question disposes of the stock of the QIE before there is a subsequent distribution to which its FIRPTA gain carryover can be applied. To the extent the QIE is a USRPI, then presumably there is a taxable gain or loss on that sale and the proper amount of FIRPTA tax, if any, has been collected. But there are cases in which the gain from the sale of QIE stock may not be subject to FIRPTA tax. This could happen in a variety of contexts.

First, consider the example above of the domestically controlled REIT with two assets, a USRPI and a non-USRPI. Assume contrary to the example above that prior to the sale of the second asset (which has maintained its value), X disposes of his DREIT stock to an unrelated third party for $100 cash. Assume that on the facts no common law recharacterization doctrine would apply to treat that sale as anything other than a sale of stock of the QIE. On the facts presented, X had a carryover FIRPTA gain account of $100 that would have been applied against the next liquidating distribution received. Instead X received proceeds from the sale of a DREIT. Should the FIRPTA gain account taint the sale of DREIT shares? This is a difficult question. On the one hand, if X had sold the DREIT shares before the first distribution, or better still, before the plan was adopted, the answer would be crystal clear: for whatever reason, Congress has decreed that sales of shares of DREIT stock should not be subjected to FIRPTA tax regardless of the extent to which the gain from those sales are attributable to the underlying USRPIs of that DREIT, while simultaneously decreeing that "any distribution" received from the very same DREIT should be subject to FIRPTA tax to the extent of such gains. The argument for taxing the gain from the sale of DREIT shares in this situation, however, is that X had previously received a distribution from a QIE which was in fact actually attributable to the gain derived from the sale of a USRPI by that QIE. The fact that X has postponed that tax until he has realized an economic gain from that investment should not allow X to turn a tax-deferral into

[73] Which might not occur in many cases for the reasons pointed out above.

a tax-exclusion when the shareholder recognizes gain from his investment in the QIE. The logical way to solve this dilemma is to make X liable to tax on the sale of the DREIT shares, but only to the extent of the lesser of the total gain recognized or the FIRPTA gain carryover that was sheltered by a recovery of basis on a prior distribution.

This “carryover” treatment should apply in all similar cases, whether they involve a shareholder of the QIE which is entitled to the benefits of Section 892, a shareholder who has become a 5% or less shareholder of a publicly-traded QIE after receiving the distribution but before selling the QIE stock, or a sale of stock of a QIE which is not a USRPHC, including one which is not a USRPHC by reason of the cleansing exception. In each of these cases, the shareholder is taking a non-FIRPTA tax attribute (its basis in stock of a QIE whose sale would not give rise to FIRPTA gain) and using it to shelter FIRPTA gain from a prior distribution.[74]

While this rule prevents some manipulation of the tax base, it does not end it. Consider what happens if instead of distributing its NPDFG account the QIE announces that it intends to do so at some point in the future and, prior to any distribution being paid, foreign shareholder X disposes of its stock of the QIE. Again, if the stock of the QIE is a USRPI, then the right amount of tax will have been levied and there is no need to invoke the application of Section 897(h)(1). However, suppose it is not a USRPI? In particular, on the facts posited, where there is a sale by the QIE of all of its USRPIs and a sale of the QIE stock prior to distribution of any of such proceeds, the QIE as a technical matter will always apparently cease to be a USRPHC by reason of the cleansing exception.

To understand this issue, assume that the REIT in the previous example is not domestically controlled. Suppose that after the REIT has sold its USRPI and before it has distributed the proceeds thereof to its shareholders, X sells the REIT stock for $200 to a third party for cash. At this point, the REIT holds no USRPIs. Under the commonly accepted interpretation of the cleansing exception the REIT is no longer a USRPHC because it no longer holds any USRPIs and the five-year taint which usually lingers in other cases is terminated because the REIT has sold all of its USRPIs in taxable transactions.[75] Therefore, the argument goes, X is not subject to FIRPTA tax on the gain derived from the sale of the REIT because it is not a sale of a USRPI. It is not clear, from a policy perspective, why the mere sale of USRPIs on which no tax is paid should cleanse a former USRPHC of its FIRPTA taint. However, this is how the statute is commonly understood to operate. While commentators have argued

[74] Note that in every case in which this issue arises, the taxpayer would already have covenanted to pay tax (either in an application for a withholding certificate or in a claim for refund). Thus, there should not be any potential for whipsaw. The covenant is the price paid for avoiding withholding (and imposition of tax) on a gross basis.

