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Memorandum

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to: Walter Harris, Industry Director, Financial Services (Large & Mid-Size Business)

from: Steven A. Musher, Associate Chief Counsel (International)

subject: Treatment of Certain Distributions in Complete Liquidation by a REIT

This advice addresses the treatment of distributions in complete liquidation under section 331 by a real estate investment trust (REIT), which is a qualified investment entity (QIE), to certain shareholders. For purposes of this advice, a QIE is a real estate investment trust or regulated investment company described in section 897(h)(4)(A).¹

ISSUES

1. Is the distribution in complete liquidation from REIT to FC1, a shareholder that at no time owned more than 5 percent of the stock of REIT, subject to tax under section 881(a), or 897(a) and 882(a)(1)?
2. Is the distribution in complete liquidation from REIT to FC2, a shareholder that owns more than 5 percent of the stock of REIT, subject to tax under sections 897(a) and 882(a)(1)?
3. Is N, a nominee that holds shares of REIT on behalf of FC1 and FC2, obligated to withhold under section 1442 or section 1445 on the liquidating distribution proceeds it receives from REIT on behalf of FC1 and FC2?

CONCLUSIONS

1. The distribution from REIT to FC1 is not subject to tax under sections 881(a), or 897(a) and 882(a)(1).

¹ After December 31, 2007, a regulated investment company described in section 897(h)(4)(A)(i)(II) is treated as a QIE only for limited purposes. See section 897(h)(4)(A)(ii).

2. The distribution from REIT to FC2 is, as a result of the application of section 897(h), subject to tax under sections 897(a) and 882(a)(1).
3. N is not obligated to withhold on the liquidating distribution proceeds it receives from REIT with respect to the shares of REIT it holds on behalf of FC1 and FC2.

FACTS

REIT is a real estate investment trust, as defined in section 856, and is domestically controlled within the meaning of section 897(h)(4)(B). REIT holds United States real property interests (USRPIs), within the meaning of section 897(c), that have a fair market value in excess of their tax basis. REIT has only one class of stock and it is regularly traded on an established securities market located in the United States.

FC1, a foreign corporation, owns three percent of the stock of REIT on Date A. FC1 has not owned more than five percent of the stock of REIT at any time.

FC2, a foreign corporation, owns ten percent of the stock of REIT on Date A.

N is a nominee within the meaning of §1.1445-8(d) that holds the stock in REIT on behalf of FC1 and FC2.

On Date A, REIT merges under state law, in a taxable transaction, into B, a domestic corporation.

LAW

Section 897 -- Overview

Section 897(a)(1) provides, in part, that gain or loss of a nonresident alien individual or a foreign corporation from the disposition of a USRPI is taken into account under section 871(b)(1) or 882(a)(1), as applicable, as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with such trade or business.

Section 897(c)(1)(A) defines a USRPI to mean (i) an interest in real property located in the United States or the Virgin Islands, and (ii) any interest (other than an interest solely as a creditor) in any domestic corporation that is a United States real property holding corporation (USRPHC). As defined in section 897(c)(2), a USRPHC means any corporation if the fair market value of its USRPIs equals or exceeds 50 percent of the fair market value of the sum of (i) its USRPIs, (ii) its interests in real property located outside the United States, and (iii) any other of its assets which are used or held for use in a trade or business.

Distributions from a QIE – General Rule

The first sentence of section 897(h)(1) provides that any distribution by a QIE to a nonresident alien individual, a foreign corporation, or other QIE shall, to the extent attributable to gain from sales or exchanges by the QIE of USRPIs, be treated as gain recognized by such nonresident alien individual, foreign corporation, or other QIE from the sale or exchange of a USRPI. In the case of a nonresident alien individual, such gain is subject to tax under sections 897(a) and 871(b)(1). In the case of a foreign corporation, such gain is subject to tax under sections 897(a) and 882(a)(1).

Section 1.1445-8 provides rules that address withholding obligations under section 1445(e) that apply to distributions from certain entities, including real estate investment trusts. Under these provisions, a real estate investment trust must withhold 35 percent (or the highest rate specified in section 1445(e)(1)) of the amount of a distribution designated as a capital gain dividend.² For this purpose, the largest amount of a 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 as a capital gain dividend, regardless of the amount actually designated.³

Section 1.1445-8(b)(3) provides a special rule for distributions to nominees when certain requirements are satisfied. When this rule applies, the obligation to withhold under §1.1445-8(b) is imposed solely on the nominee.

Subsequent to the issuance of §1.1445-8, Congress enacted section 1445(e)(6).⁴ This provision provides that if any portion of a distribution from a QIE 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 USRPI, the QIE shall deduct and withhold under section 1445(a) a tax equal to 35 percent (or, to the extent provided in regulations, 15 percent (20 percent in the case of taxable years beginning after December 31, 2010)) of the amount so treated.

Section 1445(e)(7) grants to the Secretary authority to prescribe regulations as may be necessary to carry out the purposes of section 1445(e), including regulations for the application of that subsection in the case of payments through one or more entities.

On June 13, 2007, the IRS and Treasury Department issued Notice 2007-55, 2007-27 I.R.B. 13. Notice 2007-55 announced that 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 notice further provided that 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,

² Treas. Reg. §1.1445-8(c)(2)(ii).