[75] The cleansing exception appears not to require that an entity-level tax actually be paid on the disposition of the USRPIs, only that the “gain be recognized.” §897(c)(1)(B). *See* ABA Report, *supra* note 4, at 12.

persuasively that the cleansing exception should not apply to QIEs at all,[76] this would seem to require a statutory amendment.

However, within the confines of regulations implementing Section 897(h)(1) it would seem to be possible, if desired, to promulgate regulations which would limit the application of the cleansing exception to QIE's in an appropriate way. For example, a QIE might be required not only to sell all of its USRPIs, but also to distribute the proceeds of sale of those USRPIs before the FIRPTA taint was cleansed. In effect, this rule would implement the presumed policy goal of the cleansing exception, which is to cut off FIRPTA taint after all of a USRPHC's USRPIs have been subject to a single level of tax. By implementing Section 897(h)(1) in such a way so that a single level of tax can be collected, the stage is set to link the cleansing exception to the payment of that tax. Thus in determining whether the distribution was complete, both the corporate and shareholder level FIRPTA gain accounts would have to be cleansed. A shareholder of a REIT who wished to dispose of the stock of a REIT before the distribution was complete should be able to get an exemption from withholding (and tax) if the shareholder could demonstrate that no FIRPTA tax would be imposed on the distribution of those proceeds. Conversely, where there was shareholder level gain which had been sheltered by a recovery of basis at the shareholder level, the shareholder level FIRPTA gain carryover rule would apply to appropriately tax the gain on sale even if the QIE had been cleansed.

This does not however deal with all of the cases that may arise. If, for example, the REIT is a DREIT, the USRPIs have been sold but not distributed, and the shareholder sells, what then? In appropriate cases, common law doctrines may be applied to treat the distribution as having occurred prior to the sale. But suppose no such common law doctrine is applicable on the particular facts. In the ordinary case involving a sale of DREIT shares, whatever the policy justifications for allowing an exception to FIRPTA for domestically controlled QIEs, it is generally understood that the buyer of the DREIT stock is taking the economic risk that the intrinsic value inherent in the REIT's assets may not be equal to the price he is paying, and this risk is presumably reflected in the price. In other words, the buyer has bought stock of a DREIT. On the facts posited, the buyer has bought (in the worst case) a cash company and therefore is presumably taking no risks. The seller was therefore able to obtain the higher price available for the sale of the QIE's assets without paying the tax generally required to be paid under Section 897(h)(1) with respect to such asset sales. In this case, because the exemption has an independent basis other than the cleansing exception, the problem cannot be fixed by tweaking the date cleansing occurs until the NPDFG account has been distributed.

Ideally, this problem could be resolved by a simple repeal of the exemption from FIRPTA tax for sales of domestically controlled QIEs (and repeal of the exemption from FIRPTA tax for gains derived by Section 892 investors from the sale of USRPHC stock). Such a

[76] ABA Report, *supra* note 4, at 12, 26, 29, 32-33, and 43.

change in law would undoubtedly require a statutory amendment. Alternatively, one could create a shareholder level FIRPTA taint for any QIE which had an NPDFG account. Note however that in this case there has by hypothesis been no prior distribution at all. The statutory basis for such a regulatory fix would therefore appear to be weaker than in the other carryover cases described above, where in effect the shareholder has elected to have his investment tainted. In this case, therefore, we suggest that consideration be given to a simple "bright-line" anti-abuse test which would require that the sale of the REIT stock be completed, for example, prior to the adoption of a plan of liquidation by the QIE or a sale of a specified quantity of the QIE's assets (perhaps one-third of the QIE's assets). If the sale occurred after such a point in time the sales proceeds would be tainted to the extent of the selling shareholder's share of the NPDFG account. This would in effect be a regulatory embodiment of some of the common law doctrines referred to above. Alternatively, one might require that any transferee of a QIE which has an NPDFG account (or perhaps an NPDFG account over a certain size) be required to pay a FIRPTA toll charge on a gross basis when those amounts were subsequently distributed unless the transferee was either subject to FIRPTA tax or had elected to taint a portion of its gain on sale with its share of the QIE's NPDFG account.

The basic approach suggested above—the "FIRPTA Within Gain" approach—has been adopted in other areas of the Code as well. For example, boot in a reorganization which is dividend equivalent is taxed as a dividend, but only to the extent of the lesser of the shareholder's share of earnings and profits or his gain realized on the transaction.[77] Similarly, a U.S. shareholder of a CFC who sells stock may have a portion of his gain recharacterized as a dividend, but only to the extent of the lesser of his share of the earnings and profits or the gain recognized.[78] As pointed out above, excess distributions arising from a disposition of PFIC stock are treated as ordinary income, but only to the extent of gain recognized.[79] That is not to say that these provisions are without interpretive difficulties. In some cases they can present complex issues of interpretation as well. But the point is that the concept of using a shareholder metric to measure the amount of income or gain, and a corporate metric to determine character, is not alien to the Code.

Of course, all of these examples are clearly mandated by statute. By contrast, the literal language of Section 897(h)(1) is ambiguous, so it leaves the question of whether the IRS has authority to promulgate use of such a method. If the statute declares that "any

[77] §356(a)(2).
[78] §1248(a).
[79] Similarly, foreign currency gain from the disposition of a debt security denominated in a foreign currency that is attributable to fluctuation in the value of the foreign currency between the date of acquisition and the date of disposition is treated as ordinary income, but only to the extent of the overall gain from the disposition. §988(b)(1). Recognition of accrued market discount on a sale of a market discount bond is also limited to the overall gain. §1276(a)(1). Rev. Rul. 91-32, too, appears to limit the amount of gain that is treated as ECI when a partner disposes of its interest in a partnership that is engaged in a U.S. trade or business to the amount of the partner's actual gain from the disposition. Rev. Rul. 91-32, 1991-1 CB 107.

distribution…shall…be treated as gain" to the extent of another measure which does not always coincide with the shareholder's actual gain, the IRS, it might be argued, is powerless to circumscribe the ambit of the statute and impose tax on a smaller base. This argument seems misplaced. First, the statute also refers to "any distribution" but as noted above commentators have had no trouble and have seen no conceptual difficulty in declaring that this must have referred only to distributions which constitute dividends or to some subset thereof. If it is within the IRS's power to interpret "any distribution" to mean solely "distributions designated as capital gain dividends" to avoid taxation of noneconomic gains then presumably it is within the IRS's power to define "shall…be treated as gain" in a way which limits the imposition of FIRPTA tax to the shareholder's economic income or gain. To put it another way, if the IRS has within its power the ability to narrow the definition of "any distribution" to some subset thereof, then it is presumably equally within its power to declare that the phrase "any distribution…shall…be treated as [effectively connected] gain" was limited only to those distributions which in fact constituted income or gain to the shareholder. Commentators who favor the former approach (narrowing the ambit of Section 897(h)(1)) have also acknowledged that there is authority to narrow the ambit of distributions treated as gains.[80] Section 897(h)(1) mandates taxation of a foreign shareholder's distributed gains from a QIE to the extent attributable to sales by the QIE of USRPIs. The proposed method of implementation merely limits this tax to the lesser of the foreign shareholder's share of such gains or such shareholder's overall income or gain from the QIE in question. The carryover mechanisms described above are the means to make sure that this limitation is, to the extent feasible, neither under- nor over-inclusive. Limiting the basis of the tax to the shareholder's actual economic gain from ownership of the QIE does no violence to the statutory scheme and, if anything, enhances it by making it more even-handed.

For the foregoing reasons, we believe that the IRS has the authority to promulgate regulations implementing Section 897(h)(1) and the Notice in the manner described in this Report, including with respect to the shareholder-level carryover provisions described above. If contrary to the reasoning outlined above there is concern about authority, for example, in relation to the shareholder-level carryover provisions, note that under the method suggested the "fallback" is always implementation of the Notice on a gross method (as described in alternative 6 above) unless the shareholder has affirmatively opted to elect into the version of alternative 7 described in this section. In other words, if there is a concern (which we do not share) that Section 897(h)(1) permits taxation of foreign shareholders on a gross basis but not on a net basis, then imposing gross basis taxation and allowing shareholders to elect net basis taxation instead, with the understanding that by doing so they are bound to all the provisions of that regime, including those provisions which require carryover of unused FIRPTA gain to be offset against

[80] ABA Report, *supra* note 4, at 41-44.

subsequent distributions and sales, should satisfy those concerns.[81] And that is what is being proposed.