³ *Id.*

⁴ The conference report accompanying the enactment of section 1445(e)(6) provides that “Treasury regulations under section 1445 already impose FIRPTA withholding on REITs under present law. . . No inference is intended regarding the existing Treasury regulations in force under section 1445 with respect to REITs.” H.R. Conf. Rep. No. 4297, 109th Cong., 2d Sess. 290, n. 532 (2006).

where the distribution is attributable, in whole or in part, to gain from the sale or exchange of a USRPI by a QIE or other pass-through entity. The regulations described in the notice would apply to distributions occurring on or after June 13, 2007.⁵

Distributions from a QIE to Certain Shareholders of Publicly Traded REITs

The second sentence of section 897(h)(1) provides that, notwithstanding the first sentence, any distribution by a QIE 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 USRPI 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.

Section 857(b)(3)(F) provides that in the case of a shareholder of a REIT 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 section 857(b)(3)(B) or (D) (without regard to section 857(b)(3)(F))-- (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 REIT.

Section 857(b)(3)(B) provides that a capital gain dividend shall be treated by the shareholders or holders of beneficial interests as a gain from the sale or exchange of a capital asset held for more than one year. Section 857(b)(3)(D) provides special rules for undistributed capital gains. Section 857(b)(3)(C) generally defines a capital gain dividend as any dividend, or part thereof, which is designated by the REIT as a capital gain dividend pursuant to certain procedures.

Sections 871(a)(1) and 881(a)(1) impose tax of 30 percent of certain amounts received by a nonresident alien individual or foreign corporation from sources within the United States, including dividends.

Section 1441(a) generally provides that certain persons must deduct and withhold from certain items of income of any nonresident alien individual from sources within the United States, including dividends, a tax equal to 30 percent thereof. Withholding is generally not required on gains derived from the sale of property.⁶ Section 1442(a) provides that in the case of foreign corporations subject to taxation under subtitle A, there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in section 1441 a tax equal to 30 percent thereof.

⁵ The notice also announced that regulations will clarify that distributions received by a foreign government from a QIE that are attributable to gain from sales or exchanges by the QIE of USRPIs described in section 897(c)(1)(A)(i) are not exempt from taxation under section 892.

⁶ See §1.1441-2(b)(2)(i).

Where section 857(b)(3)(F) applies, the distribution is included in the shareholder's gross income as a dividend (rather than capital gain) and is subject to income taxation under section 871(a) or 881(a), and 30 percent (or lower treaty rate) withholding under section 1441 or 1442. See §1.1441-3.

ANALYSIS

Issue 1 – Distribution to FC1, a less than 5 percent shareholder in REIT, is not subject to tax.

At the time of the distribution, FC1 owns three percent of the stock of REIT and has not owned more than five percent of the stock of REIT at any time during the prior one-year period. As a result, FC1 is a shareholder described in the second sentence of section 897(h)(1), and the distribution to FC1 is not subject to tax under sections 897 and 882(a)(1). Instead, whether the distribution to FC1 is subject to tax is governed by section 857(b)(3)(F).

Under section 857(b)(3)(F), the amount which would be included in computing long-term capital gains for FC1, as determined under section 857(b)(3)(B) or (D), is not included in computing FC1's long-term capital gain. Instead such amount is included in FC1's gross income as a dividend from REIT and, as a result, would be subject to tax under section 881(a) and 30 percent (or lower treaty rate) withholding under section 1442.

In this case, however, the distribution from REIT to FC1 under section 331 is not a dividend under section 316 and, therefore, cannot be designated by REIT as a capital gain dividend under section 857(b)(3)(C). Accordingly, no portion of such distribution is described in section 857(b)(3)(B) or (D) and, as a result, no amount is included in FC1's gross income as a dividend under section 857(b)(3)(F) or 881(a).⁷

Issue 2 -- Distribution to FC2, a greater than 5 percent shareholder in REIT, is subject to tax.

At the time of the distribution, FC2 owns ten percent of the stock of REIT and therefore, pursuant to the position articulated in Notice 2007-55, the first – but not the second – sentence of section 897(h)(1) applies. Accordingly, the distribution to FC2 is, to the extent attributable to gain from sales or exchanges by the QIE of USRPIs, treated as gain recognized by FC2 from the sale or exchange of a USRPI. Such gain is subject to tax under section 897(a) and 882(a).

Issue 3 – Withholding Obligations of N

⁷ The same result would occur if REIT was not domestically controlled. The Treasury and IRS may consider whether there is any regulatory authority in the area to impose shareholder level tax. As of the date of this advice, no regulations have been issued that would affect the treatment of distributions by a QIE in complete liquidation under section 331.

No portion of the distribution in complete liquidation from REIT to FC1 is a dividend within the meaning of section 316. As a result, no portion of the distribution is described in section 1441(b) so as to be subject to withholding by N under section 1442. See §1.1441-2(b)(2)(i).

No portion of the distribution in complete liquidation from REIT to FC2 is a dividend within the meaning of section 316. As a result, no portion of the distribution is described in §1.1445-8(c)(2)(ii), therefore N is not required to withhold under section 1445(e) as provided by §1.1445-8(b)(3).⁸ Nothing, however, relieves REIT of its obligation under section 1445(e)(6) to withhold on such distribution to the extent treated under section 897(h)(1) as gain recognized by FC2 from the sale or exchange of a USRPI.

Please call (202) 622-3860 if you have any further questions.

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⁸ Section 1445(e)(7) provides the Secretary with authority to impose withholding obligations upon nominees receiving REIT liquidating distributions on behalf of foreign persons. However, to date, this authority has not been exercised.