3. "Attributable to" FIRPTA Income or Gain

We now need to return to the second question, namely, what is the correct way to determine the amount of each distribution that is "attributable to" the QIE's FIRTPA gain and what is the mechanism for allocating that amount to a particular shareholder?[82]

We believe that the best approach starts with requiring the QIE to keep running accounts of two types of FIRPTA gain: gains attributable to USRPIs that could be paid as a capital gain dividend and all other gains attributable to USRPIs.[83] The other alternatives would be to omit any FIRPTA gains entirely from the Section 897(h)(1) calculation unless they were long-term capital gains[84] or to de-couple the calculation entirely from the usual REIT system of calculating net capital gains and losses.

If the QIE-level gain that would be subject to Section 897(h)(1) were limited to long-term capital gains that could enable avoidance because a QIE could conceivably classify some or all of its real property as safe-harbored dealer property, which would mean that the gains from dispositions would qualify as ordinary income and would escape Section 897(h)(1) taxation. This may be more than a theoretical concern because the case law for determining dealer status in real estate transactions has historically been interpreted broadly.[85] Moreover, classification of an item as ordinary or capital is not in general a relevant point of distinction under FIRPTA to separate taxable from non-taxable transactions and we do not think it should be so treated here.

The question then is how should the QIE determine which distributions are attributable to the amounts in these accounts.[86]

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[81] Consideration should be given whether the FIRPTA gain carryforwards should be absorbed on a share-by-share basis (for example, when shares are sold over time) or simply applied against any shares held by the taxpayer.
[82] As pointed out above, this question must be addressed under any suggested method of implementation of §897(h)(1) that is designed to confine the impact of §897(h)(1) to gains which are actually attributable to dispositions of USRPIs by the QIE.
[83] In keeping with the netting concept discussed above, references to "FIRTA gain" should be understood to include net FIRPTA losses as well as net FIRPTA gains. See the first example in section IV.A.2(b) above.
[84] The ABA Report, *supra* note 4, at 34 endorses this proposal.
[85] *See, e.g.*, *S&H, Inc. v. Comm'r*, 78 T.C. 234 (1982); G. Robinson, Federal Income Taxation of Real Estate ¶11.06[1][a] (Thomson Reuters/WG&L, 6th ed. with updates through May 2013) ("However, there appears to be no ironclad "one-bite" rule that protects a single sale to a single customer under all circumstances.").
[86] This exercise is necessary because, as pointed out above, QIEs do not necessarily allocate items of income the way partnerships, for example, do. Rather, income is carried out by distribution, but the categories of distributions, as described above, do not exactly match those required by §897(h)(1). Thus there is no necessary identity between the gains derived from USRPIs and the amount (or type) of distributions paid. In addition, as noted above, the Notice applies §897(h)(1) to distributions other than §301 distributions, such as redemptions and liquidation

We recommend the following approach. First, the amounts in the Long-term FIRPTA Gains account would be treated first as being allocated to the capital gain dividends designated (or dividends that could have been so designated) with respect to the tax period under consideration. The amounts in the Residual FIRPTA Gains account would be allocated to the regular dividends with respect to the tax period under consideration. The QIE would then withhold on the appropriate portion of each set of distributions. Because these calculations could only be accomplished after the close of the fiscal period, some allowance might have to be made to permit QIEs to make catch-up withholding payments in appropriate cases.[87] If each type of distribution was sufficient to carry out the entire amount of FIRPTA gain at the QIE level, the accounts would be exhausted. If not, the balance of each account would be added to the QIE's corresponding NPDFG account and carried over to the next year. In that following year, the process would be repeated, using up the oldest components of each FIRPTA Gains account first (in effect, a FIFO system).

If there were any non-301 dividend distributions at a time when the QIE had NPDFG amounts, the NPDFGs would be attributed to those distributions – in other words, those otherwise non-taxable distributions would be subject to the Section 897(h)(1) tax. In the case of redemptions, the distributions would carry out each FIRPTA Gains account in the same manner as earnings and profits would be carried out (in other words, in proportion to the redeemed shareholder's share of such account but no more), absorbing the Residual FIRPTA Gains account first. In the case of liquidations, the accounts would simply be matched against the first dollars of distributions.

Alternatively, if in any fiscal period, for example, the Long-term FIRPTA Gains account was larger than the designated capital gain dividend for the year (or the amount that could have been so designated), the excess could be allocated to regular distributions for that or the succeeding period after the Residual FIRPTA Gains account had been exhausted. In rare instances the converse process could be employed. This would result in faster recovery of FIRPTA tax at the risk of added complexity. To the extent that under any of this process a portion of the FIRPTA Gains account was allocated to a shareholder in respect of a non-capital gain distribution, the FIRPTA characterization would presumably predominate.

Example: REIT has $100 of ordinary income, $100 of gain from the sale of USRPIs, and $100 of loss from the sale of non-USRPIs. Accordingly, none of the REIT's distributions for that tax period can be designated as capital gain dividends, since there is no net capital gain. If the latter proposal were to be adopted so that the entire ordinary distribution for the year was

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distributions. These distributions cannot be designated as capital gain dividends. Thus, in precisely the type of transaction dealt with in the Notice, the simplified approach to attribution embodied in the current withholding rules under §1445 for REITs breaks down completely.

[87] The existing §1445 regulations provide for such "catch up" withholding arrangements. §1.1445-8(c)(2)(ii)(C).

taxable under FIRPTA, then there would not be any FDAP withholding with respect to that distribution; the entire distribution would simply be treated as a distribution subject to FIRPTA under Section 897(h)(1). There is nothing in Section 897(h)(1) that indicates it was intended to result in taxation of the same dollar of income twice, so if a regime is adopted which causes FIRPTA tax to be imposed on a specified distribution, presumably that tax should satisfy the taxpayer's obligation in full. Conversely, under the suggested regime, FDAP withholding tax would be imposed on the distribution and the REIT would have an NPDFG account of $100 consisting of Long-Term FIRPTA Gains that would be taxable at the shareholder level to the extent the REIT subsequently distributed (or could have distributed) a capital gain dividend, whether or not derived from the sale of a USRPI.

Withholding would match the allocation of the accounts to the distributions, with opportunities for shareholders to obtain reduced withholding certificates if need be and allowance for carryovers of untaxed allocations as described above.

In a simple case in which the only assets held by a QIE are USRPIs, there are no inside-outside basis differences, all gains are long-term capital gains, the QIE has no NOLs, and the QIE does not elect to pay corporate level taxes in lieu of paying a dividend, the suggested regime would produce results very similar to those of the existing withholding regulations and accordingly would not seem to be overly complex or difficult to administer.

Further simplification could be obtained by clarifying the scope of Section 897(h)(1) to make clear that it does not apply (as the Code says) to "any distribution" paid to a 5% or less qualifying shareholder of a publicly-traded QIE and that such a distribution would be treated in exactly the same way it would have been treated absent Section 897(h)(1). The IRS has ruled to that effect in a non-binding Office of Chief Counsel Advice Memorandum and it would be good to see that confirmed in the regulations implementing Section 897(h)(1).[88]

[88] Office of Chief Counsel Advice Memorandum AM2008-003 (February 15, 2008), *supra* 15.

Appendix

Alternative	Coverage of QIE Level Gain			Coverage of Shareholder Level Distributions					Only to Extent of Shareholder's Income or Gain
	Excludes non-USRPI Gains	Includes USRPI L/T Gains	Includes All USRPI Gains[1]	Capital Gain Dividend[2]	301(c)(1) Regular[3]	301(c)(2) & (3)	302	331	
1	✗	✓	✗	✓	✗	✗	✗	✗	✓
2	✓	✓	✗	✓	✗	✗	✗	✗	✓
3	✓	✓	✓	✓	✓	✗	✗	✗	✓
4	✓	✓	✓	✓	✓	✓	✗	✗	✗
5	✓	✓	✓	✓	✓	✓	✗	✗	✓
6	✓	✓	✓	✓	✓	✓	✓	✓	✗
7	✓	✓	✓	✓	✓	✓	✓	✓	✓

[1] This would encompass both ordinary gains and short-term gains.

[2] Includes amounts that could have been designated as capital gain dividends.

[3] Includes 302 redemptions which are dividend equivalent.

✓ = Yes

✗ = No